

# Statement of Recommended Practice

Financial Statements of Investment Trust  
Companies and Venture Capital Trusts



## Contents

	<b>Page</b>	
<b>Forward</b>		ii
<b>Introduction</b>		iv
<b>Statement by the Financial Reporting Council</b>		vi
<b>Definition of terms</b>		vii
<b>Recommended Practice</b>		xii
<b>Section</b>	<b>Paragraph</b>	
I) Introduction	1	1
II) Scope	7	5
III) Changes in accounting policies	11	9
IV) Form and content	12	11
V) Investments	25	26
VI) Significant holdings in investee undertakings	30	29
VII) Recognition of income	34	32
VIII) Finance costs and expenses		
a) General (including direct costs)	47	41
b) Finance costs	52	49
c) Investment management fees	58	53
d) Other expenses	63	58
IX) Taxation	66	60
X) Zero dividend preference shares in another ITC	70	64
XI) Foreign currency transactions	71	65
XII) Derivatives and hedging	76	68
XIII) Stock lending activities	79	70
XIV) Segmental reporting	81	72
XV) Provisions, contingencies, guarantees and financial commitments		
a) Provisions, contingencies and guarantees	83	75
b) Financial commitments	85	77
XVI) Treasury shares	86	78
XVII) Half-yearly and other accounts	87	79
<b>Appendix A – Guidance note with illustrative examples relating to paragraph 68</b>		80
<b>Appendix B – Guidance note with illustrative examples relating to paragraph 16</b>		92

## Foreword

This Statement of Recommended Practice ('SORP') for investment trust companies and venture capital trusts ('Investment Companies') is issued by The Association of Investment Companies ('Association').

The Association is recognised by the Financial Reporting Council ('FRC') as a SORP-making body and agrees to comply with its code of practice for reviewing and publishing SORPs. The latest code of practice is set out in the FRC's October 2018 'Policy on Developing Statements of Recommended Practice (SORPs)'.

The aim of the SORP is to seek to harmonise accounting practice within the industry, by identifying and setting out best practice across a wide range of issues and encouraging Investment Companies to apply its recommendations.

Investment Companies are unusual in that, although they are listed companies, the majority do not produce consolidated accounts and are not therefore automatically brought within the scope of International Financial Reporting Standards ('IFRS'). The Association therefore expects that, for the foreseeable future, some Investment Companies will be preparing their financial statements in accordance with UK GAAP and some in accordance with IFRS. SORPs do not feature in the IFRS regime, but the Association believes that many Investment Companies preparing their financial statements in accordance with IFRS will, nevertheless, wish to follow the recommendations of the SORP to the fullest extent possible. In preparing the SORP, the Association has not considered the requirements of IFRS. It is for individual IFRS reporting Investment Companies to consider the implications of following the SORP but, in order to promote consistency across the industry, the Association encourages such Investment Companies to comply with the revised SORP except where there is a direct conflict with IFRS.

The Association would like to put on record its gratitude for the time and effort spent in the review of the SORP by the SORP Working Party, whose members were selected so as to represent a broad range of interest groups.

The Association believes that the SORP will continue to provide an invaluable guide to all those involved in the preparation of the financial statements of Investment Companies. The AIC's Directors endorse the SORP and, on behalf of the Association, commend its contents.

Rachel Beagles

Chair

October 2019

## Introduction

1. The SORP is issued by the Association and it sets out recommendations, intended to represent current best practice, on the form and contents of the financial statements of Investment Companies.
2. The provisions of the SORP have been arrived at after consideration of all accounting standards issued by 30 June 2019. Regard must be paid to applicable accounting standards, laws and regulations since SORPs cannot override their requirements.
3. Investment Companies complying with this SORP shall apply the accounting standards applicable at the relevant reporting date (which does not preclude early application where permitted). Where the current edition of this SORP predates a change in legislation or accounting standards and a conflict is thereby created, or other developments lead to a conflict, the affected provisions of this SORP cease to have effect.
4. Although the recommendations in the SORP are not mandatory, FRS 100 requires that an Investment Company should state in its financial statements the title of this SORP and whether they have been prepared in accordance with the SORP's provisions currently in effect. Investment Companies are also required to disclose a brief description of any departure from the recommendations and the reason why the treatment adopted is judged more appropriate. The provisions of the SORP need not be applied to immaterial items.
5. The recommendations in the SORP are also subject to the overriding requirement that the accounts must present a true and fair view.
6. The SORP addresses the accounting for, and disclosure of, all material costs incurred by an Investment Company. It does not extend this disclosure to the 'total costs of ownership'.
7. The intention of the SORP is to recommend best practice, not to identify all possible permissible accounting practices. In addition, Investment Companies may come

across situations where there is uncertainty over the interpretation of a specific recommendation of the SORP. This may, for example, be because an Investment Company might find itself dealing with a type of transaction not contemplated when the SORP was written. In such situations, the Association expects Investment Companies to apply the SORP according to the spirit of its intention, rather than mechanistically applying the wording.

In all cases of uncertainty, the Association recommends that additional disclosures be made to ensure that the users of the financial statements are fully aware of the accounting treatment adopted.

8. Neither the Association nor the members of any committee or working party thereof can accept any responsibility or liability whatsoever (whether in respect of negligence or otherwise) to any entity complying in whole or part with the SORP or third party as a result of anything contained in or omitted from the SORP nor for the consequences of reliance or otherwise on the provisions of the SORP.

## **Statement by the Financial Reporting Council on the SORP ‘Statement of Recommended Practice: Financial Statements of Investment Trust Companies and Venture Capital Trusts’**

The aim of the Financial Reporting Council (FRC) is to promote transparency and integrity in business.

In relation to accounting standards applicable in the UK and Republic of Ireland, the FRC’s overriding objective is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users’ information needs. In particular industries or sectors, clarification of aspects of those standards may be needed in order for the standards to be applied in a manner that is relevant and provides useful information to users of financial statements in that industry or sector.

Such clarification in connection with accounting standards is issued in the form of Statements of Recommended Practice (SORPs) by bodies recognised for this purpose by the FRC. The Association of Investment Companies has confirmed that it shares the FRC’s aim of high-quality financial reporting work and has been recognised by the FRC for the purpose of issuing SORPs for Investment trust companies and venture capital trusts.

In accordance with the FRC’s Policy on Developing Statements of Recommended Practice (SORPs) the FRC carried out a review of the SORP focusing on those aspects relevant to the financial statements but also including aspects relevant to the FRC’s broader responsibilities when appropriate.

On the basis of its review, the FRC has concluded that the AIC SORP has been developed in accordance with the FRC’s Policy on Developing SORPs and does not appear to contain any fundamental points of principle that are unacceptable in the context of present financial reporting practices or to conflict with an accounting standard or to undermine the FRC’s broader objectives.

10 October 2019  
Financial Reporting Council

## Definition of terms

**Accounts and Reports Regulations** means the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 as amended by subsequent orders, regulations and legislation.

**Annual Financial Statements** (or **Financial Statements**) means that part of an **Investment Company's** Annual Report, prepared in accordance with United Kingdom law and **UK Financial Reporting Standards**, that is intended to give a true and fair view of the financial position of the **Investment Company** and of its income and expenditure for a period.

The **Association** means The Association of Investment Companies. The Association is recognised by the Financial Reporting Council ('FRC') as a SORP-making body.

The **Board** means the board of directors of an **Investment Company**.

**CAIC** means an investment company as defined by Section 833 **Companies Act 2006**.

**CAIC Status** means the status conferred on a company by virtue of it being a **CAIC**.

The **Companies Act 2006** means the Companies Act 2006 as amended by subsequent orders, regulations and legislation.

**Corporation Tax Act 2010** is the Corporation Tax Act 2010 as amended by subsequent orders, regulations and legislation.

The **Diluted Net Asset Value Attributable to Each Share** of an **Investment Company** is the **Net Asset Value Attributable to Each Share** of the **Investment Company** on the assumption that each right which the **Investment Company** has granted, and which if exercised on the date in question would dilute the **Net Asset Value Attributable to Each Share**, has been fully exercised. Such rights may be in respect of:

- a) debentures or loan stock or preference shares convertible into shares of the **Investment Company**; and /or
- b) options or subscription shares to subscribe for shares of the **Investment Company**.

The **Effective Interest Method** is defined in **FRS 102** (Appendix 1: Glossary) as “*a method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.*”

The **Effective Interest Rate** on an instrument is defined in **FRS 102** (Appendix 1: Glossary) as “*the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the carrying amount of the financial asset or financial liability.*”

An **Enhanced Scrip Dividend** means a **Scrip Dividend** incorporating a bonus element such that the market value of the shares exceeds the cash amount of the dividend the shareholder has elected to forego.

**Fair Value** is defined in **FRS 102** (paragraph 2.34(b)) as “*the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction.*”

**Finance Costs** are the difference between the net proceeds of a capital instrument classified as a liability and the total amount of the payments (or other transfers of economic benefits) that the issuer may be required to make in respect of the instrument.

**Financial Statements** - see **Annual Financial Statements** above.

**FRS** means Financial Reporting Standard.

**Hedge Accounting** applies when the requirements and conditions set out in **FRS 102** (paragraphs 12.15 – 12.25) are met.

**IFRS** means International Financial Reporting Standards.

**Income Tax Act 2007** is the Income Tax Act 2007 as amended by subsequent orders, regulations and legislation.

An **Investment** is an asset that is characterised by its ability to generate economic benefits in the form of distributions and/or appreciation in value.

**Investment Company** means an **ITC** or a **VCT**.

An **Investment Fund** means an **ITC**, **Investment Company**, limited partnership, open-ended investment company, unit trust, mutual fund or other similar vehicle for collective investment.

**Investment Management Fees** are:

- a) the fees paid to a third party for services provided in relation to the management of the investment portfolio of the **Investment Company** or the giving of investment advice; and/or
- b) the salary costs and other related costs incurred by the **Investment Company** in the employment of individuals who are responsible for or engaged in the management of the investment portfolio of the **Investment Company**.

The **Investment Trust Regulations** are The Investment Trust (Approved Company) (Tax) Regulations 2011 as amended by subsequent orders, regulations and legislation.

**ITC** means a company which is incorporated in the United Kingdom, prepares its **Annual Financial Statements** in accordance with **UK Financial Reporting Standards** and which has been approved under **Section 1158** or is directing its affairs so as to enable it to obtain or retain such approval.

**Listing Rules** means the rules which are made by the competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000.

**Net Asset Value Attributable to Each Class of Share** means the net assets of the **Investment Company** after deducting minority interests, prior ranking shares (attributing to those shares the entitlement of the holders under the Articles of Association of the **Investment Company** on a return of assets, on liquidation or otherwise) and debt (attributing to debt the appropriate entitlement, on a going concern basis, under the relevant debt instrument); and, in the case of a prior ranking share, its entitlement under the Articles of Association of the **Investment Company** on a return of assets, on liquidation or otherwise subject to sufficient assets being available.

Where treasury shares exist, and notwithstanding their treatment in the **Financial Statements**, it may be necessary to adjust the **Investment Company's** net assets, and hence the net asset value attributable to certain classes of share, to reflect appropriately any stated terms on which they can be re-issued.

**Net Asset Value Attributable to Each Share** means the **Net Asset Value Attributable to Each Class of Share** divided by the number of shares in issue in that class. Where treasury shares exist then, depending on the circumstances (see previous paragraph), it may be necessary to adjust the number of shares in issue for the number of treasury shares held.

**Performance Fee** means any part of the overall **Investment Management Fee** the payment of which is directly linked to the **Investment Company** achieving or exceeding a performance target. The target can be, inter alia, in the form of an absolute or relative return over a set period or periods or based on realisation levels.

A **Quoted Investment** is an **Investment** whose price is quoted in an active market. **FRS 102** (paragraph 2A.1a) states that "*The best evidence of fair value is a quoted price for an identical asset (or similar asset) in an active market. This is usually the current bid price*".

A **Scrip Dividend** is a distribution of shares by a company to a shareholder which the shareholder has elected to receive instead of cash in respect of the whole or part of any dividend payable or proposed to be payable by the company.

**Section 274** means Section 274 **Income Tax Act 2007**.

**Section 1158** means Section 1158 **Corporation Tax Act 2010**.

**Stock Lending** involves a transaction under which title to securities is transferred from the **Investment Company** to another party in exchange for a fee linked to the passage of time. The economic benefit of the securities transferred remains with the **Investment Company** and the party obtaining title is obliged to deliver back at a specified time equivalent securities of the same class and type; and the term shall include comparable transactions in other jurisdictions.

**Tech 02/17BL** is the guidance on the determination of realised profits and losses in the context of distributions under the **Companies Act 2006** issued by the Institute of Chartered Accountants in England and Wales ('ICAEW') and the Institute of Chartered Accountants of Scotland in the ICAEW's Technical Release: Tech 02/17BL.

**UK Financial Reporting Standards** means **FRSs** issued by the FRC.

An **Unquoted Investment** is an **Investment** other than a **Quoted Investment**.

**VCT** means a company which is incorporated in the United Kingdom, prepares its **Annual Financial Statements** in accordance with **UK Financial Reporting Standards** and which has been approved under **Section 274** or is directing its affairs so as to enable it to obtain such approval.

**ZDPS** - see **Zero Dividend Preference Shares** below.

**Zero Dividend Preference Shares** (or **ZDPS**) are preference shares which carry no entitlement to dividends but which carry the right, on a fixed date or on any earlier redemption, to the repayment of capital and a premium (designed to compensate the holders for the absence of a dividend) in priority to any capital payment to the holders of ordinary shares but after any debt and subject to assets being available.

# RECOMMENDED PRACTICE

# (I) INTRODUCTION

## 1 Notes

Notes in italics following specific recommendations in the **SORP** are intended to guide readers as to the intention lying behind the specific recommendation and to provide background information which is considered helpful.

## 2 Accounting requirements

As listed public limited companies, **Investment Companies** are subject to many requirements relating to the content and presentation of their **Financial Statements**.

These include requirements contained in:

- European law
- UK company law
- **UK Financial Reporting Standards**
- **The Listing Rules**
- Disclosure and Transparency Rules

**Note:** the **SORP** does not, however, deal comprehensively with all the requirements contained in the above so reference should be made to those requirements.

The Alternative Investment Fund Managers Directive (the 'Directive') requires that entities within its scope, and above certain thresholds, make available certain additional information to investors on request, and that such additional information can be provided either separately or as an additional part of the annual financial report. Entities required to make public an annual financial statement in accordance with the Transparency Directive, which will include **Investment Companies**, have reduced requirements. The **SORP** does not deal with the requirements contained in the Directive, so reference should be made to those requirements.

### 3 Status of SORP

The **SORP**, as recommended practice, cannot override the requirements identified in paragraph 2 above and **Investment Companies** must therefore continue to comply with those obligations. The **SORP** only applies where an **Investment Company** is preparing **Financial Statements** i.e. those prepared in accordance with United Kingdom law and **UK Financial Reporting Standards** (see Section XVII below regarding half yearly and other accounts).

**Note:** although the **SORP** is not directly applicable to investment companies preparing accounts in accordance with **IFRSs**, the Association considers that, except in the rare circumstances when there is a direct conflict with an **IFRS**, the **SORP** will continue to represent best practice. Consequently, investment companies reporting in accordance with **IFRSs** might wish to make a statement in their financial statements that, where guidance set out in the **SORP** is consistent with the requirements of **IFRSs**, the financial statements have been prepared in compliance with the recommendations of the **SORP**.

Paragraph 10.5 of **FRS 102** sets out the standing of a **SORP** where judgement is being applied regarding accounting for a transaction not specifically addressed by **UK Financial Reporting Standards**.

Paragraph 8 below sets out the position regarding non-compliance with the **SORP**.

### 4 Unique nature of investment companies

Whilst **Investment Companies** are subject to the above-noted provisions, there are certain key differences which make the reporting of financial performance by **Investment Companies** not directly comparable with that of other companies. **Investment Companies** are fundamentally different from other companies in that, with respect to their primary business, they do not provide goods or services and have no customers. Rather, they function as investment vehicles for their shareholders.

## 5 Revenue v capital distinction

Another difference from other companies relates to the separation of capital and revenue profits and losses.

**Note:** the separation of capital and revenue profits and losses is of fundamental importance to shareholders and other users of the **Financial Statements** of all **Investment Companies** and is considered essential in assessing financial performance.

For those **Investment Companies** that have **CAIC Status**, and thereby the ability to make a distribution out of revenue profits under specified circumstances regardless of the existence of capital losses, the distinction is crucial.

In addition, although for **ITCs** the distribution of capital profits by way of dividend is no longer prohibited by company and tax legislation, there remains a maximum retention test which relates to income as set out in the **Investment Trust Regulations**. This test needs to be met if the **ITC** is to continue to be approved as an investment trust. Similarly, **VCTs** are subject to the retention test set out in **Section 274** which places a limit on the level of income from shares and securities that can be retained. It follows that the separation of capital and revenue is also of fundamental importance when considering the tax status of **Investment Companies**.

As set out in paragraph 12 below, **Investment Companies** should present an Income Statement consisting of three columns called Revenue, Capital and Total. Items of a revenue nature should be recognised in the revenue column and items of a capital nature in the capital column. It follows that the total column can consist of both revenue and capital items. The determination of whether an item should be recognised as revenue or capital (or part revenue and part capital) should be carried out in accordance with the recommendations and principles as set out in the **SORP**.

## 6 Purpose of SORP

The principal objective of the **SORP** is to improve the quality and consistency of information presented in the **Financial Statements** of **Investment Companies** and, in particular, to provide a basis for standardisation of financial reporting across the industry,

including distinguishing between revenue and capital returns.

Generally accepted accounting principles ('GAAP') including the provisions of the **Companies Act 2006** and **UK Financial Reporting Standards**, apply to **Investment Companies** and the recommendations of the **SORP** have been developed within the framework of GAAP.

The **SORP** does not, however, deal comprehensively with all the requirements of GAAP, so reference should also be made to those requirements.

## (II) SCOPE

### 7 Applicability

The recommendations contained within the **SORP** apply to the **Annual Financial Statements of Investment Companies**.

**Note:** the conditions laid down by **Section 1158** which an **ITC** must meet in order to continue to be approved as an investment trust are tested by reference to each (tax) accounting period. It is therefore inevitably the case that the **SORP** is being applied to the **Financial Statements** of an **ITC** which is directing its affairs so as to qualify as an investment trust, but which will not yet have fully met the conditions to do so. Providing, in the opinion of its **Board** and supported by the facts, an **ITC** is conducting its affairs so as to meet the conditions, an inadvertent breach of the tests and even the subsequent loss of approval should not affect the applicability of the **SORP** to either the current period in question or to any future or past periods. It follows that an **ITC** should apply the **SORP** to all relevant accounting periods.

Similarly, **VCTs** will be directing their affairs to qualify as a venture capital trust but also will not yet have fully met the conditions to do so. However, as is the case with **ITCs** as described above, providing, in the opinion of its **Board** and supported by the facts, a **VCT** is conducting its affairs so as to obtain approval, an inadvertent breach of the tests and the subsequent failure to obtain approval should not affect the applicability of the **SORP** to either the current period in question or to any future or past periods. It follows that a **VCT** should apply the **SORP** to all relevant accounting periods.

Non-UK companies are not within the scope of the **SORP**, although some offshore investment companies share many of the characteristics of **Investment Companies** and prepare their financial statements in accordance with **UK Financial Reporting Standards**. Although no account has been taken in the preparation of the **SORP** of any special considerations relating to these entities, to the extent that they share the characteristics of **Investment Companies** it is not the intention to suggest that they should not comply with the recommendations of the **SORP** to the extent permitted by accounting standards and their local company law.

As listed companies, investment companies are required to prepare their consolidated accounts (if any) in accordance with **IFRSs** (see paragraph 31 below for the position on subsidiary companies). With regard to their parent company or solus accounts, these can be prepared in accordance with **IFRSs** or **UK Financial Reporting Standards** at the option of the company.

## 8 Non-compliance with SORP

In its **Financial Statements**, an **Investment Company** should state the title of the **SORP** and whether the **Financial Statements** have been prepared in accordance with those of the **SORP's** provisions currently in effect.

Where an **Investment Company** does not comply with the **SORP** it should state in its **Financial Statements** that it does not comply and give the reasons for its non-compliance, including a brief description of why the adopted treatment is judged more appropriate in the **Investment Company's** particular circumstances.

Where the non-compliance relates to non-disclosure, the **Investment Company** should state the disclosures not shown and the reasons why they have not been provided.

**Note:** the effect of a departure need not be quantified unless such quantification is necessary for the entity's **Financial Statements** to give a true and fair view.

This recommendation is consistent with the FRC's position regarding SORPs as set out in **FRS 100** (paragraphs 5 - 8).

## 9 Going concern

Where an **Investment Company** is not expected to continue in operational existence in the foreseeable future, or where there is significant doubt, the **Investment Company** should apply the provisions set out in paragraphs 3.8 and 3.9 of **FRS 102**.

**Note:** paragraph 3.8 of **FRS 102** states that:

*“When preparing financial statements, the management of an entity using this FRS shall make an assessment of the entity’s ability to continue as a going concern. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but not limited to, twelve months from the date when the financial statements are authorised for issue.”*

Paragraph 3.9 of **FRS** 102 states that:

*“When management is aware, in making its assessment, of material uncertainties related to events or conditions that cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.”*

It follows that the **Board** of an **Investment Company** will need to make an annual going concern assessment. The factors which will have to be taken into account include the existence and the proximity of any liquidation date and the probability of the liquidation.

The significance of the difference between the valuation of the **Investment Company's** assets and liabilities on a going concern basis and the estimated value of the assets and liabilities on a realisation basis should also be considered. The differences could include, for example, investments valued at a discounted bid basis, the break-up value of any loans (vs book cost), costs associated with unwinding any interest rate swaps, payments to compensate warrant holders and the costs of the liquidation.

In many cases an **Investment Company** will be considering liquidation not because of any doubts about its ability to continue as a going concern, indeed it may be financially very sound, but rather because it was set up with a fixed or limited life which is coming to its end or it is in shareholders’ best interests to do so for some other reason. Additionally, many **ITCs** have introduced continuation votes where shareholders have the opportunity, often periodically, to vote in favour or against the company continuing in existence. In any event

it will normally be the case that shareholders will have to vote in favour of a liquidation before it can occur.

It follows that, even if an **Investment Company** is approaching a wind-up or continuation vote, and where shareholders have yet to vote on the issue, it will usually be more appropriate for the **Financial Statements** to be prepared on a going concern basis whilst making the material uncertainties disclosures set out in paragraph 3.9 of **FRS 102**; and that adoption of a non-going concern basis is expected to be a rare event.

However, where shareholders have already approved the wind-up or voted against continuation or where the **Board** has concluded that there is no realistic alternative (for example a wind-up is inevitable within 12 months of the reporting date because the only option available to shareholders other than a wind-up is some form of reconstruction involving another entity) it is expected that adoption of a non-going concern basis will be appropriate.

Paragraph 32.7A of **FRS 102** requires that financial statements should not be prepared on a going concern basis if management determines after the reporting period either that it intends to liquidate the company or to cease trading, or that it has no realistic alternative but to do so.

In those cases where it is considered appropriate to prepare **Financial Statements** on a non-going concern basis, then these will usually be prepared on a 'break-up' basis and the 'valuation differences', if any, described above will fall to be recognised in the accounts. In addition, it may be necessary to reclassify loans and share capital. Except to the extent that its provisions need to be modified to enable an **Investment Company** to provide information on a non-going concern basis, the **SORP** should be complied with in full.

When reviewing going concern, **Boards** should also give consideration to the wider guidance issued by the FRC and other bodies.

## 10 Commencement date

The recommendations are applicable for all accounting periods beginning on or after 1 January 2019 but early adoption is encouraged.

# (III) CHANGES IN ACCOUNTING POLICIES

## 11 Effect on prior periods

If an existing accounting policy is changed, an **Investment Company** should account for the change in accordance with paragraphs 10.11 and 10.12 of **FRS 102**.

In addition, the disclosures required by paragraphs 10.13 or 10.14 of **FRS 102**, which include a brief explanation of why the new accounting policy is thought more appropriate, should be provided.

No restatements should be made that would solely reflect a change to the allocation between capital and revenue including the adoption of an allocation basis for the first time.

**Note:** Part 2, Schedule 1 **Accounts and Reports Regulations** requires, inter alia, as follows:

- a) Paragraph 12 requires that accounting policies shall be applied consistently from one financial year to the next.
- b) Paragraph 10 requires that, if it appears to the directors of a company that there are special reasons for departing from any of the accounting principles stated in Part 2 in preparing the company's accounts in respect of any financial year, they may do so, but that particulars of the departure, the reasons for it and its effect shall be given in a note to the accounts.

The implementation by an **Investment Company** of the recommended practices contained within the **SORP** may constitute changes in accounting policies. In addition, an **Investment Company** may decide to change an accounting policy for reasons unconnected with the implementation of the recommended practices of the **SORP**. Where there is a change of accounting policy, the recommendations as described above should be

applied. Changes to the proportion of expenses allocated between capital and revenue (including the adoption of an allocation basis for **Finance Costs** and expenses for the first time) are not considered to be matters of accounting policy and consequently no restatement of either the prior period or capital and revenue reserve balances at the beginning of the prior period is required.

## (IV) FORM AND CONTENT

### 12 Income statement

Unless another form of permitted presentation is more appropriate, **Investment Companies** should present a single statement of comprehensive income which should be called 'Income Statement'.

On the face of the Income Statement a revenue column and a capital column, prepared in accordance with the **SORP**, should be provided.

**Note:** **Investment Companies** are subject to the requirements of the **Companies Act 2006** and of **UK Financial Reporting Standards**. Therefore, the form and content of the **Financial Statements** of **Investment Companies** are basically similar to those of most other companies.

**FRS 102** (paragraph 5.2) permits an entity to present its total comprehensive income for a period either as a single statement or two statements consisting of an income statement and a statement of comprehensive income. In order to promote consistency throughout the sector, unless an **Investment Company** considers that the two-statement presentation is more appropriate in its circumstances, the single statement presentation should be provided. Paragraphs 5.5 to 5.6 of **FRS 102** deal with the presentation and content of a single statement.

As stated in paragraph 5 above, the separation of capital and revenue is of fundamental importance to shareholders and other users of **Investment Companies' Financial Statements** and is considered essential in assessing financial performance. It follows that the presentation of the three-column format on the face of the Income Statement will enable **Investment Companies** to provide users of the **Financial Statements** with this distinction clearly shown.

The single statement of comprehensive income should be called 'Income Statement' and the three columns should be called 'Revenue', 'Capital' and 'Total'. Generally, the total column of the Income Statement will be the **Investment Company's** profit and loss

account with the revenue and capital columns representing supplementary information. However, where the Income Statement includes items of income and expense that, as required or permitted by **FRS 102**, are not recognised in profit or loss, then the total column will consist of the profit and loss account and these other items. However, most **Investment Companies** will not have such items of income and expense, and the total column of the Income Statement will be the profit and loss account.

## 13 Statement of changes in equity

**Investment Companies** should present a statement of changes in equity incorporating revenue and capital information as appropriate.

**Note:** Section 6 of **FRS 102** sets out the requirements for presenting the changes in an entity's equity either in a statement of changes in equity or, if specified conditions are met and an entity chooses, in a statement of income and retained earnings which incorporates the income statement. However, given the likely level of detail required to be shown in the statement of changes in equity by **Investment Companies**, and in order to promote consistency throughout the sector, unless an **Investment Company** considers that a single statement of income and retained earnings presentation is more appropriate in its circumstances, a statement of changes in equity should be provided together with a separate statement of comprehensive income. Paragraph 12 above sets out the **SORP's** recommendations regarding the reporting of total comprehensive income.

With regard to format, it is considered that the statement of changes in equity should be presented on a columnar basis, and would normally include separate disclosure of share capital and the various individual reserves. Where relevant, the statement should show, for example, whether dividends have been paid out of revenue or capital profits.

## 14 Statement of cash flows

Unless exempt, an **Investment Company** should present a statement of cash flows in accordance with the requirements of **FRS 102**.

**Note:** a complete set of financial statements for an entity includes a statement of cash flows for the reporting period. Section 7 of **FRS 102** sets out the information that is to be presented in such a statement and how to present it.

However, paragraph 7.1A of **FRS 102** states that a statement of cash flows is not required to be provided by investment funds that meet all of the following conditions:

- i. substantially all of the entity's investments are highly liquid;
- ii. substantially all of the entity's investments are carried at market value; and
- iii. the entity provides a statement of changes in net assets.

**ITCs** and **VCTs** are investment funds for this purpose and a statement of changes in equity is the equivalent of a statement of changes in net assets. It follows that, providing substantially all of the **ITC's** or **VCT's** investments are highly liquid and carried at fair value, no statement of cash flows needs to be presented.

**ITCs** and **VCTs** will generally carry their investments at **Fair Value** (which is market value) and, consequently, the cash flow exemption will depend on whether the investments are highly liquid or not. **Tech 02/17BL** considers fair value accounting including guidance on what is meant by readily convertible to cash (Section 4). **Tech 02/17BL** is therefore a useful tool in helping to determine whether investments are highly liquid.

It is expected that **Unquoted** equity investments will not be capable of being classified as highly liquid and the liquidity position of stocks traded on junior markets such as AIM will need to be carefully considered. Many **Investment Companies** will need to consider the liquidity of their specific investments before it can be determined if the exemption applies.

## 15 Distributable reserves

An **Investment Company** should provide separately, either on the face of its balance sheet or the statement of changes in equity or in the notes to the accounts, an indication of which of its reserves are distributable and for what purposes.

**Note:** whilst the three-column format of the Income Statement will provide users with a clear separation of revenue and capital profits and losses for the period, it will not enable

users to identify distributable reserves at the balance sheet date, particularly as the total column is usually the **Investment Company's** profit and loss account (see paragraph 12 above) and dividends paid or payable by the **Investment Company** will not be shown in the Income Statement (see paragraph 18 below). An indication of which reserves are distributable will enable the level of distributable reserves to be identified which will be of benefit to users in assessing the **Investment Company's** financial position. It may also be the case that certain reserves are restricted in their use and, again, relevant details should be provided.

Where the distributability of a reserve is the subject of restrictions (legal or otherwise), a note explaining the circumstances should be added. An example of this might be the restrictions imposed on certain reserves held by some **VCTs** which, although distributable in accordance with company law, cannot be distributed by virtue of tax regulations applicable to **VCTs**.

Providing this is not prohibited by their articles, **Investment Companies** are able to distribute realised capital profits by way of dividend. If an **Investment Company's** articles do not permit such a payment, this should be stated.

If, temporarily or otherwise, an **Investment Company** is unable to pay distributions, perhaps, for example, because it is unable to meet the requirements of Section 832 **Companies Act 2006**, then the above information should still be disclosed but a note explaining the circumstances should be added.

Paragraph 3.3 of **Tech 02/17BL** states:

*"It is generally accepted that profits shall be treated as realised for the purpose of applying the definition of realised profits in companies legislation only when realised in the form of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty. In this context, 'realised' may encompass profits relating to assets that are readily realisable. This would embrace profits and losses resulting from the recognition of changes in fair values, in accordance with relevant accounting standards, to the extent that they are readily convertible to cash."*

Consequently, following on from the position set out in **Tech 02/17BL**, it may be the case that profits on certain **Investments** held at the reporting date can, when distributable profits are determined, be considered to be realised.

If an **Investment Company** wishes to disclose the amount of profit arising from the recognition of changes in **Fair Values** that is considered to be distributable, profits from **Unquoted** equity investments are unlikely to qualify, as the amounts will not be readily convertible to cash (see paragraphs 4.10 and 4.10A of **Tech 02/17BL**).

For profits on **Investments** which otherwise fall to be treated as realised (and hence distributable), **Boards** also need to consider the implication of the Block Discount provisions set out in paragraphs 4.16 to 4.22 of **Tech 02/17BL**. For the vast majority of such **Investments** it is expected that the provisions will not apply as the profit will be realisable over a short period of time in the ordinary course of business (see paragraph 4.19 of **Tech 02/17BL**). However, it is necessary to consider the position on an investment-by-investment basis.

The position with regards to losses is set out in paragraphs 4.29 to 4.33 of **Tech 02/17BL**.

However, given the onerous nature of the identification of distributable profits from changes in **Fair Values** and the fact that, in any event, the profit on **Investments** held will change as the **Fair Values** of those **Investments** change, rendering the information much less useful, the **SORP** does not require, either in the primary statements or in the notes to the accounts, the disclosure of the net profit or loss on **Investments** held at the reporting date analysed between those that are realised and those that are unrealised in accordance with the position set out in **Tech 02/17BL**. Rather, the net profit or loss on **Investments** held at the reporting date should be shown as a single figure described as 'Investment Holding Gains' or similar term. Where relevant, in a note to the accounts it should be stated that this figure has not been analysed between those amounts that are distributable and those that are not distributable.

## 16 Investment profits and losses

Profits or losses arising during the reporting period on the revaluation or disposal of <b>Investments</b> classified as at fair value through profit or loss should be shown in the
--

capital column of the Income Statement.

Either on the face of the balance sheet or the statement of changes in equity or in the notes to the accounts, **Investment Companies** should identify separately capital reserves that relate to the revaluation of **Investments** held at the reporting date.

**Note:** as stated in paragraph 12 above, the total column of the Income Statement will usually be an **Investment Company's** profit and loss account and, as set out in paragraph 25 below, it is expected that **Investments** held by an **Investment Company** should normally be classified as at fair value through profit or loss.

In such circumstances, profits and losses on **Investments** arising during the reporting period (whether they relate to **Investments** held at the reporting date or realised during the reporting period) will be reflected in the capital column of the Income Statement (and thereby the profit and loss account).

The amount relating to the net profit or loss on **Investments** held at the reporting date (i.e. generally speaking the difference between the valuation of the investments and their cost) should be shown separately on the face of the balance sheet, or on the statement of changes in equity or in the notes to the accounts as a single figure described as 'Investment Holding Gains/Losses' or similar term. As detailed in paragraph 15 above, the **SORP** is not requiring profits on **Investments** held at the reporting date to be analysed between those that are distributable and those that are not.

Any supplementary information which is provided in the annual report and accounts, including any information provided to meet regulatory obligations, should clearly describe to the users of the annual report and accounts what the information represents.

For example, supplementary information described as movements in the year or gains/(losses) in the year should only show the movement in the value of those figures that has occurred since the prior year end. Any figures that include historical movements or gains/(losses) that have accumulated prior to the last year end should be clearly described.

The reader should also refer to the Association's separate guidance note on this recommendation (see Appendix B).

## 17 Returns per share

In addition to the return per share based on the profit or loss for the period as shown in the total column on the face of the Income Statement, **Investment Companies** should disclose the net revenue return per share and the net capital return per share on the actual basis. **Investment Companies** should also disclose, with equal prominence, the returns per share on the diluted basis in accordance with the provisions of paragraph 1.4 of **FRS 102**.

**Note:** as the revenue and capital columns represent supplementary information, it is appropriate that a return per share and a diluted return per share, if applicable, are disclosed with respect to each column on the face of the Income Statement.

In calculating diluted returns, any potentially dilutive security should be assessed by reference to the company's share price and not its **Net Asset Value Attributable to Each Share**. Full details of the amounts used in calculating the returns should be disclosed in the notes to the **Financial Statements**.

As stated in paragraph 12 above, although it is expected to be a rare event, some **Investment Companies** may include in their Income Statement items of income and expense that, as required or permitted by **FRS 102**, are not recognised in profit or loss. Returns per share should be based on the company's profit and loss account and, consequently, the calculations should exclude such items.

Paragraph 1.4 of **FRS 102** states that, where an entity's ordinary shares are publicly traded, which will be the position for **Investment Companies**, it should apply IAS 33 Earnings per Share (as adopted in the EU).

## 18 Dividends

An **Investment Company** should show, by way of a note to the accounts, information regarding the total amount of dividends paid or payable on its shares (whether classified as equity or liability) with respect to the reporting period including any dividend proposed by the **Board**.

The disclosure should include for each separate dividend the amount paid or proposed to be paid and the figures in pence per share, together with the totals for the period. The disclosure should also show for each separate dividend whether it has been or will be paid out of revenue or capital profits.

**Note:** under company law and accounting standards, certain dividends proposed by the **Board** of an **Investment Company**, particularly any final dividend due to be approved by its shareholders at an annual general meeting and interim dividends not paid within the reporting year, will not be classified as a liability and therefore will not be recognised in the **Financial Statements**. Rather, as it is likely to be the case that the previous year's final dividend and the current year's interim dividend or dividends will have been paid in the reporting year, the **Financial Statements** will generally reflect last year's final plus the current year's interim dividends.

In any event, it will be the case that, even where they have been recognised in the **Financial Statements**, dividends paid in connection with a class of share classified as equity will not be shown in the Income Statement, but rather such dividends will appear as items in the statement of changes in equity. Dividends on shares classified as liabilities will form part of the finance cost of those shares and will be reflected as appropriate (see paragraphs 52 and 53 below).

Dividends which appear as items in the statement of changes in equity may have been paid out of capital profits. Consequently, it will be necessary to determine whether dividends have been paid out of revenue or capital profits in order to establish from which reserve category they should be deducted (see paragraph 13 above for details of the statement of changes in equity and 15 above for the disclosure requirements relating to distributable reserves).

In order to qualify as an investment trust or venture capital trust, an entity needs to meet the tests set out in the **Investment Trust Regulations** or **Section 274** respectively for which the proposed dividend should be taken into account. Making the above disclosures will make it easier for users of the **Financial Statements** to establish that the legislative conditions have been met. Disclosure requirements relating to reserves and dividends are also set out in Paragraph 43, Part 3, Schedule 1 **Accounts and Reports Regulations**.

## 19 Net asset value attributable to each class of share

An **Investment Company** should disclose in its **Financial Statements** the **Net Asset Value Attributable to Each Class of Share**.

**Note:** see explanatory note to paragraph 21 below.

## 20 Classification of share capital

An **Investment Company's** share capital should be classified and disclosed as either equity or a liability in accordance with the requirements of Section 22 of **FRS 102**.

**Note:** for a conventional **Investment Company** without a fixed life and with its ordinary shares entitled to all net revenue and capital gains, there is little doubt that such ordinary shares will fall to be classified as equity. On the other hand, a preference share that provides for mandatory redemption for a fixed amount at a fixed date is almost certain to be classified as a liability.

Where an **Investment Company** has a fixed or limited life and/or where share classes have been issued with a fixed or limited life or with specific entitlements then, in accordance with the requirements of Section 22 of **FRS 102**, as long as certain conditions are met the most subordinate class of share capital issued by a limited life company will usually be classified as equity.

The conditions are set out in paragraph 22.4 of **FRS 102**. One condition states that, for a share class to be classified as equity, the total expected cash flows attributable to the instrument are required to be based substantially on the company's profit or loss, change in the recognised net assets or change in the fair value of the recognised and unrecognised net assets.

It is not considered that the existence of a typical income share, with its entitlement to a pro-rata share of the net revenue generated by the company and a fixed amount on wind-up, will prevent a typical capital share from being classified as equity. In addition, an income share, in the circumstances where the issuing company has insufficient assets to meet the fixed amount due in wind-up, does not fall to be classified as equity because the income share will not be the most subordinate share class.

Some **Investment Companies** issue subscription shares which convert into ordinary shares on exercise. Providing the ordinary shares are classified as equity, the subscription shares will usually also fall to be classified as equity, but classification should be determined on a case-by-case basis.

**Investment Companies**, particularly **VCTs**, commonly raise additional capital through the issue of new shares often referred to as 'C' Shares. Funds raised as 'C' Shares will typically represent a separate ring-fenced pool of value (distinct from the net assets attributable to ordinary shareholders) managed within the overall objectives and policies of the company. At a date in the future, the 'C' Shares will be converted into new ordinary shares, with identical rights to the existing ordinary shares, in the proportion that the net asset value of a 'C' Share bears to the net asset value of an ordinary share. Until conversion the assets are managed as two separate pools.

Sometimes additional capital is raised through the issue of new shares where it is intended that they will not be converted. In such circumstances, the assets are managed as separate pools throughout the life of the shares.

The classification of these shares will depend on their detailed rights and entitlements, in particular the terms of any contractual obligation on the company.

The rights and entitlements attaching to share classes can vary enormously and it will be for the **Board**, in conjunction with its advisers, to determine the classification of existing or newly issued share classes. Paragraphs 52 and 53 below deal with **Finance Costs** where share classes are classified as liabilities.

## 21 Net asset value per share – disclosure and reconciliation

Whether net asset value per share information is disclosed within, or solely outside of, the **Financial Statements**, a full reconciliation of the **Net Asset Value Attributable to Each Share** and the **Diluted Net Asset Value Attributable to Each Share** (if applicable) so disclosed, both for the period under review and for the corresponding previous period, to the amounts shown in the **Financial Statements** should be disclosed in the notes to the

accounts. In addition, details (including the number of shares and the relevant net assets) of the amounts used in the calculations should be given. The calculations should be carried out on the Articles Basis, as described below, and in accordance with the definitions set out in the Definition of Terms section of the **SORP**.

Where such information is not disclosed elsewhere in the annual report, the **Net Asset Value Attributable to Each Share** and the **Diluted Net Asset Value Attributable to Each Share** (if applicable) should be shown in the **Financial Statements** together with the reconciliations and details mentioned in the previous paragraph.

**Note:** information relating to the **Net Asset Value Attributable to Each Share** ('NAV per share') is of fundamental importance to users of the **Financial Statements of Investment Companies** and an allocation of net assets in accordance with rights applying on a return of assets, as set out in the Articles of Association of the **Investment Company** ('the Articles Basis'), is considered to be generally most relevant to individual shareholders. This is because an allocation of net assets on the Articles Basis enables a shareholder to apply an asset valuation to the shareholding, which may be important in terms of assessing the risk and security attaching to those shares.

However, with regard to, for example, certain financial liabilities, it may be more appropriate to include them in the calculations at their **Fair Value** rather than the amount shown in the **Financial Statements** and other adjustments to carrying values may be necessary – such adjustments will form part of the reconciliation and disclosure information given in accordance with this paragraph.

For the calculation of **Diluted Net Asset Value Attributable to Each Share**, it is also considered appropriate to apply the Articles Basis, again with any adjustments to carrying values appropriately reconciled and disclosed.

Some **Boards** may feel that it is more appropriate to disclose net asset value per share information in the annual report outside of the **Financial Statements**. Where this is the case it is important that users of the annual report are provided with a full reconciliation of the information so disclosed to the figures included in the **Financial Statements** and the basis on which the calculations have been made.

Where net asset per share information is not provided outside of the **Financial Statements** it should be included within them, together with the full reconciliation and calculation disclosures.

Where treasury shares exist, a net asset value per share figure disclosed within the **Financial Statements** should be based on the assumption that those treasury shares have been cancelled. However, where shareholders give authority for treasury shares to be sold at a price below net asset value, this should be disclosed together with the fact that such a sale (or sales), which is at the discretion of the **Board**, would dilute the net asset value otherwise shown. Companies should have regard to Listing Rule 15.4.11.

No net asset information should be shown for subscription shares as, although they are technically shares, no assets are attributable to them.

## 22 Net asset value – reconciliation with statement of total return

Differences between the movement in **Net Asset Value Attributable to Each Class of Share** and that as shown in the Income Statement should be reconciled and disclosed by way of a note to the accounts. No reconciliation of the differences in terms of pence per share of either the NAV or the diluted NAV need be disclosed.

**Note:** for many reasons (e.g. shares have been issued in the period) the movement in assets attributable to each class of share may not be fully explained by the returns shown in the Income Statement. In such circumstances, the **Investment Company** should disclose by way of note a full reconciliation between the opening and closing net assets attributable.

The impact, in terms of NAV per share, of certain types of transaction (e.g. share buybacks) can, especially when the **Investment Company** has a complicated share structure, be difficult or onerous to ascertain. A reconciliation of the movement of assets in terms of pence per share is not considered to be as important to users of the **Financial Statements** as a reconciliation of **Net Assets Attributable to Each Class of Share**. Accordingly, it is not recommended that a reconciliation of the movement of NAV per share or the diluted NAV per share be provided.

## 23 Disclosures where more than one class of share exists each representing a separate ring-fenced pool of value

Where an **Investment Company** has issued separate classes of share each representing a separate ring-fenced pool of value, additional disclosures at the individual class level should be provided sufficient for the financial position and performance of the separate pool to be ascertained.

Where not disclosed elsewhere in the annual report, disclosure should be made in the **Financial Statements**.

**Note:** some **Investment Companies** issue one or more classes of share where the money received and any investments purchased therefrom will be ring-fenced from the assets attributable to the company's other share classes. In general terms, the particular share class will only be entitled to profits arising from its pool of value and will not be entitled to any share of profits from any other assets owned by the company. Sometimes these separate share classes will ultimately convert into other share classes and sometimes they will remain separate.

Where such separate share classes exist, additional disclosures at the individual share class level should be provided so that the income, assets and liabilities and net asset value per share etc. attributable to each class can be ascertained. Depending on the circumstances, this could mean that, in order to show the financial position of the separate classes, additional income statements, balance sheets and even cash flow statements might need to be presented, as well as net asset values and portfolio information. If a separate share class has converted to another share class during the accounting period such that it no longer exists at the balance sheet date, it will not usually be necessary to provide such additional disclosures.

Where two or more share classes together form a separate ring-fenced pool of value, the two or more classes shall be treated as a single class as appropriate for this purpose.

Such additional information can be disclosed in a section of the annual report outside of the **Financial Statements**, within the **Financial Statements** or in a mix of the two, and it is for the **Board** to determine the appropriate location in its company's circumstances.

## 24 Other factors affecting returns and net asset values

Where it is not readily apparent from the **Financial Statements**, and not fully described elsewhere in the annual report, disclosure should be made of material factors affecting the returns and net assets attributable to shareholders or to different classes of share where more than one class exists.

**Note:** where further disclosures would aid the user's understanding of historic returns achieved and the risks attaching to returns potentially attainable by **Investment Companies** (including returns on different classes of share) such disclosures should also be provided. These additional disclosures could include the impact or potential impact arising from the nature and extent of any gearing (see 'a' below). Further examples are the extent to which assets are available at the balance sheet date to cover any predetermined final liability or loan covenant obligations (see 'b' below), the break-up value of any loans (see 'b' below) and any material factors affecting the ability of **Investment Companies** to pay dividends. In order to help users assess the impact of the material factors on prospective returns, **Boards** should consider providing illustrative return statistics such as hurdle rates.

Where quantification of the impact on shareholder returns of these factors is not practicable, the disclosures should be presented in narrative form.

In most cases, this additional information is more appropriately disclosed in a section of the annual report outside of the **Financial Statements**, although it should be noted that if the information is also required by **FRS 102** then it must be disclosed within the **Financial Statements**.

Where an investment company has separate classes of share with ring-fenced portfolios and entitlements to income, additional disclosures at the individual class level should be provided (see paragraph 23 above).

- a) Gearing is a factor that affects the returns to shareholders. Some gearing is clearly disclosed on the face of the **Financial Statements**, for example bank loans and other capital instruments, but investments in warrants, derivatives and similar securities also involve gearing. If the **Investment Company** has holdings in **Investments Funds** which themselves have borrowings and/or are in turn invested in geared **Investment Funds**, the resulting layer of gearing can also amplify the effect on the value of the **Investment Company's** net assets of movements in underlying share prices.
- b) It is not only the level of gearing that can affect the returns to shareholders; the type of indebtedness and the terms and conditions attaching to it are also relevant to a shareholder's understanding of the implications of gearing for their investment.

# (V) INVESTMENTS

## 25 Accounting classification

Unless another choice is more appropriate, **Investments** held by an **Investment Company** should be accounted for in accordance with the provisions set out in Sections 11 and 12 of **FRS 102** in full and measured at **Fair Value** with changes in fair value recognised in profit or loss.

**Note:** in accordance with the requirements of paragraph 11.2 of **FRS 102**, an entity shall choose to account for its financial instruments (which includes **Investments**) in accordance with either:

- a) the provisions of both Section 11 and Section 12 in full; or
- b) the recognition and measurement provisions of IAS 39 (Financial Instruments: Recognition and Measurement (as adopted in the EU)) and the disclosure requirements of Sections 11 and 12; or
- c) the recognition and measurement provisions of IFRS 9 (Financial Instruments (as adopted in the EU)) and IAS 39 (as amended following the publication of IFRS 9) and the disclosure requirements of Sections 11 and 12.

As the measurement and recognition provisions in Sections 11 and 12 are largely based on **IFRSs** and in order to promote consistency throughout the sector, unless one of the other options is more appropriate in its circumstances, an **Investment Company** should choose to account for its **Investments** in accordance with the provisions of both Section 11 and Section 12 in full.

As **Investment Companies** manage and evaluate their investments on a **Fair Value** basis, providing the conditions set out in Section 11 and Section 12 are met, investments should be measured at **Fair Value** with changes in fair value recognised in profit or loss.

## 26 Disclosure of fair value analysis

For **Investments** held at **Fair Value**, an **Investment Company** should disclose the fair value hierarchy analysis required by paragraph 34.22 of **FRS 102**.

In addition, until accounting periods beginning on or after 1 January 2017, (unless the company has early adopted the amendments to FRS 102 'Fair value hierarchy disclosures'), where **Fair Value** is estimated using a valuation technique which falls to be disclosed within level 'c' of the Appendix to Section 2 of **FRS 102**, the value of **Investments** where the estimate relies significantly on assumptions and non-observable market data should be disclosed separately from the value of **Investments** where the estimate relies on observable market data.

**Note: Investment Companies** are required by paragraph 34.22 of **FRS 102** to disclose an analysis of the total value of investments which fall within the separate levels of the fair value hierarchy set out in the Appendix to Section 2 of FRS 102 (until accounting periods beginning on or after 1 January 2017, unless the company has early adopted the amendments to FRS 102 'Fair value hierarchy disclosures'), or amended paragraph 34.22 (for accounting periods beginning on or after 1 January 2017, or if the company has early adopted the amendments to FRS 102 'Fair value hierarchy disclosures').

Until accounting periods beginning on or after 1 January 2017, (unless the company has early adopted the amendments to FRS 102 'Fair value hierarchy disclosures'), the hierarchy consists of three levels, 'a' 'b' and 'c'. Level 'c' is for those investments where fair value is not estimated by reference to a quoted price or a valuation technique based on the price of a recent transaction for an identical asset to the one being measured.

Where relevant, level 'c' will therefore include investments whose **Fair Value** has been estimated using assumptions and non-observable market data as well as observable market data. As the distinction between the two can be important information for users of the **Financial Statements**, the **SORP** is recommending that level 'c' should be analysed between the two and the values disclosed.

An **Investment Company** is also required to disclose the basis for determining **Fair Value** in accordance with paragraph 11.43 of **FRS 102**.

## 27 Investment properties

Where an **Investment Company** holds an investment property, as defined in Section 16 of **FRS 102**, it should comply with the provisions of **FRS 102**.

**Note:** **Investment Companies** should measure and include changes in the **Fair Value** of investment properties in the capital column of the Income Statement. Any increase in fair value will not fall to be treated as a realised profit unless the process of marketing and/or negotiation is complete at the valuation date and legal completion occurs shortly thereafter (see paragraph 4.13 of **Tech 02/17BL**).

## 28 Unquoted Investments – disclosure re changes in valuation

Disclosure should be made where the value of an **Unquoted Investment** held by an **Investment Company** has been written up or down to a material extent during the accounting period including the amount of the write-up or write-down.

**Note:** an **Investment Company** need only disclose write-ups or write-downs which are material in the context of its **Financial Statements**.

## 29 Unquoted investments – disclosure re disposals

For each disposal of an **Unquoted Investment** during the accounting period, which disposal is material in the context of the **Investment Company's Financial Statements**, disclosure should be made of its:

- a) net disposal proceeds;
- b) cost; and
- c) carrying value at the end of the previous accounting period (if held at that date).

# (VI) SIGNIFICANT HOLDINGS IN INVESTEES UNDERTAKINGS

## 30 Substantial holdings – disclosure

An **Investment Company** should disclose any holding in an investee undertaking which comprises 3% or more of any class of capital if the holding is material in the context of its **Financial Statements**.

**Note:** where an **Investment Company** has a substantial holding in an investee undertaking, this fact should be disclosed in the **Financial Statements** since it may have implications in areas of interest to users of the **Financial Statements**, such as risk, liquidity and marketability. The **Investment Company** should disclose the name of the investee company and the percentage held.

## 31 Subsidiary undertakings

If an **Investment Company** is classified as a parent undertaking of one or more subsidiary undertakings then, unless the subsidiary undertaking or undertakings are excluded from consolidation by virtue of the requirements of the **Companies Act 2006** or **FRS 102** (where **Investments** held as part of an investment portfolio are excluded from consolidation), consolidated financial statements should be prepared. In such cases those consolidated financial statements should be prepared in accordance with **IFRSs**.

**Note:** an **Investment Company** may meet the criteria contained within the **Companies Act 2006** and **FRS 102** to be classified as a parent undertaking of another undertaking. This may arise because the **Investment Company** chooses to conduct some of its activities through a subsidiary undertaking, for example by having a dealing subsidiary; or it may arise for other reasons. If the criteria are met, the **Investment Company** is required to prepare consolidated financial statements for its group - 'group' is defined as 'a parent undertaking and its subsidiary undertakings' - unless all of the **Investment Company's** subsidiary undertakings are permitted or required to be excluded from consolidation.

Section 9 of **FRS** 102 (particularly paragraphs 9.9(b) and 9.9C) excludes from consolidation any investment held as part of an investment portfolio. It follows that for an **Investment Company** whose only subsidiaries are such investments, the preparation of consolidated financial statements is not required.

When required, the consolidated financial statements fall to be prepared in accordance with **IFRSs** and the **SORP** has no direct effect (see paragraph 3 above). It should be noted that **IFRS** 10 (Consolidated Financial Statements (as adopted in the EU)) contains similar, but not identical, provisions relating to investment entities and their exemption from the requirement to provide consolidated financial statements.

## 32 Investments in associates

If an **Investment Company** is a parent and has an investment in one or more associates that are held as part of its investment portfolio, it should account for those associates at Fair Value with changes in **fair value** recognised in profit or loss.

If an **Investment Company**, which is not a parent, has an investment in one or more associates then, unless it accounts for those associates at **Fair Value** with changes in fair value recognised in profit or loss, the additional information required by **UK Financial Reporting Standards** and company law should be shown.

**Note:** with regard to portfolio investments, paragraph 14.4B of **FRS** 102 states that, “Where an investor is a parent and has an associate that is held as part of an investment portfolio, the associate shall be measured at **Fair Value** with changes in fair value recognised in profit or loss in the consolidated financial statements.”

Paragraph 14.4 of **FRS** 102 states that, where an investor has one or more associates but is not a parent, then the company can elect from three alternative accounting policies. Such associates which are held as part of an investment portfolio should be accounted for at **Fair Value** with changes in fair value recognised in profit or loss.

The disclosure requirements for associates are set out in paragraphs 14.12 to 14.15A of **FRS** 102. It should be noted that **Investment Companies** that are exempt from preparing

consolidated financial accounts (see paragraph 31 above), or would be if they had subsidiaries, are exempt from the requirement set out in paragraph 14.15A of **FRS 102**.

### **33 Investment funds – disclosure**

Where an **Investment Company** holds, or at any time during the accounting period has held, an interest of 10% or more in any class of units/shares in an **Investment Fund**, or a holding of units/shares in an **Investment Fund** which is material in the context of the **Financial Statements** of the **Investment Company**, the following should be disclosed:

- a) the name of the **Investment Fund**;
- b) the proportion and value of each class of the units/shares held; and
- c) if the **Investment Fund** and the **Investment Company** are managed or advised by the same manager or by different managers from the same group, whether any arrangement is or has been in place to avoid the double charging of fees and expenses and, if not, the rate of charge of fees in respect of the **Investment Fund**.

In addition, disclosure should be made of the total value of all of the **Investment Company's** holdings in **Investments** managed or advised by its manager (or by different managers from the same group).

**Note:** the principles and recommendations set out above in respect of subsidiary undertakings and associated undertakings apply equally to holdings in **Investment Funds**. Disclosure of the specified information in relation to an **Investment Company's** interests in **Investment Funds** may enhance the user's understanding of the financial position of the **Investment Company**.

## (VII) RECOGNITION OF INCOME

### 34 Accruals basis

The accruals basis of accounting should be applied to all items of income.

**Note:** **Investment Companies** receive much of their income in the form of dividends, interest, fees and commissions. In order to state fairly the results and position of an **Investment Company** at any point in time, the accruals basis of accounting should be applied to all items of income. The accruals principle is one of the pervasive accounting concepts identified in **FRS 102** (paragraph 2.36).

### 35 Currency translations

The translation of transactions which are denominated in a foreign currency should be carried out in accordance with the provisions of Section 30 of **FRS 102**.

**Note:** profits or losses arising from foreign currency transactions are to be allocated between revenue and capital in accordance with the underlying nature of the transaction. See Section XI below for further discussion.

### 36 Returns on shares (including dividends to be treated as capital)

Subject to paragraphs 42 and 43 below, a return on a share, other than a return falling within paragraph 37 below, (whether in respect of dividends, excluding any related tax credits, redemption, or otherwise), should be recognised when the **Investment Company's** right to the return is established (e.g. for dividends, normally the ex-dividend date). If circumstances dictate, the return, including dividends, should be regarded and recognised as a capital receipt.

**Note:** dividends should generally be recognised as revenue. In deciding whether a dividend should be regarded as a capital receipt an **Investment Company** should review

all relevant information as to the reasons for and sources of the dividend, as well as its reasons for investing.

Capital reconstructions or reorganisations of the investee involving the payment of a dividend might be considered a capital receipt. Dividends which need to be considered in this context are often referred to as 'special dividends' although this does not mean that those not so described should always be taken to revenue.

The fact that a dividend has been paid out of the paying company's reserves, and not current year profits, would not of itself indicate that the dividend should be recognised as capital.

Dividends received from an investee **Investment Company** will usually fall to be recognised as revenue and the fact that they may have been paid out of capital profits by the investee is not of itself sufficient reason to recognise the dividends in capital.

It is normally necessary to consider the facts and circumstances on a case-by-case basis before a conclusion can be reached.

## 37 Returns on shares – fixed amount

Subject to paragraphs 42 and 43 below, where any returns (whether in respect of dividends, redemption, or otherwise) on any share are for a fixed amount (other than the returns on **Zero Dividend Preference Shares** in another **ITC** which are dealt with in Section X below), then those returns should be recognised and accrued on the basis set out in paragraph 41 below.

## 38 Ex-dividend basis

Dividends as set out in paragraph 36 above should normally be recognised on an ex-dividend basis.

**Note:** in the case of a return receivable on a share falling within paragraph 36 above (for example, a dividend or that part of the total return on participating preference shares which represents a proportion of the dividends paid on the relevant shares), the **Investment**

**Company's** right to the income is generally established on the ex-dividend date or, in the absence of a formal ex-dividend date, on the date on which the share is traded ex-dividend.

It is recognised there is a possibility that, subsequent to the ex-dividend date, the shareholders of the investee undertaking may not approve the dividend or, in the case of an interim dividend, that payment will not be made. This possibility is generally considered to be remote, although the **Board** should satisfy itself, particularly with regard to interim dividends, that it is not aware of any circumstances which might lead to any doubt arising, and consequently does not undermine the appropriateness of recognition on the ex-dividend date. Therefore, in the case of a dividend receivable on a share falling within paragraph 36 above, the amount due should be brought into account on the ex-dividend date or, in the absence of an ex-dividend date, on the date on which the **Investment Company's** right to the dividend is established. In some cases, the **Investment Company's** right to the income may not be established until the income is actually received by the **Investment Company**. Where this is the case, it is appropriate that the income is brought into account on the date of receipt.

### 39 Returns on debt securities – fixed amount

Subject to paragraphs 42 and 43 below, where any returns (whether in respect of interest, redemption, or otherwise) on a debt security are for a fixed amount, then those returns should be recognised as revenue or capital, depending on their nature, and accrued on the basis set out in paragraph 41 below.

### 40 Returns on debt securities – non-fixed amount

Subject to paragraphs 42 and 43 below, a return (whether in respect of interest, redemption, or otherwise) on a debt security other than a return falling within paragraph 39 above, should be recognised as revenue or capital, depending on its nature, and accrued when the **Investment Company's** right to the return is established.

**Note:** see paragraph 41 below for the principles to be applied in determining returns.

## 41 Returns on shares for a fixed amount and debt securities

The calculation of the revenue return on shares for a fixed amount and debt securities should be based on the coupon payable by the instrument adjusted to spread any premium or discount on purchase or redemption over its remaining life.

However, if necessary, the return should be adjusted so that the amount recognised in revenue is in line with reasonable commercial expectations. Any adjustment should be recognised in capital within net gains and losses on investments.

**Note:** determining the appropriate revenue return that should be recognised for shares for a fixed amount or debt securities can be problematic. The **Effective Interest Method** is a method for allocating interest income over the life of an instrument based on the **Effective Interest Rate**. However, this was not designed as a way of identifying revenue returns in the context of an **Investment Company**. That said, the principles underlying the **Effective Interest Method** so as to reflect the **Effective Interest Rate** should be utilised by **Investment Companies** in calculating revenue returns, unless the resultant return is not in line with reasonable commercial expectations. In these circumstances, the calculation of the amount to be recognised in revenue should be adjusted to take into account such expectations.

An example of when such an adjustment might be required is when a redemption premium is designed to protect the value of the instrument holder's investment in the company rather than reflect a commercial rate of revenue return.

Where a distressed security is purchased, the purchase cost reflects incurred credit losses which should be taken into account in calculating the return. Again, the amount recognised in revenue should reflect reasonable commercial expectations.

The return on the instrument may be non-fixed, linked to, for example, interest base rates, the RPI, or other indexes. Clearly, where this is the case it will only be possible to calculate the **Investment Company's** return when returns from the instrument are known, and the **Investment Company's** return may change when such variables change.

Where the circumstances of the instrument change so that the original assumptions underlying the return calculations are no longer valid, an appropriate adjustment should be made so that the future returns reflect the change.

It is important that **Investment Companies** do not recognise in revenue any element of a return which is capital in nature (and should therefore be reflected in capital) and vice versa. Comparing the revenue element of the return with reasonable commercial expectations may help highlight issues. However, careful consideration of the circumstances and commercial substance of the terms of an instrument should be made before any part of the return on it is recognised in capital. As such instruments are expected to be measured at **Fair Value** (see paragraph 25 above), the return (both revenue and capital if any) should be consistent with the valuation basis. It is expected that any return recognised in capital would be disclosed within net gains and losses on investments.

An **Investment Company** should provide details in the notes to the financial statements of its accounting policies relating to the recognition of returns on shares for a fixed amount and debt securities including the basis for determining reasonable commercial expectations if relevant.

Revenue recognition where there is doubt over receipt is dealt with in paragraphs 42 and 43 below.

## 42 Doubt over income – prior to recognition

Where, immediately before recognition is due, it is not considered probable that a return will actually be received by the **Investment Company**, the recognition of the return should be deferred until the doubt is removed.

**Note:** see paragraph 23.28 of **FRS 102**.

## 43 Impaired income – after recognition

Where, subsequent to the recognition of an amount of income, it becomes clear that payment will not be received or the collectability becomes doubtful, an impairment

provision to reduce the value of the asset to the recoverable amount should be made.

The provision should be recognised as an expense, rather than as an adjustment of the amount of income originally recognised.

**Note:** paragraph 27.5 onwards of **FRS 102** deal with the principles to be applied relating to impairment.

## 44 Scrip dividends

Where an **Investment Company** has elected to receive its dividend in the form of shares rather than in cash, the amount of the cash dividend foregone should be recognised as income and shown in the revenue column of the Income Statement. Any excess in the value of the shares received over the amount of the cash dividend foregone should be recognised as capital and shown in the capital column of the Income Statement.

**Note: Investment Companies** may have the opportunity to elect to receive their dividends in the form of additional shares rather than in cash. The share equivalent is sometimes referred to as a **Scrip Dividend** and consists of shares fully paid-up out of the paying company's reserves. Sometimes, in order to give the shareholders an incentive to elect to take the shares rather than the cash dividend, **Enhanced Scrip Dividends** are offered. The question arises as to whether, for accounting purposes, the receipt in the form of shares comprises a capital or a revenue item.

In the case of **Scrip Dividends** which are not **Enhanced Scrip Dividends**, in substance the receipt of shares is regarded as the receipt of cash dividends with a simultaneous reinvestment of the proceeds in an issue of new shares. Therefore, the book cost of investments is debited and income credited with the amount of the cash dividend.

In the case of **Enhanced Scrip Dividends**, the enhanced element has the substance of a bonus issue of shares and is therefore capital in nature; only the amount equivalent to the cash dividend is of a revenue nature.

## 45 Fees and commissions earned

The following principles should be applied in determining the revenue recognition basis of different types of fees and commissions:

- a) fees which are an integral part of a financial instrument should be recognised in the calculation of the return on the instrument;
- b) fees earned for services provided should be recognised as the services are provided. However, where the service provided is, in substance, an intrinsic part of an intention to acquire or dispose of an **Investment**, fees should be recognised as capital and shown in the capital column of the Income Statement;
- c) fees which are dependent on the occurrence of a significant act or event should be recognised only when the significant act or event has occurred;
- d) underwriting commission should generally be recognised as revenue, and shown in the revenue column of the Income Statement when the issue underwritten closes. Where, however, the **Investment Company** is required to take up all of the shares underwritten, the commission received in respect of the underwriting commitment should be recognised as capital and shown in the capital column of the Income Statement. Where the **Investment Company** is required to take up a proportion of the shares underwritten, the same proportion of the commission received should be recognised as capital, with the balance recognised as revenue (underwriting is considered further in Section XV below);
- e) **Stock Lending** fees should be recognised as revenue and shown in the revenue column of the Income Statement evenly on a time- apportionment basis. Since the fees are generally based on interest calculated on the market value of the securities on loan, such fees should be recognised on the same basis as interest income (**Stock Lending** is dealt with in Section XIII below); and
- f) changes in the fair value of a written option should normally be recognised as revenue and shown in the revenue column of the Income Statement. Where, however, it can be demonstrated that there is a clear connection between the writing

of the option and the maintenance or enhancement of the **Investment Company's Investments**, then the change in fair value should be recognised as capital and shown in the capital column of the Income Statement.

**Note:** paragraph 23A.21A of **FRS 102** deals with the recognition of financial services fees.

With regards to options, an **Investment Company** may wish to write options for different purposes. It may believe that it can extract additional value by writing options and receiving premiums in the expectation that the options will either not be exercised or, in overall terms, any losses that may arise following exercise will be outweighed by the value of the premiums received. In such cases, the premiums are considered to be revenue in nature, as the primary purpose behind the writing of the option is to receive the premium. As any losses arising from the exercise of an option are likely to be capital in nature, the **Board** should consider carefully whether disclosures under paragraph 46 below are required.

As the exercise of an option will normally result in a loss in value to the **Investment Company** (either by being required to dispose of **Investments** at below their market value or by being required to acquire **Investments** at above market value), it may appear that the writing of an option cannot be connected with the maintenance and enhancement of the **Investment Company's Investments**. However, in some cases, an option may be written for this purpose.

For example, an **Investment Company** may have a significant holding in a relatively illiquid investment. It may have decided that, as the holding has reached a certain value, it would like to dispose of that holding. However, due to its size and illiquidity, the **Investment Company** believes that there may be difficulties in realising the holding at this price through the market place. Writing an option may therefore result in the disposal of the holding at a more attractive price than would have been possible had the **Investment Company** simply sold through the market. In such cases, whilst the **Investment Company** will naturally still seek to maximise the value of the option premium received, the premium is an incidental part of a larger capital transaction and is being written with the aim of it being exercised. The premium should therefore be treated as a capital receipt.

The premium on the option (as with written options generally) is likely to be treated as the option's initial fair value, with changes in its fair value being reflected in the total column of

the Income Statement at each reporting date. However, where it falls to be recognised as revenue, an amount of the premium such that the total is recognised evenly over its life should be shown in the revenue column of the Income Statement with the appropriate amount shown in the capital column of the Income Statement which results in the total amount shown being the overall change in the fair value of the option. Where the option is exercised any balance remaining should be recognised immediately in the revenue column with a corresponding adjustment in the capital column.

## 46 Transactions having a material effect on income

Where there is a reasonable expectation that a transaction, or series of transactions, will increase an **Investment Company's** revenue at the expense of capital (or vice versa) by a material amount, the **Investment Company** should disclose in its **Financial Statements**, in aggregate and for each material transaction, the following:

- a) a description of the transaction;
- b) the revenue from the transaction; and
- c) the capital profit or loss on the transaction.

**Note:** the net revenue of an **Investment Company** can be affected by the purchase or sale of dividend income; that is the practice of buying securities cum-dividend and selling ex-dividend (or vice versa) shortly thereafter. It follows that where, for example, there is a pattern of buying securities cum-dividend (or special cum) and selling ex-dividend (or special ex) (or vice versa) or there have been sales of **Investments** within one month of purchase, the relevant amount of revenue lost or gained should be disclosed in the notes to the accounts. As a further example, an **Investment Company** may increase its revenue at the expense of capital by writing option contracts with a 'low' exercise price and other transactions, having similar consequences, may be equally possible. In order for a user of the **Financial Statements** to appreciate the impact on revenue and capital it is appropriate that disclosure is made.

## (VIII) FINANCE COSTS AND EXPENSES

### a) General (including direct costs)

#### 47 Introduction

The **Board** should determine whether capital profits should reflect the indirect costs as well as the direct costs incurred in generating capital gains.

The approach selected should be applied consistently and encompass all expenses, i.e. an **Investment Company** should not reflect in its capital profits allocable indirect **Finance Costs** but exclude allocable indirect expenses or vice versa, except where expressly provided by the **SORP**.

Where an **Investment Company** invests in **Investment Funds** and the costs incurred by those **Investment Funds** are not included in the various expense disclosures made by the **Investment Company** that fact should be stated.

**Note:** as stated in paragraph 12 above, **Investment Companies** should provide a revenue column and a capital column prepared in accordance with the **SORP** on the face of the Income Statement. It follows that the concept of 'capital profits' is central to the recommendation, although there is no formal definition as to what a capital profit is.

It is accepted that the term capital profits means 'net capital profits'. In other words, expenses can be taken into account in determining the amount of capital profits before those profits are carried to capital reserve. The question then arises as to what expenses may legitimately be taken into account in arriving at capital profits.

Given the lack of an explicit definition of capital profits, it is appropriate to look to generally accepted accounting principles to assist in determining the basis on which capital profits might be calculated. However, the concept of capital profits (as distinct from revaluation surpluses) is not widely used in financial reporting, and there are therefore few generally accepted principles for their determination.

Generally, without regard to the special circumstances of **Investment Companies**, capital profits relate to the disposal of fixed assets - that is assets intended for continuing use in the business - or otherwise relate to a capital transaction; and such transactions are regarded as separate from the operating activities of the company. Capital profits are calculated on a transaction by transaction basis, by deducting the cost of the asset involved from the sales proceeds, with only the direct costs of the transaction being taken into account.

Indirect or time-related costs are generally taken into account only where they can be regarded as forming part of the production cost of the asset; for example, interest costs included as part of the cost of a development property held as a fixed asset (Section 25 of **FRS 102** deals with borrowing costs). Company law (paragraph 27 (3), Part 2, Schedule 1 **Accounts and Reports Regulations**) permits, but does not require, the inclusion of overheads and interest on capital borrowed to finance the production of an asset, but only to the extent that they relate to the period of production.

The general accounting approach to determining capital profits is therefore based on a transactional approach. Capital profits are amounts excluded from operating profits for some particular reason because they result from a special type of transaction, rather than regarded as being earned from the business operations of the company. Indirect costs are incurred in carrying on the business of the company. They are not as such related to the capital transaction and are, therefore, not deducted in arriving at the capital profit. Furthermore, indirect costs are incurred irrespective of whether capital profits are made (and irrespective of whether capital transactions occur) and are therefore not attributed to capital.

For an **Investment Company**, the rationale underpinning the general accounting approach to determining capital profits differs in certain respects - the achievement of capital gains on **Investments** is not a special type of transaction but a central business objective of an **Investment Company**; and indirect costs such as **Finance Costs** and **Investment Management Fees** are incurred not irrespective of whether capital profits are made or whether capital transactions occur but in pursuit of the **Investment Company's** strategic investment objectives, which include the achievement of capital gains.

Therefore, one approach to determining capital profits recognises that an **Investment Company** has two principal business objectives - the maintenance or enhancement of the value of its Investments and the generation of income from its **Investments** - and that certain indirect costs are incurred in furtherance of both objectives. Under this approach, in determining capital profits, capital gains are matched with the costs incurred in earning those capital gains and it is therefore appropriate to allocate such indirect costs between capital (i.e. those costs incurred to maintain or enhance the value of the **Investments**) and revenue ('the allocation approach').

Under the allocation approach, and following on from the overriding consideration that costs can be allocated to capital only where they have been incurred to maintain or enhance the value of the **Investments** of the **Investment Company**, the question arises as to the basis on which indirect costs should be allocated between capital and revenue, in order to determine capital profits and revenue profits respectively. The recommended bases for **Finance Costs, Investment Management Fees** and other expenses are set out in the following pages.

Another approach to determining capital profits for an **Investment Company** is to apply the general accounting basis described above and charge all indirect costs to revenue ('the non-allocation approach').

The **Board** should decide which of the two approaches to determining capital profits it believes to be the more appropriate and then apply the relevant recommended practices set out below in respect of **Finance Costs, Investment Management Fees** and other expenses.

The decision to allocate or not is for the **Board** to determine and an analysis of all the relevant factors that should be considered in reaching this decision is beyond the scope of this **SORP**. However, once the decision to allocate has been taken, the basis should be as set out in the **SORP**. The allocation approach adopted should be applied consistently from one period to the next. It therefore follows that a change to the approach should only be made following careful consideration of the factors involved.

Neither the initial decision to allocate nor subsequent changes to the allocation approach or the basis of allocation are considered to be matters of accounting policy (see paragraph 11 above).

An **Investment Company** may invest in **Investment Funds**. Where this is the case, it is not a requirement for the **Investment Company** to include in its own cost disclosures, on a 'look through' or any other basis, all or part of any costs incurred by the funds. However, its own cost disclosures, for example those required by paragraph 49 below, should, where relevant, state that they do not include costs incurred by the funds. It should be noted that, where it applies, the disclosure set out in paragraph 61(c) below is still required to be made.

## 48 Changing the basis of allocation

The basis of allocation should only be altered following a fundamental change in the assumptions made. The allocation should not be altered for short-term fluctuations in market conditions.

**Note:** the **Board** should review on a regular basis the assumptions underpinning the basis of allocation. It is not appropriate to change the assumptions for short-term fluctuations in, for example, market conditions or portfolio mix unless the **Board** is of the view that the fluctuations represent permanent features or changes in long-term trends of such significance that the current basis of allocation, for example the previously expected long-term split of returns in the form of capital gains and income from the entire investment portfolio, can no longer be justified. Consequently, it is anticipated that a change to the basis of allocation following such a review will be an infrequent event.

An alteration to the basis of allocation is not considered to be a matter of accounting policy (see paragraph 11 above).

## 49 Expenses incidental to purchase or sale

The total of expenses incurred in acquiring or disposing of **Investments** categorised as at fair value through profit or loss in the reporting period, showing total amounts related to acquisitions and disposals separately, should be disclosed by way of a note to the

accounts.

**Note:** certain expenses, such as brokerage fees and stamp duty, are incurred as part of the process of buying and selling **Investments** and, for **Investment Companies**, it is considered that such expenses are capital in nature. The total of such expenses, showing separately the total amount related to acquisitions, the total amount related to disposals and the overall total, should be disclosed by way of a note to the accounts.

Where an **Investment** has been categorised as at fair value through profit or loss, any difference between its cost (excluding expenses incurred) and its initial fair value is not considered to be an incidental expense.

An **Investment Company** may also, for example, incur professional fees as part of the **Investment** acquisition or disposal process. Providing such types of fee are incidental to the transaction, it is appropriate for them to be disclosed as described above. Where such incidental expenses have been incurred but the transaction not proceeded with, this does not alter the nature of the expense which should still be allocated to capital.

## 50 Performance fees – split between capital and revenue

That part of a **Performance Fee** directly attributable to the capital performance of the **Investments** of an **Investment Company** should be allocated to capital and shown in the capital column of the Income Statement. That part directly attributable to the revenue performance of the **Investment Company** should be allocated to revenue and shown in the revenue column of the Income Statement. Any balance remaining should be allocated between capital and revenue and shown in the capital and/or revenue column of the Income Statement as appropriate.

**Note:** a **Performance Fee** can be structured in many ways and new variations are being continually developed. It is therefore impossible for the **SORP** to cater specifically for every type of **Performance Fee** that has already been established or could be in the future. As a result, only a general recommendation can be made.

**Performance Fees** arise only if the **Investment Company** outperforms or achieves some stated benchmark or target. It follows that **Performance Fees** are a special case and, unlike **Investment Management Fees** (excluding any **Performance Fee** element) which are dealt with in paragraph 58 below, are considered to be a direct expense of an **Investment Company** generating its capital gains or revenue. The split between the two depends on the terms of the agreement and the relative performance of the component parts on which the fee is based.

For a **Performance Fee** which consists of different component parts, it is necessary, where possible, to analyse the amount paid or to be accrued between that attributable to the capital outperformance of the **Investment Company's Investments** and other factors.

That part of the fee which relates to the capital outperformance of the **Investment Company's Investments** should be charged to capital, with that part relating to revenue outperformance being charged to revenue. Any balance of the fee should be charged between capital and revenue as determined by the **Board** based on the guidance set out below.

In line with principles already established, it is considered that a **Performance Fee** should only be allocated to capital to the extent that it can be clearly demonstrated that the expense relates to the capital outperformance of the **Investment Company's Investments**. The capital and revenue elements can often be precisely determined by reference to the contract and the actual performance of the **Investment Company**, although on occasions assumptions have to be made.

If the **Performance Fee** is payable solely by reference to the capital performance of an **Investment Company's Investments**, for example, it is considered appropriate for the whole of it to be charged to capital. A **Performance Fee** payable by reference to the combined revenue and capital return, on the other hand, would require a careful assessment of the extent to which the incurrence of the **Performance Fee** could reasonably be said to relate to capital outperformance of the **Investments**. For example, if the relative return from the revenue component is immaterial in the overall context of the **Performance Fee**, perhaps because the revenue component has underperformed or only marginally outperformed then, on the grounds that the **Performance Fee** will have arisen

wholly or predominately by virtue of the capital performance of the **Investments**, the whole of the **Performance Fee** should be allocated to capital.

Full disclosure should be made of the allocation and the basis of allocation.

## 51 Performance fees – recognition

**Performance Fees** should be recognised applying the provisions of Section 21 of **FRS 102** and ensuring that, as far as possible, the recognition of the fee is matched to the changes in the component parts on which the fee is based.

**Note:** **Performance Fees** can be significant; it is important that **Investment Companies** do not overstate or understate their NAVs by, for example, recognising changes in the value of their assets, but not recognising the consequential impact of those changes on the quantum of the **Performance Fee**.

**Boards** need to take into account the requirements of Section 21 of **FRS 102** in determining whether the **Investment Company** should provide for any estimated **Performance Fee** liability at the balance sheet date. The **Performance Fee** will be the subject of a contractual obligation of the **Investment Company**, and its terms and conditions, including the calculation basis, will be precisely defined. In terms of **FRS 102**, the contractual establishment of the **Performance Fee** is considered to be the past event that gives rise to a present obligation that will probably require a transfer of economic benefits in settlement. Only the amount payable is uncertain and **FRS 102** requires the amount recognised as a provision to be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

**Boards** therefore need to consider the terms of the **Performance Fee** and compare them with the relevant performance of the **Investment Company** up to the balance sheet date. Where the relevant performance of the **Investment Company** has met the criteria of the **Performance Fee**, albeit that future circumstances may dictate that no **Performance Fee** is ultimately due, **Boards** need to determine the amount to be provided (using reasonable assumptions where necessary). For example, where an **Investment Company** is one year into a three-year **Performance Fee** contract, one way to determine the liability at the balance sheet date is to assume that the **Investment Company's Investments** perform in

line with its benchmark over the following two years. Using that assumption, it is possible to calculate the **Performance Fee** to be recognised. At the end of the second year the process would be repeated except that the **Board** would then be looking at two years of actual performance.

It is possible that the calculations at any specific date could result in the reduction of an amount previously provided or, in certain circumstances, even a payment being due to the **Investment Company**.

Disclosures in the **Financial Statements** relating to the **Performance Fee** provision should be made in accordance with the relevant requirements of paragraph 21.14 of **FRS 102**.

## b) Finance Costs

### 52 Finance costs of share capital classified as a liability

Dividends on share capital issued by an **Investment Company** which is classified as a liability should normally be recognised as an expense and shown in the revenue column of the Income Statement where the dividend has been paid out of revenue profits. Where the dividend has been paid out of capital profits it should be shown in the capital column of the Income Statement. **Finance costs**, excluding dividends, of share capital issued by an **Investment Company** which is classified as a liability, with the exception of **ZDPS** issued by an **ITC** dealt with in paragraph 53 below, should normally be recognised as an expense and shown in the capital column of the Income Statement.

**Note:** as described in paragraph 20 above, some classes of share capital issued by an **Investment Company** might fall to be classified as liabilities. In such circumstances, although the **Finance Costs** to be reflected in the total column of the Income Statement will be determined by the requirements set out in Sections 11 and 12 of **FRS 102**, the question arises as to the proportion of **Finance Costs**, if any, that should be allocated to capital.

The dividend element of the return is usually designed to be revenue in nature and paid out of revenue profits. However, **Investment Companies** may, as they are permitted to do, on occasion pay dividends out of capital profits. It follows that the dividend element of the **Finance Cost** should normally be recognised as an expense and shown in the revenue column of the Income Statement unless the dividend has been paid out of capital profits in which case it should be shown in the capital column of the Income Statement.

The capital return element, for example the difference between the issue price and redemption value, is designed to be capital in nature, and payment of the pre-determined amount is dependent on and determined by the capital performance of the **Investments** of the issuing **Investment Company**. It follows that this element of the **Finance Cost** should be allocated to capital.

## 53 Finance costs of zero dividend preference shares

The **Finance Costs** of **ZDPS** issued by an **ITC** should normally be recognised as an expense and shown in the capital column of the Income Statement.

**Note:** whilst a **ZDPS** is theoretically capable of being classified as either a liability or as an equity instrument, it is expected that the majority issued by **ITCs** will be classified as liabilities. In such circumstances, the question arises as to the proportion of **Finance Costs** that should be allocated to capital. The arguments are similar to those set out in the explanatory note to paragraph 70 below in respect of an **ITC** holding **ZDPS**. The return is designed to be capital in nature, and payment of the pre-determined amount is dependent on and determined by the capital performance of the **Investments** of the issuing **ITC**. It follows that all of the **Finance Costs** should be allocated to capital. This treatment also matches the recommendation set out in paragraph 70 below in respect of an **ITC** holding **ZDPS**. The recommendation applies equally to **ZDPS** issued by a company which is a subsidiary of an **ITC**.

## 54 Finance costs of debt – basis of allocation to capital

If the **Board** decides that capital profits should reflect indirect costs as well as direct costs incurred in generating capital gains, then the **Finance Costs** of debt, insofar as they relate to the financing of **Investments** of the **Investment Company** or to financing activities aimed at maintaining or enhancing the value of **Investments** of the **Investment Company**, and insofar as the debt does not meet the **Hedge Accounting** criteria (refer to Section XII below), should be allocated between capital and revenue.

Such costs should be allocated between capital and revenue in accordance with the **Board's** expected long-term split of returns, in the form of capital gains and income respectively, from the relevant **Investments** of the **Investment Company**. It should generally be assumed that the relevant **Investments** are those comprising the entire investment portfolio of the **Investment Company**. Where, however, it can be demonstrated that there is a continuing specific relationship between a particular **Finance Cost** and the returns or expected returns from a particular part of the investment portfolio, the relevant **Investments** in relation to that particular **Finance Cost** should be taken to be

those comprising that part of the **Investment Company's** portfolio.

**Note:** **ITCs** often seek to take advantage of gearing in order to enhance the returns to their shareholders. The question arises as to whether the associated **Finance Costs** should be charged to capital or revenue or allocated between the two.

In relation to **Finance Costs** of debt, the appropriate accounting treatment is dependent upon which approach to determining capital profits - the allocation approach or the non-allocation approach (see paragraph 47 above) - the **Board** believes to be appropriate.

In assessing its expected long-term split of returns the **Board** should take into account the factors set out in the explanatory note to paragraph 58 below. In addition, it should take into account the following factors:

- a) the purpose of the borrowing. The allocation of **Finance Costs** should be based on the characteristics of the relevant **Investments**; and
- b) the term of the borrowing. The basis of allocation of **Finance Costs** should reflect the **Board's** expected split of returns from the relevant **Investments** over the period of the borrowing.

Some **ITCs**, in order to avoid paying early repayment penalties, choose not to repay outstanding loans that are no longer required for investment purposes, but rather maintain a balance in cash or bonds to offset the loan. In some cases, this offset can be part of a formal arrangement with the loan provider in order to maintain loan covenant ratios.

Providing the purpose of the cash or bond portfolio is to act as a loan offset until the loan matures or other events force repayment, then the part of the loan represented by the offset can be considered to have a continuing specific relationship with the cash or bond portfolio. It follows that the **Finance Cost** of that part of the loan can be allocated between capital and revenue in accordance with the **Board's** expected split of returns in the form of capital gains and income respectively from the cash or bond portfolio.

Where a **Board** has determined that the **Finance Costs** relate to a specific part of the investment portfolio, it is important to consider the impact on the expected long-term split of

returns of changes (e.g. sales or purchases) to that specific portfolio and how such changes should be reflected in the allocable amount.

## 55 Gains and losses following repurchase or early settlement of debt

Gains and losses on the repurchase or early settlement of debt should be recognised as capital and shown in the capital column of the Income Statement.

**Note:** it can be the case that a loan and a derivative contract, such as an interest rate swap, are so inextricably linked that, in economic terms, the combination of the two instruments is equivalent to a single debt. In such cases the gain or loss arising from the early repayment or redemption of both instruments should be dealt with in accordance with the recommendation set out above.

Given the multiple different finance arrangements available, **Boards** should consider seeking advice where they have any concerns that their circumstances are such that they might render the general recommendation of the **SORP** inapplicable.

## 56 Disclosure of accounting treatment re finance costs

Full disclosure should be made of the accounting treatment adopted in respect of **Finance Costs** including, where relevant, the basis of allocation.

## 57 Accounting for finance costs where no allocation made

If the **Board** decides that capital profits should not reflect indirect costs, then the **Finance Costs** of debt should be charged wholly to revenue, unless the debt meets the **Hedge Accounting** criteria (refer to Section XII below).

**Note:** the recommended treatment regarding gains and losses following the repurchase or early settlement of debt (see paragraph 55 above) applies even in the circumstances where capital profits do not reflect indirect costs.

## c) Investment Management Fees

### 58 Investment management fees – basis of allocation

If the **Board** decides that capital profits should reflect the indirect costs (i.e. those not falling within paragraphs 49 or 50 above) incurred in generating capital gains then, unless an **Investment Company** has two or more separate and distinct portfolios, each with a different management fee arrangement, **Investment Management Fees** (excluding any **Performance Fee** element which is dealt with in paragraph 50 above) should be allocated between capital and revenue in accordance with the **Board's** expected long-term split of returns, in the form of capital gains and income respectively, from the entire investment portfolio of the **Investment Company**. Where such separate portfolios exist, then fees under each different management fee arrangement (excluding any **Performance Fee** element) should be allocated between capital and revenue in accordance with the **Board's** expected long-term split of returns, in the form of capital gains and income respectively, from the separate investment portfolios.

***Note:** except where an **Investment Company** has two or more separate and distinct portfolios, **Investment Management Fees** (excluding any **Performance Fee** element) are recommended to be allocated between capital and revenue based on the **Board's** expected long-term split of returns, in the form of capital gains and income respectively, from the entire investment portfolio of the **Investment Company**. This basis of allocation is considered appropriate because:*

- a) it is consistent with the principle that returns and costs should be matched with one another so far as their relationship can be established or justifiably assumed. In this case, as the profits arising on the sale or revaluation of **Investments** will be taken to capital, it follows that expenses which have been incurred to maintain or enhance the value of those **Investments** may be allocated to capital;
- b) it recognises that the indirect costs are incurred with a view to enhancing future returns, which may not be expected to follow the historical pattern of returns; and
- c) it recognises the commercial principle that an **Investment Company** would generally not incur such costs unless the benefits were expected to exceed the

costs; and applies this commercial principle also to the respective sources of benefit.

In assessing its expected long-term split of returns, the **Board** may wish to take account of various different factors, including:

- a) the nature of the overall return and its split between capital and revenue;
- b) the objectives of the **Investment Company**; and
- c) current, historical and prospective yields.

For those **Investment Companies** which have two or more separate and distinct investment portfolios, each with its own management fee arrangement, it is recommended that the allocation between capital and revenue of the separate management fees be based on the **Board's** expected long-term split of returns, in the form of capital gains and income respectively, from each separate investment portfolio.

## 59 Disclosure of accounting treatment re management fees

Full disclosure should be made of the accounting treatment adopted in respect of **Investment Management Fees** including, where relevant, the basis (or bases) of allocation.

## 60 Accounting for management fees where no allocation made

If the **Board** decides that capital profits should not reflect indirect costs, then all **Investment Management Fees** (excluding **Performance Fees**) should be charged to revenue.

## 61 Disclosure of the terms of the investment management contract and income received by the manager derived from its relationship with the investment company it manages

Where the **Board** has delegated the investment management function to a separate management company ('Manager') there should be clear disclosure of the terms of the investment management contract and other financial benefits the Manager receives which are derived from the relationship. In addition to the disclosure required by the **Listing Rules** (refer to explanatory note below), the **Investment Company's** disclosure should include:

- a) the split of the total expense for the accounting period between **Investment Management Fees, Performance Fees** and other fees and expenses;
- b) details of other fees and expenses paid or payable to the Manager by the **Investment Company** in respect of the accounting period, insofar as they are material;
- c) if the **Investment Company** invests in other **Investment Funds** which are managed or advised by the Manager, or by another member of the group of which the Manager is a member, whether any arrangement is in place to avoid the double charging of fees and expenses;
- d) if at any time during the accounting period a director of the **Investment Company** was also a director of the Manager or of another member of the group of which the Manager is a member, that fact; and
- e) any other financial benefits that the Manager receives which are derived from its relationship with the **Investment Company**.

**Note:** it is important that full disclosure is made by the **Investment Company** of fees, expenses and other income received by the Manager. This includes amounts paid directly by the **Investment Company** to the Manager or paid by a third party to the Manager but derived from the Manager's relationship with the company. Such disclosures should also

include any indirect benefits the Manager receives. In addition to the amount, the disclosure should include a description of the nature of the service performed by the Manager or the benefit received.

For example, where the Manager receives fees directly from investee companies of the **Investment Company**, for example where its staff sits on the board of an investee company of the company, or where the Manager earns commission, for example for arranging **Stock Lending** in relation to the company's investments or acting as a promoter to a fundraising, these should be disclosed.

The disclosures required by the **Listing Rules** are set out in chapter 15 paragraph 15.6.2.

## 62 Investment manager as a related party

Where, in accordance with the criteria set out in Section 33 of **FRS 102**, an **Investment Company** and its separate management company are related parties, then the disclosures required by **FRS 102** should be made.

**Note:** the **Listing Rules** (chapter 15 paragraphs 15.2.11 and 15.2.12A) require that the board of directors of an investment company must be able to act independently of any investment manager appointed to manage its investments. In complying with this, a majority of the board must not be directors, employees, partners, officers or professional advisers of or to the investment manager or any other company in the same group as the investment manager. Additionally, a majority of the board must not be directors, employees or professional advisers of or to other investment companies or funds that are managed by the same investment manager (or any other company in the same group as the investment manager) as the investment company. The existence of an independent board demonstrates that the **Investment Company** is free to pursue its own financial and operating policies.

**FRS 102**, Section 33, defines a related party and sets out the required disclosures in the event that a related party relationship exists. In terms of an **Investment Company** and its separate management company, it is considered that it would be rare for the management company to be a related party as defined in **FRS 102**. In practice, only if the manager itself is controlled by a person who has control, significant influence or is a member of key

management personnel of the **Investment Company** will such a related party relationship exist.

The disclosures set out in paragraph 61 above should be provided but not, unless the manager is a related party to the investment company as defined by **FRS 102**, in a way which either states or implies that a related party relationship exists. In particular, the heading to the disclosures should avoid the use of the term 'related party'.

It should be noted that, although paragraph 15.5.4 of the **Listing Rules** states that any manager of a closed-ended fund is a related party, this is not relevant for an **Investment Company's Financial Statements** which should be prepared in accordance with the requirements set out in UK law and **UK Financial Reporting Standards**.

## d) Other Expenses

### 63 Expenses – basis of allocation to capital

If the **Board** decides that capital profits should reflect the indirect costs (i.e. those not falling within paragraphs 49 and 50 above) incurred in generating capital gains, then expenses (excluding **Investment Management Fees** and issue costs) should be charged to capital (in whole or in part), and shown in the capital column of the Income Statement, only to the extent that a clear connection with the maintenance or enhancement of the value of the **Investments** of the **Investment Company** can be demonstrated.

**Note:** this criterion would normally preclude such expenses as administration costs, secretarial costs and custody and depositary fees from being charged to capital. While these costs may be necessarily incurred in running an **Investment Company**, and the **Investment Company** will have the maintenance or enhancement of the value of its **Investments** as a principal objective, the connection between these costs and the maintenance or enhancement of the value of the **Investments** is not considered sufficiently clear or direct to justify them being charged to capital.

With regard to expenses such as those incurred by an **Investment Company** in making or defending a bid, or in a reconstruction or reorganisation, it may appear that they should naturally be shown in the capital column of the Income Statement and be reflected in capital reserves. However, an **Investment Company's** capital reserve is primarily a reserve for reflecting the profits arising on the revaluation or sale of its **Investments**, and it follows that such expenses should not be taken to capital automatically. However, providing the **Board** can demonstrate that the expense was incurred, wholly or partly, in connection with the maintenance or enhancement of the value of the **Investments**, then such costs (or a proportion thereof) can properly be allocated to capital. In particular, where an **Investment Company** is approaching a wind-up (see paragraph 9 above re going concern considerations) and a provision for liquidation expenses (including perhaps costs relating to an associated reconstruction) has been made, the **Board** needs to consider why those expenses have been/are going to be incurred and whether the circumstances meet the maintenance or enhancement test for allocating them to capital. It may also be the case that certain of the costs should be treated as being related to the disposal of the **Investment Company's** assets (see paragraph 49 above).

The basis of allocation of such expenses could include the expected long-term split of returns, in the form of capital gains and income respectively, from the entire investment portfolio of the **Investment Company**, but might also, for different types of expenses, reflect time spent or a combination of bases.

Costs associated with the issue or repurchase of shares classified as equity are considered to be integral to a transaction with owners of the **Investment Company** and should be taken into account in determining the net proceeds that are reported in the statement of changes in equity. Such costs should not be disclosed in the Income Statement.

## 64 Disclosure of accounting treatment re expenses

Full disclosure should be made of the accounting treatment adopted in respect of expenses including, where relevant, the basis (or bases) of allocation.

## 65 Accounting for expenses where no allocation made

If the **Board** decides that capital profits should not reflect indirect costs, then all expenses - other than direct costs (refer to paragraphs 49 and 50 above) and issue costs - should be charged to revenue.

## (IX) TAXATION

### 66 Overseas tax recoverable

Provision should be made against overseas tax recoverable to recognise any shortfall in the recovery position and for the expense of recovering the tax.

**Note:** where an **Investment Company** is invested overseas, it may receive income net of withholding tax and be obliged to recover the withholding tax directly from the overseas tax authorities or within the terms of a double taxation treaty. On entitlement to such an item of income, an **Investment Company** would generally record a receivable in its accounts in respect of the overseas tax recoverable.

Because of particular circumstances prevailing, or because of the expense involved in obtaining recovery, provision should be made as set out in the recommendation above.

### 67 Irrecoverable VAT

Irrecoverable VAT allocable to items disclosed separately in an **Investment Company's Financial Statements** should be included in their cost where practicable and material. Separate disclosure should be made of the irrecoverable VAT element of a particular expense if material.

**Note:** the VAT recovery position of **Investment Companies** will vary, depending on the division of their 'supplies' between those where there is a right to recover and those where there is no such right. In accordance with the provisions of paragraph 29.20 of **FRS 102**, irrecoverable VAT should be disclosed as set out above.

### 68 Allocation of tax relief between capital and revenue

The tax effect of different items of income (or gain) and expenditure (or loss) should be allocated between capital and revenue on the same basis as the particular item to which it relates.

Any tax relief obtained on expenses should be allocated between capital and revenue on the assumption that expenses charged to revenue are matched first against taxable revenue items. Tax relief is only reflected in capital to the extent that 'additional' expenses are utilised from capital to reduce or eliminate the **Investment Company's** tax liability. The amount of tax relief on such expenses should be the amount of corporation tax, or additional corporation tax, that would have been payable were it not for the existence of these 'additional' expenses. This method of allocation is often referred to as the 'marginal basis'.

For taxable capital items the allocation assumption is reversed, and expenses charged to capital are matched first against those items.

**Note:** consistent with the principle that returns and costs should be matched with one another so far as their relationship can be established or justifiably assumed, where an **Investment Company** has allocated or charged expenses to capital, it is necessary to allocate tax relief between revenue and capital.

In most circumstances, capital profits of an **Investment Company** are not subject to corporation tax in the UK as **Investment Companies** are exempt from tax on such gains. For most **Investment Companies** this means that the majority of, if not all, taxable items or amounts will arise in revenue. In such cases, it is considered appropriate that expenses which have been charged or allocated to revenue should be set off against taxable income in priority to expenses which have been charged to capital. It follows that, where revenue expenses exceed taxable income, there will be no allocation of tax relief to capital even where capital expenses exist. It is only when taxable income in the revenue account exceeds expenses charged or allocated to revenue that tax relief should be allocated to capital (with a corresponding charge to revenue).

The quantification of the amount of tax relief obtained should be based on the amount of corporation tax, or additional corporation tax, that would have been paid at corporation tax rates in force during the accounting period, were it not for the existence of the expenses charged to capital. For this purpose, corporation tax is deemed to be the amount payable, if any, after set-off of overseas tax. It must be noted that it is tax relief, and not tax, that is being allocated. Therefore, the fact that the **Investment Company** is not in an overall tax paying position is not, of itself, a reason not to allocate tax relief on expenses.

Where an **Investment Company** is subject to corporation tax on items reflected in capital (e.g. on the disposal of interests in certain offshore funds), expenses charged or allocated to capital would be utilised against such items in priority to expenses charged or allocated to revenue for the purpose of the allocation of tax relief.

The calculation of the allocation of tax relief can be further complicated by the existence of excess management expenses brought forward from previous years.

It is fairly straightforward to track the amount of revenue and capital expenses which are allocated against taxable income on the marginal basis, and thereby to keep a record of the amount of revenue and capital expenses available for offset in future periods. The question, however, arises as to what to do with management expenses brought forward arising in periods before the marginal basis is adopted, which might have been allocated between revenue and capital on a variety of bases.

By examining past records, and by applying reasonable assumptions, an **Investment Company** should be able to establish the amount of excess management expenses brought forward which relates to expenses charged or allocated to revenue and the amount which relates to expenses charged or allocated to capital.

With regard to taxable revenue items, any excess management expenses brought forward that relate to expenses charged or allocated to revenue should be used in priority to either current year expenses charged or allocated to capital or excess management expenses brought forward relating to expenses charged or allocated to capital. The reverse priority is to be applied with regard to taxable capital items.

As this is such a complicated area, the reader should also refer to the Association's separate guidance note on this recommendation (see Appendix A).

## 69 Deferred tax

An **Investment Company** should provide for deferred tax and make such disclosures as required by **FRS 102**.

**Note: Investment Companies** are unique in the sense that they will normally be revaluing their **Investments** to **Fair Value** but such gains and losses will normally be neither taxable or relievable, even on realisation, due to an **Investment Company's** exemption from tax on capital gains as a result of it being approved as an investment trust or venture capital trust. In normal circumstances, an **Investment Company** will obtain exempt status for each successive accounting period and therefore there should be no material deferred tax timing differences arising in respect of the revaluation or disposal of **Investments**.

Notwithstanding this, the reconciliation required by paragraph 29.27 of **FRS 102** (which is to the total tax charge rather than the current tax charge previously required by accounting standards) should be provided in respect of the **Investment Company's** total profits included in its profit and loss account (i.e. generally the total column of the Income Statement – but see paragraph 12 above) for the reporting period. However, a note should be provided explaining that, due to the company's status as an **Investment Company**, and its intention to continue meeting the conditions required to obtain approval in the foreseeable future, the company has not provided deferred tax on any capital gains and losses arising on the revaluation or disposal on **Investments**.

When gains and losses arise which are treated as capital in nature for accounting and legal purposes but are treated as income for tax purposes (e.g. overseas dividends recognised in capital, gains and losses arising on the disposal of interests in certain offshore funds etc) resulting in current or deferred tax charges arising in capital, or current or deferred tax charges or credits arise in capital for some other reason, it is considered that it would be helpful to the user of the accounts to provide an explanation of the circumstances giving rise to this tax charge or credit. For the purpose of assessing whether a disclosure of this nature should be given, no account should be taken of any credit or charge arising under paragraph 68 above.

# (X) ZERO DIVIDEND PREFERENCE SHARES ('ZDPS') IN ANOTHER ITC

## 70 Recognition of return from holding of ZDPS

The return to an **ITC** from a holding of **Zero Dividend Preference Shares** in another **ITC**, including that part of the return which arises through the movement of the market value over time towards the redemption value, should be recognised as a capital return and shown in the capital column of the Income Statement.

**Note:** an **ITC** may hold **ZDPS** in another **ITC**. Such shares are generally issued at a discount to the value at which they will be redeemed in order to compensate the holder for the absence of dividend.

The question arises as to whether the return on such shares, including the premium on redemption, is a capital return, shown in the capital column of the Income Statement, or an income return, shown in the revenue column of the Income Statement, or whether the return is a mixture of both capital and revenue.

The market value of such shares will move over time towards their redemption value but will also reflect a range of other factors, such as the prevailing level of interest rates, the risk attaching to the shares and political factors.

It could be argued that the premium paid on such shares is effectively rolled-up income deferred to redemption and therefore that the return should be recognised through revenue on the accruals basis. However, the return is designed to be capital in nature and the redemption of such shares is generally paid out of the accumulated capital reserves of the **ITCs** that have issued them; the holder of such shares generally having no entitlement to the revenue reserves of the **ITC**. Because the return on such shares is generally dependent on the capital performance of the **ITCs** that have issued them and there is no guarantee that there will be sufficient assets to pay the redemption value on liquidation, it is considered that the whole of the return on such shares is capital in nature.

# (XI) FOREIGN CURRENCY TRANSACTIONS

## 71 Accounting basis

The provisions of Section 30 of **FRS 102** should be applied by **Investment Companies**.

**Note:** where an **Investment Company** enters into transactions which are denominated in a foreign currency, the results of those transactions need to be translated into the currency in which the **Investment Company** reports. Section 30 of **FRS 102** is the principal section dealing with foreign currency translation as it relates to the preparation of financial statements.

Paragraph 30.2 of **FRS 102** states that an entity shall identify its functional currency, which is the currency of the primary economic environment in which it operates, which may be different from its presentational currency, which is the currency in which the financial statements are presented.

Where an **Investment Company** carries out all, or predominately all, of its transactions in a foreign currency, perhaps because it is a 'single country fund', then it will need to determine, in accordance with the provisions of **FRS 102**, whether it should record its transactions, on initial recognition, in that foreign currency i.e. the foreign currency will become its functional currency.

However, in the context of an **Investment Company**, the indicators set out in **FRS 102** will usually be mixed and the functional currency not obvious. Paragraph 30.15 of **FRS 102** states that "*the functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity*". The **Board** should use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

In reaching its conclusion, it is considered that the **Board** should have regard to the currency of the **Investment Company's** investors and its share capital and the currency in which dividends and expenses are generally paid (which will generally determine its

presentational currency). In broad terms, this would mean that the functional currency of the **Investment Company**, given its unique nature, would, other than in very rare circumstances, be the same as its presentational currency.

## 72 Capital or revenue

Foreign exchange differences should be recognised as capital and shown in the capital column of the Income Statement if they are of a capital nature, and recognised as revenue and shown in the revenue column of the Income Statement if they are of a revenue nature.

**Note:** the question arises, in relation to the **Financial Statements** of an **Investment Company**, of whether to recognise a foreign exchange difference, arising through the application of the provisions of Section 30 of **FRS 102**, as a revenue or capital item.

For most transactions the position is clear-cut. Thus, the foreign exchange gain or loss arising on the retranslation of **Investments** which are denominated in a foreign currency is clearly of a capital nature. On the other hand, the exchange gain or loss arising between the date at which a dividend denominated in a foreign currency is recognised in the accounts and the date that the cash is received is clearly of a revenue nature.

For other transactions, the position may be less clear-cut. Where the transaction involves buying or selling a financial instrument it is necessary to determine whether the financial instrument falls within the definition of an **Investment** or meets the **Hedge Accounting** criteria, in order to determine whether changes in its value are of a capital or revenue nature.

## 73 Hedging criteria

Foreign exchange differences arising on transactions which meet the **Hedge Accounting** criteria should be accounted for in accordance with the recommendations set out in Section XII.

## 74 Costs of foreign exchange

Foreign exchange costs, including bank charges and premiums and discounts, should be treated in the same manner as the transactions to which they relate.

## 75 Disclosures

The following should be disclosed in the **Financial Statements**:

- a) the accounting policy in respect of foreign exchange;
- b) foreign exchange gains or losses taken to revenue; and
- c) foreign exchange gains or losses taken to capital.

**Note:** the accounting policy disclosure should include reference to the **Investment Company's** functional currency, including details as to how the **Board** reached its decision.

## (XII) DERIVATIVES AND HEDGING

### 76 Derivatives – treatment of gains or losses and fair value analysis

A derivative transaction should be accounted for in accordance with Section 12 of **FRS 102**.

With regards to the location - capital or revenue - of recognition, gains or losses on derivative transactions should be recognised as capital and shown in the capital column of the Income Statement if they are of a capital nature, recognised as revenue and shown in the revenue column of the Income Statement if they are of a revenue nature or apportioned between capital and revenue if they are of a mixed nature.

For derivatives held at the balance sheet date, a fair value analysis in accordance with the fair value hierarchy levels set out in paragraph 26 above should be provided.

Where the derivative transaction meets the **Hedge Accounting** criteria, it should be dealt with in accordance with the recommendations set out in paragraph 77 below.

**Note: Investment Companies** enter into derivative transactions from time to time. As the range of transactions and situations which may arise in this area are very broad, the **SORP** does not seek to address them all; rather it puts forward principles to be applied.

Whether gains or losses on derivative transactions fall to be treated as capital or revenue will depend on the nature of the transaction. Both the underlying motives of the transaction and its circumstances are considered to be important in determining whether changes in its value are of a capital or revenue nature. Consequently, where, for example, the transaction has been entered into in order to generate or protect capital returns and the circumstances of the transaction support this, then any gains or losses should be recognised as capital and similarly for transactions entered into to generate or protect revenue returns where any gains or losses should be recognised as revenue. In some circumstances gains or losses may have to be apportioned between capital and revenue to

reflect the nature of the transaction. **Boards** should ensure that an appropriate record of the motives and circumstances underlying each transaction is made.

The position with regard to options written by an **Investment Company** is set out in paragraph 45 above and the treatment where **Hedge Accounting** applies is set out in paragraph 77 below. Foreign currency transactions are dealt with in Section XI above.

The disclosure provisions of paragraph 34.22 of **FRS 102** apply to derivatives as much as to investments and other financial instruments held at fair value. It follows that a fair value analysis between the hierarchy levels as set out in paragraph 26 above, should be provided with respect to derivatives held at the balance sheet date. The derivatives fair value analysis can be shown separately or included as part of the analysis of financial instruments generally.

## 77 Hedging – treatment of gains or losses

Where a transaction is subject to **Hedge Accounting** then as regards the location - capital or revenue - of recognition, the gain or loss on the hedging instrument or hedge transaction should be treated consistently with the gain or loss on the position being hedged.

**Note:** the rules relating to **Hedge Accounting**, including the documentation, accounting, effectiveness requirements and disclosure requirements, are set out in Section 12 of **FRS 102**.

## 78 Fees and commissions

Fees and commissions earned by an **Investment Company** on transactions in derivative instruments should be recognised in accordance with the principles set out in paragraph 45 above.

# (XIII) STOCK LENDING ACTIVITIES

## 79 Treatment in financial statements

In accordance with generally accepted accounting principles on reporting the substance of transactions, securities transferred (or 'lent') by an **Investment Company** in a **Stock Lending** transaction should be included in the **Financial Statements** of the **Investment Company** as if they were owned by the **Investment Company**, and, except in the circumstances when it is cash not legally separated from the **Investment Company's** assets, the collateral to which the **Investment Company** has title during the arrangement should be excluded from the **Financial Statements** of the **Investment Company**. Cash collateral not legally separated from the **Investment Company's** assets should be recognised as an asset with a payable due to the borrower being recognised as a liability.

**Note:** **Stock Lending** provides increased liquidity to market makers. Under a **Stock Lending** agreement, an **Investment Company** transfers securities to a counterparty for a fee, in return for which it is agreed that securities of the same kind and amount will be transferred back at a later date. Until the subsequent transfer takes place, the **Investment Company** generally receives collateral in the form of cash or liquid securities marginally in excess of the market value of the securities transferred.

Although legal title to the securities passes from the **Investment Company** during the transaction, the economic benefit remains and, taken as a whole, the arrangement has the substance of a secured loan of the **Investment Company's** securities in return for a fee. During the life of the transaction the **Investment Company** retains the risks and rewards of ownership, since it continues to be exposed to fluctuations in market values and, in addition, it is compensated for any revenue return on the securities while they are on loan. Furthermore, the **Investment Company** is not exposed to any market risks attaching to the collateral and any income received by the **Investment Company** on the collateral is paid to the 'borrower'.

In the circumstances where the collateral is sold or transferred such that the **Investment Company** no longer has title but retains the liability to return the full value, the company is exposed to the market risks attached to the collateral and the impact of this must be included in the **Financial Statements**.

As the ultimate realisation of a financial asset is its conversion into cash, cash collateral which is not legally separated from the **Investment Company's** assets should be recognised as an asset with a payable to the borrower recognised as a liability.

## 80 Disclosure

In order that users of the **Financial Statements** are aware of the extent to which an **Investment Company's** securities are the subject of **Stock Lending** arrangements, disclosure should be made of:

- a) the aggregate value of the securities on loan at the balance sheet date;
- b) the maximum aggregate value of securities on loan at any time during the accounting period;
- c) the nature and value of the collateral held by the **Investment Company** in respect of securities on loan either at the balance sheet date or at any time during the period under review where, in respect of any particular transaction, the value of the collateral is, or was at any time during the period under review, less than the value of the securities lent; and
- d) any fee income derived from **Stock Lending** activities during the period.

# (XIV) SEGMENTAL REPORTING

## 81 Disclosure requirements

Where an **Investment Company** has different operating segments as defined in **IFRS 8**, it should disclose segmental information in accordance with the provisions of **IFRS 8**.

**Note:** paragraph 1.5 of **FRS 102** states that entities with publicly traded debt or equity instruments, which will include **Investment Companies**, shall apply **IFRS 8** (Operating Segments (as adopted in the EU)).

The provisions contained within **IFRS 8** include the reporting of general information regarding each reportable segment and information about profit or loss, assets and liabilities. In addition, **IFRS 8** requires the reporting of information about products and services and geographical areas unless the necessary information is not available and the cost to develop it would be excessive.

An **Investment Company's** investment activity would be expected to constitute an operating segment as defined in **IFRS 8**. Therefore, **Investment Companies** that carry out only investment activity generally have only a single operating segment. **Investment Companies** may, however, carry out activities in addition to their investment activity - for example, the provision of leasing services, fund management services and management services to venture capital investee undertakings etc. If any of these is the case, an **Investment Company** may be required to disclose segmental information in accordance with the provisions of **IFRS 8**.

As stated in paragraph 4 above, with regard to their primary business **Investment Companies** have no customers. It follows that, unless an **Investment Company** carries out activities other than its primary business, references to 'customers' in **IFRS 8** are not applicable.

## 82 Other disclosure requirements

Whether or not **Investment Companies** have different operating segments as defined in **IFRS 8**, they should nevertheless disclose in the **Financial Statements**, unless they are fully described elsewhere in the annual report, the following analyses and information (in addition to those required by the **Listing Rules** and other relevant provisions):

- a) a broad geographical analysis of the undertakings whose securities are held in the portfolio;
- b) an analysis of total income between income from **Investments** and other income; and an analysis of each of these components into material subcomponents; and
- c) a list of all investments held at the balance sheet date with a value greater than 5% of its portfolio and at least the ten largest investments including the value of each investment and, with respect to any **Unquoted Investments** included in the list, the following:
  1. a brief description of its business;
  2. the proportion of capital owned or potentially owned if significantly different;
  3. the cost of the investment and aggregate market value, if any, at the latest practicable date;
  4. total income recognised by the **Investment Company** in the reporting period, including dividends (highlighting any abnormal dividends) and other amounts;
  5. turnover and pre-tax profits for the latest audited financial year; and
  6. net assets attributable to shareholders as at the date of the latest audited balance sheet, distinguishing if appropriate between the net assets attributable to different classes of share.

Where relevant, comparative figures should also be provided.

The analysis and information provided should take into account any separate ring-fenced pools of value that exist.

**Note:** in addition to the disclosures described above, with regard to the **Unquoted Investments** included in the list a **VCT** should provide details of the voting rights attributable to the shares owned, the method of valuation applied and additional brief details of the results and assets and liabilities taken from the investee company's most recent accounts.

**VCTs** should also provide details of any investments made in any company in which other funds managed by the same investment manager have also invested.

**Investment Companies** should also provide an analysis of the investment portfolio between equity shares, convertible securities, fixed income securities and other investments.

The analyses required by the **Listing Rules** are:

- a) a comprehensive and meaningful analysis of its portfolio (15.6.2); and
- b) an analysis of income between dividends, interest and other forms of income (15.6.7).

Where separate ring-fenced pools of value exist (see paragraph 23 above), the analysis and information should be provided with respect to each separate pool as relevant.

Disclosure requirements relating to financial instruments are also set out in **FRS 102** (Sections 11 and 12 and paragraphs 34.17 to 34.33). These include the methods and assumptions used in determining the fair value of each class of financial asset, an analysis for each type of risk to which the **Investment Company** is exposed and hedges as described in Section 12.

The **SORP's** recommendations regarding the fair value hierarchical disclosures required by paragraph 34.22 of **FRS 102** are set out in paragraph 26 above.

# (XV) PROVISIONS, CONTINGENCIES, GUARANTEES AND FINANCIAL COMMITMENTS

## a) Provisions, Contingencies and Guarantees

### 83 Accrued items – capital or revenue

Where the requirements of Section 21 of **FRS 102** dictate that a provision should be made, the charge should be recognised in capital, and shown in the capital column of the Income Statement, if the provision relates to a present obligation which is of a capital nature and in revenue, and shown in the revenue column of the Income Statement, if it is of a revenue nature.

**Note:** as part of its investment activity an **Investment Company** may, for example, enter into arrangements such as **Performance Fees** or the provision of guarantees and comfort letters to third parties.

In addition, an **Investment Company** may enter into similar arrangements as part of its general activities.

The **Board** will need to consider whether, in accordance with the terms of Section 21 of **FRS 102**, such arrangements give rise to an obligation at the reporting date that can be reliably estimated and that probably requires a transfer of economic benefits in settlement, and consequently whether a provision needs to be recognised.

Some such arrangements may also fall within the scope of the financial instruments sections of **FRS 102** and will need to be considered in that context.

**Performance Fees** are dealt with in paragraphs 50 and 51 above.

## 84 Disclosure of items not provided for

In complying with the relevant provisions of the **Companies Act 2006** and **FRS 102**, contingencies and guarantees which have not been provided for should each be classified and disclosed if required.

**Note:** some such arrangements may also fall within the scope of the financial instruments sections of **FRS 102** and will need to be considered in that context.

## b) Financial Commitments

### 85 Disclosure

In complying with the relevant provisions of the **Companies Act 2006** and **FRS 102**, commitments which have not been provided for should each be classified and disclosed if required.

**Note:** in general terms, commitments commonly entered into by **Investment Companies**, such as underwriting the obligations of third parties or the provision of additional funds to investee undertakings such as limited partnerships, will not require to be provided for or disclosed in accordance with the terms of **FRS 102**.

To the extent that such commitments fall within the scope of the financial instruments sections of **FRS 102** (particularly paragraphs 11.8 (c) and 11.14(c)) they will need to be considered in that context.

Funding commitments, as dealt with in paragraphs 34.57 to 34.63 of **FRS 102**, refer to the provision of resources to other entities with no expected financial return e.g. funding a charity. Hence, the investing activities of **Investment Companies** which fall within the scope of Sections 11 and 12 of **FRS 102**, are not funding commitments for which the recognition and disclosure provisions of paragraphs 34.59 to 34.63 of **FRS 102** apply.

It should be noted that sub paragraph 2 of paragraph 63, Schedule 1 to the **Accounts and Reports Regulations** states that *“particulars and the total amount of any financial commitments, guarantees and contingencies that are not included in the balance sheet must be disclosed”*.

# (XVI) TREASURY SHARES

## 86 Treasury Shares

Treasury Shares should be accounted for in accordance with the requirements of **FRS 102**.

**Note:** paragraph 22.16 of **FRS 102** states that the cost of a company purchasing its own equity shares which are then held in treasury ('Treasury Shares') should be deducted from equity (that is shareholders' funds).

With regard to disclosure in the company's **Financial Statements**, the Treasury Shares will have been purchased out of distributable profits (usually capital profits for an **Investment Company**) and therefore the relevant reserve should be reduced; with the reduced figure being shown on the face of the balance sheet. Movements in the reserve during the period will be shown in the statement of changes in equity and the notes to the accounts as appropriate. As a result of this presentation, the company will not also be showing on the face of the balance sheet a separate debit reserve, which would probably be the case under the **Accounts and Reports Regulations** if the cost of the Treasury Shares was to be shown separately, as this will lead to double-counting.

In addition, notwithstanding that Treasury Shares have no entitlement to dividends or other distributions and that they may be excluded for net asset value calculation purposes, a company's issued share capital should not be reduced to reflect any Treasury Shares until they have been cancelled.

# (XVII) HALF YEARLY AND OTHER ACCOUNTS

## 87 Requirements

The recommendations contained within the **SORP** apply to the **Annual Financial Statements of Investment Companies**. However, in addition, an **Investment Company** is required by law to prepare a half-yearly financial report covering the first six months of each financial year. For its half-yearly financial report, the **Investment Company** must follow the same principles for recognising and measuring as when preparing its annual financial report. It is considered that the half-yearly financial report of an **Investment Company** should include, as a minimum, a management report, a condensed Income Statement, a condensed balance sheet, a condensed cash flow statement (unless it is exempt), a condensed statement of changes in equity plus comparative figures.

The principles set out in the **SORP** also apply to accounts prepared in order to meet the requirements of Sections 838 and 839 of the **Companies Act 2006**.

**Note:** although the figures presented will be determined in accordance with the principles set out in the **SORP**, interim and initial accounts prepared in accordance with the requirements set out in Sections 838 and 839 respectively of the **Companies Act 2006** are for a specific purpose, and the full disclosures set out in the **SORP** are not required.

The requirement to prepare a half-yearly financial report is contained in the Disclosure and Transparency Rules. FRS 104 sets out a basis for the preparation and presentation of interim financial reports.

## Appendix A

### Guidance Note with illustrative examples relating to paragraph 68

This appendix is illustrative only and does not form part of the **SORP**. The purpose of the appendix is to provide guidance and illustrative examples on the application of paragraph 68 of the **SORP** to assist in clarifying its meaning.

The Guidance Note was issued in January 2003. It refers to paragraph 66 which is paragraph 68 of this **SORP**.

## **The Association of Investment Companies ('Association')**

### **Statement of Recommended Practice: Financial Statements of Investment Trust Companies and Venture Capital Trusts**

#### **ALLOCATION OF TAX RELIEF ON EXPENSES**

##### **Guidance Note**

## **Background**

Paragraph 66\* of the Statement of Recommended Practice: Financial Statements of Investment Trust Companies and Venture Capital Trusts ("SORP") deals with the allocation of tax relief on expenses. This Guidance Note supplements the recommendation of paragraph 66\* and its accompanying explanatory note.

The Association agrees to abide by the Accounting Standards Board's ("ASB's") code of practice for SORP-issuing bodies, as set out in the ASB's July 2000 Statement SORPs: Policy and Code of Practice ("code of practice"). This permits the Association, as a SORP-issuing body, to provide informal guidance under certain circumstances.

The Association's SORP Working Party believes that informal guidance on this issue would be appropriate under paragraph 19(c) of the code of practice. The overall aim of this guidance is to assist practitioners in the preparation of the financial statements. It should be recognised that this guidance does not form part of the SORP, nor has it been reviewed by the ASB. It is intended to explain and illustrate what the recommendation of the SORP is intended to achieve, and how it could be applied to certain specific situations, but does not carry the authority of the SORP.

## **Expenses**

In this Guidance Note, the term "expenses" refers only to expenses which are deductible for corporation tax purposes. Expenses which have been charged in an investment trust company's or venture capital trust's ("Investment Company's") financial statements which are non-deductible for corporation tax purposes are irrelevant for the purposes of allocating tax relief and therefore have been ignored.

The terms "revenue expenses" and "capital expenses" refer to expenses which are charged to revenue and capital (and shown in the revenue and capital columns of the Income Statement respectively) in the financial statements of an Investment Company.

## Basic Principle

The basic principle lying behind the recommendation in paragraph 66\* of the SORP is that tax relief should be allocated under what is commonly referred to as the "marginal basis". This means that, in calculating how much tax relief should be allocated, revenue expenses are matched first against taxable income reflected in the revenue column of the Income Statement and capital expenses are matched first against taxable income reflected in the capital column

of the Income Statement. Tax relief is only allocated to capital to the extent that capital expenses (if any remain after offsetting these expenses against taxable capital items) are required to reduce or eliminate the company's taxable profits. Vice versa, tax relief is only allocated to revenue to the extent that revenue expenses (if any remain after offsetting these expenses against taxable revenue items) are required to reduce or eliminate the company's taxable profits.

It should be noted that paragraph 66\* refers to the allocation of tax relief, not to the allocation of tax, and therefore the fact that the company is not in an overall taxpaying position is not, of itself, a reason not to allocate tax relief on expenses.

In practice (as the majority of taxable income will normally arise on revenue items), any allocation of tax relief will result in a debit being charged to revenue and a corresponding credit to capital. For the remainder of this paper it has been assumed that this is the case.

However, there is no reason in principle (for example, in a year when a substantial taxable gain arises in capital) why the allocation of tax relief should not operate in the opposite direction (i.e. a credit to revenue and a debit to capital).

## Basic Calculation

The basic way of calculating the amount of tax relief that should be allocated to capital is to perform two separate "tax calculations":

- the UK corporation tax that is payable by the company including all expenses, whether charged to revenue or capital (Step 1).
- the UK corporation tax that would be payable by the company if it were to ignore all capital expenses except to the extent that capital expenses can be used to offset taxable income arising in capital (Step 2).

In both cases, the amount of UK corporation tax payable is that calculated using the corporation tax rates in force during the accounting period on the level of profits determined under the above principles. The difference between these two figures represents the amount of tax relief attributable to expenses charged to capital and therefore is the amount that should be allocated to capital under paragraph 66\* of the SORP.

**Note:** in some cases, depending on the level of profits, the rate of corporation tax that would be applied to the company's profits in Step 1 will be lower than that in Step 2 (e.g. because the company's profits chargeable to corporation tax in Step 1 fall within the small companies or starting rate bands). However, as the company would be paying the higher rate of tax were it not for the existence of the other expenses, this properly reflects the tax relief that is attributable to these expenses and therefore this difference should be reflected in the allocation of tax relief to capital.

A single unified rate of corporation tax applies on/after 1 April 2015.

### a) No allocation of tax relief

#### Example 1

An Investment Company has the following items of income and expense in its first accounting period. It will be paying corporation tax at 30% on its profits chargeable to corporation tax (as will be the case in all examples).

	<b>Revenue</b>	<b>Capital</b>
	<b>£</b>	<b>£</b>
<b>Taxable income</b>	900,000	
<b>Management fee</b>	(500,000)	(500,000)
<b>Other expenses</b>	(450,000)	

In this case revenue expenses (£950,000) exceed taxable income and therefore, in accordance with paragraph 66\* of the SORP, no allocation of tax relief to capital is required.

### b) Allocation of tax relief

#### Example 2

An Investment Company has the following items of income and expense in its first accounting period.

	<b>Revenue</b>	<b>Capital</b>
	<b>£</b>	<b>£</b>
<b>Taxable income</b>	<u>900,000</u>	
<b>Management fee</b>	<u>(500,000)</u>	<u>(500,000)</u>
<b>Other expenses</b>	<u>(200,000)</u>	

#### Step 1 – UK Corporation Tax Payable – Including all expenses

	<b>£</b>
Taxable income	900,000
Less revenue expenses	(700,000)
Less capital expenses	<u>(200,000)</u>
Profits chargeable to corporation tax	<u>NIL</u>
UK corporation tax payable at 30%	<u>NIL</u>

Step 2 – UK Corporation Tax Payable – Ignoring capital expenses

	<b>£</b>
Taxable income	900,000
Less revenue expenses	(700,000)
Profits chargeable to corporation tax	<u>(200,00)</u>
UK corporation tax payable at 30%	60,000

The difference between these two figures is £60,000 and this is the amount that should be allocated to capital in accordance with paragraph 66\* of the SORP.

## Taxable Income Arising in Capital Account

In most cases, taxable income only arises on revenue items. Where tax able income arises on capital items (e.g. gains on the disposal of interests in certain offshore funds) capital expenses are taken into account in Step 2 to the extent that these can be offset against taxable income arising in capital.

Example 3

	<b>Revenue £</b>	<b>Capital £</b>
<b>Taxable income</b>	900,000	400,000
<b>Management fee</b>	(500,000)	(500,000)
<b>Other expenses</b>	(200,000)	

Step 1 – UK Corporation Tax Payable – Including all expenses

	<b>£</b>
Taxable income	1,300,000
Less revenue expenses	(700,000)
Less capital expenses	<u>(500,000)</u>
Profits chargeable to corporation tax	<u>100,000</u>
UK corporation tax payable at 30%	<u>30,000</u>

## Step 2 – UK Corporation Tax Payable – Ignoring capital expenses

	£
Taxable Income (excluding taxable income included in capital offset by expenses charged to capital)	900,000
Less revenue expenses	<u>(700,000)</u>
Profits chargeable to corporation tax	<u>200,000</u>
UK corporation tax payable at 30%	<u>60,000</u>

The difference between these two figures is £30,000 and this is the amount that should be allocated to capital in accordance with paragraph 66\* of the SORP.

**Note:** if, in the above example, capital expenses were only £300,000 then no allocation of tax relief would be necessary as these capital expenses would be fully offset against taxable income arising in capital.

## **Excess Management Expenses Brought Forward**

Very often, an Investment Company's management expenses will exceed its taxable income. As a result, the Investment Company will be left with excess management expenses which are available to carry forward to offset against taxable income arising in future periods. Such expenses should be classified as either revenue or capital expenses and a memorandum kept of the aggregate amount carried forward of each type.

In calculating the allocation of tax relief to capital in future years, expenses should be allocated in the following order:

### **Location of Taxable Income**

Order of Offset	Revenue	Capital
1.	Current year revenue expenses	Current year capital expenses
2.	Brought forward revenue expenses	Brought forward capital expenses
3.	Current year capital expenses	Current year revenue expenses
4.	Brought forward capital expenses	Brought forward revenue expenses

#### Example 4

The facts are the same as for Example 2. In the company's second accounting period, it has the following income and expenses.

	<b>Revenue</b> £	<b>Capital</b> £
<b>Taxable income</b>	900,000	
<b>Management fee</b>	(300,000)	(300,000)
<b>Other expenses</b>	(200,000)	

The company has £300,000 of excess management expenses brought forward from its first accounting period and these will be recorded as capital expenses for the purposes of allocating tax relief in future periods.

#### Step 1 – UK Corporation Tax Payable – Including all expenses

	£
Taxable Income	900,000
Less current year revenue expenses	(500,000)
Less current year capital expenses	(300,000)
Less brought forward capital expenses	<u>(100,000)</u>
Profits chargeable to corporation tax	<u>NIL</u>
UK corporation tax payable at 30%	<u>NIL</u>

#### Step 2 – UK Corporation Tax Payable – Ignoring capital expenses

	£
Taxable Income	900,000
Less current year revenue expenses	<u>(500,000)</u>
Profits chargeable to corporation tax	<u>400,000</u>
UK corporation tax payable at 30%	120,000

The difference between these two figures is £120,000 and this is the amount that should be allocated to capital in accordance with paragraph 66\* of the SORP. The company has £200,000 of capital expenses to carry forward to future periods.

When an existing Investment Company first applies the SORP's recommendations, it will have to establish how much of its brought forward expenses are revenue expenses and

how much capital expenses. This, in turn, will depend on the basis (or bases) of allocation that it has used in previous accounting periods. This will require examining past records and possibly applying reasonable assumptions.

In practice, an Investment Company which has, in the past, adopted a basis of allocating tax relief which has resulted in a higher level of tax relief being allocated to capital will find itself with more revenue expenses carried forward and/or less capital expenses carried forward than an otherwise identical company that previously adopted a basis of allocating tax relief which resulted in a lower level of tax relief being allocated to capital.

#### Example 5

The facts are the same as for Example 2 and Example 4, except that the accounting period in Example 2 relates to a period prior to the introduction of the SORP, when the company was adopting the "proportional method" of allocating tax relief (i.e. allocating tax relief evenly across all expenses with no order of priority).

The total amount of expenses carried forward will remain the same, namely £300,000. However, under the proportional method, the amount of revenue and capital expenses carried forward to the second accounting period would be in the same proportion as the ratio of expenses charged between revenue and capital account in the first accounting period.

£500,000 out of a total of £1,200,000 expenses have been charged to capital during the first accounting period, a total of  $\frac{£500,000}{£1,200,000} \times £300,000 = £125,000$  of the expenses carried forward would be recorded as capital expenses. The balance of £175,000 would be recorded as revenue expenses carried forward.

Having calculated this, the allocation of tax relief for the second accounting period would now be:

### Step 1 – UK Corporation Tax Payable – Including all expenses

	£
Taxable Income	900,000
Less current year revenue expenses	(500,000)
Less brought forward revenue expenses	(175,000)
Less current year capital expenses	<u>(225,000)</u>
Profits chargeable to corporation tax	<u>NIL</u>
UK corporation tax payable at 30%	<u>NIL</u>

### Step 2 – UK Corporation Tax Payable – Ignoring capital expenses

	£
Taxable Income	900,000
Less current year revenue expenses	(500,000)
Less brought forward revenue expenses	<u>(175,000)</u>
Profits chargeable to corporation tax	<u>225,000</u>
UK corporation tax payable at 30%	<u>67,500</u>

The difference between these two figures is £67,500 and this is the amount that should be allocated to capital in accordance with paragraph 66\* of the SORP. The company has £200,000 of capital expenses carried forward to future accounting periods. This is made up of the £125,000 of brought forward capital expenses and £75,000 of current year capital expenses.

## Overseas Tax

The existence of overseas tax can further complicate the position in respect of allocating tax relief, as the tax treatment of overseas tax can vary according to whether the company would be in an overall taxpaying position or not. Where a company is in a taxpaying position, it would offset overseas tax against its corporation tax liability. When it is in a non-taxpaying position, it will normally use the overseas tax to reduce taxable income in order to preserve expenses carried forward.

## Example 6

An Investment Company has the following items of income and expense in its first accounting period.

	<b>Revenue</b> £	<b>Capital</b> £
<b>Taxable income</b> (overseas dividends of £1,000,000 paid under deduction of 15% withholding tax)	1,000,000	
<b>Management fee</b>	(500,000)	(500,000)
<b>Other expenses</b>	(200,000)	

### Step 1 – UK Corporation Tax Payable – Including all expenses

	£
Taxable Income (withholding tax treated as expense)	850,000
Less current year revenue expenses	(700,000)
Less current year capital expenses	<u>(150,000)</u>
Profits chargeable to corporation tax	<u>NIL</u>
UK corporation tax payable at 30%	<u>NIL</u>

### Step 2 UK Corporation Tax Payable – Ignoring capital expenses

	£
Taxable Income	1,000,000
Less current year revenue expenses	(700,000)
Profits chargeable to corporation tax	<u>300,000</u>
UK corporation tax payable at 30%	90,000
Less double tax relief	<u>(90,000)</u>
UK corporation tax payable	<u>NIL</u>

The difference between these two figures is nil and therefore no allocation of tax relief to capital is required. The company has £350,000 of capital expenses to carry forward.

## **Assumptions**

Although the offsetting of certain expenses against taxable income is automatic, the offsetting of other expenses and other forms of tax relief (e.g. finance costs, group relief etc.) are at the option of the company. At the time of the preparation of the financial

statements, it may not be entirely clear which of these options will be the most tax efficient for the company. In calculating the amount of tax relief that should be allocated, reasonable assumptions should be made and, to the extent that future events dictate a different course of action, adjustments should be made in future accounting periods to reflect the actual position. The same principle applies if there is income or expenses whose taxability/deductibility is uncertain.

## **Conclusion**

This Guidance Note is not intended to be prescriptive and has been issued to help clarify the intention lying behind the recommendation in paragraph 66\* of the SORP and to aid practitioners in applying the recommendation. In addition, Investment Companies may find themselves confronted with situations and issues that are not covered by this Guidance Note. Where such situations arise, it is hoped that they will apply the recommendation of paragraph 66\* in accordance with the spirit of its intention and, if appropriate, provide additional disclosures.

*\*paragraph 68 of this SORP*

## Appendix B

### Guidance Note with illustrative examples relating to paragraph 16

This appendix is illustrative only and does not form part of the **SORP**. The purpose of the appendix is to provide guidance and illustrative examples on the application of paragraph 16 of the **SORP**.

The Guidance Note was issued in October 2019.

## **The Association of Investment Companies ('Association')**

### **Statement of Recommended Practice: Financial Statements of Investment Trust Companies and Venture Capital Trusts**

#### **Guidance Note - Paragraph 16: Investment profits and losses**

## **Background**

Paragraph 16 of the Statement of Recommended Practice: Financial Statements of Investment Trust Companies and Venture Capital Trusts ("SORP") deals with investment profits and losses. This Guidance Note supplements the recommendation of paragraph 16 and its accompanying explanatory note.

The Association agrees to abide by the Financial Reporting Council's (FRC's) Policy on Developing Statements of Recommended Practice (SORPs) published in October 2018. This permits the Association, as a SORP-issuing body, to provide additional guidance under certain circumstances.

Following a public consultation, the Association believes that additional guidance on this issue is appropriate. The overall aim of this guidance is to assist practitioners in the preparation of the financial statements. It should be recognised that this guidance does not form part of the SORP. It is intended to illustrate how companies may provide additional information on gains and losses, but does not carry the authority of the SORP.

## **The AIFMD**

The Alternative Investment Fund Managers Directive (AIFMD) sets out certain content and format requirements of the balance sheet or statement of assets and liabilities and of the income and expenditure account. (AIFMD Regulations Article 104.)

This includes the provision that the income statement or relevant notes disclose the realised and unrealised gains/losses on investments.

To assist members, the Association has considered how companies may provide supplementary information on disclosure on investment profits and losses which could meet the requirements of accounting standards, the SORP (paragraph 16) and the AIFMD.

Alongside the recommendations in the SORP, the AIC recommends companies disclose:

- the sales proceeds received during the period from the disposal of investments and the book cost of those investments when they were purchased; and
- a paragraph to explain that these investments have been revalued over time and until they were sold, any unrealised gains/losses were included in the fair value of the investments.

The following illustrative example may assist members make their disclosures.

<b>Notes to the accounts: Investments held at fair value through profit or loss</b>	<b>2019 £</b>	<b>2018 £</b>
Opening book cost	125	100
Opening investment holding gains/(losses)	53	20
Opening fair value	178	120
<b>Analysis of transactions made during the year</b>		
Purchases at cost	0	25
Sales proceeds received	(160)	0
Gains/(losses) on investments (agrees to the capital column of the income statement)	14	33
<b>Closing fair value (agrees to the figure in the balance sheet)</b>	<b>32</b>	<b>178</b>
Closing book cost	25	125
Closing investment holding gains/(losses)	7	53
<b>Closing fair value</b>	<b>32</b>	<b>178</b>
<p>The company received £160 (2018 £0) from investments sold in the year. The book cost of these investments when they were purchased was £100 (2018 £0). These investments have been revalued over time and until they were sold any unrealised gains/losses were included in the fair value of the investments.</p>		

October 2019

