

IFRS insights for asset managers

The changing shape of financial reporting

Consolidated financial statements

What you need to know

- ▶ A single model of control replaces the two models that previously existed (i.e., power over operating and financing policies for some entities, versus risks and benefits for others)
- ▶ An investor controls an investee when it has power, exposure to variable returns and the ability to use such power to affect those returns
- ▶ The Boards expect to publish an exposure draft on consolidation by investment entities that is largely based on current US GAAP in June 2011, with the purpose of achieving largely converged accounting requirements
- ▶ Certain aspects of the investment entity proposals are likely to differ, for example, whether a parent of an investment entity can use the investment entity exemption in its consolidated financial statements
- ▶ For more information, refer to *IFRS Developments Issue 1 (May 2011)*

The International Accounting Standards Board (IASB) has issued three new standards: IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, and IFRS 12 *Disclosure of Interests in Other Entities*. These new standards are effective for annual periods beginning on or after 1 January 2013.

IFRS 10 replaces the portion of IAS 27 *Consolidated and Separate Financial Statements* that addresses the accounting for **consolidated** financial statements. In addition, the issues raised in SIC-12 *Consolidation – Special Purpose Entities* are now included in IFRS 10. What remains in IAS 27 is limited to accounting for subsidiaries, jointly controlled entities, and associates in **separate** financial statements.

The IASB and the US Financial Accounting Standards Board (the Boards) also expect to issue an exposure draft in June 2011 proposing to provide investment entities (as defined) an exception from consolidating their controlled investments.

This publication provides an overview of IFRS 10 and IFRS 12 and also looks ahead to the proposed accounting for investment entities.

Impact for asset managers and funds

- ▶ More entities may be consolidated than under current IFRS
- ▶ Consolidation decisions will need to be evaluated on a continuous basis, and not just at implementation or at each reporting date
- ▶ Key financial statement metrics may be impacted (e.g., debt/equity ratios)
- ▶ Communications with stakeholders, such as investors, finance providers and regulators, will be necessary to inform them of the effects of changes to the group structure
- ▶ Additional disclosures will be required, both for newly consolidated entities and unconsolidated entities
- ▶ If arrangements have been historically structured in a manner that achieved a particular accounting treatment, significant judgement will probably need to be applied to determine whether the same results are achieved under the new standards
- ▶ Accounting systems, business processes and controls will need to be updated
- ▶ Bank covenants and regulatory requirements should be considered

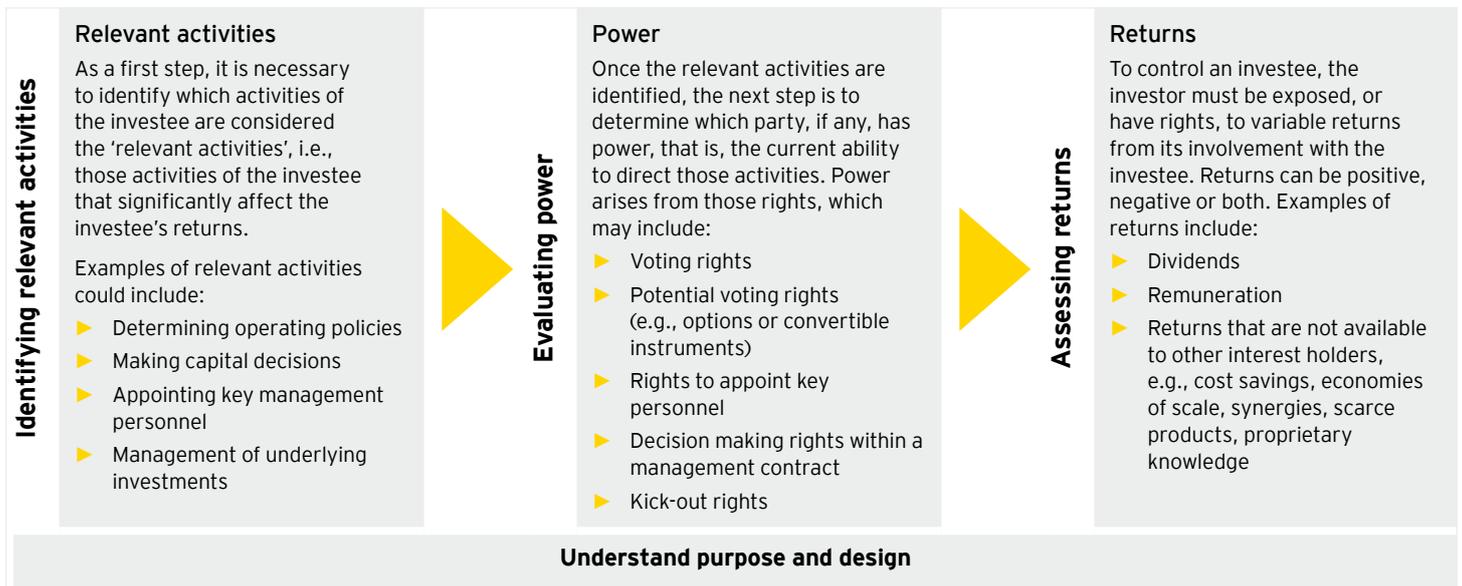
Consolidation principles

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Having power, without being able to affect those returns using that power, would not demonstrate control. This principle applies to all investees, including structured entities (previously called 'special purpose entities'). Consequently, for an investor to control an investee, the investor must possess all of the following:

- ▶ Power over the investee, which is described as having existing rights that give the current ability to direct the activities of the investee that significantly affect the investee's returns (such activities are referred to as the 'relevant activities')

- ▶ Exposure, or rights, to variable returns from its involvement with the investee
- ▶ Ability to use its power over the investee to affect the amount of the investor's returns

IFRS 10 uses the term 'investor' to refer to a reporting entity that potentially controls one or more other entities, and 'investee' to refer to an entity that is, or may potentially be, the subsidiary of a reporting entity. That is, a party can be an 'investor' and potentially control another party, without having a direct financial interest in that party.



Key issues for asset managers

Principal or agency relationships

When decision-making rights have been delegated to an asset manager, or are being held for the benefit of others, it is necessary to assess whether the decision-making party is a principal or an agent. This assessment is particularly relevant when the asset manager is also invested in the fund.

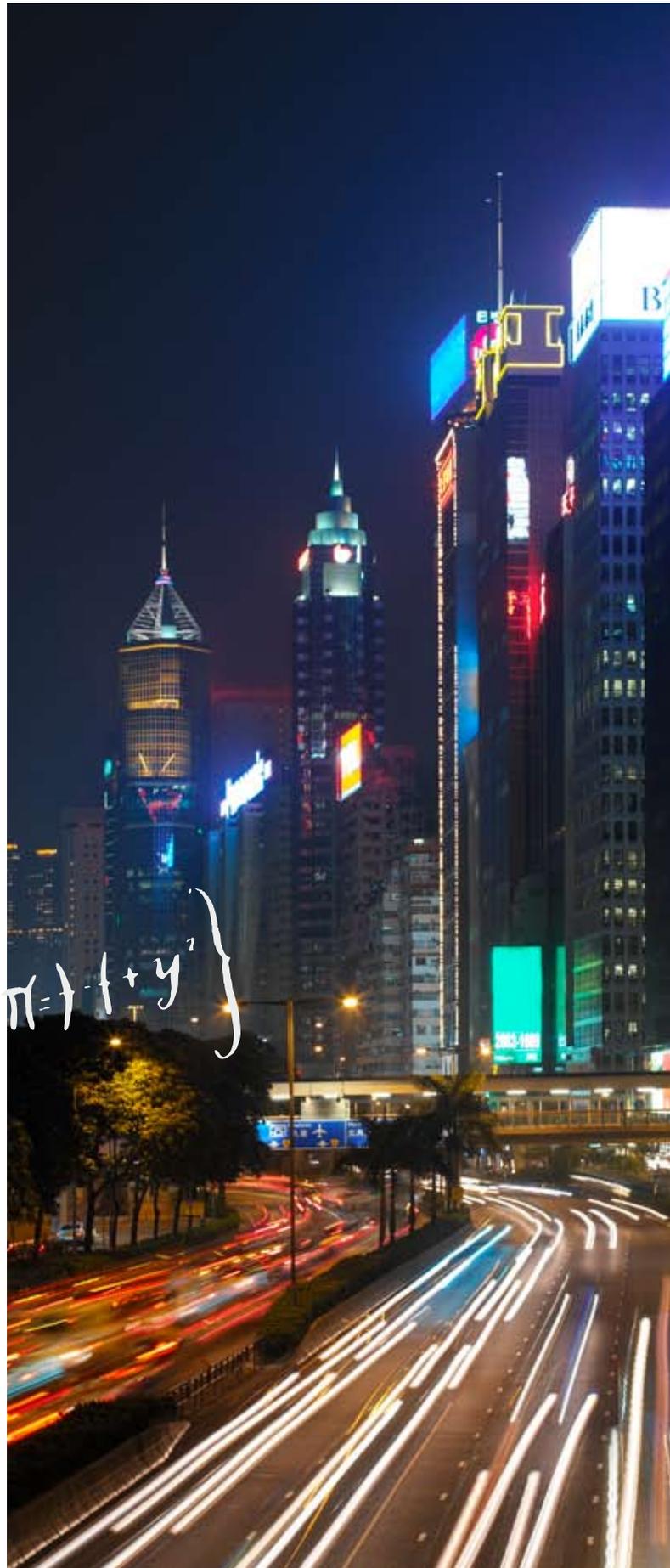
The overall relationship between an asset manager and other parties involved with the fund should be considered when determining whether the asset manager is an agent or a principal. Significant judgement based on facts and circumstances may be required. The following factors, amongst others, are considered.

Scope of authority

The scope of an asset manager's decision-making authority is evaluated by considering the range of activities that it is permitted to direct and the discretion it has when making decisions about those activities.

An asset manager will usually have discretion over the key activities of the funds, i.e., day-to-day investment decisions. These will be limited, to a greater or a lesser extent, by the investment management agreement. The extent to which the manager is able to adjust this agreement, and the discretion that the agreement allows, will be an indication as to whether the manager is acting as an agent or principal.

The asset manager, or its related parties, may be involved in the design of a fund. In such cases, the asset manager also considers the purpose and design of the fund, the risks to which the fund was designed to be exposed and the risks it was designed to pass on to the parties involved. Significant involvement in the design of a fund may indicate that the asset manager had the opportunity and incentive to obtain rights that result in it having the ability to direct the fund's relevant activities.



Handwritten mathematical notes in white ink on a semi-transparent background. The notes include: 16 , $(14^2 - 67)$, 0001.13 , 62 , $(\arcc = x^{10})$, $\int \frac{\partial}{\partial \theta} \pi = f + y^2$, and a circled phrase "what is it?".

Rights held by other parties – removal rights

When a single investor holds substantive rights to remove the asset manager without cause, in isolation, this fact would be sufficient to conclude that the asset manager is an agent. Other rights held by a single investor, such as some liquidation or redemption rights, might also indicate that the asset manager is an agent. Where these rights require more than one investor to agree to the removal of the asset manager, the number and dispersion of the investors will need to be considered together with other factors, before concluding whether the asset manager is acting as principal or agent.

Remuneration

An asset manager cannot be an agent unless the following two factors are present (although these factors, in isolation, are not sufficient to conclude that an asset manager is an agent):

- ▶ Its remuneration is commensurate with the level of skills required to provide those services
- ▶ Its remuneration agreement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated on an arm's length basis ('market terms')

It is also important to consider the magnitude and the variability of the asset manager's remuneration relative to the fund's returns (the greater the magnitude, and the greater the variability, the less likely that the asset manager is an agent).

Variable returns through other interests

When an asset manager or its related parties hold other interests in an investee, this may indicate that it is not an agent. By virtue of holding those other interests, the IASB believes that decisions made by the asset manager may differ from those it would have made if it (or its related parties) did not hold those other interests. This is most likely to arise from significant direct interests held by the asset manager (or its related parties).

Examples

Factors to be considered		Fund 1 – Principal	Fund 1 – Agent
Scope of decision-making authority	<i>Fact pattern</i>	The asset manager must make decisions in the best interests of all investors and in accordance with the entity's governing agreement; it has extensive decision-making discretion.	
	Evaluation	The asset manager's extensive decision-making authority is an indicator that it is a principal.	
Rights held by other parties	<i>Fact pattern</i>	Investors can remove the asset manager by a simple majority vote, but only for breach of contract.	
	Evaluation	Not conclusive, the investors' rights are protective rights because they are only exercisable for breach of contract.	
Remuneration	<i>Fact pattern</i>	The asset manager is paid fixed and performance-related fees that are commensurate with the services provided and include only market terms.	
		1% of assets under management and 20% of profits if a specified profit level is achieved.	
	Evaluation	The remuneration aligns the economic interest of the asset manager in the fund without creating significant exposure to variability of returns, which is an indicator that the asset manager is an agent.	
Other interests	<i>Fact pattern</i>	20% investment in the fund.	2% investment in the fund.
	Evaluation	The 20% investment creates exposure to variability of returns from the activities of the fund of such significance that might, when having considered with all the other factors, indicate that the asset manager is a principal.	The 2% investment creates exposure to variability of returns from the activities of the fund, without creating exposure of such significance that, when considered with all the other factors, indicate that the asset manager is a principal.
Conclusion	Evaluation	Based on the fact pattern and evaluation of the indicators as a whole, the asset manager may conclude that it is a principal which controls and would consolidate the fund. However, in different circumstances, for example, remuneration or other factors being different, control might arise where the level of investment is different. The greater the magnitude of, and the variability associated with the asset manager's total economic interests (remuneration and other interests), the more emphasis the asset manager would place on those economic interests in the analysis, and the more likely the asset manager is a principal.	Based on the fact pattern and evaluation of the indicators as a whole, the asset manager concludes that it is an agent that does not control and would not consolidate the fund.

Key issues for funds

Potential voting rights

Substantive potential voting rights, such as currently exercisable options, that, if exercised, would give a fund the ability to direct the relevant activities of an investee, may indicate that the fund controls the investee. Terms and conditions of potential voting rights are more likely to be substantive when the exercise of those rights would benefit the fund, for example, if the options were in the money.

Holding less than a majority of voting rights

A fund holding less than a majority of an investee's voting rights may still control an investee when the investee's relevant activities are controlled by voting rights and other voters are widely dispersed.

To determine if a fund controls an investee, judgement is required and all available facts and circumstances are considered, including:

- ▶ The larger the fund's holding of voting rights (both on an absolute basis and relative to the size of other voters' interests), and the more widely dispersed the other voters are, the more likely it is that they will be able to exercise control
- ▶ Rights arising from other contractual obligations
- ▶ Potential voting rights

Other key issues

Power over a portion of an investee

IFRS 10 also sets out requirements for how to apply the control principle in circumstances where the investor has control over specified assets of an investee. While an investor generally assesses whether it has control of another legal entity, IFRS 10 also states that control could exist at a level below a legal entity, that is, of a 'deemed separate entity', which would result in consolidation or deconsolidation of that deemed separate entity, but not the entire legal entity. In such cases, when assessing control, an investor, such as a fund manager, a fund, or an investor in a fund, considers whether it has power over specified assets of an investee in determining whether this portion of an investee is considered to be a deemed separate entity. In substance, if all of the assets, liabilities and equity of the deemed entity are ring-fenced from the overall investee, control over such portion of the entity (often referred to as a 'silo') should be assessed separately.

Like, for example, an investor who may need to consider whether it controls individual sub-funds in an umbrella structure individually. The assessment may change over time due to changes in the composition of the sub-funds.

Protective rights

Protective rights are those rights that are designed to protect the interests of their holder, without giving that party power over the entity to which those rights relate. An investor that holds only protective rights does not have power, and cannot prevent another party from having power over an investee.

An example of a protective right is the right to remove the asset manager in certain exceptional circumstances (e.g., for cause).

Structured entities

The new consolidation model applies equally to structured entities (previously known as 'special purpose entities' and which are accounted for under SIC-12) and more traditional entities where voting rights provide power. In assessing control, the purpose and design of the structured entity, as well as the expected returns, are considered (amongst other factors).

This may lead to a different conclusion when, under SIC-12, an investor did not previously consolidate, because the investor did not have rights to the majority of expected returns. Under the new standard, one might conclude that the investor controls the structured entity.



Continuous reassessment

An investor is required to reassess whether it controls an investee if the facts and circumstances indicate that there are changes to one of the three elements of control. For example, reassessment would be required if:

- ▶ Substantive changes are made to an investee's governance or structure
- ▶ An event occurs (even one that the investor is not involved in) that changes which party has power
- ▶ Changes in an investor's involvement mean that it is no longer exposed, or has rights, to variable returns

For example, if an asset manager provides all of the seed money for a fund upon inception, it is possible that the asset manager controls (and therefore consolidates) the fund at inception, but this conclusion may change as third parties invest in the fund and dilute (or eliminate) the asset manager's interest.

Equally, when removal rights are the key factor in establishing whether an asset manager is a principal or an agent, and these removal rights change, for example, becoming more or less substantive, the principal or agent analysis may change.

How we see it

A single control-based model is a significant change from the previous two-model approach (power over operating and financing policies versus risks and benefits). Management will need to re-evaluate whether the parent, asset manager, or fund needs to consolidate its investments on transition to the new requirements. For parents and funds, this re-evaluation will be affected by the decisions the Boards make for investment entities, if and when that exception is finalised. Therefore, management should closely monitor the investment entities project, to determine how it may affect their financial statements, and comment on the proposals when they are released.

Disclosure

Disclosure requirements, which are now included in a separate standard, IFRS 12, must enable users of the accounts to understand:

- ▶ Significant judgements and assumptions (and changes thereto) made by the investor in determining whether it controls the investee
- ▶ Interests that non-controlling shareholders have in the group's activities
- ▶ Effects of restrictions on the investor's ability to access and use assets, or settle liabilities, of consolidated entities, as a result of where the assets or liabilities are held in the group
- ▶ Nature of, and changes in, the risks associated with the investor's control of, or involvement with structured entities

Transition

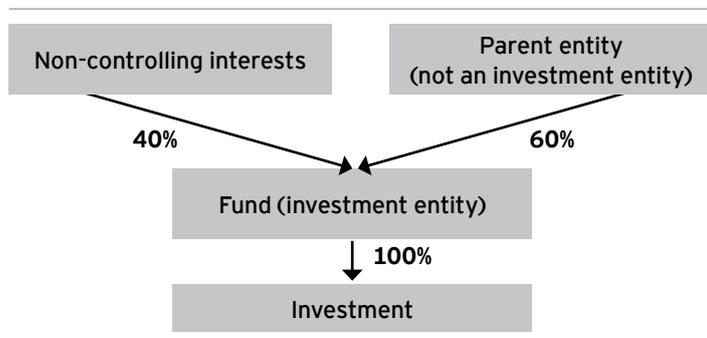
Application of IFRS 10 is retrospective, with consolidation applied from the date of gaining control. However, if it is not practical to apply the standard fully retrospectively, consolidation is required from the earliest date practicable, which may be the current period. The effective date is 1 January 2013, but entities may apply IFRS 10 early, if they also early adopt IFRS 11 and IFRS 12.

Consolidation for investment entities

An exposure draft of the Boards' proposals is expected during June 2011. Based on the Boards' deliberations to date, an investment entity would account for the investees that it controls at fair value, rather than consolidating those investees. It is expected that to qualify for this special accounting, an investment entity would be required to meet all of the following criteria:

Express business purpose	The entity's express business purpose is investing for current income, capital appreciation, or both
Exit strategy	The entity has identified potential exit strategies and a defined time (or range of dates) at which it expects to exit the investment
Investment activity	The entity's activities are substantially all investment activities carried with a view to generate current income, capital appreciation, or both
Unit ownership	The entity's ownership is represented by units of investments
Pooling of funds	The entity's owners' funds are pooled to avail themselves of professional investment management
Fair value	All of the entity's investments are managed, and their performance is evaluated (both internally and externally), on a fair value basis
Reporting entity	The entity must be a reporting entity

The above criteria are generally based on the current US GAAP investment company guidelines. However, the Boards currently differ in their proposals on whether the parent of an investment entity will also be allowed to use the exception from consolidation (and so apply fair value accounting). The diagram and narrative below illustrate this potentially significant difference:



Under both proposals, the fund (which meets the definition of an investment entity outlined in the proposals) would account for its controlled investments at fair value in its own financial statements.

Under the FASB proposal, the parent entity will be able to retain the fund's fair value accounting treatment, even where it is not itself an investment entity. On the other hand, under the IASB proposal, where the parent does not qualify as an investment entity, it must consolidate all controlled investments in its consolidated financial statements (that is, the fair value accounting would not be retained).

The IASB has stated that any changes that are required to IFRS 10 as a result of this project will have the same effective date as IFRS 10, so that investment entities will not have to change their accounting twice.

How we see it

An exception from consolidation for investment entities will align IFRS with the current accounting available to investment companies reporting under US GAAP. However, differences in the proposed accounting in the parent entity's consolidated financial statements will not achieve full comparability between the two GAAPs.



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