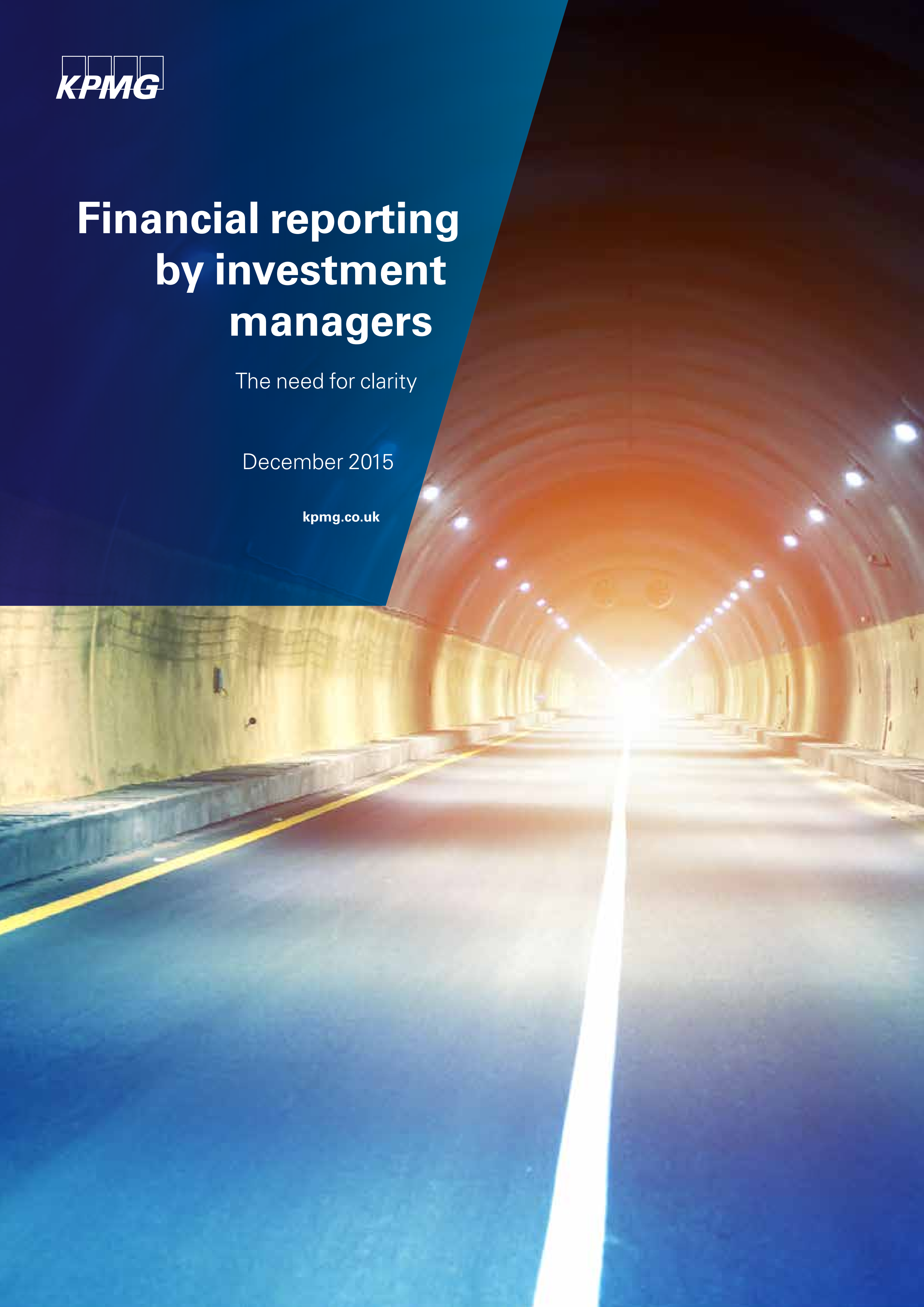


Financial reporting by investment managers

The need for clarity

December 2015

kpmg.co.uk

Contents

01 Executive summary

Welcome to the 2015 edition of Financial Reporting by Investment Managers.

The investment industry is working in an ever-more complex environment. Businesses in the sector are not only faced with tighter regulation, at a time when investor pressure to deliver improved performance is increasing, but they are also faced with a significant degree of market volatility and the arrival of new technologies.

They are also facing new risks. Across the financial services sector as a whole, challenger companies are entering the market, typically harnessing the potential of new technologies. The investment management industry is unlikely to remain immune from these disruptive forces. Meanwhile, cyber and IT risks are becoming ever more acute. Technological changes are helping investment managers to deliver a better service but this in turn exposes companies to the threat of malicious attack or indeed damaging systems failures.

Against this backdrop, the demands on firms to produce annual reports that provide a clear and transparent account of performance goals, the progress being made towards those goals, and emerging risks has probably never been greater.

A complex task

Factors such as increased regulation and market volatility are impacting upon performance. In this respect, there is a real challenge inherent in preparing reports that take account of these factors, while also providing a true and accurate picture of the performance of individual businesses that can be compared to reports published by other firms in the sector.

This raises questions of consistency. In addition to the financial report, the alternative performance measures cited by investment managers continue to play an important role in providing investors and analysts with the information they need to assess the performance of individual firms. It is therefore vital that commonly used measures – such as Assets Under Management – should be compiled according to parameters that are consistent across the industry. Equally important, within each individual company the parameters should be consistent year to year.

Reporting is also affected by regulatory requirements that ultimately result in reports becoming larger: the new rules on enhanced risk reporting are a case in point. Providing shareholders with a greater degree of insight is clearly a good thing but there is a danger that by simply including more information in reports – without fully considering how that information is selected, presented and structured – preparers will deliver documents that are opaque rather than enlightening.

As new risks emerge, arguably one of the greatest challenges is to quantify the threats in a way that is meaningful. This year's reports suggest that cyber risk, in particular, has been under reported, perhaps because firms have struggled to quantify the danger to their business.

The pressure to produce better reports highlights the importance of the finance, risk, compliance and internal audit functions within companies. This year, for the first time, we have conducted a survey of how these functions are resourced and run.

The need for clarity

Annual reports in the investment management sector are, on average, 24% longer now than they were in 2011 and that increase in size is understandable given the factors outlined above. However, it is vital that a bigger word count is accompanied by more, rather than less, clarity. The sections in this year's report cover investment management firms, wealth managers and alternative managers.

The benchmarking report

This year's report suggests the performance of investment managers has been relatively resilient in recent years, with firms in the sector diversifying to drive improved performance. Pressure on fees has been less acute than expected. Wealth manager performance has been more mixed, with increased Financial Conduct Authority (FCA) regulation being a factor.

Annual survey

In the first of what will be an annual survey, we have compared the resourcing and cost base of the finance, compliance and internal audit functions within firms. The growing importance of these functions is evident, but this is not in all cases reflected by a commitment to increased resourcing.

Narrative reporting

Longer annual reports are in part due to preparers responding to the requirement for enhanced narrative reporting. The challenge is to provide greater clarity and ensure consistency when non-GAAP alternative performance measures are used.

Corporate governance

The coming year's annual reports will mark a first attempt by firms to comply with the new risk-reporting requirements. It will be necessary for businesses to provide an assessment of risk management, a review of internal control systems and the viability of the business, but also to provide a full account of the underlying assumptions. Meanwhile, investment managers are lagging the wider FTSE-250 community in terms of gender diversity.

Remuneration

The trend towards increased use of variable remuneration components is continuing and there are indications that recently implemented shareholder voter rights are having an impact on remuneration policy. This is evidenced by one company in our sample, in acknowledgment of the views expressed by a significant group of investors, not pursuing a proposed policy change, despite shareholder voting not being binding.

Accounting

The consolidation suite of standards (IFRS 10, 11 and 12) were effective for EU preparers for accounting periods that began on or after 1 January 2014. As a result of the changes, a number of groups are including consolidation as a key policy judgement. Preparations for transition to UK GAAP and the implementation of IFRS 9, 15 and 16 continue.

02 Benchmarking

The performance of investment managers has been resilient in the financial years under review and there are signs that there is more diversification in their product offerings. Performance of wealth managers on the other hand has been more mixed.

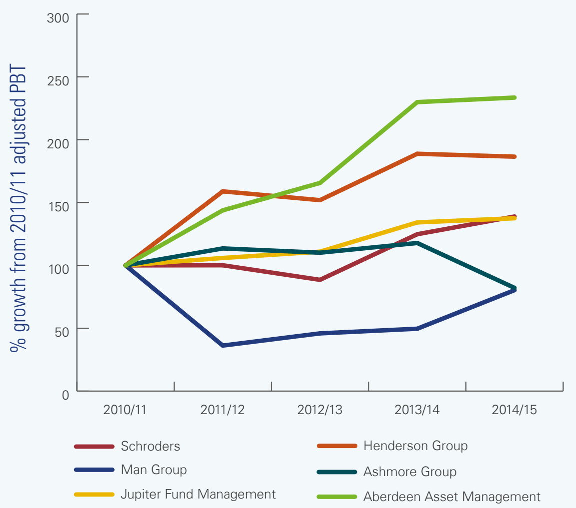
Adjusted profits before tax

The profits before tax (PBT) figures contained in this year's reports suggest that investment management firms have been stable overall. In contrast, there is significantly more divergence among wealth management firms.

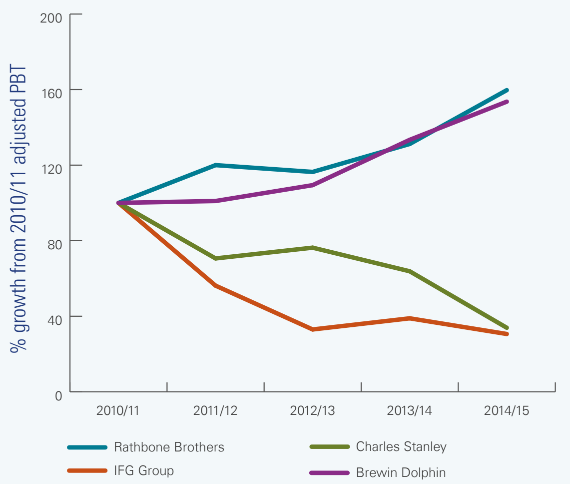
The variation in the performance of wealth managers may in part be due to the impact of regulation in the sector. In particular, the industry has been grappling to keep up with changes in the expectations from the regulator over suitability. This has eaten up resources and placed pressure on performance. It may also be the case that wealth managers are feeling the heat from new competitors coming into the marketplace. A number of wealth managers are consequently rationalising their client base with the aim of exiting/reducing the burden of smaller clients that are no longer profitable. This may help to shore up performance in the longer term, but could also limit access to the next generation of savers.

Adjusted PBT arguably provides the focus when investors scrutinise annual reports but the figures need to be treated with a certain amount of circumspection. As we explore in greater depth in the section on Narrative Reporting, the criteria underpinning the move from statutory to adjusted PBT are not necessarily consistent from one business to another, so direct comparisons are not always straightforward.

IM – Adjusted PBT Growth 2010/2011 to 2014/2015



WM – Adjusted PBT Growth 2010/2011 to 2014/2015



"In order to assess the performance of investment management businesses, shareholders and analysts need to understand the underlying factors driving higher or lower AUM figures. This in turn raises the question as to whether the data provided is granular enough to offer an accurate picture."

This year our industry analysis covers 15 investment managers in the UK for the year ends falling between 30 June 2014 and 31 March 2015:

Traditional Investment Managers ('IM')

Aberdeen Asset Management PLC
Ashmore Group plc
Henderson Group plc
Jupiter Fund Management plc
Man Group plc
Schroders plc

Wealth Managers ('WM')

Brewin Dolphin Holdings PLC
Charles Stanley Group PLC
IFG Group Plc
Rathbone Brothers Plc

Alternative Managers ('ALT')

3i Group plc
Electra Private Equity PLC
Intermediate Capital Group plc
IP Group plc
SVG Capital plc

Assets under management

Assets Under Management (AUM) is a key indicator of performance in the investment management sector but there are certain question marks over the transparency, usefulness and relevance of the data presented. The financial years under review show an overall rise in AUM.

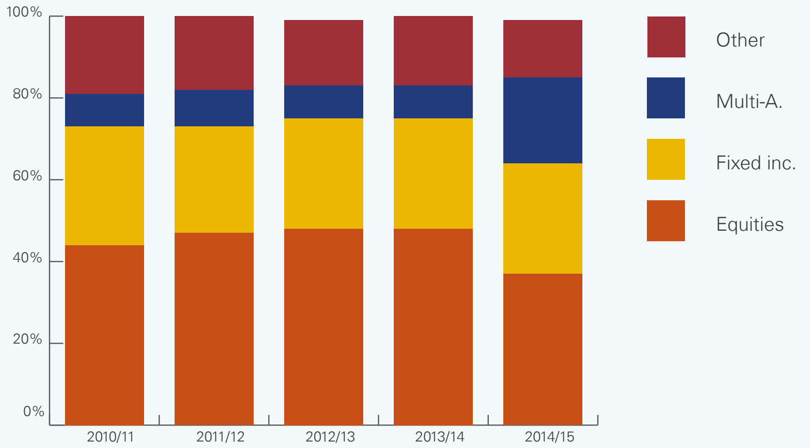
Give that changes in headline AUM figures can be driven by a number of factors, including: falls or rises in the value of a particular market (for example, equities or property); inflows and outflows of investor funds; foreign currency fluctuations or acquisitions. Shareholders and analysts need to understand these underlying factors in order to assess the performance of the business.

For instance, the degree to which an improvement in the AUM number is due to organic growth or acquisition is not always presented.

Current trends

As we pointed to in our 'Investing in the Future' report in 2014, this year's results reveal a degree of change in the asset classes held by businesses in the sector mainly through strategic acquisitions. In particular, there is greater emphasis on multi-asset classes.

IM – AUM by Asset Class[1]

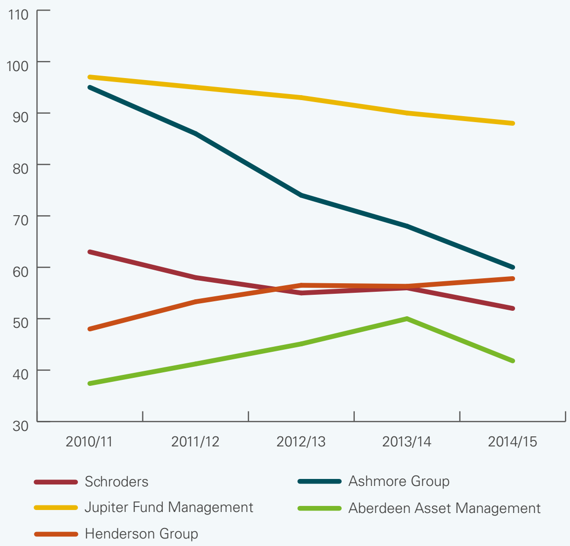


[1]Man Group Plc did not disclose AUM by asset class and is therefore not included

AUM growth from 2007/2008 to 2014/2015 (IM and WM)[2]

[2] Other entities covered by this report did not disclose AUM figures.

IM - BPS as disclosed within FS or client presentations[3]



[3]Man Group Plc did not disclose bps within their Annual Report

Multiple solutions

This shift towards multi assets is underpinned by an increasing demand for solutions and outcome orientated propositions in the retail and institutional markets.

There has been less diversification in terms of geography, perhaps because specific market expertise has been harder to acquire.

Basis points fees

As the graph illustrates, there has been some downward pressure on fees, although this trend has not been as great as we might have predicted. Looking ahead, we would expect to see changes in the range of products that companies are offering having an impact on fees, but as yet the degree to which fees will be impacted remains uncertain.

"Operating margins for investment managers have remained relatively resilient in the face of significant fee pressures. These pressures are only likely to increase in light of the FCA's recently announced asset management market study. We expect that this will lead to an increased focus on transparency and comparability across managers. It will be interesting to see what long term implications this has on the industry and how well positioned investment managers are to adapt accordingly."

Ravi Lamba, Director, KPMG in the UK

Margins

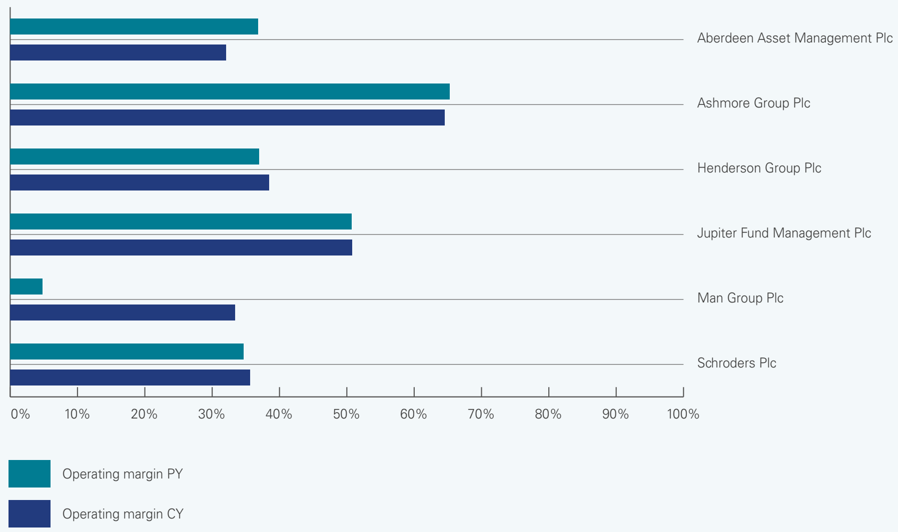
The good news for investment managers is that margins have remained reasonably consistent across this year and last year. However, the same is not true of wealth management firms: as we observed earlier in this section, wealth managers are facing much tighter regulation from the FCA and, in particular, this has meant expending more resources – namely time and money – on regulation.

Labour-intensive wealth managers

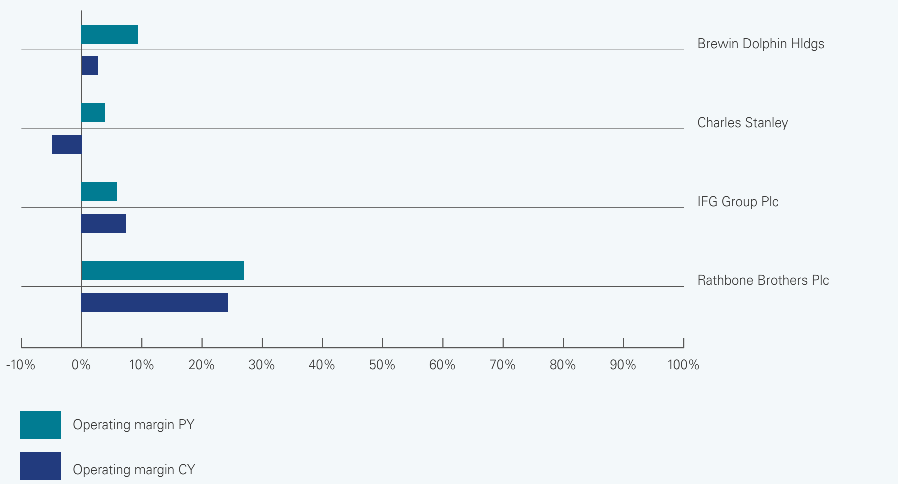
In addition, wealth managers operate on much more labour-intensive business models than investment management firms. Clients often expect a bespoke and personal service, which requires an investment in a sufficient number of highly paid advisers.

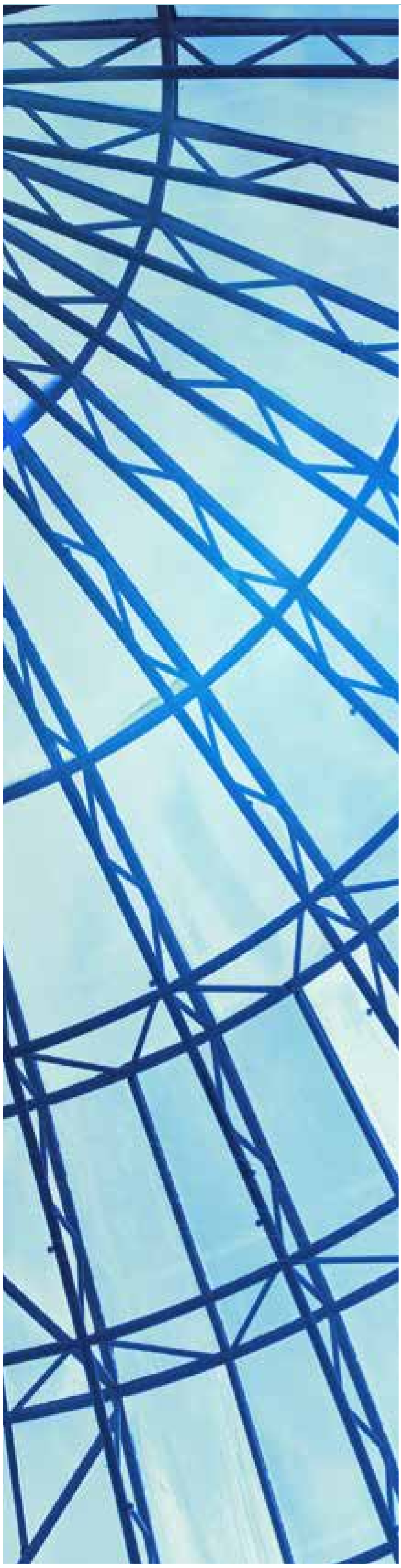
Looking forward, investment management firms and wealth managers may have to adapt to a changing marketplace if they are to maintain their margins. Certainly there is a case for more investment in information technology (to replace legacy systems) if they are to compete with pressures and new challengers in the marketplace.

IM – Operating Margin



WM – Operating Margin





“It is noticeable that cyber risk is generally underplayed, with only wealth managers placing it in the top five (under information technology).”

Risks

Loss of key personnel, treasury and credit, and legal and regulatory issues are identified as the top three risks in both the investment management and wealth management sectors. Meanwhile, alternative companies name investment performance, liquidity, and loss of key personnel as their top risks.

Given the prominence of cyber risk issues in the news in general, and in the financial sector – the Bank of England stated in 2014 that investment management firms were underestimating the danger – this is surprising. It may be that, while businesses are well aware of IT and cyber risks, companies don’t know how to describe or quantify them to shareholders.

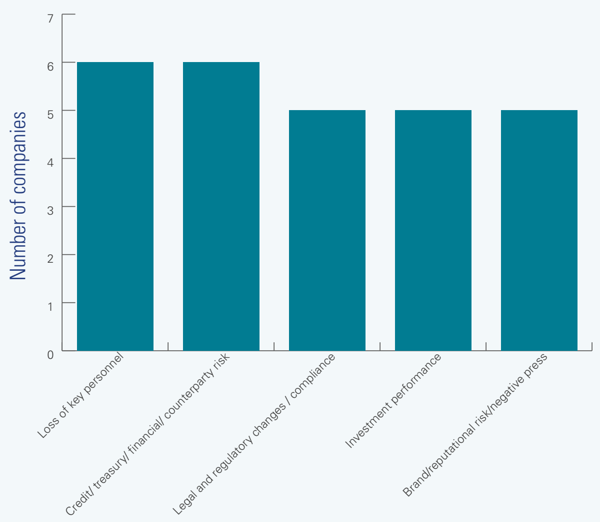
Some of the key cyber risks across the industry segments are:

1. Investment managers
    a. Theft or loss of sensitive information or IP leading to reputational, financial risks.
    b. Loss of availability of key IT systems/services or website (particularly if there are retail investors).
    c. Regulatory penalties from a cyber-breach.
    d. Third party/supply chain cyber risks.
2. Wealth managers
    a. Data protection and cyber security services for High-net worth individuals or Ultra high net worth individuals.
    b. Risks form theft of private data of clients.
3. Alternative managers
    a. Cyber risks in portfolio companies – specifically if investments are concentrated on a handful of portfolio companies.
    b. Risks from theft from insiders (disgruntled employees, bribery etc.).

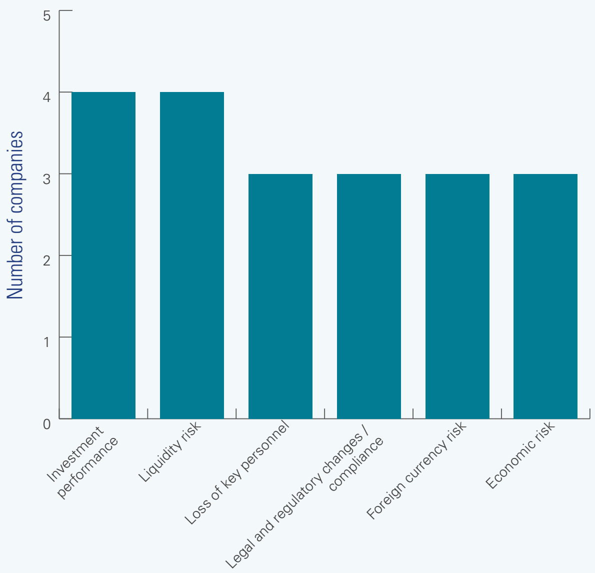
Loss of key personnel risk

Losing key personnel remains the number one risk, at least in the investment management and wealth management sectors. Fund managers within companies are brands in themselves and when they leave one company for another, there is a danger that funds will follow.

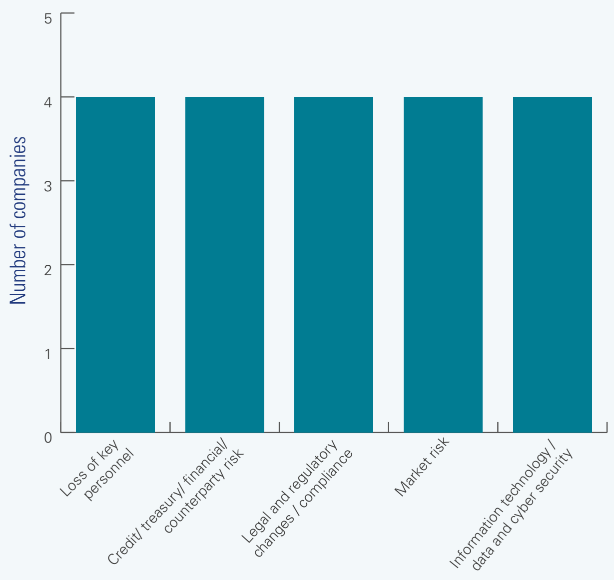
IM - Top 5 risks identified by the board



ALT - Top 6 Risks identified by the board



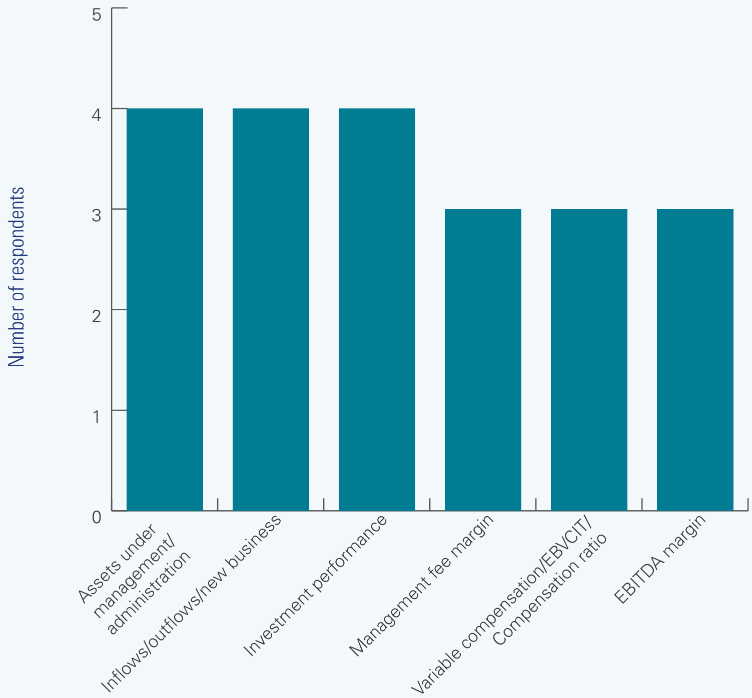
WM - Top 5 risks identified by the board



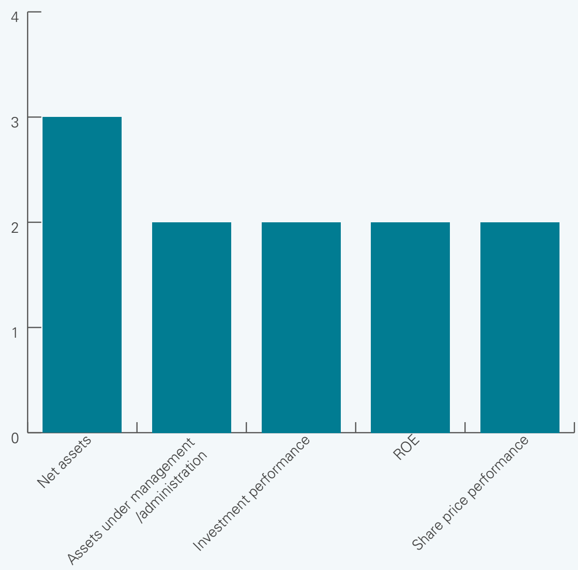
Key Performance Indicators (KPIs)

Businesses use a wide range of KPIs to chart their performance and it is important that the measures used internally correlate to those that are published in the annual report. This is a topic we discuss in more detail in the Narrative Reporting section.

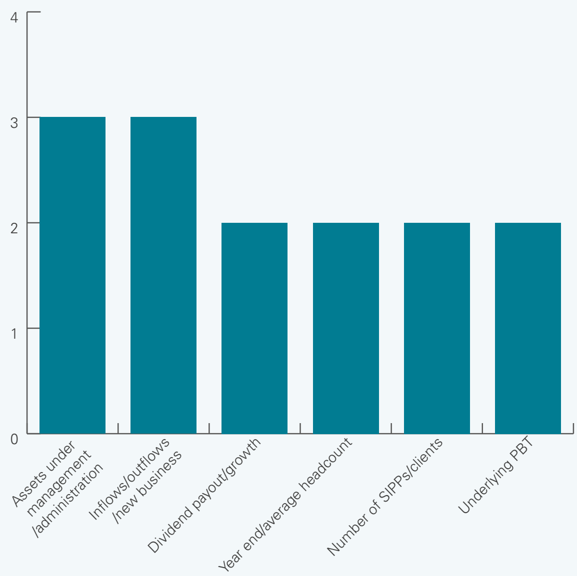
IM - Top 6 KPIs used by the company

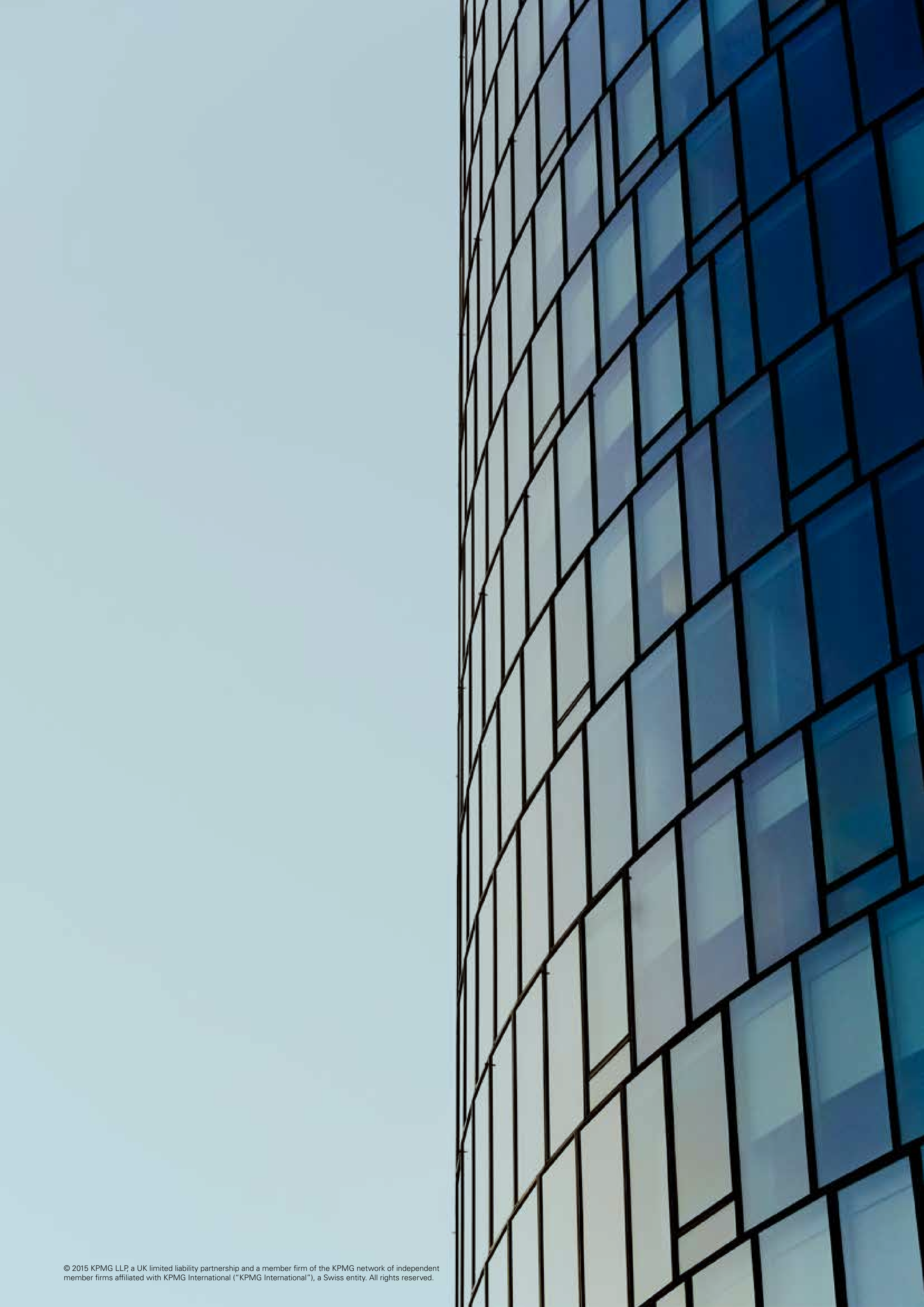


ALT - Top 5 KPIs used by the company



WM - Top 6 KPIs used by the company





03 Survey

Behind the Finance, Compliance and Internal Audit Functions

"Our survey suggests that despite finance functions being asked to do more, increased expectations are not necessarily being matched by a commensurate increase in investment."

Against a background of increased regulation – and the rising expectations of internal and external stakeholders around reporting and transparency – finance, compliance and internal audit functions within the investment management industry have never been under greater pressure.

There is widespread awareness among investors and analysts of the important role these back-office functions play in providing and validating information while also underpinning regulatory compliance. However, there is little transparency on how they are structured and resourced. Equally, there is little opportunity for investment managers to compare the performance of their own back offices with those of competitors.

We have taken the opportunity to carry out a survey of the companies included in this year's FRIM report. Eight firms responded, providing us with insight into how these key functions are managed and resourced by key players in the industry. All the reporting was conducted on an anonymous basis.

The finance function

The pressures on finance functions are mounting. Not only are staff being asked to provide additional information for annual reports, but there is also internal pressure to provide higher quality and more timely management information and budgets along with additional regulatory reporting.

For many in the finance function, the information they are being asked to feed into the reporting process is taking them some way out of their comfort zone. For instance, to some extent they are being asked to 'own' information supplied for governance and remuneration reporting, which might be considered the more natural province of HR and compliance teams.

Indeed, of the eight firms questioned, only three intended to grow their finance functions, while three expected them to remain around the same size and two were planning to shrink the departments.

Systems

The survey also found a significant variety in the number of finance systems used by respondents. On average, firms in the sector are running six different systems – with one business reporting a total of 14 systems. Different systems are often used for reconciliations, payroll, regulatory reporting, treasury management, general ledger recording, consolidation, financial statement production, portfolio company accounting, AUM analysis, budgeting and working capital management.

There are potential risks here, as the use of multiple systems can result in a number of problems, including:

- Operational inefficiencies
- Control weaknesses
- An increased likelihood – particularly in the case of older systems – of manual interventions, which exacerbate the two points above.

Reporting and the need for internal/external consistency.

When we asked respondents to provide details of their most significant KPIs, some named as many as 40 measures: some of these were operational, some financial, and others related to compliance.

Each individual business will have its own measures but it is important that companies are consistent between their internal reporting and external communications. The KPIs that are seen as most relevant internally should also be communicated in the annual report.

Finance staff and resourcing

According to our survey, on average only 17% of finance function personnel have no finance-specific qualifications, while 30% have graduate or post-graduate qualifications and 53% have professional qualifications.

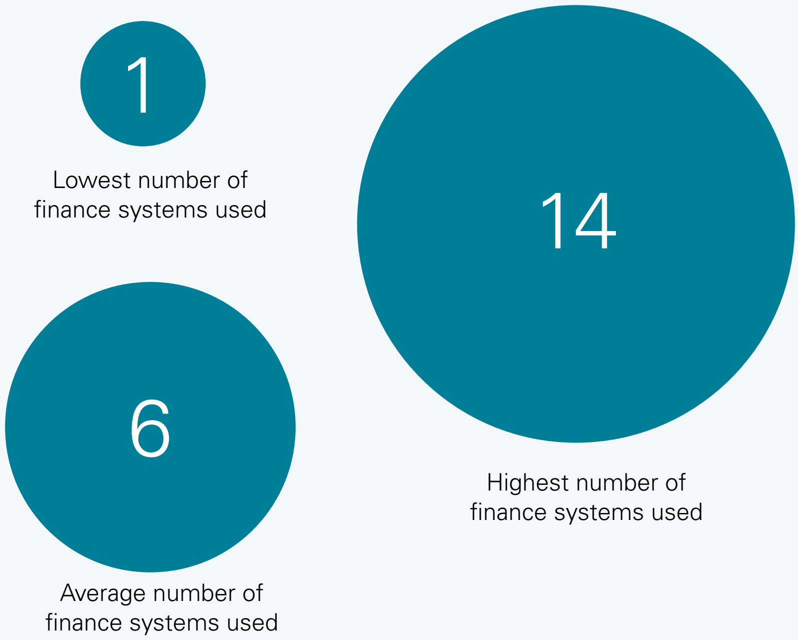
In other words, finance functions are populated by well-qualified individuals and this is reflected in salaries. However, there are some variations in pay and costs across the sub sections of the industry. Senior finance staff in wealth management firms tend to be least costly – an average of £78,028 (pay and related costs) – while the most costly are seen in alternative firms, with costs for senior people averaging £128,814. Investment management costs sit in between, with an average of £100,465.

Finance

a. Size of finance function

AUM category	< £50bn	>£50bn	Alternative
Number of respondents	3	2	3
Avg. number of legal entities	25	119	85
Avg. number of staff	28	100	20

b. Number of finance systems



Finance efficiency

Alternative finance functions lead the way in terms of processing and providing management information. The average turnaround time in alternative managers is 11 days, while the figures for wealth management and investment management were 12 and 13 days respectively.

Compliance departments

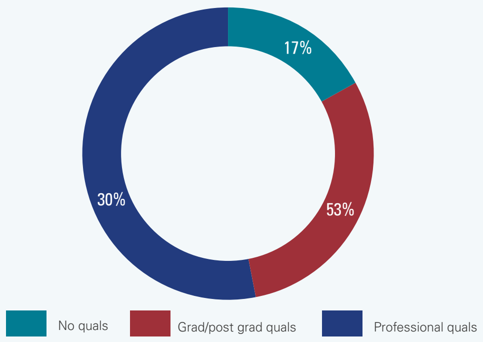
In both traditional investment management and wealth management firms, we found that the number of people employed in compliance rises sharply between companies with an AUM of less than £50 billion and firms managing sums above that figure showing that, in today's environment, compliance needs to be able to scale up to support growth and expansion. In contrast, the compliance function in alternative firms is relatively small.

Compliance personnel tend to be more costly than those in the finance function, with average costs coming in at £79,778, £112,821 and £158,333 (pay and related costs) across wealth management, investment management and alternative managers respectively.

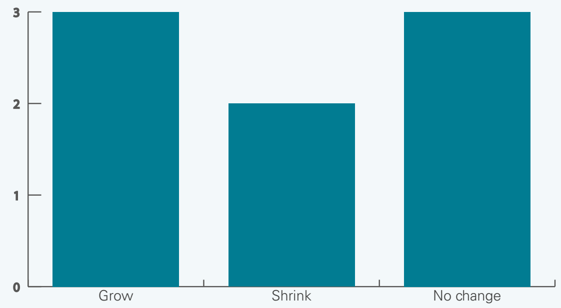
However, compliance people tend to be less directly well qualified, with on average only 39% holding professional qualifications and 44% educated to graduate or post-graduate level. It is likely, however, that the slightly higher salaries reflect the growing demand for compliance staff, who have to be attracted from other functions. Demand is expected to grow further, continuing the upward pressure on salaries.

As with finance, three out of the eight firms surveyed expected to grow their departments and three expected to retain the current size. However, only one respondent was considering a reduction.

c. Composition



d. Direction of function



e. Costs

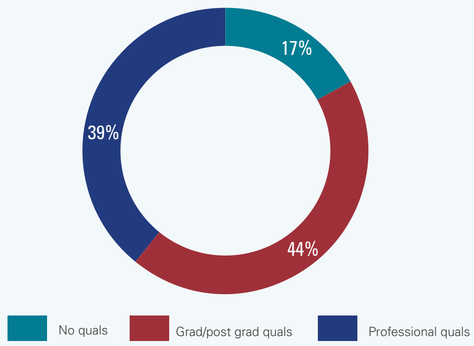
Category	WM	IM	ALT
Avg. finance staff	36	72	20
Avg. finance people costs (£m)	2.77	7.20	2.53
Avg. cost per FTE (£)	78,028	100,465	128,814

f. Efficiency and speed of reporting

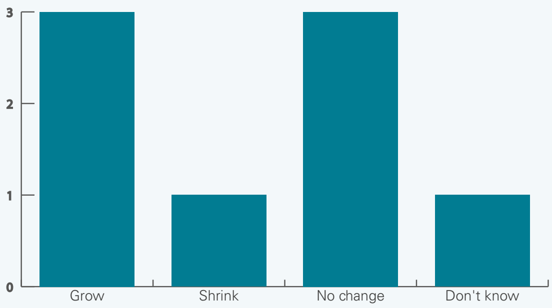
Compliance:

a. Composition

AUM category	< £50bn	>£50bn	Alternative
Number of respondents	3	2	3
Avg. number of regulated entities	10	30	4
Avg. compliance staff	21	50	4



b. Direction



c. Costs

Category	WM	IM	ALT
Number of respondents	2	3	3
Avg. compliance staff	23	39	4
Avg. finance people costs (£m)	1.79	4.40	0.63
Avg. cost per FTE (£)	79,778	112,821	158,333

Internal audit

The responses to our questions on internal audit present a more complex picture. Firms have a choice here: they can do everything in house; they can outsource; or they can opt for a fully co-sourcing model, under which third-party auditors are coordinated by an internally appointed director or otherwise responsible individual. Our survey shows that of the 8 firms who responded 37% co-source while only 12.5% outsource, with the remainder using an in house model.

Overall, investment managers carry out the greatest number of internal audit reviews each year – 30 reviews, compared with 26 and 10 in wealth management and alternative, respectively. The cost per review is highest in investment management and lowest in wealth management.

Conclusion

Demand for the services provided by finance, compliance and audit continues to rise, and the high qualifications expected in these functions are reflected in rising salaries and rising costs. Against this backdrop some firms are seeking to either limit the size of functions or even reduce them. However, that intention must be balanced against the rising pressure on personnel to address new regulatory and reporting demands and the need for better, streamlined technology to support the functions.

Internal audit:

a. Structure and people

	%	Avg. employees	People costs (£)	Costs per person (£)
In-house	50%	4	0.55	137,500
Co-sourced	37%	5	0.73	146,000
Outsourced	13%	N/A	N/A	N/A

b. Scope

	Avg. number of reviews	Total costs (£m)	Costs per review (£)
Traditional	30	1.5	50,000
Wealth	26	0.63	24,231
Alternative	10	0.3	30,000

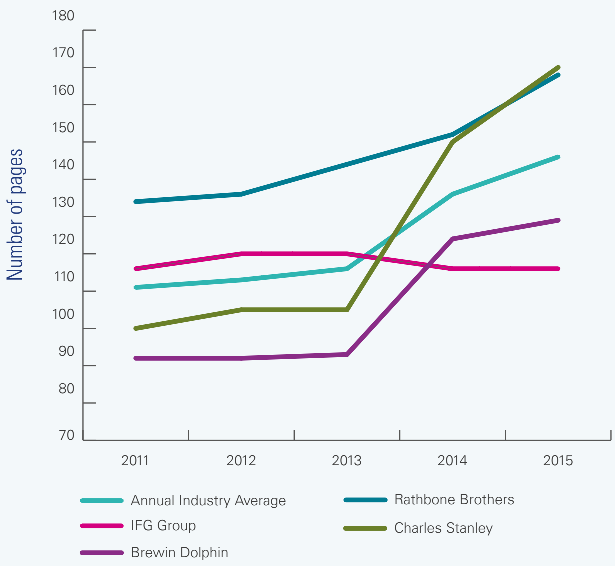
04 Narrative Reporting

Word for word and pound for pound, annual reports have progressively increased in size in recent years.

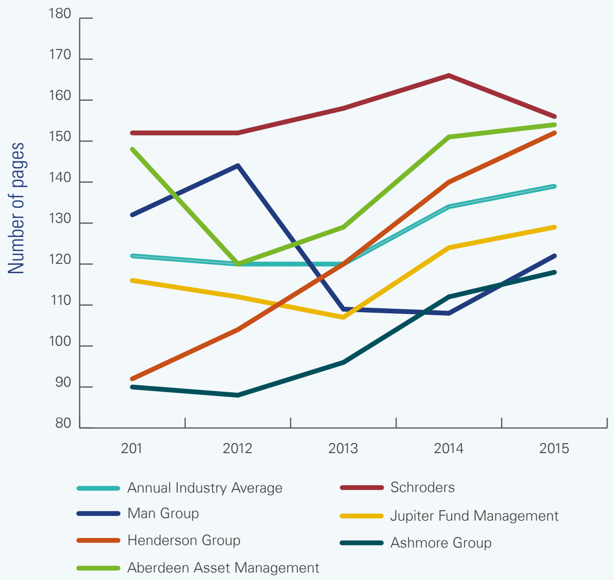
As our graph illustrates, an annual report in 2011 was, on average, 112 pages in length. Today, that figure is 129 pages, representing an increase of 24%.

There are a number of good reasons why reports have grown weightier: narrative reporting has become important and demanding. Equally, there is a requirement for narrative reporting to spell out the objectives, strategy and progress made by the company. Across all sectors, listed companies have responded to the demands of regulators and the expectations of investors by including more financial and non-financial information.

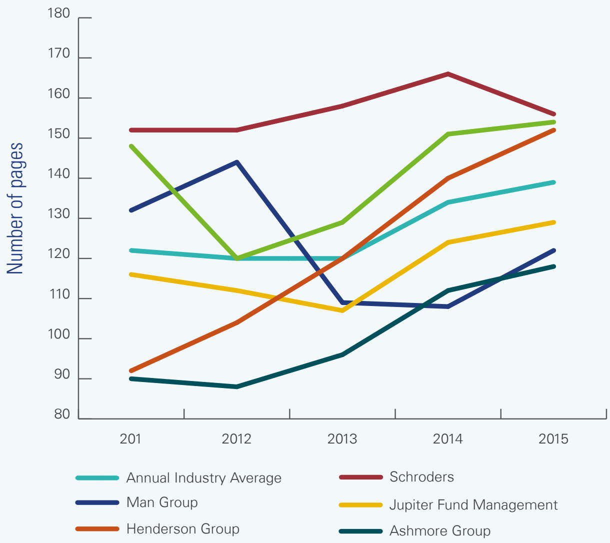
WM - Report length over time



IM - Report length over time



ALT - Report length over time



Greater length, less clarity?

In theory, stakeholders should be better informed than ever before. In practice, greater length and the provision of more comprehensive information does not necessarily equate to increased clarity. Indeed, by including a greater amount of information without paying the necessary attention to its relevance and presentation, businesses run the risk of publishing reports that are incomprehensible to many investors.

Faced with the prospect of falling foul of regulators, or failing to meet investor expectations, preparers have little incentive to edit the information at their disposal – the tendency is to play safe and include as much as possible. However, the result can easily be less clarity and less relevance.

There is an awareness of the problem. The International Accounting Standards Board (IASB) has published amendments to the IAS 1 guidelines, with the intention of encouraging preparers to move away from a checklist approach to reporting and to focus instead on relevance and materiality. This should, in turn, give preparers the platform that they need to produce more concise reports, which nonetheless provide investors with the 'big picture'.

Non-GAAP measures

As our research indicates, the financial statement section of the report currently accounts for around 35% of the average annual report. This has traditionally been the heart of the annual report, as it contains audited, GAAP-compliant information. However, over time an increased emphasis on additional narrative reporting has, in turn, resulted in much greater use of alternative performance measures (APMs). Three classes of APM have become commonplace in annual reports:

1. Disaggregation or subtotalling (e.g. earnings before interest, tax, depreciation/amortisation).
2. Quasi-financial measures (e.g. BPS or operating margins).
3. Operational metrics (e.g. assets under management or flow of funds).

The use of APMs is not a bad thing. For instance, in the investment management sector, performance-related metrics – such as assets under management (AUM) and flow of funds – provide relevant, industry-specific information about individual businesses that is not conveyed by information in the financial statement section of the report.

Our research into this year's reports and analyst presentations confirms that companies in the investment management sector tend to focus on at least one – and often more than one – alternative performance measure, with AUM flows considered to be the most relevant.

The most commonly used measures (AUM is a case in point) are generally understood by investors. Perhaps more importantly, there is an informal understanding within the industry as to how these measures are calculated, compiled and presented.

APM inconsistencies

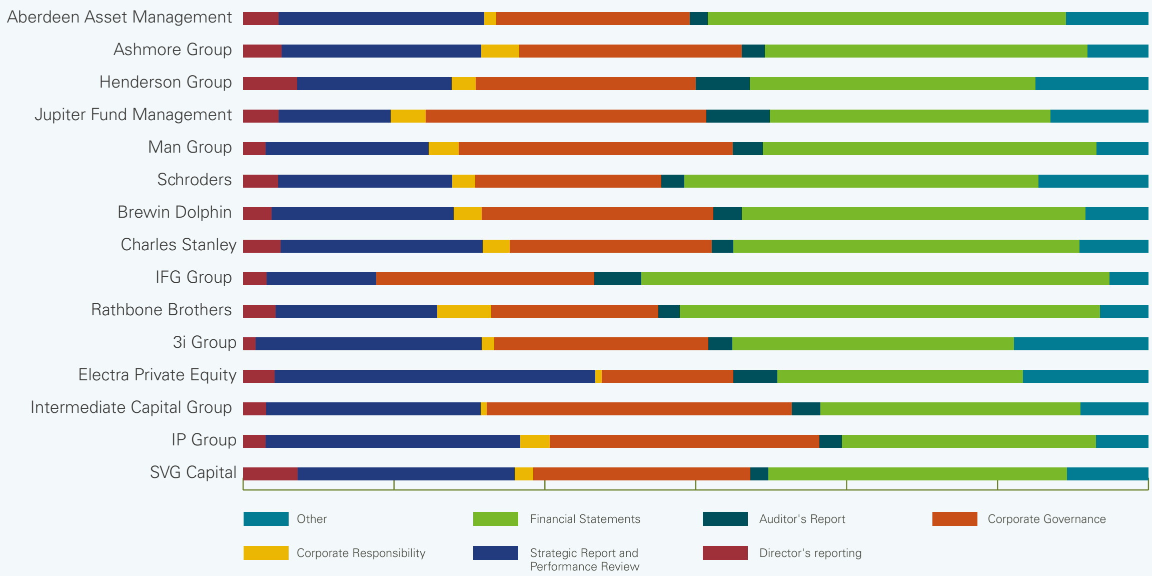
There continues to be some variation in the APMs that companies choose to deploy or emphasise from one year to the next. This potentially makes it difficult for investors to assess the company's year-on-year performance.

Equally, investors should be aware that outside the constraints of GAAP compliance, variations can exist in the time periods over which data for APMs is compiled. The potential problem here is that a similar APM used in two separate annual reports may, in fact, be based on different timeframes or even bases of compilation. As a result, it is not always possible to compare like with like.

Selective calculation

There is also a danger that companies will be selective with the facts to present the most favourable position possible. For instance, when companies quote earnings with factors such as one-off costs stripped away, the intention is clearly to highlight the underlying strength – or weakness – in medium and long-term trends and performance. The danger is that a company will choose to strip out an unexpected charge but include a sharp spike in revenues that is also attributable to a one-off event or unusual circumstance.

Industry - Composition of annual reports



"There is clearly a debate to be had about the use of APMs. KPMG believes the investment management industry for the most part is clear and transparent but there may be a case for additional independent scrutiny"

To take another example, not all companies adjust amortisation of intangibles, or Financial Services Compensation Scheme (FSCS) levies in arriving at adjusted PBT. In other words, it is still the prerogative of the company to decide what to include or exclude.

In order for APMs to be useful, and provide the information investors want, the key is the disclosure around the APMs need to be clear and transparent so that investors can use the information as needed.

Regulation on the horizon

There is the prospect of more stringent regulation. The European Securities and Markets Authority (ESMA) recently issued a consultation document containing proposals to enhance transparency and comparability when APMs are used.

The proposals acknowledge the importance of APMs but would require companies to give them much less prominence than GAAP information. ESMA is also recommending that companies using APMs should give them 'meaningful names,' explain their context, present them consistently over time, and cross-reference the measures to the most meaningful GAAP data. Any additional narrative reporting should be reconciled with GAAP amounts.

There is clearly a debate to be had about the use of APMs. KPMG believes the investment management industry for the most part is clear and transparent but there may be a case for additional independent scrutiny or extended assurance from auditors before the figures are published. This would provide investors and analysts with the assurance that APMs are calculated according to consistent principles.

The narrative challenge

What we are looking at is a complex narrative containing a broad range of information, some of which will have traditionally been presented in other sections of the financial report.

The challenge is to pull together this information in a format that tells a coherent story. The least effective way is to simply drop existing information into the strategic report, without considering how it will be structured and presented. However, the result can be a mishmash of data that fails to provide a comprehensive but easy-to-understand narrative – the information is present but there is no real connection between the various components of the report.

Our view is that a much more effective strategy is to effectively start with a blank sheet of paper. Rather than recycling old material, the preparers work on the premise that the strategic report is something new that should be designed and structured from the bottom up.

That means taking a holistic approach to the report, with preparers understanding how content contained in other sections – for example, in areas such as remuneration policy or governance practices – relates to strategy narrative.

“Annual reports have lengthened but while much of the additional information is useful, the key to effective communication is coherence, coupled with a commitment to providing performance data that is consistent and comparable, and underpinned by a verifiable methodology.”

05 Corporate Governance

Amendments to the UK Corporate Governance Code (which became effective on 1 October 2015) will introduce new complexity to the preparation of statements on risk, including the statement on long term viability. Meanwhile, the investment management sector has made some progress towards increasing the number of women on boards, but representation at the highest level fails to reflect a more even gender mix elsewhere in organisations.

Risk disclosure

Following amendments to the UK Corporate Governance Code, new risk-focused disclosure requirements have come into force for reporting periods beginning on or after 01/10/2014. The purpose of the new requirements is to provide shareholders with an enhanced understanding of the principal risks facing the companies in question, and how they affect long-term viability.

The shock of the new – questions for the audit committee

The amendments to the Code represent something more than just a small change to previous disclosure requirements. To comply with the code, audit committees in particular will have to answer a new and perhaps unfamiliar set of questions.

For instance, under the current arrangements directors are required to report assessed risk and provide assurance on going concerns over a 12-month period. The new code requires that directors extend that assessment and provide a much more thorough account of why a particular time period has been chosen, and why that timeframe is particularly applicable in terms of the circumstances of the business, its business model and objectives.

Equally, the process undertaken to make the confirmation will have to consider exactly what is meant by a 'robust assessment' of the principle risks. This account is likely to include details of the data used in making the assessment, an account of the stress and sensitivity testing that has taken place, and the assumptions on which the assessment is based. Any statement on risk and long-term viability will have to factor in how the company is positioned in the wider marketplace and provide an account of what competitors are doing.

Ultimately, the board must clearly map out the relationship between the principal risks facing the business and the potential impact of those risks on the long-term viability of the company.

Diversity

In last year's report we noted that the Investment Management industry lagged behind the wider community of FTSE-350 companies in terms of women appointed to board positions.

Viability statements - leverage from ICAAP

Business need not – and should not – be starting from scratch. The investment management industry is particularly well positioned to deal with the new requirements, as much of the analysis required under the new code amendments will already have been prepared for ICAAP documentation.

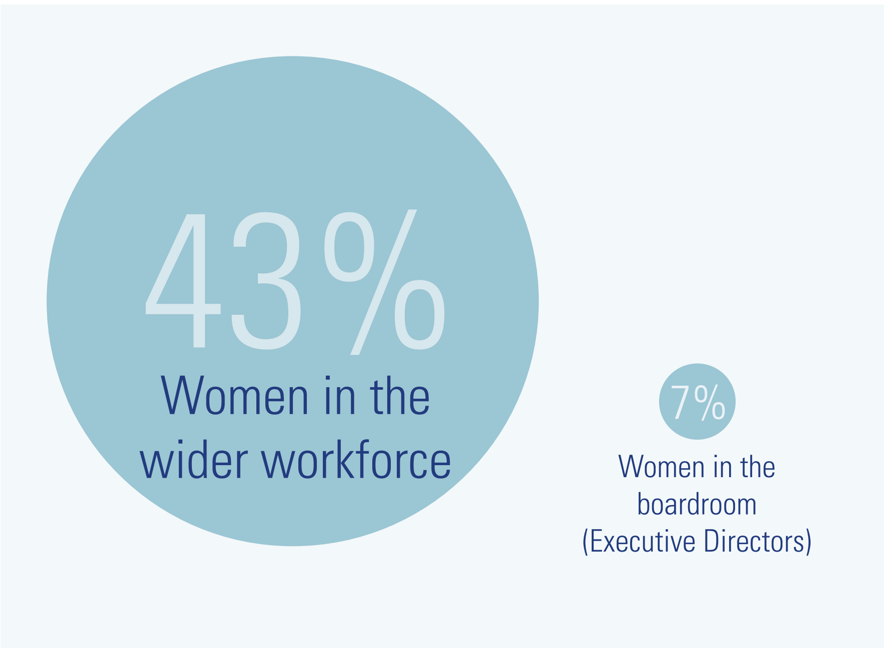
The challenge facing boards will be to take the existing information (along with anything new and relevant) and use it to demonstrate that the process of risk assessment has indeed been robust. Investors and regulators will also want to be assured that the board has done enough to manage and mitigate risks.

Some progress has been made in this regard, however, there is still some way to go if firms in the sector are to meet the aspirational targets set both in the UK and at EU level.

Based on an analysis of those firms that provide the relevant information, we estimate that women account for around 43% of investment management firm payroll. However, things look very different when you narrow the focus to representation at executive director level. Currently only around 7% of executive directors are women, although the figure is slightly

> “It’s important to recognise that we are all operating in intensely competitive times, with unprecendented levels of transformation and the speed of decision making increasing. At times like this, it’s all too easy for us as individuals, and indeed, as companies, to fall into surrounding ourselves with likeminded people to make decision making easier. So it’s important to recommit ourselves to putting diversity at the front of our mind and taking small steps in very practical ways to making a difference.”

Claire Harvey, Head of Diversity and Inclusion, KPMG in the UK



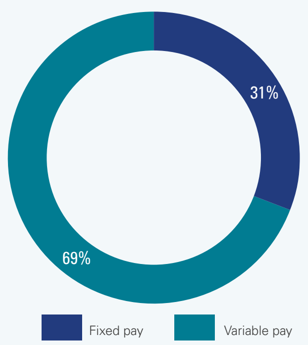
improved upon if non-executives are factored in. This mismatch between the percentage of women working at all levels of organisations and the few who make it through to the highest levels, suggests that the industry should be doing much more to ensure that talented people are promoted, regardless of gender.

The balance between male and female employers and directors is part of a larger debate on gender, which also includes remuneration. In July this year, David Cameron outlined plans to force companies to publish details of the pay gap between men and women – details which some of the companies in our sample are already including in their report. If such measures come into force, the male/female pay issue will be forced higher up the agenda when annual reports are published, and companies will be questioned on policy. This is a development that KPMG supports.

06 Remuneration

"Remuneration remains an area of considerable focus, not only for investors but also for analysts and regulators. Companies should focus on clarifying the link between remuneration policy, practice and company strategy in order to satisfy the investors' expectations of transparency and alignment of interests."

2014/15 All Executive Directors: Fixed Pay vs Variable Pay (Median)



More than seven years after the collapse of Lehman Brothers, the lessons learned from the financial crisis are continuing to influence remuneration policy and practice. This year's bonus payouts and long-term incentive gains are higher than in previous years and are based on achievement of incentive metrics.

As users and auditors of annual reports, we continue to find limited transparency regarding the role that reward policy plays in helping investment management firms to deliver on long-term strategic goals.

A coherent trend

In last year's report we identified an increase in the proportion of variable versus fixed pay paid to executives. Data from this year's crop of companies suggests this theme is continuing.

Our analysis of this year's remuneration levels reveals that median variable pay accounts for 69% of total remuneration, with fixed pay accounting for the remaining 31% of the total (see graph). This compares with a median variable pay of 62% in 2013/14 and 50% a year earlier.

While remuneration committees across all sectors continually address the often-thorny problem of aligning pay with performance, the debate over remuneration strategy has been particularly acute in the financial services sector.

In the wake of the financial crisis, investors have been seeking assurance that pay is linked to long-term outcomes rather than short-term performance measures. Or, to put it another way, investors are keen to see remuneration strategies that only trigger performance-based payouts when a return on investment has been achieved. Equally important, shareholders want to see a balance between strategies that deliver returns, and the checks and balances in place to manage risk. Again, the expectation is that this will be reflected in remuneration outcomes.

Shareholder voting spurs action

One of the key developments in the last two years for the main market companies has been the arrival of legislation giving shareholders the right to a binding vote on remuneration policy at least every three years, and this is already having an impact. Of the companies included in our sample population, to date there have been no majority votes against remuneration policy, but some significant votes against remuneration policy (over 20%) were taken into consideration by company boards.

There is evidence that the new rights bestowed on shareholders have resulted in boards adopting a more responsive and proactive approach to remuneration policy. For instance, although the policy vote for one company included in our sample fell short of the figure required to force a change in policy, the board took note of the views expressed by a significant group of investors and subsequently changed its approach and did not implement the proposed policy amendment.

The regulatory background

Future trends in the mix of fixed and variable pay may be coloured by changes in the regulatory framework.

The Credit Requirement Directive IV (CRD IV) has applied caps to the proportion of variable pay that can be awarded by banks and other credit institutions. Final European Banking Authority (EBA) guidelines due to be published at the end of 2015 may impact on investment management firms. Those that are part of a CRD IV group, or that have a CRD IV subsidiary, may fall under the directive and require a variable pay cap. The high proportion of variable pay relative to fixed pay, as shown by the data, indicates that the effect of any legislative change of this sort could be significant.

The importance of aligning pay with strategy

There is no 'one size fits all' approach to linking pay with performance. However, KPMG believes that it is important for firms to align executive reward with the overall strategic goals of the organisation.

That link between reward, performance and the fulfilment of strategic goals is not always fully spelled out in annual reports. Indeed, according to our analysis of the wider FTSE-350 annual reports, only one-fifth make the link clear – for instance, by cross-referencing between remuneration reports and the strategic narrative. Of the investment management reports we examined, only one company provides a direct link to the strategic report.

The need for transparency

Remuneration remains an area of considerable focus, not only for investors but also for analysts and regulators. Companies should focus on clarifying the link between remuneration policy, practice and company strategy in order to satisfy the investors' expectations of transparency and alignment of interests.

07 Accounting update

Implementation of IFRS 10, 11 and 12

The consolidation suite of standards (IFRS 10, 11 and 12) were effective for EU preparers for accounting periods that began on or after 1 January 2014. These standards introduced a different framework for assessing 'control', whilst also introducing new and enhanced disclosures detailing interests held in other entities. There were two main areas of impact for the investment management industry:

1. Changes to concept of control resulted in more funds being consolidated

    – Added volatility to financial statements as the conclusion on control could change year on year

    – Communicating this change to stakeholders and their expectations over the makeup and composition of the balance sheet. Compliance with certain covenants or key internal ratios may have also been impacted

    – Differences in practice over whether Defined Benefit Pension Plan holdings should be included in the holdings considered as part of the control assessment

    All traditional investment managers included in the FRIM for whom the standards was effective were required to consolidate additional entities as part of their group accounts in the current or prior year. The impact was not significant for those in the wealth management industry, whilst many alternative managers were able to take advantage of the Investment Entity exemption contained within IFRS 10 to avoid the need to consolidate their investment portfolio.

2. New and more detailed disclosures are required, but questions remain over the usefulness and relevance of this information

    – We observed significant divergence in practice concerning the disclosures made about interests in unconsolidated structured entities. As this is a new requirement and there is only limited guidance within the standard, we anticipate that industry best practice and understanding will continue to develop over the coming years

    – Challenges in implementing the requirements and capture of all disclosures mandated within the standard

    A number of groups are now including consolidation as a key accounting policy or judgement, along with audit committees and auditors in the long form audit opinions. Under the old IFRS framework, consolidation was relatively straightforward for most investment managers so it is clear that these new standards have added a degree of complexity and judgement to the financial reporting process.

New UK GAAP

New UK GAAP is effective for reporting periods beginning on or after 1 January 2015. All preparers under 'Old UK GAAP' will be required to transition to New UK GAAP (FRS 101, FRS 102 or the new FRSSE/FRS105), or adopt EU-IFRS as a new accounting framework. The extent of the impact of any transition will be dependent upon the balances and transactions recorded by the particular company in question. We have highlighted below a number of areas that we have seen those transitioning identifying as GAAP differences:

<table>
<tr><th>Accounting area</th><th>Key EU-IFRS consideration</th><th>Key FRS 101 consideration</th><th>Key FRS 102 consideration</th></tr>
<tr><td>Goodwill</td><td>Under EU-IFRS, goodwill is not amortised.

Under EU-IFRS, negative goodwill is recognised immediately in profit and loss.</td><td>Under FRS 101, goodwill is not amortised.

Under FRS 101, negative goodwill is recorded on the balance sheet.</td><td>Under FRS 102, goodwill is amortised over its useful life.

Under FRS 102, negative goodwill is recorded on the balance sheet.</td></tr>
<tr><td>Inter-company</td><td colspan="3">Under EU-IFRS and FRS 102, intercompany balances are required to be measured initially at fair value.

A difference bettween the loan priciple amount and fair value will arise if the loan is not on commercial terms e.g. term loan with nil interest. Any difference between loan principle amount and fair value is recognised as a capital contribution as appropriate.

This a key difference from old UK GAAP.</td></tr>
<tr><td>Financial instruments</td><td colspan="2">Under EU-IFRS and FRS 101, it is likely that more financial instruments will be required to be carried at fair value. Any derivatives that are held off balance sheet under old UK GAAP will need to be recognised. Embedded derivatives are recognised separately from their host instrument (although this is changing under IFRS 9).</td><td>Under FRS 102, preparers will be required to categorise their financial instruments as 'Basic' or 'Other'. Basic instruments will be carried at amortised cost and Other instruments will be carried at fair value.

FRS 102 contains an option to apply EU-IFRS equivalent financial instrument accounting requirements.

Embedded derivatives are not accounted for separately from their host instrument.</td></tr>
<tr><td>Deferred tax</td><td colspan="2">More defered tax is expected to be recognised under EU-IFRS and FR 101 than old UK GAAP.

EU-FRS 101 uses a temporary difference approach to calculate deferred tax balances.</td><td>More deferred tax is expected to be recognised under FRS 102 than under old UK GAAP.

FRS 102 uses a 'timing difference-plus' approach, which includes a number of additional specific rules, when calculating deferred tax.</td></tr>
</table>

IFRS 15

- The IASB has delayed the effective date of IFRS 15 by 12 months to 1 January 2018. Early adoption is permitted, however, the standard is not yet endorsed by the EU.
- For investment managers, the standard is likely to introduce new areas of judgement, primarily around:
  - Determining who the customer is: whether the fund or the individual investor is the customer will have downstream implications upon revenue recognition and the treatment of costs.
  - Identifying the performance obligations: under IFRS 15 revenue is recognised as the relevant performance obligation is completed. Investment managers will need to determine what they have contracted to do for their customers and whether certain obligations should be considered as a single obligation. This could impact the timing of revenue recognition on, for example, up front or distribution fees.
  - Timing of recognition of performance fees: performance fees will be a form of variable consideration under IFRS 15. Variable consideration must be recognised when it is highly probable that there will not be a significant reversal in the amount recognised. Investment managers who recognise performance fees at crystalisation will need to consider whether any portion of the un-crystalised performance fee meets IFRS 15 revenue recognition requirements at each reporting date.
  - Capitalisation of costs: IFRS 15 requires all incremental costs in relation to obtaining new contracts with customers to be capitalised. Investment managers will need to first determine who their customer is and then ensure that all incremental costs are correctly accounted for. This could result in certain bonuses or other payments to sales or distribution staff members needing to be capitalised and amortised.

IFRS 9

- IFRS 9 is effective 1 January 2018. The level of impact on investment managers will largely depend upon the nature of the financial instruments held and how they are managed.
- IFRS 9 introduces a change in the model used to assess impairment, moving away from an 'incurred' loss methodology to one that assesses the expected loss. Along with changes to hedge accounting, IFRS 9 also makes certain changes to the classification and measurement of financial instruments.
- The standard includes three categories of financial assets (Amortised Cost, Fair Value Through Other Comprehensive Income and Fair Value Through Profit and Loss) and does away with the existing Available for Sale category. Investment managers may be able to designate certain equity instruments that are not held for trading as Fair Value Through Other Comprehensive Income upon initial recognition. For these assets the fair value movements that are recognised in Other Comprehensive Income will not recycle to the profit and loss as they currently do for Available for Sale assets.
- Unlike IAS 39, an instrument will be classified based upon all of its contractual terms. Preparers will no longer be required or permitted to separate an embedded derivative from a financial asset host.

Leases

In October 2015 and after a long period of deliberation, discussion and consultation following the release of the leasing exposure draft in 2013, the IASB announced that the new leasing standard (IFRS 16) will be effective for accounting periods beginning on or after 1 January 2019 (subject to EU endorsement) with early adoption available.

Broadly, the impact of implementing the new standard will mean that more leases will come on balance sheet, subject to a small number of exemptions. Lessees will be required to recognise a 'Right-of-use' asset on balance sheet, which represents the right to use the underlying asset, and a lease liability which represents the obligation to make lease payments. The lease liability will be amortised using the effective interest method and as such will have the effect of presenting the leased asset as one acquired on a financed basis.

Preparers in the investment management industry will need to think about the impact of the new standard upon regulatory capital, covenant compliance, stakeholder management and financial KPIs.

06

Conclusion

In terms of purely physical evidence, it is hard to escape the fact that the annual reports published by investment managers have become more bulky in response to the demands of investors, regulators and policymakers.

The increasing size of the reports is perhaps inevitable and reflects genuine efforts to ensure that investors, analysts and other stakeholders have the best possible information when they assess the performance of individual firms.

However, there is a danger that more does not necessarily mean better. For instance, changes to the corporate governance code will require, in coming years, a more comprehensive account of risk. This will, in turn, require boards and audit committees to think hard about the underlying assumptions that underpin their assessment. The challenge is then to convey their findings meaningfully.

More generally, it is important that in the narrative reporting sections of their reports, firms convey a clear picture of their objectives, current performance and the strategies in place to achieve their goals. In order to do so and to help ensure consistent and clear messaging, we suggest companies consider incorporating the information included in investor and analyst briefing materials in the front end reporting. When using alternative performance measures, it is vital that they are compiled according to consistent criteria that not only relate to figures used in previous reports but also provide a high degree of comparability with other firms in the sector.

Our study of this year's reports suggests that, while much good work is being done, there is still much that can be improved upon. As firms respond to the increased regulatory pressures, we believe it is important that each business should have someone who has responsibility for ensuring that reports provide the clarity and transparency required.

Acknowledgements

We would like to thank all the firms that participated in this survey and the analysts that helped to develop our research.

A special thanks goes to Ravi Lamba, Paul McKechnie and Scott Flavin.

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