IFRS 10 – Consolidation for fund managers
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Quality In Everything We Do
Introduction

In this publication, we explore the impact of the IASB’s new standard IFRS 10 Consolidated Financial Statements (IFRS 10) on fund managers and their funds, and we consider some typical examples that might apply in the industry.

Whereas previous standards on consolidation did not specifically address the unique relationship between fund managers and funds, IFRS 10 now contemplates those relationships.
What do fund managers need to know?

IFRS 10 establishes a single control model that applies to all entities, replacing guidance previously contained in IAS 27 and SIC 12.

- An investor will control an investee when it has power, exposure to variable returns and the ability to use such power to affect those returns.
- An investor has power when it has rights that give it the current ability to direct the relevant activities.
- This ability to use power to affect returns is evaluated by considering whether the fund manager is acting as principal or as agent.
- When a fund manager is deemed to be acting as principal for a fund it manages, the fund manager would consolidate the fund. Conversely, if the fund manager is acting as an agent, it would not consolidate the fund it manages.
- There are four factors to consider when assessing whether a fund manager is acting as principal or agent. Of these factors, a fund manager’s exposure to variability of returns and rights held by third parties, including the right to remove (or kick out) the fund manager and the right to direct the relevant activities, will have a critical influence on the conclusion.
- Fund managers may reach differing consolidation conclusions over funds they manage compared with their current practice.
- Understanding the purpose and design of an investee is critical when identifying who has control by knowing the goal of each investor; that is, why the investor is involved with the investee, and what that involvement is.
- IFRS 10 is applicable for accounting periods beginning on or after 1 January 2013. For entities reporting under IFRS as adopted by the EU, adoption is mandatory only for accounting periods beginning on or after 1 January 2014, but with early adoption permitted.
A new concept of control

IFRS 10 establishes a single control model that applies to all entities, replacing guidance previously contained in IAS 27 Consolidated and Separate Financial Statements (IAS 27) and SIC 12 Consolidation – Special Purpose Entities (SIC 12).

IFRS 10’s control model is summarised, as follows:

“An investor controls an entity 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.” (IFRS 10 paragraph 6)

The combination of factors is illustrated in the diagram below:
IFRS 10 paragraph B8 states that “An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor’s consideration of the purpose and design of the investee will also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.”

Understanding the purpose and design of the investee helps to determine a number of important elements in the relationship between fund managers and funds:

- To which risks was the investee designed to be exposed, and what are the risks it was designed to pass on to the parties with which it is involved?
- What are the relevant activities?
- How are decisions about the relevant activities made?
- Who has the ability to direct the relevant activities?
- Which parties have exposure to variable returns from the investee?
- How do the relevant activities affect returns?
- Do the parties that have power and exposure to variable returns have the ability to use that power to affect returns?

In short, understanding the purpose and design of the investee sheds light on the objective of each investor and therefore whether control exists.

**Application date and transition provisions**

- IFRS 10 was issued in May 2011 and is effective for annual periods beginning on or after 1 January 2013. In June 2012, the IASB clarified its transition guidance for first-time application of IFRS 10.
- At the date of initial application (“the beginning of the annual reporting period in which IFRS 10 is applied for the first time”), an entity is not required to make retrospective changes to its previous accounting for its involvement in entities if the consolidation conclusion reached under IFRS 10 is the same as that reached under the previous guidance in IAS 27 and SIC 12.
- Relief from retrospective application at the date of initial application has been extended for interests disposed of in the comparative period. Furthermore, if, under IFRS 10, there is a change in the consolidation conclusion at the date of initial application, the requirement to adjust comparative information is limited to the period immediately preceding the date of initial application. Adjustment to earlier periods is permitted but not required.

Within the European Union (EU), adoption of IFRS 10 is mandatory for accounting periods beginning on or after 1 January 2014, but, with earlier adoption permitted to allow for consistent application for EU-registered entities that are part of a global group.
The link between power and variable returns

Typically, a fund manager is likely to satisfy the first two criteria of the control model (described above), as follows:

- **Power** — a fund manager is likely to have power (i.e., the current ability to direct the relevant activities). This is because the fund manager would normally have decision-making rights over the relevant activities.
- **Variable returns** — a fund manager is always exposed to variable returns through its involvement with a fund as a result of earning management fees and performance fees. In addition, a fund manager often holds a direct interest in the fund (either directly or potentially through certain related parties).

The key determinant in deciding whether a fund manager has control over a fund is the link between power and variable returns.

**Delegated power – principal or agent**

An agent is a party that is engaged to act on behalf of another party (principal), but which does not have control over the investee. An investor may delegate decision-making authority to an agent on some specific issues or on all relevant activities, but, ultimately, the investor as principal retains the power. Accordingly, a decision maker that is not an agent is a principal.

It is necessary to assess whether the decision maker is acting as a principal or an agent, to determine whether the decision maker is deemed to have control.

IFRS 10 provides guidance for analysing control, by asking whether the decision maker (e.g., a fund manager), is acting as a principal, or as an agent that is acting primarily on behalf of other investors.

An agent cannot have control over the investee and therefore will not consolidate the investee. In contrast, a fund manager that is a principal controls the investee and so will consolidate the investee.

**De facto agents**

When assessing control, the nature of relationships with other parties (such as related parties), will need to be considered in order to conclude whether these related parties are in effect acting on behalf of the fund manager (i.e., whether they are *de facto* agents). Where related parties are *de facto* agents of the fund manager, the fund manager’s decision-making rights and exposure to variable returns via the *de facto* agent, together with its own, will need to be considered in totality when assessing control.

**How we see it**

**Consolidation conclusion and potential implications**

As a result of applying IFRS 10, fund managers may reach a different consolidation conclusion than they do today about the funds they manage, when applying IAS 27 and SIC-12. Different consolidation conclusions will not only be driven by new guidance under IFRS 10, but also by the level of judgement its application requires.

For example, in some cases, the fund manager may be regarded as acting as a principal, thus it will consolidate additional funds and consequently increase the size and complexity of its balance sheet. This may have a direct impact on systems, processes and controls, key metrics and ratios, as well as how the fund manager communicates with investors.

If a fund manager were to consolidate additional funds under IFRS 10, the fund manager may also have to consider implications regarding the sufficiency of a fund manager’s regulatory capital and other regulatory reporting requirements. In addition, consolidation of additional funds may place extra demands on already tight financial reporting timetables.

When applying IFRS 10, a fund manager may also conclude that it no longer controls a fund when it had previously consolidated the fund under IAS 27 or SIC-12.

Fund managers should perform the new analysis of what, if any, funds they may need to consolidate to allow sufficient time for appropriate planning to take place in advance of their selected date of application.
Determination of whether the fund manager is acting as principal or agent

IFRS 10 paragraph B60 requires that the following factors are evaluated to determine whether the fund manager is acting as principal or agent:
1. The scope of the fund manager’s decision-making authority over the fund.
2. The rights held by third parties.
3. The remuneration to which the fund manager is entitled in accordance with the remuneration agreement(s).
4. The fund manager’s exposure to variability of returns from other interests that it holds in the fund.

We discuss all four factors in more detail below.

Diagram 1 — Evaluating whether a fund manager is acting as principal or agent

- Weigh the factors
- Scope of decision-making authority
- Compensation
- Other interests
- Rights held by others

How we see it

The fund manager will have to use judgement to qualitatively evaluate all aspects of its arrangement, including its power, the rights that are held by third parties and the aggregate of its exposure to variability of returns. The following are examples of potential areas of complexity:
- Identifying the relevant activities, and the risks the entity is designed to pass on
- Identifying which party has the ability to direct or participate in decisions over the relevant activities
- Considering options that may give an investor the current ability to direct the relevant activities
- Deciding whether rights to remove a decision maker or rights to direct decisions are substantive
- Evaluating where, if a decision maker has interest in the fund, how significant its overall returns are.

The judgemental nature of the evaluation of the principal/agent criteria could result in diversity in accounting among fund managers.
1. Scope of decision-making authority

In many cases, it will be clear that control of an investee is held through voting rights. However, when this is not clear, a crucial step in assessing control is identifying the relevant activities of the investee. Relevant activities and how they influence whether an investor has power are discussed in detail in our publication, Applying IFRS: Challenges in adopting and applying IFRS 10.

The scope of a fund manager’s decision-making authority is considered by evaluating the activities that it is able to direct and the discretion it has when making these decisions. In particular, it is necessary to understand how the decision-making authority relates to the relevant activities of the fund.

In some cases, a fund manager will need to work within the defined fund mandate, such as in an index tracking fund. However, this alone does not mean that the fund manager has decision-making authority. Further assessment is needed to determine what type of decisions can or need to be made, and what the fund manager’s role will be in making those decisions. Where a fund manager’s mandate excludes discretion over certain key activities of a fund, the degree to which this affects its ability to direct the relevant activities will need to be carefully considered.

2. Rights held by third parties – removal (or kick-out) rights

This factor considers the circumstances in which a third party (or parties) has the ability to remove the fund manager. For a right to convey power, the right must give current ability to direct the relevant activities. Rights are only considered if they are substantive (i.e., the holder must have the practical ability to exercise the right). Whether or not the rights are substantive depends on the facts and circumstances of each case.

Rights held by a single party

Removal rights are determinative when a single third party is able to remove the fund manager without cause.

Rights held by many parties

While removal rights may be stipulated in the investment management agreement, on some occasions they may only be exercised if a number of different investors act together. The greater the number of parties that need to act together, the less indicative this will be of an agency relationship.

Removal rights that are protective in nature

Protective rights typically relate to fundamental changes in the activities of an investee. These rights protect the investor in circumstances that are beyond the purpose and design of the entity. For example, rights that provide for the removal of the fund manager for committing fraud would not typically be considered part of the purpose and design, and therefore are protective rights. Consequently, power does not arise from protective rights and they are not relevant when assessing whether a fund manager is acting as principal or agent.

Almost all contracts will provide for the removal of the fund manager in some manner, so judgement will need to be exercised to determine whether the right is substantive or protective.
Currently exercisable

An investor has power when it has existing rights that give it the ‘current ability’ to direct the relevant activities. However, current ability does not always mean ‘able to be exercised this instant’. In order to assess the current ability, an understanding is required to determine whether there are any restrictions regarding such rights and how the restrictions will affect the decision-making (if at all) during the period of this restriction. For example, if limited decisions will be made prior to the right becoming exercisable, the restriction may not be substantive.

If an investor has the ability to remove the fund manager subject to a notice period, the current ability will be affected by the length of the notice period and any restrictions surrounding the decision-making of the fund manager during this notice period.

Penalty fees

The ability to remove the fund manager may be subject to barriers to exercise. Barriers may include a lack of suitable replacements or a penalty or severance fee payable to that fund manager if it is removed. The magnitude of such fees will have a bearing on how substantive the removal right is and, in certain circumstances, the penalty or fee may render the removal right non-substantive.

Other rights

In some cases, rights held by other parties (such as liquidation rights and redemption rights) may be considered in the same way as removal rights if, in substance, they have the same effect as a removal right when assessing whether a fund manager is an agent or a principal.

Liquidation rights

These rights may allow investors to enforce the liquidation of a fund. For example, investors may be allowed to close the fund earlier than the fund’s contracted life, if specific performance targets are not met within the fund’s early years. Alternatively, liquidation rights could be structured without cause. When assessing the substance of these rights, a fund manager will need to consider the relevant facts and circumstances.

Redemption rights

Funds will often contain redemption rights that allow investors to redeem their units. These rights may in substance represent liquidation rights; that is, if the level of redemption is significant, it may force the fund manager to liquidate the fund and its underlying assets. However, there may be restrictions on the ability to exercise redemption rights (e.g., gating provisions), and therefore, the fund manager may be able to reject a redemption request. In assessing whether these rights are substantive, a fund manager or investor will need to consider all of the relevant facts and circumstances.

Some of the criteria that may be more relevant when evaluating removal rights are shown in diagram 2.

Diagram 2 – Evaluating whether removal rights are substantive

<table>
<thead>
<tr>
<th></th>
<th>Many parties required to act together</th>
<th>Single party/few parties required to act together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exercisable only for cause</td>
<td>Exercisable without cause</td>
<td></td>
</tr>
<tr>
<td>Significant financial penalty to exercise</td>
<td>Insignificant financial penalty to exercise</td>
<td></td>
</tr>
<tr>
<td>Skills held by decision-maker are unique</td>
<td>Several other parties could fulfil role of decision-maker</td>
<td></td>
</tr>
<tr>
<td>Not currently exercisable</td>
<td>Currently exercisable</td>
<td></td>
</tr>
</tbody>
</table>

Principal  Agent

Decision-maker
3. Remuneration

The following conditions are necessary for a fund manager to be deemed an agent:

- The remuneration the fund manager earns is commensurate with the services it renders.
- The remuneration arrangement only includes terms and conditions that are customarily present in arrangements for similar services and level of skills negotiated on an arm’s-length basis.

**How we see it**

In practice, we expect that most fund manager contracts will satisfy the remuneration conditions, because third parties investing in a fund are unlikely to agree to remuneration clauses that are not commensurate with the service rendered by the fund manager, or fee structures that are not market-related. However, meeting these conditions in isolation is not sufficient to conclude that a fund manager is an agent.

4. Exposure to variability of returns through other interests

The greater the magnitude and variability of the returns that a fund manager is exposed to from its involvement with a fund, the less likely it is acting as an agent. IFRS 10 describes variable returns as those that have the potential to vary as a result of the investee’s performance. For a typical fund manager, variable returns are likely to be a combination of a direct interest, management fees and performance or other incentive fees that the fund manager earns.

In assessing a fund manager’s exposure to variability of returns, one challenge is how to consider a fund manager’s various interests on a collective basis. This may include management fees, performance fees, direct interests, loans and the provision of guarantees. The differing nature of these interests means that any method of aggregation will be highly subjective. For example, performance fees receive only upside and guarantees are only exposed to downside risk, whereas direct interests are exposed to both upside and downside variability, as the return varies with the value of the fund.

In our view, the presence of a downside risk would be weighted more heavily than economic interests that are exposed only to upside risk (e.g., management fees).
The decision tree below provides a summary of the four factors that require careful consideration. The decision tree does not rank the factors by order of importance, but does confirm that in certain circumstances, either removal rights or remuneration are determinative. If these factors are not determinative, then a qualitative assessment of all four factors will be required. It is important to remember that, as part of this assessment, the purpose and design of an investee is critical when assessing whether an investor has control of an investee.

**Does a single party have substantive removal rights? (IFRS 10 B65)**

- **No**
  - **Is compensation:**
    - Commensurate with regards to the services rendered
    - Does it only include terms and conditions that are customarily present in arrangements for similar services and level of skills negotiated on an arm's-length basis? (IFRS 10 B70)

- **Yes**
  - Then, assess the following factors:
    - The scope of the manager’s decision-making authority over the investee
    - The rights held by third parties (i.e., removal rights)
    - The decision maker's exposure to variability of returns from remuneration and other interests that it holds in the investee

**Agent (do not consolidate)**

**Principal (consolidate)**
Analysis of the examples in IFRS 10

IFRS 10 includes the following examples that highlight all four factors discussed above, but, in particular, they illustrate how third party rights and variability of total returns should be qualitatively considered in the assessment of a principal/agent relationship. In general, the examples demonstrate that the more easily the fund manager can be removed, the higher a level of exposure to variability of returns will be required before the entity would conclude it is acting as a principal. Although these examples provide guidance on assessing a principal/agent relationship, they are not intended to create ‘bright lines’ but, rather, are for illustrative purposes only.

<table>
<thead>
<tr>
<th>Example (IFRS 10 reference)</th>
<th>Scope of decision-making rights</th>
<th>3rd party rights to remove fund manager</th>
<th>Remuneration</th>
<th>Other interests</th>
<th>Principal/Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>Narrowly defined remit</td>
<td>None</td>
<td>1% of net asset value</td>
<td>10% direct interest</td>
<td>Agent</td>
</tr>
<tr>
<td>14A</td>
<td>Wide ranging discretion</td>
<td>Removal for cause</td>
<td>1% of net asset value and 20% of profits after a hurdle is reached</td>
<td>2% direct interest</td>
<td>Agent</td>
</tr>
<tr>
<td>14B</td>
<td>Wide ranging discretion</td>
<td>Removal for cause</td>
<td>1% of net asset value and 20% of profits after a hurdle is reached</td>
<td>20% direct interest</td>
<td>Principal*</td>
</tr>
<tr>
<td>14C</td>
<td>Wide ranging discretion</td>
<td>Removal without cause by independent board</td>
<td>1% of net asset value and 20% of profits after a hurdle is reached</td>
<td>20% direct interest</td>
<td>Agent</td>
</tr>
<tr>
<td>15</td>
<td>Narrow discretion</td>
<td>Removal without cause by widely dispersed investors</td>
<td>1% of net asset value and 10% of profits after a hurdle is reached</td>
<td>35% direct interest</td>
<td>Principal</td>
</tr>
</tbody>
</table>

*Example 14B of IFRS 10 states “... having considered its remuneration and the other factors, the fund manager might consider a 20 per cent investment to be sufficient to conclude that it controls the fund.”
Methods to calculate exposure to variability

While IFRS 10 does refer to the need to consider “remuneration and other interests in aggregate” (IFRS 10 paragraph B72), neither the guidance in the standard nor the examples discussed above show how these elements should be aggregated in practice. The IASB notes in the Basis for Conclusions that it was concerned that bright lines might encourage structuring to achieve a particular accounting result. As a result, we believe that the overall evaluation of whether a decision maker is acting in the capacity of principal or an agent is primarily a qualitative evaluation requiring the use of judgement.

At the time of writing, we were aware of at least two approaches in practice that have developed in the asset management industry to evaluate a fund manager's aggregate exposure to variability. One approach simply aggregates the possible returns, assuming they are all achieved, while the other models scenarios of the returns actually expected. We address these methods using a simple example in Appendix A to this document. While we believe that the overall evaluation is primarily qualitative, a mathematical calculation of overall returns may be helpful in understanding exposure to total returns.

Continuous assessment

IFRS 10 introduces the need for continuous assessment of investees, described as follows:

“An investor 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 listed in paragraph 7” (IFRS 10 paragraph B80).

Paragraph 7 of IFRS 10 states:

“Thus, an investor controls an investee if and only if the investor has all the following:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of the investor’s returns.”

Therefore, it is possible that an investee could change its consolidation conclusion between reporting periods, as facts and circumstances change. However, a change in market or economic conditions would only trigger a re-assessment of control if the evaluation of one of the principal/agent criteria were to change.

In practice, the continuous assessment needs to reflect not only changes in the relationship between investee and investor, such as direct interests or fees, but also changes in factors outside the relationship, such as changes to the dispersion of other shareholdings (i.e., other investors could acquire new rights or have existing rights become substantive). As such, a change will require a new consolidation assessment to be performed. The fund manager should consider both how to identify such changes and how to record and measure individual factors that may affect the consolidation decision. This evaluation should always be considered in the context of the investee's purpose and design.
Investment entity exception to consolidation

The IASB recently issued an amendment to IFRS 10 to provide an exception to the consolidation requirement for entities that meet the definition of an investment entity. Entities that qualify as investment entities must not consolidate their subsidiaries; instead, those subsidiaries are accounted for at fair value through profit or loss in accordance with IAS 39 Financial Instruments: Recognition and Measurement and/or IFRS 9 Financial Instruments. However, there is one exception to this rule. If an investment entity has a subsidiary that provides investment-related services (such as management services) to the investment entity itself, then the investment entity must consolidate that subsidiary.

When assessing whether an entity is an investment entity, all facts and circumstances, including the purpose and design, must be considered.

To satisfy the investment entity definition, an entity must:

- Obtain funds from one or more investors for the purpose of providing those investors with professional investment management services
- Commit to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both
- Measure and evaluate the performance of substantially all of its investments on a fair value basis

The investment entity exception will not be relevant for a fund manager unless the fund manager is also the investor in funds of other entities, which we believe will be a rare occurrence.

In addition to meeting the definition, an entity must consider whether it has typical characteristics of an investment entity, including:

- Having more than one investment - to diversify the risk portfolio and maximise returns
- Having more than one investor - to pool funds to maximise investment opportunities
- The fact that investors in the entity are not related parties of the investment entity
- All ownership interests in the entity are in the form of equity or similar interests

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity, but the investment entity will need to provide additional disclosure if some or all of these characteristics are missing.

Originally, the exposure draft proposed that an entity would not qualify as an investment entity if the entity provided substantive investment-related services to third parties. However, some respondents, as well as the IASB staff, were concerned that this would exclude a number of private equity companies that should otherwise qualify as investment entities. After some debate, the IASB decided that an entity will not be disqualified from being an investment entity only because it provides substantive investment-related services to third parties. An investment entity may therefore also provide investment-related services to third parties as well as investors, even if those activities are substantial to the entity.
An investment entity may also provide the following services to the investee, provided they are undertaken to maximise investment returns:

- Management services and strategic advice
- Financial support

The exception to consolidation used by investment entities is not retained by parent entities that are not themselves investment entities. That is, a non-investment entity parent is not permitted to ‘roll up’ the investment entity accounting, but must consolidate all entities that it controls.

**How we see it**

The majority of respondents to the exposure draft supported allowing the roll-up of the investment entity accounting, arguing that fair value information is as relevant at the parent-entity level as at the investment entity level. However, the IASB decided not to permit this, largely due to the structuring opportunities it may create. The IASB also noted that this will create a difference as compared to US GAAP, which requires all parents of investment entities to retain the fair value accounting used by an investment entity subsidiary.

An investment entity must elect the exemption from the equity method in IAS 28 *Investments in Associates and Joint Ventures*.

In a change from what was proposed in the exposure draft, entities that are venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities, will still be permitted to elect to measure investments in associates and joint ventures at fair value in accordance with IAS 39 or IFRS 9.

The investment entity exception is applicable for periods beginning on or after 1 January 2014, with early adoption permitted. Further information on the investment entity exception can be found in our publication, *IFRS Development Issue 44: Investment entities final amendment*, that was published in November 2012.
Application examples

Below are six examples of typical fund manager fund relationships that highlight key indicators in determining whether the fund manager is acting as a principal or agent.

These examples further demonstrate that, while the key factors are likely to be the exposure to variable returns and the rights held by other parties, the manner in which these factors are weighted in the overall evaluation may be influenced by the ability of the fund manager to affect the variable returns.

Example 1

A fund manager of an Investment Trust (the Trust), earns a market-based management fee of 1% of net asset value and a performance fee of 20% over a hurdle rate of 8% outperformance, per annum. The fund manager also holds a 15% direct interest in the Trust.

The fund mandate is broad and the fund manager is able to invest in a range of equity and debt instruments. The Trust has an independent board that acts on behalf of the shareholders, that was appointed at inception and that is subject to annual reappointment by a majority of investors voting at the annual meeting. The decision-making activity is delegated by the board to the fund manager.

The board is responsible (by majority vote) for the appointment and removal of the fund manager without cause.

Other shareholdings in the fund are dispersed with no individual shareholder holding more than 15%.

No redemption rights are held by shareholders.
Considerations
When analysing whether the fund manager is a principal or an agent, the following criteria should be considered:

Scope of decision-making authority
The board has delegated decision-making authority to the fund manager via the fund mandate. This confirms that the fund manager possesses the decision-making authority to affect the returns of the fund.

Rights held by third parties
The fund manager may be removed without cause by a majority of the board. While it is representative of a substantive removal right, on its own it is not determinative, given the requirement for the majority of board members to act together.

Remuneration
The remuneration structure is typical of this type of arrangement. In the absence of indicators to the contrary, this factor is unlikely to be determinative.

Exposure to variable returns through other interests
The fund manager has exposure to variable returns from its direct interest, management fee and performance fee. The exposure to variable returns will need to be considered in a qualitative context as part of the evaluation of all four factors which require consideration in assessing whether the fund manager is acting as an agent or a principal.

Conclusion
Taking into consideration the analysis of the IFRS 10 examples discussed earlier, there is a substantive removal right, which would appear to be sufficient to outweigh the fund manager’s overall exposure to variable returns through its direct interest, performance fee and management fee. Therefore, based upon the facts and circumstances, it is reasonable to conclude that the fund manager is acting as an agent.

Example 2
The fund manager is a wholly owned subsidiary of a property investment company which is a direct investor in an Investment Trust (the Trust). The Trust invests in property assets and securities within the real estate market. The Trust has a sub-fund that holds assets on behalf of investors and is managed by the fund manager who has been delegated the decision-making authority and so the power to direct the relevant activities. The investor group is widely dispersed.

The investors’ returns are based on the net income of the Trust which is achieved through its activities of property rental and investment. There are no restrictions on the decision-making activities of the fund manager in respect of the Trust’s activities. The fund manager may only be removed by a vote of investors representing 50% of the votes. The vote for removal of the fund manager is only triggered if there is cause, as specified within the investment management agreement between the fund manager and the Trust, e.g., a breach of contract.

The investment company owns 100% of the fund manager and 20% of the units in the Trust. The fund manager is entitled to a trust management fee, a leasing fee and a property fee, calculated, as follows:

• The trust management fee is 5% of all gross proceeds earned on property investments per annum
• The leasing fee is 5% of gross proceeds for the first year of a new or extended lease of a property investment
• The property fee is 5% of a property purchase price and the fee is due on completion of a property purchase by the Trust.
Considerations

Scope of decision-making authority
The relevant activities of the Trust revolve around maximising net rental income and capital value of property investments. The fund manager has decision-making authority with respect to all of the relevant activities of the Trust. No activities require investor approval.

Rights held by third parties
There are third-party rights with respect to removal of the fund manager, but they are not substantive. The fund manager can only be removed with cause.

Remuneration
The remuneration structure is considered to be at the market rate given the presence of third parties (investors). In the absence of indicators to the contrary, this factor is unlikely to be determinative.

Exposure to variable returns through other interests
The property investment company has exposure to variable returns through direct interests and various fee arrangements (through the fund manager’s activities). The fee arrangements are based on the performance and activities of the Trust and reflect variable returns available to the investment company that are not available to other investors. In addition, it is appropriate to assess the expected level of activity that will be needed (e.g., lease turnover) to be able to understand the relationship of these factors to the overall returns of the fund.

Conclusion
In assessing whether the property investment company would consolidate the sub-fund, interests of the investment company as well as that of the fund manager, a wholly owned subsidiary of the property investment company, would be taken into consideration.

Through the fund manager, the property investment company has decision-making authority over the relevant activities of the Trust. The fund manager can only be removed with cause, therefore, third party rights are not relevant when assessing whether the property investment company consolidates the sub-fund.

The property investment company benefits from a significant variable return when considering both the variable fee arrangements (in particular, the percentage fees received for transactions executed by the fund manager on behalf of the Trust) and the 20% interest held in the units of the Trust.

Considering this significant exposure to variable returns and the fact that there are no substantive removal rights, it is likely that the property investment company will consolidate the sub-fund.

Additional analysis will however be necessary to assess whether the sub-fund is consolidated directly by the fund manager within its own financial statements, or whether the sub-fund is only consolidated by the investment company as part of its group financial statements.
Example 3

The fund manager is the general partner (GP) of a fund set up as a limited partnership. The fund invests in private equity assets which it then plans to sell for capital gains.

The GP is able to select investments within certain parameters, for example, it cannot invest in tobacco or alcohol-related products or companies.

The fund is set up with a 10-year life, of which the initial three years will be an investment period (Investment Period) when the fund will purchase, but not divest, investments.

The fund itself is comprised of five limited partners, all with an equal share. The GP has a 0.01% share in the fund.

The GP can be removed without cause by the limited partners, but only after the initial three year Investment Period described above. Three out of the five limited partners are required to remove the GP. During the initial three year period, the GP can only be removed for cause, e.g., breach of contract.

The GP receives a fee equal to 1% of committed capital and receives a carry of 20% of excess returns once a hurdle of 8% has been met. The carry only accrues on the sale of assets, which are only typically expected to occur towards the end of the life of the fund. The carry is payable only at the end of the fund’s life, unless the GP is removed. In this case, any carry earned up until the point of removal is payable on removal.

Considerations

Scope of decision-making authority

The GP has broad decision-making authority (within the restrictions contained in the mandate) relating to the relevant activities of the limited partnership.

Rights held by third parties

There are substantive third party rights to remove the GP, but they are only exercisable after the initial three year Investment Period. From the fourth year onwards, the GP can be removed without cause by the limited partners. A simple majority of the limited partners (three out of the five) is required to remove the GP. Therefore, while substantive, the removal rights are not in the hands of a single party and would not be considered determinative on their own.

Remuneration

The remuneration structure is typical of such a relationship and, in the absence of indicators to the contrary, this factor is unlikely to be determinative.
Exposure to variable returns through other interests

The assessment of performance fees requires significant judgement when quantifying the aggregate exposure to variable returns. This is further complicated because returns are only generated on the sale of the assets. Such asset sales will tend to be towards the end of the life of the fund, and it is only in the event of sale that carry will be generated. Sales are not guaranteed until the end of the fund’s life.

The overall exposure to variability of returns is primarily through a market remuneration arrangement (the carry of 20%). If the GP is removed by third parties, any carried interest that has accrued until this point will be payable.

Conclusion

Although the GP cannot be removed without cause in the first three years, it only receives a 1% fee during this period. Only after the initial Investment Period do third parties have the right to remove the GP by a vote of three of the five limited partners. While the GP earns 20% carry as well as the 1%, it is not exposed to downside risk, unlike the exposure of the other investors. The GP is therefore deemed to be an agent and would not consolidate the fund.

Example 4

A fund manager creates a listed trust (the Listed Trust), the units of which are sold in the open market, leaving the fund manager with 15% of the remaining units. Those units that are held in the market are highly dispersed.

The Listed Trust invests in real estate assets (properties) which are leased at a market rate to unrelated third parties. The lease rates can be adjusted to a current market rate on a five-yearly basis.

The fund manager is able to make decisions relating to the purchase and sale of properties with few restrictions. The fund manager may be removed by investors without cause, provided that 75% of the investors (excluding the fund manager), cast their votes at a meeting specially convened at the request of 10% of the investors. Removal of the fund manager is also subject to a three month notice period.

The fund manager earns a fee of 1% of gross asset value of the Listed Trust. A performance fee of 5% of profit earned on property sales is payable to the fund manager upon completion of the property sale.
Considerations

Scope of decision-making authority
The fund mandate allows the fund manager broad decision-making authority. The fund manager has full discretion and is responsible for decisions made in respect of buying and selling assets that create the returns for the fund. Buying and selling assets are relevant activities of the fund.

Rights held by third parties
Third parties have the right to remove the fund manager, but the exercise of the removal right requires at least 10% of the investors (who are widely dispersed) to convene a special meeting to vote on the fund manager’s removal. Such a meeting is considered to be difficult to convene. In addition, once convened, at least 75% of the votes are then required for the removal of the fund manager. Therefore, the removal rights are not likely to be considered substantive.

Remuneration
The remuneration structure is typical for such trust structures. In the absence of indicators to the contrary, this factor is unlikely to be determinative.

Exposure to variable returns through other interests
In addition to the fund manager’s exposure to returns arising from its 1% fee arrangement and performance fee, the 15% direct interest in the Listed Trust exposes the fund manager to positive and negative variable returns based on the performance of the fund.

Conclusion
Although the fund manager has decision-making authority, third party removal rights are not substantive and the level of aggregate exposure to variable returns may be indicative of an agency relationship. Consequently, it is likely that the fund manager is acting as an agent.

A variation on example 4
If the entities leasing the properties are part of the same group as the fund manager, then this may indicate an additional variable return that is due to the group, as the group may benefit additionally from this relationship. The exposure to variable returns generated by the group’s interest in the lease contracts is however difficult to quantify. IFRS 10 paragraph B57 states that returns should include “returns that are not available to other interest holders [...] such as combining operating functions to achieve economies of scale”. This could be interpreted to include any benefit the group may gain from the leasing agreement and its relationship with the Listed Trust. In this case, it is worth remembering the importance that the purpose and design of the investee has in determining control. Given this greater economic benefit and the group’s overall exposure to variable returns, one would be more likely to conclude that the Listed Trust should be consolidated by the group. The fund manager has decision-making authority to direct the activities of the Listed Trust in favour of the group’s overall exposure to variable returns.
Example 5

The fund manager is an Authorised Corporate Director (ACD) of an Investment Company with Variable Capital (ICVC).

The ICVC is split into five sub-funds, all of which have different investment mandates. Each mandate is broadly scoped and the fund manager is able to invest in a range of equity and debt instruments.

The fund manager receives a fee equal to 1% of net asset value for each sub-fund.

Investors in each sub-fund hold redemption rights that allow investors to redeem their units to the sub-fund at the current net asset value. The fund manager is able to reject such requests when, either individually or in aggregate, they exceed 10% of the net asset value of the sub-fund in an annual reporting period.

Investors in an individual fund may also elect to liquidate that sub-fund in its entirety, provided they gather the favourable vote of 75% of investors of that sub-fund.

The ACD may be removed without cause by a vote of investors representing 75% of units held across all sub-funds. Such a vote must be called by investors holding at least 10% of units across all sub-funds.

Although the ACD will endeavour to maintain each sub-fund on a separate basis, the governing documents allow the assets of one sub-fund to be used to settle the liabilities of another. However, this scenario is considered unlikely because assets within funds are likely to exceed liabilities in almost all sub-fund structures.

The fund manager holds a 30% aggregate of units across the five sub-funds, and it can hold a maximum of 40% of units in any one sub-fund. Other unit holdings are dispersed, with no individual investor holding more than 20% in any one sub-fund, or across the master fund as a whole.
Considerations

For the purposes of this example, we have assumed the sub-funds do not meet the criteria to be treated as separate silos. When analysing whether the fund manager is a principal or agent, the following factors should be considered:

**Scope of decision-making authority**
The fund manager has broad decision-making authority.

**Rights held by third parties**
Investors do have the ability to remove the ACD, but such a vote can only be called by investors holding at least 10% of units across all sub-funds. In the absence of any evidence that units across the five sub-funds are concentrated in the hands of a limited number of investors, the 10% minimum unit holding would not be reasonably achieved. Therefore, given the barriers to exercise, the removal right would not be considered substantive. Other rights held by investors include redemption and liquidation rights. The redemption rights can be blocked by the fund manager and thus are not equivalent to kick out rights. The liquidation rights may be exercised without approval by the fund manager. However, as consolidation is being assessed at the ICVC level, this right would only be likely to be an important consideration if a limited number of investors were able to exercise the right together. As mentioned above, this is not expected to be the case in this scenario.

Remuneration

The remuneration structure is typical of such a relationship and in the absence of indicators to the contrary, this factor is unlikely to be determinative.

**Exposure to variable returns through other interests**
The fund manager will be exposed to variable returns from both its remuneration (1% of net asset value) and its direct interest of 30%. The fund manager is therefore exposed to significant variability of returns.

Conclusion

The fund manager's significant exposure to variable returns (including downside exposure), and the lack of substantive removal rights held by third parties, indicate that the fund manager is acting as principal. Although the fund manager only has 1% remuneration and no performance fee, more weight is attributable to the level of direct interest of 30%. A 30% direct interest will carry more weight, than say an equivalent performance fee percentage, because the direct interest is exposed to downside risk as well as upside risk.
Example 6

A hedge fund manager has established a fund that invests in alternative assets.

The fund manager is able to choose from a wide range of assets for investment purposes. The fund has an unlimited life and the fund manager may not be removed without cause.

Investors may redeem holdings to a maximum of 10% of the total assets in the funds within a financial year.

At inception, the fund manager is the sole investor in the fund because it seeks to demonstrate positive fund performance before inviting external investors to participate. At the end of year one (which corresponds with the financial year end of the fund manager), the fund manager holds 80% of the equity in the fund.

At the end of year two, the fund manager’s holding is diluted to 10%, because 10 external investors, holding between 5% and 10% each, have since invested in the fund.

The fund manager receives a fee equal to 2% of net asset value at the period end and 20% of outperformance if a hurdle rate of 8% performance is met in any one year.
Considerations

Scope of decision-making authority
By virtue of the fund’s mandate, the fund manager has a broad scope of decision-making authority.

Rights held by third parties
There are no substantive third party rights to remove the fund manager. The removal rights are protective in nature because the fund manager cannot be removed without cause.
Redemption rights are subject to a maximum provision (i.e., no more than 10% of the fund in any one period) and so are only exercisable at the discretion of the fund manager. If there was no such restriction, assuming the redemption rights are not widely dispersed, they would effectively override the protective nature of any removal rights because investors would be able to liquidate the fund at any time. The redemptions rights are not widely dispersed as they are held by ten external investors.

Remuneration
The remuneration structure is typical of such a relationship and, in the absence of indicators to the contrary, this factor is unlikely to be determinative.

Exposure to variable returns through other interests
In the first year of the fund, the fund manager holds 80% of the direct interest in the fund together with its exposure to the management and performance fees. Irrespective of the intention to sell down this interest, this is a significant majority of the variable returns due from the funds. Furthermore, through its direct interest, the fund manager has exposure to downside risk as well as upside risk.

In the second year, the fund manager’s exposure to returns from its direct interest falls to 10%, although it will still accrue management and performance fees.

Conclusion
In the first year of the fund, the fund manager is deemed to be a principal due to its significant exposure to variable returns from its direct interest.

In the second year, there is a change of facts and circumstances, which requires a reassessment of the consolidation conclusion.

By the end of the second year, most of the fund manager’s direct interest is diluted due to investment by external investors, so the fund manager will have a direct holding of only 10%. Even though the fund manager still has broad decision-making authority relating to the relevant activities of the fund and there are no substantive removal rights, the level of variable returns has been sufficiently reduced such that the fund manager will be assessed to be an agent.

Consequently, the fund manager would deconsolidate the fund at the point at which it is deemed to be an agent.
Adopting IFRS 10 may require significant time and effort. Management should plan accordingly and start the process now, if they have not done so already, considering the items below.

**Increased use of judgement**
IFRS 10 will require judgement in assessing whether a manager is functioning as a principal or an agent. In particular, judgement will be required in determining:

- The scope and discretion of the fund manager's decision-making authority
- Whether removal rights are substantive and the weighting that should be given to these rights
- Whether remuneration is market commensurate or not
- The expected level of variable returns and specifically the probability of contingent (e.g., performance) fees being earned

In addition, it will be necessary to ensure that these judgements are applied consistently across the fund manager's fund population.

**Systems and processes**
Depending on their size and the nature of the investment activity, there may be a number of funds that will need to be evaluated under IFRS 10, which may increase the pressure on existing processes. The need to review what may be a large number of contracts will be labour-intensive and the lack of obvious bright lines offers no shortcuts.

Obtaining the necessary information could prove to be an arduous task if it is not readily available or centrally stored. In addition, a significant amount of time may be required to document the thought process and the rationale for a particular decision. This documentation will need to be reviewed internally as well for quality assurance purposes before it is handed over to auditors.

Fund managers will also need to consider that, as facts and circumstances change, IFRS 10 requires that funds may need to be reassessed for consolidation if the change affects one of the three elements of control. This change may arise as a result of external as well as internal factors. Establishing processes and controls for identifying such factors will be critical.

Consequently, the documentation arising from the initial review will need to be sufficiently detailed to capture the possibility of changes in facts and circumstances that may affect the consolidation conclusion.

**Key financial metrics**
If new funds are consolidated, or previously consolidated funds are de-consolidated, management will need to consider how key financial metrics will be impacted. For example, total assets and total liabilities may increase or decrease. Such changes may have a significant effect on compliance with loan covenants. Management should also consider how any such changes in consolidation will be communicated to loan providers, and whether the company will need to renegotiate/amend existing loan covenants due to potential compliance issues subsequent to adoption of IFRS 10.

Management should assess how such changes will be presented in prospectuses and investor communications. Furthermore, bonuses and other compensation plans that are based on financial measures could also be affected. Management may need to reassess whether the original targets continue to be appropriate (i.e., can they still be met or are they now too easy to meet?), considering the impact on such metrics after the adoption of IFRS 10.

**Regulatory considerations**
Changes in the group (i.e., which funds are controlled) could affect compliance with regulatory capital requirements as well as regulatory reporting. An increase in the number of funds that are consolidated may also increase the volume of regulatory reporting depending on the requirements in the individual jurisdictions. In addition, maintaining auditor independence, which is the joint responsibility of the auditor and management, may become more complex as a result of consolidating new funds (depending on how independence is defined for local requirements).
Internal controls
When there is a regulatory requirement to report on the group’s internal controls, management should evaluate the internal controls it has in place related to newly-consolidated entities. It should also consider any effects de-consolidation may have on the materiality of remaining entities relative to the rest of the group, as the size of the group changes.

Transactions and arrangements
Fund managers need to consider the requirements of IFRS 10 when establishing new contracts/investment mandates or when they are modifying existing ones. If a fund manager has historically made arrangements in a manner that achieved a particular accounting treatment, it will need to consider whether the same results are achieved under IFRS 10.

How will a fund’s investor reporting be affected?
Under IFRS 10, investors are likely to request more information from a fund. This information will allow investors to assess whether they have control over the fund or whether control is held by other investors or by the fund manager.

Conclusion
As the analysis of the examples above demonstrates, the range of factors to be considered when assessing consolidation by a fund manager is significant. IFRS 10 deliberately avoids bright lines or simplistic analysis. Consequently, funds will need to be reviewed on a case-by-case basis.

In addition, the new continuous assessment requirement will require development of an ongoing process to identify changes in indicators of control.
How we can help
Ernst & Young has an experienced team of accounting, IFRS adoption, finance process, tax, and IT professionals to advise you in assessing how IFRS 10 will affect your business and to raise your level of preparedness. In the chart below, we outline the challenges that you are likely to face when preparing for IFRS 10 adoption, and we describe how Ernst & Young may be able to help.

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| Understanding the technical accounting requirements of IFRS 10           | ➢ Design and help deliver training sessions for your personnel on the accounting and financial statement disclosure implications of IFRS 10.  
                                                                                 ➢ Share insights and updates from the IASB and evolving market views.                                                                                           |
| Determining the impact of IFRS 10 on the financial statements             | Advise you on:                                                                                                                                                     |
                                                                                 ➢ Disciplined approaches to gathering the necessary scoping information to implement the new standards.                                                                 |
                                                                                 ➢ Identifying shortfalls in available information to adopt the new standards.                                                                                     |
                                                                                 ➢ Assessing the impact of implementing IFRS 10 on key financial ratios, performance measures and regulatory capital.                                                  |
                                                                                 ➢ Developing a process for managing the significant judgements and estimates that would be necessary.                                                           |
                                                                                 ➢ Identifying potential events that could trigger a re-assessment of a consolidation conclusion.                                                                |
                                                                                 ➢ Developing a process to embed these consolidation re-assessment triggers into the financial statement close process.                                                |
| Understanding how your peer group is addressing the challenges of adoption| ➢ Provide observations of how others are approaching IFRS 10, problems they have encountered and solutions developed.                                                   |
                                                                                 ➢ Assist in the evaluation of your position relative to your peers by sharing with you the results of our recent survey on the expected impact of IFRS 10 on an entity’s financial statement close process. |
| Assessing the impact on tax positions arising from the adoption of IFRS 10 | ➢ Advise you in analysing changes to tax positions arising from the adoption of IFRS 10 and strategically managing the resulting impact.                             |
| Planning for adoption of IFRS 10                                          | Advise you on:                                                                                                                                                     |
                                                                                 ➢ The design of the adoption timeline.                                                                                                                             |
                                                                                 ➢ Identifying and agreeing specific changes to entity data collection and reporting processes with local and group management.                                 |
                                                                                 ➢ Identifying and implementing changes to supporting IT systems.                                                                                                  |
                                                                                 ➢ Revising financial statements and other impacted reports.                                                                                                          |
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| Understanding the areas to which management judgement needs to be applied | ▶ Advise management on those areas within IFRS 10 that require the careful use of judgement.  
▶ Provide input into accounting manuals and policies selected by management.  
▶ Provide you with coordinated support to Ernst & Young subject-matter resources (Regulatory, Tax, Finance, Transformation, etc.) on a global basis. |
| Improving your adoption readiness | Advise you on:  
▶ The effectiveness of your IFRS 10 adoption project and your overall state of readiness.  
▶ Your data collection and reporting processes, governance and resulting reports, including areas needing improvement in advance of adoption on 1 January 2013.  
▶ Your remediation plans for any areas identified as requiring improvement. |
| Stakeholder management | ▶ Advise on developing a communication plan for appropriate education and briefing of key internal stakeholders.  
▶ Engage with your external reporting and investor relations teams regarding development of a communications plan. |
For the purposes of illustrating the two methodologies, we have developed an example using the following simplified assumptions, based on the fact pattern established in examples 14B and 14C of IFRS 10:

- A performance fee of 20% is payable on all outperformance after management fees, after a hurdle of 8% is met. Therefore, to earn a performance fee at all, the annual return of the fund must be at least 8%, but then the performance fee is due on the full amount of the outperformance.
- The performance fee is calculated at the fund's financial year end date, based on the return over the financial year.
- The fund's year-end date coincides with that of the fund manager.
- The management fee is 1% of net asset value, also calculated at the fund's year end, based on the net asset value at that date.
- The fund manager also has a direct equity interest of 20%.
- For the purposes of this methodology, and our examples later, performance of a fund is based on net asset value rather than market or listed value, although in practice performance may be based on market value.

**Method 1 — marginal return assuming performance hurdle is met**

This method assumes the fund manager's performance target is met and exceeded and the fund manager's variable return is based on the marginal returns after the hurdle is met. This method ignores the probability of the outperformance and the possible effects of a negative return. Consequently, the more likely a performance fee is expected to be achieved, the more appropriate this method of aggregation would be.

To illustrate this methodology, if the fund outperforms the 8% hurdle over the performance period, the fund manager's return is, as follows:

- 1% management fee
- 19.8% performance fee (that is on performance after management fees of 1% deducted, (20%*99%))
- 15.8% direct interest (that is the 20% direct interest, net of the management and performance fee, (80%*99%)*20%)

Therefore, once the hurdle is exceeded, the aggregate variable returns attributable to the fund manager are 36.6% of the performance of the fund.

**Method 2 — total return**

If there is doubt surrounding the achievability of the performance fee, this method becomes more appropriate. Using this methodology, variable returns due to the fund manager will fluctuate based on the overall performance of the fund, as opposed to assessing marginal returns after a hurdle has been achieved. This method places greater emphasis on the expected performance of a fund, which is not the case in method 1.

For example, if the fund returns 5% during the performance period, the fund manager’s exposure to variable returns is, as follows:

- 1.1% management fee
- 0% performance fee (the fund returns only 5%, which is below the 8% threshold for a performance fee to be earned)
- 1.78% direct interest (20% of the return after deducting management fees, (5%-1.1%)*20%)

Therefore, the aggregate variable returns attributable to the fund manager are 2.88% of the fund's net assets, or 28.8% of the performance of the fund.

In summary, the higher the performance fee hurdle, the greater the potential uncertainty as to the extent performance fees should be taken into consideration when assessing a fund manager’s exposure to variability of returns. The method used to aggregate variable returns is likely to lead to different levels of aggregated returns. This does not mean that the analysis of variable returns should become a complex mathematical exercise requiring a statistical analysis to arrive at a predicted return. On the contrary, in our view, the IASB did not intend for the aggregating of remuneration and other interests via complicated calculations. Rather, we believe the focus should be on a qualitative approach to the assessment based on a consideration of all facts and circumstances, which may incorporate a method to aggregate variable returns. The methods discussed above are intended to illustrate how such an aggregation might look in practice as part of an overall qualitative approach to that assessment.
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