

Consolidated financial statements and the control concept

Ten discussion areas for investment managers

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The change to the definition of control introduced in IFRS 10, Consolidated Financial Statements [“IFRS 10”] is expected to have a significant effect on investment managers applying IFRS.

Managers may be required to consolidate certain investees for the first time or more entities may fall within the existing consolidation scope. This will not only have an impact on the financial reporting process but it will also affect how users of the financial statements such as regulators, finance providers and shareholders will understand and interpret these changes in the financial statements.

Investment managers will have to apply the more comprehensive scope and guidance in IFRS 10 when determining whether they control the entities they are involved with and consequently, whether they will need to consolidate those entities in their own financial statements. IFRS 10 supersedes the consolidation requirements in IAS 27, *Consolidated*

and Separate Financial Statements [“IAS 27”] and SIC-12, *Consolidation—Special Purpose Entities* [“SIC-12”] (together, the ‘current Standards’) and is effective for annual periods beginning on or after 1 January 2013, with earlier application being permitted. For companies that prepare their financial statements in accordance with IFRSs as adopted by the European Union, the mandatory effective date of IFRS 10 is 1 January 2014, although earlier application is permitted.

This article focuses on the practical challenges that will need to be addressed by investment managers when applying the new control definition in IFRS 10 and provides a number of examples that will assist them in the successful implementation of this Standard.



1. Background information on IFRS 10

IFRS 10 defines the principle of control and establishes control as the basis for determining which entities are to be consolidated. It addresses (a) the divergence that exists in practice when applying the control concept in the current Standards; (b) the perceived conflict of emphasis between IAS 27 (emphasis on the power to govern so as to obtain benefits) and SIC-12 (greater emphasis on risks and rewards); and (c) the lack of transparency that was highlighted during the financial crisis about the risks to which investors are exposed from their involvement with certain vehicles.

2. The control definition

An investment manager controls an investee if and only if it has all the following: (a) power over the investee; (b) rights or exposure to variable returns from involvement with the investee; and (c) the ability to use power over the investee to affect the amount of its returns.

The remainder of this article provides an explanation of each of these three elements and matters to consider in their application. For investment managers, the first two elements are relatively easy to assess and are more than likely to be met. However, more in-depth analysis and judgement is required in reaching a conclusion on the third element, which is particularly relevant to the investment management industry.

3. The purpose and design of the investee

When considering the purpose and design of an investee, the control assessment may be clear in cases where an investee is controlled by means of equity instruments that give the holder the majority voting rights. However in more complex cases an investee may be designed in a manner that voting rights relate only to administrative tasks and that relevant activities are directed through contractual arrangements. In such cases further consideration would need to be given to the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with it and the risks to which the investor is exposed.

4. The relevant activities of the investee

The control assessment is made by reference to an investee's relevant activities. Relevant activities are activities of the investee that significantly affect the investee's returns. Examples of relevant activities may include managing the underlying investments or obtaining financing.

5. An investment manager shall determine whether it has power over an investee

An investment manager has power over an investee when it has existing rights that give it the current ability to direct the investee's relevant activities.

For the purpose of assessing power, only substantive rights (that is, having the practical ability to exercise that right) shall be considered.

Factors that an investment manager will need to consider in determining whether rights are substantive include the following:

- (a) Whether there are any barriers that prevent the holders from exercising their rights
- (b) Whether a mechanism is in place that provides the holders with the practical ability to exercise their rights collectively
- (c) Whether the holders would benefit from exercising their rights

Protective rights (that is, those rights that protect the interest of the holder), however, should not be considered.

6. An investment manager shall determine whether it has rights or exposure to variable returns from its involvement with the investee

An investment manager has these rights or exposures when its returns from its involvement have the potential to vary as a result of the investee's performance.

An investment manager's involvement will generally take the form of one or more of the following—a fixed percentage of management fees, performance fees, direct investments, loans receivable and obligations to provide credit support and guarantees with respect to the investee's performance. Thus, the determination of whether this condition is satisfied is likely to be fairly straightforward for investment managers.



(5) Examples

When other parties have the right to remove the investment manager but the right is exercisable only for breach of contract, then this right is not considered to be substantive.

When the investment manager can be removed from acting as manager of a fund by a simple majority of the fund's investors but a simple majority requires a large number of widely dispersed and unrelated third party investors to act together, then this right will not necessarily be considered to be substantive.

When the holder of these rights would benefit from exercising them by realising synergies with the investee, then these rights are likely to be substantive.

7. An investment manager shall determine whether it has the ability to use power over the investee to affect the amount of its returns

This step in the control assessment considers the interaction between the first two elements of the control definition and requires an investment manager to determine whether it acts as a principal or an agent. A significant element of judgement will sometimes be required in making this assessment.

An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). An agent does not control an investee when it exercises decision-making rights delegated to it.

The investment manager is an agent if there is a single party that holds substantive rights to remove it without cause. In the absence of this, the investment manager has to consider the following factors in determining whether it is an agent or a principal:

- (a) The scope of its decision-making authority over the investee
- (b) The rights held by other parties (including the investee's board of directors (or other governing body))
- (c) The remuneration to which it is entitled
- (d) Its exposure to variability of returns from other interests that it holds in the investee

**(7) Example
(extracted from Appendix B of IFRS 10)**

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee. On formation, the equity instruments represent 10% of the value of the assets purchased. The asset manager manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee of 1% of assets under management and performance-related fees of 10% of profits if the investee's profits exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee. The remaining 65% of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Although operating within the parameters set out in the investee's prospectus, the asset manager has extensive decision-making rights that give it the current

ability to direct the relevant activities of the investee. Therefore, it has power over the investee. The asset manager's fees and its equity interest expose the asset manager to variable returns from its involvement with the investee.

In the absence of a single party that holds substantive rights to remove the asset manager without cause, all the factors in IFRS 10 need to be considered in determining whether the asset manager is acting as a principal or whether he is acting as an agent. The combination of the asset manager's equity interest with the fees (despite these being commensurate with the services provided) creates exposure to variability of returns from the activities of the investee that is of such significance that it indicates that the asset manager is a principal. The removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the investee from its equity interest, which indicates that the asset manager is a principal, and concludes that it controls the investee.

The weighting that is placed on these factors is based on the individual facts and circumstances. An investment manager may need to consider the following in making this assessment:

- (a) The discretion that it has when making decisions
- (b) The existence of substantive removal rights (kick-out rights) held by other parties
- (c) The existence of rights held by other parties that restrict its discretion
- (d) Whether its remuneration is commensurate with the services provided
- (e) Whether the remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis
- (f) Whether it holds other interests in the investee
- (g) The magnitude of, and variability associated with, its remuneration and other interests
- (h) Whether its exposure to variability of returns is different from that of other investors and, if so, whether this might influence its actions

(7) Example (extracted from Appendix B of IFRS 10)

A fund manager establishes markets and manages a fund that provides investment opportunities to a number of investors. The fund manager must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided. The fund manager also has a 20% pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Although the fund manager must make decisions in the best interests of all investors, the fund manager has extensive decision-making rights that give it the

current ability to direct the relevant activities of the fund. Therefore, it has power over the investee.

The fund manager's fees and its 20% investment expose the fund manager to variable returns from its involvement with the investee.

In the absence of a single party that holds substantive rights to remove the fund manager without cause, all the factors in IFRS 10 need to be considered in determining whether the fund manager is acting as a principal or whether he is acting as an agent. The combination of the fund manager's 20% investment with the fees (despite these being commensurate with the services provided) creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager through the board of directors, which indicates that the fund manager is an agent. In this example, the fund manager places greater emphasis on the substantive removal rights and concludes that it does not control the fund.

Investment managers will have to apply the more comprehensive scope and guidance in IFRS 10 when determining whether they control the entities they are involved with and consequently, whether they will need to consolidate those entities in their own financial statements

8. An investment manager shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity.

A deemed separate entity is often called a 'silo'. In substance, all the assets, liabilities and equity of silos are ring-fenced from the overall investee. If the investment manager concludes that it controls a silo, then it treats that portion as a subsidiary in its consolidated financial statements.

(8) Examples

An investment manager is involved in a legal entity (a fund) which was established in a particular jurisdiction. The investment manager concludes that it does not control the legal entity. If the legal entity includes portions that meet the definition of a deemed separate entity, the investment manager will need to assess whether it controls one or more of these portions. As an example, the investment manager will need to consider whether certain sub-funds in an umbrella structure meet the definition of a deemed separate entity in IFRS 10. In making this assessment, the investment manager may need to consider the laws and regulations in the specific jurisdiction in which the legal entity is established.

9. An investment manager shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

Examples of such facts and circumstances include changes in decision-making rights, changes affecting the investment manager's rights or exposure to variable returns from its involvement with the investee and changes which indicate that the investment manager's status as a principal or an agent has changed.

10. Investment managers will need to determine whether the exception to consolidation introduced by the October 2012 Amendment to IFRS 10, entitled *Investment Entities*, applies.

The Amendment defines an investment entity and introduces an exception to the principle that all subsidiaries shall be consolidated. The Amendment stipulates a requirement for a parent that meets the definition of an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss. A parent that does not meet the definition of an investment entity would, however, be required to consolidate all of its subsidiaries, even if those subsidiaries meet the definition of an investment entity. The Amendment is effective for annual periods beginning on or after 1 January 2014, with earlier application being permitted.



To the Point:

- The change to the definition of control introduced in IFRS 10 is expected to have a significant effect on investment managers applying IFRS. Investment managers will have to apply this new definition when determining whether they control the entities they are involved with.
- An investment manager controls an investee when it has the following: (a) power over the investee; (b) exposure, or rights, to variable returns from involvement with the investee; and (c) the ability to use power over the investee to affect the amount of its returns
- The control assessment requires an understanding of the purpose and design of the investee and of its relevant activities
- Only substantive rights are taken into consideration when making this assessment; in other words, protective rights are disregarded
- An investment manager will need to apply the new guidance in IFRS 10 to determine whether it is acting as a principal or as an agent. Significant judgement may be required in making this assessment