

## IFRS industry insights

### The new consolidation standard – insights for the investment management industry



IFRS 10 uses control as the single basis for consolidation, replacing the more risks and rewards focused approaches included in SIC-12.

The International Accounting Standards Board's (the 'IASB' or the 'Board') recently issued consolidation standard is likely to have a significant impact on the investment management industry. IFRS 10 *Consolidated Financial Statements* replaces the consolidation guidance previously contained in IAS 27 *Consolidated and Separate Financial Statements* and SIC 12 *Consolidation – Special Purpose Entities*. Concurrent with the issuance of IFRS 10, the IASB also issued:

- IFRS 11 *Joint Arrangements*;
- IFRS 12 *Disclosure of Interests in Other Entities*;
- IAS 27 *Separate Financial Statements* (revised 2011), which has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (revised 2011), which has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

In addition to IFRS 10, the standard likely to have the most significant effect on the investment management industry is IFRS 12. IFRS 10 and IFRS 12 (as well as IFRS 11, IAS 27 (revised 2011) and IAS 28 (revised 2011)) are effective for annual periods beginning on or after 1 January 2013. In addition to the five standards issued in May 2011, the IASB also has on its agenda a project to address consolidation for investment entities. This project has been ongoing for some time, with an exposure draft (ED) expected to be published this month. It is unclear at this time when a final standard will be published by the IASB.

This Industry Insight publication highlights many of the issues investment managers are likely to encounter as they adopt IFRS 10 and IFRS 12 and provides insight and examples to assist in the implementation of the new standards. Additionally, this industry publication discusses the expected investment entity ED that will be particularly relevant for the financial reporting of funds, although the ED may also have implications for investment managers.

#### Assessment of control

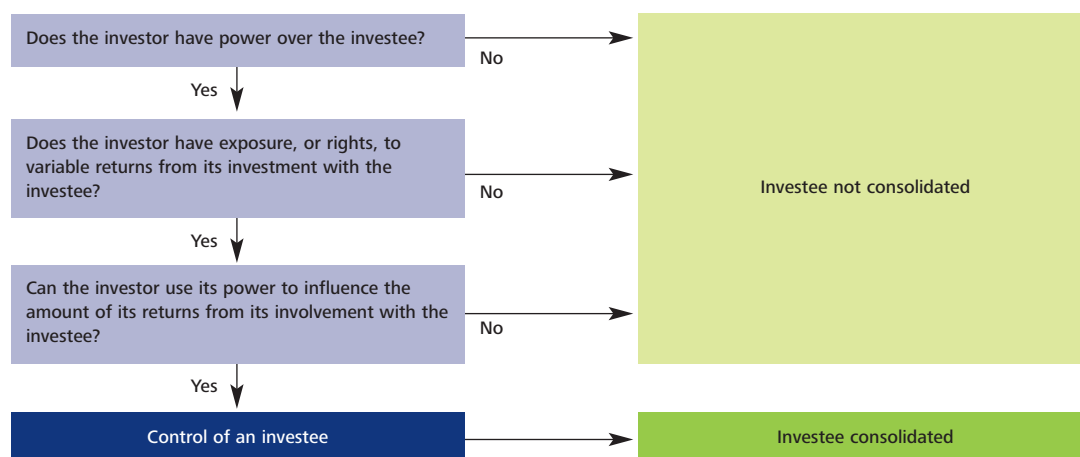
IFRS 10 uses control as the single basis for consolidation, replacing the more risks and rewards focused approaches included in SIC-12. IFRS 10 identifies the following three elements of control:

- power over the investee;
- exposure, or rights, to variable returns from involvement with the investee; and
- the ability to use power over the investee to affect the amount of the investor's returns.

An investor must possess all three elements to conclude it controls an investee. The assessment of control is based on all facts and circumstances and the conclusion is reassessed if there is an indication that there are changes to at least one of the three elements of control.

IFRS 10 defines power as “existing rights that give the current ability to direct the relevant activities” and adds that the relevant activities are those that significantly affect the investee’s returns.

#### IFRS 10 Consolidation Assessment



#### Observation

In developing IFRS 10, the IASB identified the following four areas of current divergence in determining whether an investee should be consolidated:

- where an investor controls an investee with less than a majority of the voting rights;
- special purpose entities and application of SIC-12’s ‘economic substance’ notion;
- issues around principal vs. agent relationships; and
- consideration of protective rights.

The Board considered that a perceived difference in emphasis between IAS 27 and SIC-12 has led to an inconsistent application of the concept of control. As a result, the decision was taken to withdraw the separate guidance in SIC-12. Whether the consolidation assessment under IFRS 10 will change for a particular entity as compared to under IAS 27 and SIC-12 may depend on exactly how IAS 27 and SIC-12 have been interpreted and applied historically.

IFRS 10 defines power as “existing rights that give the current ability to direct the **relevant activities**” and adds that the relevant activities are those that significantly affect the investee’s returns. The standard provides examples of rights that may give an investor power over an investee including:

- voting or potential voting rights;
- rights to appoint, reassign or remove key management personnel who have the ability to direct the relevant activities;
- rights to appoint or remove another entity that directs the relevant activities;
- rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

The second step in the consolidation assessment requires an investor to assess whether it is exposed, or has rights, to variable returns from its involvement with the investee. IFRS 10 clarifies that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. The standard provides examples of returns which include:

- dividends, other distributions (such as interest payments on debt securities) and changes in the value of the investor’s investment in that investee;

---

For investment managers, the determination of whether their power influences their returns will depend on whether the manager is a principal or an agent ...

- servicing and management fees, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity; and
- returns that are not available to other interest holders.

#### Observation

Investment managers' financial involvements with their funds or products may take various forms. Fee arrangements may include a base management fee of assets under management (AUM) or an incentive fee where the investment manager shares in the returns on the investments once the investors reach an established hurdle rate of return. Investment managers may also invest in their funds or products to better align the interests of the investors with their own. These investments may take many forms, including a pro-rata equity ownership in a fund or an investment in a tranching debt security issued by a structured entity (e.g., securitisation vehicle). Investment managers may also have other involvement with their managed funds or products such as a contractual obligation to provide credit support should the net asset value (NAV) of a money market mutual fund 'break the buck'.

Determining whether an investment manager's involvement with a fund exposes it, or provides it rights, to variable returns will sometimes be obvious (e.g., direct investments and incentive fees). However, even a fixed base management fee (e.g., 2% of AUM) would have a variable return element as the AUM amount varies based on investment performance.

The third and final step in the consolidation assessment considers the interaction between the first two steps. Specifically, can the investor use its power to influence its returns from its involvement with the investee? For investment managers, the determination of whether their power influences their returns will depend on whether the manager is a principal or an agent engaged to act on the behalf of, and for the benefit of, other investors and therefore does not control the fund. An investment manager that can be removed by a single party would always be considered an agent. If no single party holds removal rights, then an investment manager, in assessing whether it is a principal or agent, would consider the following factors:

- the scope of its decision-making authority over the investee;
- the rights held by other parties;
- the remuneration to which it is entitled in accordance with the remuneration agreement(s); and
- its exposure to variability of returns from other interests that it holds in the investee.

Furthermore, for an investment manager to be considered an agent, its remuneration must be commensurate with the services provided and the remuneration agreement must include only terms, conditions or amounts customarily present in other similar arrangements negotiated on an arm's length basis.

#### Observation

For investment funds, the 'relevant activities' are likely to be the investment decisions made by the investment manager. However, the determination as to whether the investment manager is a principal and therefore can use its power to influence its return will often be based, in part, on whether removal rights held by the fund investors are substantive. Single party removal rights will always be considered to be substantive; in the absence of single party removal rights other factors should be considered. For example, certain fund structures may provide investors the right to elect a board of directors that provide the investors a mechanism to exercise collectively the investors' rights including the ability to remove the investment manager. Important factors to consider in making a determination of investors' rights include, among other items, which parties appoint the board of directors, whether the board members are independent or are related parties to the investment manager, what mechanism exists for the investors to exercise their voting rights (e.g., established annual general meetings) and if there are any barriers for investors to exercise their voting rights. Other fund structures may not provide investors with a mechanism for their investors to act collectively in exercising their rights (typically hedge funds and private equity funds) and have typically not provided single party removal rights. For all funds structures, unless single party removal rights have been granted, the investment manager should also consider its fee arrangements and the variability of other interests it may hold.

---

**IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor).**

In assessing the exposure to variability of returns, an investment manager should consider that the greater the magnitude of, and variability associated with, its overall economic interests (including remuneration), the higher the likelihood the investment manager is a principal. Additionally, if the exposure to variability of returns of the investment manager is different from that of other investors (e.g., because of subordination of interests) investment managers should consider how that may influence their decisions as an investment manager.

**Observation**

IFRS 10 highlights that the subordination of interests may increase the exposure to variability. For example, investment managers may often hold a portion of the subordinated notes in a structured product (e.g., a CDO) to better align their own interests with those of the investors. The resulting exposure to variability from investments in the 'equity' tranche of structured products may impact the consolidation assessment.

IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor). The standard clarifies that the arrangements with other parties need not be contractual and provides examples of parties who might act as 'de facto agents' of the investor:

- the investor's related parties;
- a party that received its interest in the investee as a contribution or loan from the investor;
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties);
- a party that cannot finance its operations without subordinated financial support from the investor;
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor; and
- a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

When an investment manager identifies other parties as 'de facto agents', the investment manager would consider the other investors' decision-making rights and exposure, or rights, to variable returns together with its own interests when assessing whether it controls the fund or product.

**Observation**

The issue of 'de facto agents' may be of particular relevance for hedge funds and private equity funds.

Because of the long term nature of their investments, the governing documents of private equity funds may prevent or restrict the investors' rights to transfer their interest in the fund without the investment manager's consent. If so, the investors subject to this restriction may be considered de facto agents of the investment manager.

Similarly, investments in a fund by key management personnel would also need to be considered as part of the 'de facto agent' assessment because they are included as part of the definition of related parties under IAS 24. Investment managers may also arrange for financing to provide their employees the ability to invest in the fund, which may result in those employees also being considered 'de facto agents' of the investment manager.

The following examples are adapted from the application examples contained in IFRS 10 and illustrate the provisions of the IFRS 10 consolidation model being applied to investment funds and products:

#### **Example: UCITS fund**

An investment manager sponsors and manages a regulated UCITS fund under the EU's Undertakings for Collective Investments in Transferable Securities directive. The fund prospectus outlines the investment objectives of the fund, but the investment manager has sole discretion in executing those investment objectives by investing in particular assets.

The investment manager receives an investment management fee of 1% of the net asset value (NAV) of the fund; the fee is a market based fee and commensurate with the services provided by the investment manager. The investment manager has also made a 10% pro-rata investment in the fund with the investment manager's risk capped at its equity investment (i.e., it has no responsibility to fund any losses in the fund).

The fund's board of directors includes no independent directors and the investors in the fund have not been provided with any substantive voting or decision making rights, although they are permitted to redeem their interests within established limits by the fund.

#### **Does the investment manager have power over the investee?**

While acting in accordance with the investment objective established in the fund prospectus and within the requirements of the regulatory landscape, the investment manager is considered to have power over the fund as it has existing rights providing it the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation).

#### **Does the investment manager have exposure, or rights, to variable returns from its involvement with the investee?**

The investment manager receives a market based management fee (1% of NAV) commensurate with the level of service provided and has made a pro-rata 10% investment in the fund. The investment management fee and the investment stake in the fund both expose the investment manager to variability of returns from the activities of the fund.

#### **Can the investment manager use its power to influence the amount of returns from its involvements with the investee?**

The 1% management fee and the 10% investment in the fund are both influenced by the investment manager's power to make investment decisions. However, those interests do not create exposure that is of such significance to indicate the investment manager is a principal and instead indicate the investment manager is acting in the capacity of an agent. The investment manager would not consolidate the UCITS fund.

#### **Example: Private equity fund**

An investment manager has launched a private equity fund which locks investors in to the fund for a 10-year period. The fund offering memorandum details the investment objective of the fund but the investment manager has sole discretion in executing the investment objective.

The investment manager receives as compensation for its investment management services a 1% and 20% fee (an annual management fee of 1% of assets under management ('AUM') and an incentive fee of 20% of returns above a hurdle rate of return). To provide investors confidence that the investment manager's interests are aligned with their own, the investment manager also retains a 2% ownership stake in the private equity fund. The investment manager's downside risk is capped at its equity investment and accrued carried interest (e.g., the incentive fee earned to date); it has no obligation to fund investor losses.

The investors in the fund have been provided with simple majority 'kick-out' rights, but these are only exercisable upon the investment manager's breach of the investment management agreement.

#### **Does the investment manager have power over the investee?**

While the investment manager is required to act in accordance with the investment objective established in the fund offering memorandum, the investors hold only protective rights through the ability to remove the investment manager for breach of contract, and the investment manager is still considered to have power over the private equity fund as it has existing rights providing the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation).

**Does the investment manager have exposure, or rights, to variable returns from its involvement with the investee?**

The investment manager's 2% ownership stake in the private equity fund, as well as its 1% and 20% fee arrangements both expose the investment manager to variability of returns from the activities of the fund.

**Can the investment manager use its power to influence the amount of returns from its involvements with the investee?**

The investment manager's 2% ownership stake in the private equity fund, as well as its 1% and 20% fee arrangements, are all influenced by the investment manager's power to make investment decisions. However, those interests do not create exposure that is of such significance to indicate the investment manager is a principal and instead indicate the investment manager is acting in the capacity of an agent. The investment manager would not consolidate the private equity fund.

**Example: Hedge fund**

An investment manager sponsors and manages a hedge fund. The fund offering memorandum details the investment objective of the fund but the investment manager has sole discretion in executing the investment objective.

The investment manager receives as compensation for its investment management services a 1% and 20% fee. The investment manager has also decided to take a strategic investment in the hedge fund retaining a 20% ownership interest. The investment manager's downside risk is capped at its equity investment and accrued carried interest (e.g., the incentive fee earned to date); it has no obligation to fund investor losses.

The investors in the fund have been provided with simple majority 'kick-out' rights, but these are only exercisable upon the investment manager's breach of the investment management agreement.

**Does the investment manager have power over the investee?**

While the investment manager is required to act in accordance with the investment objective established in the fund offering memorandum, the investors hold only protective rights through the ability to remove the investment manager for breach of contract, and the investment manager is still considered to have power over the hedge fund as it has existing rights providing the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation).

**Does the investment manager have exposure, or rights, to variable returns from its involvement with the investee?**

The investment manager's 20% ownership stake in the hedge fund, as well as its 1% and 20% fee arrangements, both expose the investment manager to variability of returns from the activities of the fund.

**Can the investment manager use its power to influence the amount of returns from its involvements with the investee?**

Each of the investment manager's interests in the hedge fund (management fee of 1% of AUM, incentive fee of 20% of returns above the hurdle rate of return, and a 20% ownership stake in the fund) are influenced by the investment manager's power over strategic asset allocation.

The investment manager's 20% stake in the fund along with the remuneration received could create exposure to variability of returns from the activities of the fund that is of such significance as to indicate the investment manager is acting in the role of principal rather than as an agent.

In assessing the consolidation criteria above, the investment manager might consider a 20% investment to be sufficient to conclude it controls the hedge fund and therefore should consolidate it. Should the investment manager's ownership stake in the fund change over time, it would need to reconsider the implications for the consolidation conclusion.

### **Example: Collateralised Debt Obligation**

An investment manager establishes and manages a collateralised debt obligation ('CDO') by issuing debt securities with five tranches of senior notes and a subordinated (or 'equity') note class which represents 10% of the total capital in the CDO.

Using the proceeds raised through the note issuance, the investment manager manages a collateral pool in accordance with the indenture agreement by investing in loans and other debt securities. As compensation for providing investment management services, the investment manager earns a market based fee arrangement commensurate with the level of service which includes a base management fee of 40 basis points of the outstanding collateral pool, a subordinated management fee of 60 basis points of the outstanding collateral pool, and an incentive fee of 10% of excess cash flows once the subordinated note holders have received a hurdle rate of return.

To align the interests of the investment manager with the note holders, the investment manager is also required to hold 35% of the equity tranche; the remaining 65% of the equity tranche is widely held by third party investors. The other equity investors hold simple majority 'kick out' rights and may remove the investment manager without cause.

#### **Does the investment manager have power over the investee?**

While the investment manager is required to act in accordance with the investment objective established in the indenture agreement, and the equity note holders hold simple majority removal rights, the investment manager is still considered to have power over the CDO as it has existing rights providing the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation). Even though the removal rights can be exercised without cause, those rights receive little weighting in the consolidation analysis because they are held by a group of widely held investors and require a majority to exercise.

#### **Does the investment manager have exposure, or rights, to variable returns from its involvement with the investee?**

Each component of the investment manager's fee arrangements in the CDO (the 40 basis point management fee on the outstanding collateral pool, the 60 basis point subordinate fee on the outstanding collateral pool and the 10% excess cash flow incentive fee) as well as the 35% ownership interest in the equity tranche expose the investment manager to variability of returns from the activities of the fund.

#### **Can the investment manager use its power to influence the amount of returns from its involvements with the investee?**

Each component of the investment manager's fee arrangements in the CDO as well as the 35% ownership interest in the equity tranche are influenced by the investment manager's power over strategic asset allocation.

The investment manager holding 35% of the equity tranche, along with the remuneration for investment management services, creates subordinated exposure to losses and rights to returns of the investee which are of such significance that it indicates the investment manager is acting in the role of principal rather than as an agent.

As all three of the consolidation criteria have been met, the investment manager would conclude that it controls the CDO and therefore should consolidate it.

### **Observation**

The examples included in IFRS 10 are intended to illustrate the application of the general concepts of the principal/agent guidance rather than creating "bright-lines" of, for example, the level of investment exposure which would lead to the determination that an investment manager is acting as a principal. A significant amount of judgement will sometimes be required in determining whether a decision maker is a principal or agent.

### **Disclosures of interests in other entities**

In addition to the issuance of IFRS 10, the IASB also issued IFRS 12 with the objective of improving disclosures around the nature of, and risks associated with, an entity's interests in other entities and their impact on the financial statements. Involvements with other entities include interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The greatest effect of IFRS 12 for investment managers is likely to be the required disclosures for consolidated subsidiaries and unconsolidated structured entities.

---

For interests in subsidiaries, the disclosure requirements are intended to provide financial statement users with information on the group's composition and non-controlling interest holders' interests in the group's activities and cash flows.

For interests in subsidiaries, the disclosure requirements are intended to provide financial statement users with information on the group's composition and non-controlling interest holders' interests in the group's activities and cash flows. Information should be provided on:

- the nature and extent of significant restrictions on an entity's ability to access or use assets, and settle liabilities of the group;
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
- the consequences of losing control of a subsidiary during the reporting period.

In addition, detailed disclosures on non-controlling interests are required at an individual subsidiary level for each subsidiary with non-controlling interests material to the group, specifically:

- the name of the subsidiary;
- the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary;
- the proportion of ownership interests held by non-controlling interests;
- the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held;
- the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period;
- accumulated non-controlling interests of the subsidiary at the end of the reporting period; and
- summarised financial information about the subsidiary.

For interests in unconsolidated structured entities, IFRS 12 requires disclosure of information about the nature and extent of an entity's interests in unconsolidated structured entities and the nature of, and changes in, the risks associated with those entities. Where an entity has an interest in an unconsolidated structured entity, the entity should disclose:

- the carrying amounts and line items in the statement of financial position where the assets and liabilities related to its interests in unconsolidated structured entities are recognised;
- an estimate of the entity's maximum exposure to loss from its interests in unconsolidated structured entities; and
- a comparison of those two amounts.

Additionally, if an entity has provided any financial or other support (whether contractually required or not) or intends to provide support to consolidated entities or unconsolidated structured entities, it should disclose information around those arrangements. Finally, for any unconsolidated structured entities the entity sponsors but in which it no longer has an interest at the reporting date, the entity should disclose how it determined it was the sponsor, what income it received during the reporting period and the carrying amount at the time of transfer of all assets transferred to the structured entity during the reporting period.

**Observation**

IFRS 12 differentiates structured entities from those entities controlled by voting rights. For investment managers, distinguishing which of its managed funds are subject to voting rights and which are not (and therefore may be considered structured entities) may be time consuming in order to establish the appropriate population for disclosure purposes.



## Investment entity exposure draft

IFRS 10 may affect not only the investment manager's accounting but also the fund accounting as the fund would be required to consolidate the investments which it controls. However, the IASB is expected to issue an exposure draft that would provide a consolidation scope exemption for investment entities. Instead of applying consolidation accounting, an investment entity would be required to measure its controlled investments at fair value through profit or loss. The proposed criteria for which entities would be considered investment entities and therefore qualify for the consolidation scope exemption are expected to include:

- the entity has no other substantive activities outside of investing activities;
- the entity's sole business purpose is investing to generate and distribute income or for capital appreciation;
- the entity has an exit strategy for the investments it holds;
- the entity is comprised of proportionate units of ownership such as ordinary shares or partnership interests;
- the entity pools funds from investors to avail the owners of professional investment management;
- the entity's investments are managed and evaluated on a fair value basis; and
- the entity itself is a reporting entity.

### Observation

The investment entity project is a convergence project between the IASB and the US Financial Accounting Standards Board (FASB). However, the IASB and FASB have reached a different tentative decision on a key issue for investment managers. The FASB has tentatively decided to permit a non-investment entity parent of an investment entity to retain the investment entity's use of fair value accounting while the IASB would not.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.co.uk/about](http://www.deloitte.co.uk/about) for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2011 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 12988A

Member of Deloitte Touche Tohmatsu Limited