IFRS 10 Application

A Dilemma for Mutual Fund Industry

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Background

The IASB issued IFRS 10, 'Consolidated financial statements' (IFRS 10), in May 2011. It introduced new guidance on control and consolidation. This Standard provided a framework for an asset manager to use when interpreting IFRS 10 to determine whether control exists – in particular, the assessment of principal versus agent among other factors that may be useful to consider for the application of the standard.

The new standard has changed the criteria for how asset managers (including the insurance or banking groups that own asset management companies) assess the funds they manage for consolidation. It is clear in IFRS 10 that control does not depend on a '50% line' of ownership. Managers that have drawn this line in the past may find that they consolidate more funds. Moreover, it is also clear that the asset manager's power alone does not lead to control of the funds it manages. Judgement, considering all of the relevant factors, will be required. *"The key principle in IFRS 10 is that power, returns and the ability to use the power to vary the returns should exist in order for one entity to control another."*

Consolidation in General Accounting Terms

Consolidated financial statements combine the financial statements of separate legal entities controlled by a parent company into one set of financial statements for the entire group of companies, which means assets, liabilities, equity, income, expenses and cash flows of the parent (company) and its subsidiaries are presented as those of a single economic entity.

IFRS 10 — Consolidated Financial Statements

The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. Control requires exposure or rights to variable returns and the ability to affect those returns through power over an investee. The basic objectives or requriements of IFRS 10 can be summarised as;

- Requires a parent entity (an entity that controls one or more other entities) to present consolidated financial statements
- Defines the principle of control, and establishes control as the basis for consolidation
- Set out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee
- Sets out the accounting requirements for the preparation of consolidated financial statements defines an investment entity, and
- Sets out an exception to consolidating particular subsidiaries of an investment entity.

IFRS 10 – A Dilemma for Mutual Funds Industry and its Value Addition for the User of the Financial Statements

Since past year, the implications and adoption of IFRS 10 has been the center of discussion in Mutual Funds Industry. One of the most difficult areas is whether mutual funds should be consolidated with the Asset Management Companies, and whether the Asset Management Companies qualifies for the definition of Investment entity, which needs a meticulous analysis.

Principle of Control and the Basis for Consolidation

The key principle under IFRS 10 is that power, returns and the ability to use the power to vary the returns should exist in order for one entity to control another entity. In context of mentioned three factors the asset management company (AMC) must assess whether the relationship of AMC (hereinafter referred to as Fund Manager) with Funds is of agent or principal (in other words fund manager have control and power over fund or not).

The control principle in IFRS 10 sets out the following three elements of control:

a) Power over the investee;
b) Exposure, or rights, to variable returns from involvement with the investee; and
c) The ability to use power over the investee to affect the amount of those returns.

The IFRS 10 addresses this by including guidance specific to fund managers. Key to assessment of control is determining whether the fund manager is acting as an agent (that is, on behalf of other) or as principal (that is, for itself); only in the latter case does the fund manager control the entity.

Now we look into the general definition of an Agent and Principal.

- An agent is “a party primarily engaged to act on behalf and for the benefit of another party or parties and therefore does not control the investee when it exercises its decision-making power". This means that if a fund manager is an agent; it acts primarily on behalf of others (the investors of the fund) and so does not control the fund.
- A principal “acts primarily for itself and therefore controls the fund”.

As per Black’s Law Dictionary, Agent-Principal relationship is ‘A relationship wherein an individual acts in place of another individual. The agent will work in place of the individual known as the principal’.

The Standard sets out criteria to help assess whether the fund manager is acting **as agent** or **principal**. However, the standard doesn’t define bright lines, so the fund manager will need to use significant judgment in many cases.

The application guidance in IFRS 10 says that the decision maker (i.e. the assets manager) should consider the overall relationship between itself, the investee (i.e. the fund) and other parties involved with the investee (i.e. third party investors in the fund) in determining whether it is acting as an agent.

The fund manager has to consider the following factors in determining whether it is an agent or a principal:

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

In Pakistan's framework, an asset management company on the above four points can be assessed as follows:

Scope of Decision-making Authority

A fund manager establishes and manages a fund that provides investment opportunities to a number of investors. The fund manager must make decisions in the best interests of all investors and in accordance with the limits prescribed in the Regulations (including various Circulars) and the fund's Constitutive Documents. The investment decisions taken by the Fund Managers are strictly regulated under the comprehensive regulatory requirements (i.e. under NBFC regulations, various SECP circulars etc. which defines per party/entity, sector limits as well as investment avenues/asset classes) and the restrictions outlined in the constitutive documents of the Funds. Therefore, the Fund Manager generally has a very narrow ranging discretion within the defined framework, and therefore appears to be acting as an Agent.

Furthermore, in Pakistan, Fund Managers have several other stakeholders (other than unit holders of the fund which are in fact the prime stakeholders) to which they are answerable and comply with their directions. They include the Trustee of the Fund, who is also the Custodian of funds’ assets and liabilities and protector of unit holders interests, and the Regulator of funds, Securities and Exchange Commission of Pakistan (SECP). The control/power is shared by the Fund Manager, the Trustee and the Regulator and therefore the Fund Manager acts more as an Agent rather than principal.

The Rights Held by other Parties

The SECP may, either at its own or on the recommendation of the Trustee or Unit Holders representing such percentage of the total Units in issue for the time being as may be prescribed by the Regulations, remove the Management Company in such manner and on the occurrence of such circumstances as are prescribed under the Regulations. Rights that provide for the removal of the Fund Manager under these regulations are generally protective rights. Protective rights (i.e. rights which protect the interest of the unit holder) should not be considered, as power does not arise from protective rights and they are not relevant while assessing the operating capacity of the Fund Manager.

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. If a small number of unit holders hold substantial percentage of units in a fund, this might indicate that they hold substantive rights to remove the Fund Manager in which case the Fund Manager is acting as an agent. We have seen instances in the past when a sizable investor removed the asset management company and appointed another one in the Fund.

The Remuneration to which it is Entitled and the Ability to Use Power over the Investee to Affect the Amount of those Returns

Link between Power and Returns

“paragraph 17 - an investor control an investee if the investor not only has the power over the investee and exposure or rights to variable returns from its investment with investee, but also has the ability to use its power to affect the investors return from its involvement with the investee”

In respect of the returns, under present practice the investor (AMC) is exposing to variable returns through an Arm’s length management fee (i.e. charging an amount on the Assets Under Management on fixed basis as per the Regulations which caps the Managment Fee for each category of Funds) and on investment in fund on the basis of the Net Asset Value with the same rights (pari passu) as any other investor of that fund. The Fund Manager cannot control the returns/performance of the fund based on the size of the fund manager's investment in the fund.

The level of exposure to returns from management fees and ownership interest should be considered in conjunction with asset manager's power. Considering the legal structure of Asset Management Companies in Pakistan and the role of the Trustee and SECP over funds through strict regulation, the fund manager's power is restricted from acting on its own behalf, even in case where it has exposure to variability of returns. Hence, level of returns is not sufficient to indicate that fund manager will be using its power for its own benefit**.**

Other Factors need to be Considered before Adaption of IFRS 10 in Pakistan

No Defined Bright Lines

The standard sets out various criteria to help assess whether a particular fund need to be consolidated to Asset Management Company, and these criteria need to to be reassessed at every period end. which typically means a fund consolidated at one period end may not be consolidated at subsequent period. Now, this point is too much to absorb for local investors, and keeping their technical understanding of accounting issues in mind, it appears that they will not be able to understand the reason for such varying practices.

Conclusion

Application IFRS 10 to the mutual funds industry and Asset management companies will lead to serious distortion and volatility in the financial statements of the Management Company and ultimately leading to the confusion among investors at large. As explained by IASB, the fair value information is more useful for decision making than consolidated information. Due to specialised nature of this industry, the consolidation may affect the investment business model and makes it harder for investors to understand what they are most interested in (i.e. the value of the entity's investments). Therefore MUFAP's recommedation to SECP is to not apply IFRS 10 to the asset management industry, as AMCs only operate as 'Agents' under the defined NBFC Rules and Regulations.