

# Practical guide to IFRS

## IFRS 10 for asset managers

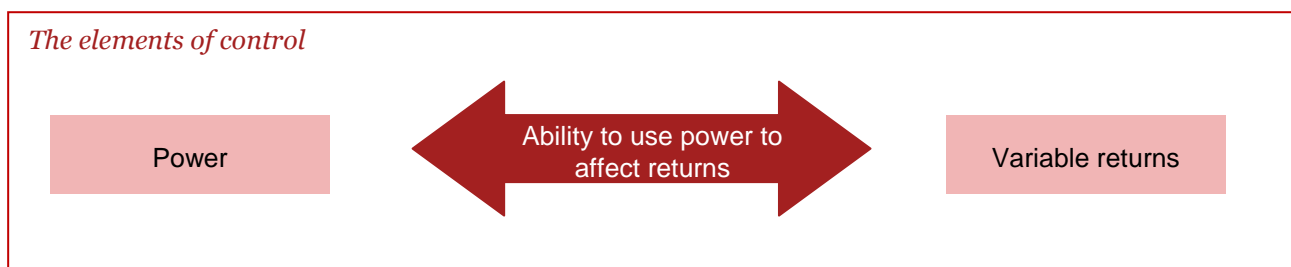
### At a glance

The IASB issued IFRS 10, 'Consolidated financial statements' ('IFRS 10' or 'the standard'), in May 2011. It introduces new guidance on control and consolidation. The new standard is effective for financial years beginning on or after 1 January 2013. Early adoption is permitted.

This publication sets out 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. It also includes our analysis of the illustrative examples from IFRS 10, and other factors that we believe may be useful to consider in practice. PwC has also produced a practical guide to IFRS 10, '[Consolidated financial statements – redefining control](#)'.

The new standard will change how asset managers (including the insurance or banking groups that own asset managers) assess the funds they manage for consolidation. It is also likely to change the number of funds that are consolidated by asset managers. 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. On the other hand, 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.



One of the most difficult areas to assess under previous guidance was whether or not the asset manager should consolidate the funds that they manage. IFRS 10 addresses this by including guidance specific to asset managers.

- Key to the assessment of control is determining whether the manager is acting as agent (that is, on behalf of others) or as principal (that is, for itself); only in the latter case does the asset manager control the entity.
- The standard sets out criteria to help assess whether the asset manager is agent or principal. However, the standard doesn't define bright lines, so the asset manager will need to use significant judgement in many cases. The criteria are only definitive in the cases of single-party removal rights or off-market fees.
- The criteria relate to the concepts of power over an investee and exposure to variable returns from an investee.
- An asset manager will almost always have power over the fund that it manages.
- In many cases, the factors relating to scope of decision-making and remuneration are likely to have less weight than rights held by others and exposure to variable returns.

- Removal rights or other rights held by others need to be substantive in order to indicate that the asset manager has reduced or insufficient power to control. How substantive such rights are is likely to be an area of significant judgement.
- Exposure to variable returns through a management fee alone might indicate that the asset manager is an agent. However, these fees – along with other interests, such as direct investments in a fund – might indicate that the asset manager is a principal. This also is likely to be a key point of judgement.

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## The principle of control

IFRS 10 establishes control as the basis for consolidation. It requires an investor to assess whether it controls all entities in which it has an interest, regardless of the nature of the entity or the investor's involvement with the investee.

Control requires that three factors be present. An investor must have:

- power over the investee;
- exposure or rights to variable returns from its involvement with the investee; and
- the ability to use its power to affect the amount of returns. [IFRS 10 para 7].

It is difficult for an asset manager to determine control in relation to funds that it manages. The manager generally has some degree of power (through the management agreement) and some exposure to variable returns (through fees for services and any ownership interests held); but the asset manager's degree of power does not generally change with its exposure to variable returns. This can be contrasted with an entity's investment in another entity's ordinary shares, where there is generally a direct link between the number of shares held, the power that those shares confer and the share of residual returns that the investor is exposed to. In contrast, the asset manager might increase its direct interest in a fund, but there is unlikely to be a change in its power over the fund.

The asset manager might be exercising its power primarily on behalf of other investors (acting as agent) or on its own behalf (acting as principal). This distinction might be difficult to determine. Most principal-agent assessments therefore require management to consider all relevant factors, including the extent of the asset manager's participation in the fund's returns and the variability of the manager's returns in relation to the overall variability of the fund's returns.

All three elements of power, exposure to variable returns and the ability to use power to affect returns must be present for control to exist. For example, an investment management agreement without any substantive removal rights might grant the asset manager power to direct the relevant activities of the fund. These are the activities that significantly affect the fund's returns. However, if the asset manager does not have significant exposure to variable returns of the fund, control will not exist. On the other hand, where substantive removal rights exist, an asset manager might not control a fund even if it has exposure to variable returns through fees and an investment in the fund.

## Agent or principal

The asset manager must determine whether it is an agent or a principal in relation to the fund. An agent is “...a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority”. [IFRS 10 para B58]. This means that if an asset manager is agent, it acts primarily on behalf of others (the investors in the fund) and so does not control the fund. It may be principal if it acts primarily for itself, and therefore controls the fund.

The application guidance in IFRS 10 says that a decision-maker (that is, the asset manager) should consider the overall relationship between itself, the investee (that is, the fund) and other parties involved with the investee (that is, third-party investors in the fund) in determining whether it is acting as agent. Factors that management should consider are:

1. Scope of the asset manager's decision-making authority;
2. Rights held by other parties;
3. Remuneration to which it is entitled; and
4. Exposure to variability of returns.






The first two factors deal with the extent of the asset manager's power over the fund and whether there are any restrictions on those powers. For example, an asset management agreement gives the asset manager power over

the relevant activities of the fund (day-to-day management). However, investors can remove the asset manager at any point in time without cause, by a majority vote, and there are only five investors in the fund. In such circumstances, the manager's power over the fund seems to be limited through substantive removal rights held by other parties.

The third and fourth factors relate to the returns criterion; they require the asset manager to consider the magnitude and variability of the returns it gets (expected and maximum) from the fund relative to the total returns expected from the fund's activities. For example, a manager's exposure to a fund's variable returns might be limited to the on-market management fees it receives. The manager might be an agent where the fees do not expose it sufficiently to magnitude and variability of returns. In other circumstances, the manager might be exposed to variable returns through some or all of: management fees, performance fees, carried interest and investments in the fund. Management should analyse carefully whether all sources of returns in aggregate, along with consideration of the asset manager's power over the fund, are sufficient to indicate that the manager is a principal.

### *Guidance and examples from IFRS 10*

We have used the examples in IFRS 10 to analyse how an asset manager can apply the control guidance. In practice, all relevant facts and circumstances should be analysed because a variation in one or another might lead to a different conclusion. The table below summarises IFRS 10's examples. The individual factors are analysed in the sections that follow:



<b>Examples from IFRS 10</b>	<b>Example 13 – publicly traded fund</b>	<b>Example 14 – non-traded fund</b>	<b>Example 14A – non-traded fund</b>	<b>Example 14B – non-traded fund</b>	<b>Example 14C – non-traded fund</b>
<i>Scope of decision-making authority</i>	Narrowly defined	Wide discretion	Wide discretion	Wide discretion	Wide discretion
<i>Rights held by other parties</i>	Not substantive	Not substantive	Not substantive	Not substantive	Substantive
<i>Remuneration</i>	On market	On market	On market	On market	On market
<i>Exposure to returns</i>	Insufficient	Insufficient	Insufficient	Sufficient	Sufficient
<b>Conclusion</b>	<b>Agent</b>  <b>No control</b>	<b>Agent</b>  <b>No control</b>	<b>Agent</b>  <b>No control</b>	<b>Principal</b>  <b>Control</b>	<b>Agent</b>  <b>No control</b>

### *Scope of decision-making authority*

An asset manager must assess the scope of its decision-making authority. Factors relevant to this assessment include:

- activities that are permitted pursuant to the relevant governing agreements and laws, and whether such activities are relevant activities of the fund;
- the discretion that the asset manager has in directing these relevant activities;
- the purpose and design of the fund;
- the risks to which the fund was designed to be exposed and those risks it was designed to pass on to the parties involved; and
- the level of involvement of the asset manager in the design of the fund.

[IFRS 10 paras B62-B63].

Examples from IFRS 10	Example 13 – publicly traded fund	Example 14A – non-traded fund	Example 14B – non-traded fund	Example 14C – non-traded fund
<i>Activities</i>	<ul style="list-style-type: none"> <li>Narrow parameters defined by fund's investment mandate</li> <li>Requirements of local law and regulations apply</li> <li>Fund can invest in diversified listed equities</li> </ul>	<ul style="list-style-type: none"> <li>No information is given on parameters, investment mandate or extent of limitations imposed by local law and regulations</li> </ul>		
<i>Discretion</i>	<ul style="list-style-type: none"> <li>Full discretion within parameters of the mandate</li> </ul>	<ul style="list-style-type: none"> <li>Wide decision-making discretion</li> <li>Asset manager must act in the best interests of all investors</li> </ul>		
<i>Purpose and design</i>	<ul style="list-style-type: none"> <li>Investment fund open to retail investors offering a diversified portfolio of equity securities of publicly traded entities</li> <li>The asset manager established, marketed and manages the fund</li> </ul>	<ul style="list-style-type: none"> <li>Investment fund open to a number of investors</li> <li>The asset manager established, marketed and manages the fund</li> </ul>		
<i>Risks</i>	<ul style="list-style-type: none"> <li>Value changes in diversified listed equities</li> </ul>	<ul style="list-style-type: none"> <li>No information given on the risks to which the fund, the asset manager and the investors are exposed</li> </ul>		
<b>Conclusion</b>	 <p><b>The asset manager has power</b></p>		 <p><b>The asset manager has power</b></p>	

### Activities and discretion

Power is the ability to direct the relevant activities of an investee. These are the activities that significantly affect an investee's returns. The relevant activities of a fund are usually the asset selection decisions, including acquiring, holding, managing and disposing of assets. The asset manager typically has discretion over the fund's investing decisions, but the extent of that discretion might be limited. The standard's examples illustrate this; both examples limit the asset manager's ability to direct the activities of the fund as a result of restrictions imposed by the investment mandate, legal, regulatory or other factors. The asset manager's ability to direct the activities of the fund seem to be more restricted in example 13, but the standard concludes that the manager has power in both circumstances.

### Example

*An entity manages a tracker fund whose purpose is to produce returns based on the DAX index. The asset manager's discretion is limited, but it is still able to make the decisions that affect the returns of the fund: how to invest so as to best track the index and minimise any tracking error.*

### PwC observation

The activities that are permitted by law, regulation or the investment mandate are usually the relevant activities of the fund (that is, those that generate the fund's returns). Almost all funds require decisions to be made that affect the returns of the fund. The asset manager will almost always have power over those relevant activities. Restrictions on the scope of the asset manager's activities might affect the overall control decision when considered in conjunction with the other factors, including the level of returns to which the manager is exposed.

## Purpose and design

The asset manager should consider the purpose and design of the fund, including the involvement of investors or others in the fund's establishment. Example 13 of IFRS 10 includes a publicly traded fund that might be assumed to be open to retail and institutional investors. Example 14 of IFRS 10 includes a fund that provides “investment opportunities to a number of investors”. There is no indication in these examples that parties other than the asset manager are significantly involved in determining the purpose and design of the fund. This is likely to be the case in most situations.

The asset manager might have less involvement in purpose and design where it begins to manage a fund that already exists (for example, either by being awarded the fund management contract or through an acquisition). This is not sufficient on its own to indicate that the asset manager does not have power.

Some funds are set up with one investor. The single investor might have had significant input into its design.

### Example

*An asset manager is significantly involved in designing a fund's structure and investment objectives. This might indicate that it had the opportunity and incentive to obtain rights that result in the manager being able to direct the relevant activities. However, the asset manager's involvement in the purpose and design of a fund at its inception is not in itself sufficient to give it power over the fund. [IFRS 10 para B51].*

### Example

*An investor has approached an asset manager to determine the investment mandate to a relatively detailed and specific level for a fund in which the investor will be the only unit-holder. This might indicate that the asset manager did not have the opportunity to obtain rights that would result in the asset manager having power over the fund. It may rather be an indicator that the investor has primarily engaged the asset manager to act on its behalf and thus the asset manager's decision-making authority has been delegated by the investor to the manager as its agent.*

### PwC observation

‘Purpose and design’ is unlikely to be a significant factor in assessing whether or not an asset manager has power over a fund that it manages. An asset manager is not likely to have more power over a regulated retail fund compared to a fund offered to a few sophisticated investors. In both cases, the fund is designed to offer asset management services to investors. However, where others have been involved in the design this might indicate that the asset manager did not have the opportunity to obtain rights that result in the asset manager having power over the fund, or that its power is limited.

## Risks

Consideration is required of the risks that the fund was established to gain exposure to, and of the parties to whom such risks are expected to flow. The funds are established to expose investors to fair value risk on investments made in examples 13 and 14 of IFRS 10 (example 14 does not specify, but we assume this to be the case). Some risk is passed on to the investment manager (that is, through its variable fee); however, neither fund has separate risks (for example, fair value and credit risk) to which different classes of investors are exposed.

### PwC observation

Where all parties involved are exposed to the same risks (the risk of value changes in the fund), consideration of risks is unlikely to be a determining factor. However, it could be significant if risks are attributed differently to various parties.

### Example

*An asset manager provides a guarantee of a fund's investment returns. This may suggest that the manager is more likely to have an incentive to obtain rights that result in the asset manager having power (and it may also expose the manager to greater variability of returns).*

### Conclusion

*A fund will normally have relevant activities. Most asset managers will have set up the fund, determined its activities and be managing it with full discretion within its set parameters. In most cases, this will indicate that the asset manager has power. Asset managers will therefore need to consider whether there are limits on their power, together with the level of exposure to the fund's variable returns in determining whether or not they are principal.*

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## ***Rights held by other parties***

Rights held by other parties can restrict the asset manager's power to direct the fund's relevant activities. These restrictions might indicate that the asset manager is exercising its rights on behalf of others, rather than for itself.

The standard addresses the following rights held by other parties:

- single-party removal rights;
- multi-party removal rights; and
- rights held by a board of directors.

Other rights that may be relevant include rights to:

- change the investment mandate;
- put the units or shares back to the fund; and
- force liquidation of the fund.

Rights held by other parties should be substantive and not simply protective in nature in order to limit the power of the asset manager. Protective rights exist to protect the interests of the party holding the rights without giving them power. [IFRS 10 App A, para B27]. For example, a right that allows an investor to approve a change in a fund's investment mandate is protective; a right that permits the investor to change the investment mandate directly is more likely to be a substantive participating right.

To assess whether rights are substantive, management should consider:





- whether any barriers (economic or otherwise) exist that prevent their exercise by the holder;
- how many parties are needed to exercise; and
- whether the parties with the rights would benefit from their exercise.

[IFRS 10 para B23].

Rights do not need to have been exercised for them to be substantive. [IFRS 10 para 12]. Without a history of an asset manager being removed, removal rights can be substantive. What's important is whether those rights are practically capable of being exercised.



## Guidance and examples from IFRS 10

Examples from IFRS 10	Example 13 – publicly traded fund	Example 14A – non-traded fund	Example 14B – non-traded fund	Example 14C – non-traded fund
Single-party removal right	No	No	No	No
Other rights	No	Protective (breach of contract)	Protective (breach of contract)	Board right of re-appointment every year
Other factors to be considered	Investors can redeem interests at any time	None	None	Services provided by manager could be provided by others
<b>Conclusion</b>	 <b>Power</b>	 <b>Power</b>	 <b>Power</b>	 <b>No power</b>

## Removal rights

### Single-party removal rights

The asset manager is an agent where single-party removal rights are present. [IFRS 10 para B65]. However, in order to be determinative, the removal rights must also be substantive. Even when removal rights are exercisable without cause, the asset manager still needs to consider whether there are any barriers (economic or otherwise) that could prevent the rights from being exercised. Such barriers could mean that the removal right is not substantive. [IFRS 10 para B23(a)].

#### Example

*A removal right is only exercisable if the asset manager is in breach of contract. Breach of contract includes fraud and negligence but does not encompass poor investment performance. The removal right is not substantive because it applies only in exceptional circumstances (that is, it is protective).*

### Multi-party removal rights

Removal rights exercisable by more than one party are not conclusive in determining whether an asset manager is acting for the benefit of others. [IFRS 10 para B65]. The ability of the rights to limit the manager's power should be assessed further (in conjunction with the other three factors).

A significant consideration is the number of investors required in order to exercise the removal rights. The strength of the removal right will then need to be weighed with the other factors to determine whether the asset manager is the agent or principal.

#### Example

*Investors representing more than 50% of a fund must vote in person to remove the asset manager, with each investor holding less than 0.001% of the fund. Even if the fund convenes an annual general meeting, the investors might not have the practical ability to exercise their rights. The removal rights held by investors might be seen as non-substantive in this situation.*

#### Example

*A fund has 20 investors, each holding less than 10% of the fund's units. A simple majority 50% vote can remove the asset manager. A register of investors is available, and any investor can convene a vote. The investors are able to benefit if the removal right is exercised and it can be considered a substantive removal right that limits the power of the asset manager. However, the removal right is not sufficient on its own to conclude that the fund manager is an agent. The removal right should be considered, alongside the manager's scope of decision-making authority, remuneration and exposure to variability of returns.*

### **PwC observation**

Other factors that might affect the assessment of removal rights include:

- any barriers or penalties (including financial penalties such as compensatory management fees) to exercise;
- the mechanism by which the investors are able to coordinate themselves;
- the length of any required notice period; and
- the specialisation of the asset management service.

The specialisation of the asset management service is not dealt with in the standard's examples, except to say that the service could be performed by other asset managers (example 14C). When determining whether a removal right is substantive, an asset manager should evaluate whether there are other asset managers who could provide the service. Asset managers should look to market indicators for similar types of funds and expertise. There may be some specialised funds that could not be managed by any other market participants, but we would expect this to be rare.

### **Example**

*Removing the asset manager of a limited life fund requires the investors to compensate the asset manager equal to one year's worth of management fee. The asset manager will need to use judgement to assess whether the penalty renders the removal right not substantive. The manager may consider whether the penalty is common across similar funds and whether it has been exercised in practice in other funds. The manager should also consider whether the penalty would prevent investors exercising their rights when compared with the potential losses they may suffer due to perceived poor management.*

### **Example**

*A manager sets up a fund, which has the manager's name: 'Manager X Growth Fund'. The name of the fund cannot be changed even if the manager is removed. This clause may be a barrier to the exercise of the removal right; however, it would need to be considered whether, in practice, the removed asset manager would actually wish its brand to remain associated with a fund from which it had been removed, and whether a new asset manager would want to manage a fund under the name of a competitor.*

Are notice periods and rights to reappoint an asset manager equivalent to removal rights? Notice periods are not dealt with in the standard's examples. A board's right to appoint the manager annually is considered to be a substantive right that limits the asset manager's powers in example 14C. In our view, a positive appointment of an asset manager for a limited period is different from an indefinite contract with a removal right exercisable with a notice period. The reappointment right creates a mechanism by which the asset manager's performance is positively considered. A removal right is only exercised from the point that the service is unsatisfactory. It may be assumed that where an asset manager is appointed for one year, its services will not be unsatisfactory on the first day of appointment. Our view is that a one-year re-appointment right is more substantive than a one-year notice period.

The guidance on substantive rights is relevant when considering notice periods. Questions that an asset manager should ask in assessing the impact of notice periods on the principal-agent determination include:

- How long is the notice period?
- Is there only a short window during which notice can be given?
- Will the decisions taken within the notice period significantly affect the returns of the fund?

### **Board of directors**

A board of directors or similar body might have rights that substantively limit an asset manager's power. A board is not considered to be a single party for the purpose of assessing removal rights; so any rights that a board has will not be conclusive on their own in determining agent/principal. [IFRS 10 para BC135]. The board acts for the investors in the fund rather than being seen as a single party with a removal right. The asset manager should consider whether and how the investors can influence decisions about relevant activities of the

fund through the board (for example, by exercising voting rights). Boards of funds may only exist for regulatory reasons to protect the rights of the investors, and they might not be able to participate in the decisions about the relevant activities of the fund.

Some funds might have boards or similar committees that could limit the asset manager's power. In these cases, it needs to be determined whether the board's rights are substantive. This can be done by asking questions such as:

- How has the board been formed and by whom?
- Who has the ability to re-appoint the board?
- How does the board solicit investors' views?
- How are the investors able to exercise their rights via the board and participate in decision-making?
- What are the decision-making abilities of the board, and what is its remit?

### **PwC observation**

Removal rights and other rights are likely to be a key indicator of whether an asset manager is acting as principal or agent. These rights allow investors to retain decision-making powers, even when they have been delegated to an asset manager. They can indicate that an asset manager is using its power on behalf of others and is acting as an agent. However, this is only true when the rights are substantive.

A board will often have only protective rights. Or a board might have significant powers but no way of representing the investors in the fund (for example, due to the number of investors in a mutual fund and there being no mechanism for them to meet). The apparently significant powers might not therefore be substantive. The rights exercised through a board need to be substantive in order for them to limit the power of the asset manager.

An asset manager should also consider how the rights work when exercised in assessing whether removal or other rights are substantive.

### *Example*

*An asset manager can be removed by a simple majority at an investor meeting. The asset manager has a 51% interest in the fund, but any shares held by the asset manager are non-voting. The 49% investor(s) might therefore be able to remove the asset manager. However, voting rights re-attach to the manager's shares once removed. With a 51% vote, the asset manager can then vote itself back in – in which case, the removal rights are not substantive.*

### *Example*

*An asset manager owns 55% of a fund and has granted a removal right to an 'independent' third-party who has no relationship with the investors in order to conclude that it is an agent for the 45% investor in the fund. Such a right is not substantive – in particular, because the holder of the right would not benefit from the right and has no incentive to exercise it.*

### *Example*

*A board is appointed by the asset manager that sets up the fund at the inception of the fund. The fund's constitution states that the board can be re-appointed or changed by the investors, but there is no mechanism for regular investor meetings. In addition, the investors are so numerous and dispersed that they cannot realistically convene a meeting. Rights held by the investors through the board to re-appoint the board are unlikely to be substantive.*

### *Rights to change the investment mandate*

The fund's investors might have the power (either directly or through a representative body) to change the investment mandate. Such rights, if substantive, might limit the asset manager's power over the fund.

#### **PwC observation**

In most cases, the rights of investors to change the fund's investment mandate will not be substantive. Most mandates are widely drawn, and it therefore is unlikely that such rights will be exercised. Similarly, it might be difficult or impossible for the rights to be exercised due to other barriers such as the number of investors.

#### *Example*

*A manager acts for a limited life private equity fund with only four investors. The fund's mandate is to invest in French biotech start-ups. The fund's governing documents allow the investors to change the mandate by a simple majority vote, but they cannot remove the manager. The investors might have substantive powers that limit the power of the asset manager. However, the manager should consider all relevant factors, including whether the manager has the expertise to carry out a different mandate.*

*A similar provision in the governing documents of a mutual fund whose shares are held by more than 4,000 investors is likely to have no impact on the extent of the asset manager's power if the investors are not practically able to coordinate themselves to vote and can easily leave the fund by selling or putting back their units.*

### *The rights of investors to put back their units*

Some might argue that a fund's investors have power – thereby limiting the power of the asset manager – because they are able to exit the fund through redemption rights. Our view is that the ability of investors to put their units back to the fund does not affect the asset manager's power over the fund. Rather, if units are redeemed, the asset manager has power over a larger share of a smaller fund.

### *Liquidation rights*

Puttable units that are held by a single or by very few investors might be considered substantive rights that could affect the power of the asset manager. The rights might be equivalent to liquidation rights and give the investors the power to direct the fund manager. The asset manager will need to consider how substantive the rights are by assessing all relevant factors, including:

- How many investors can cause effective liquidation?
- Are the investors locked in for the expected life of the fund so that the right is not realistically exercisable?
- Is it practical for the assets in the fund to be liquidated?
- Are there any barriers or penalties that would prevent the liquidation of assets?
- Does the fund have the right to prevent or significantly delay redemption?

#### **PwC observation**

A liquidation right is more likely to indicate that the asset manager is an agent when the fund has a single investor who has been involved in the design of the fund and has the power to liquidate the fund without cause, either directly or by requiring their units to be redeemed.



### **Conclusion**

*Rights held by other parties are likely to be key in determining whether an asset manager is an agent or a principal. Substantive removal or other rights (for example, an independent board that is able to participate in the key decisions on behalf of investors) are likely to be strong indicators that an asset manager's power is limited. All relevant factors will need to be considered in order to determine whether such rights are substantive.*

## Remuneration

An asset manager earns fees for its management services, which typically take the form of a fixed percentage of net asset value or committed capital, a performance fee against a benchmark, a carried interest or some combination of these. The greater the magnitude and variability of an asset manager's remuneration relative to the overall returns of the fund, the more likely the asset manager is to be a principal. [IFRS 10 para B68]. An asset manager cannot be an agent without its remuneration being commensurate with the services provided, and including terms and conditions that are customarily present in arm's-length arrangements for similar services and requiring similar skills (that is, the management contract must be on-market). [IFRS 10 paras B68-70].

### Guidance and examples from IFRS 10

Examples from IFRS 10	Example 13 – publicly traded fund	Example 14 – non-traded fund
Magnitude	1% of NAV	1% of NAV + 20% of total profits if hurdle is achieved
Variability	<ul style="list-style-type: none"><li>Upside varies in direct proportion to total returns of investors</li><li>No downside (minimum zero return)</li></ul>	
Terms commensurate and customary	Yes	Yes
Conclusion	<div><b>The asset manager does not have sufficient exposure to returns through remuneration alone</b></div> <div><b>The asset manager does not have sufficient exposure to returns through remuneration alone</b></div>	

In examples 13 and 14 of IFRS 10, the asset manager's remuneration meets the conditions described above, indicating that the asset manager is an agent. It is only when the arm's-length remuneration is considered in addition to any direct interest in the fund that its size or variability becomes important.

### PwC observation

As long as remuneration is at arm's length and has customary terms and conditions then, on its own, it is not generally an indicator that the asset manager has sufficient exposure to returns to evidence control.

### Conclusion

*Asset managers may need to look at market data, including fees charged by other managers of similar products, in order to determine whether remuneration is on-market. However, in funds with significant investors who are unrelated to the asset manager, it might be relatively easy to demonstrate that the fees are at-market. The asset manager might be exposed to variable returns through fees it receives, together with investments it holds in the fund. Asset managers should assess the overall exposure to variable returns from all sources when determining whether or not control exists.*






## Exposure to returns

An asset manager might have other interests in a fund in addition to its management fees. These typically include a direct investment in, or loan to, the fund.

The asset manager should consider the magnitude and variability of its economic interests, taking its remuneration together with any other interests it holds. The greater the magnitude and variability, the more likely the asset manager is to control. Exposure should be evaluated relative to the total variability of the fund's returns. This should primarily be based on expected returns but should also take account of the asset manager's

maximum exposure. In addition, the asset manager should consider whether its exposure to returns is different from other investors and whether this might influence its actions. [IFRS 10 paras B71-B72].

### Guidance and examples from IFRS 10

Examples from IFRS 10	Example 13 – publicly traded fund	Example 14 – non-traded fund	Example 14A – non-traded fund	Example 14B – non-traded fund	Example 14C – non-traded fund
Direct interest	10%	0%	2%	20%	20%
Returns (fees + direct interest)	1% of NAV  + 10% of total remaining returns	1% of NAV + 20% of total returns if hurdle is achieved	1% of NAV + 20% of total returns if hurdle is achieved + 2% of total remaining returns	1% of NAV + 20% of total returns if hurdle is achieved + 20% of total remaining returns	1% of NAV + 20% of total returns if hurdle is achieved + 20% of total remaining returns
Conclusion	 <b>Not sufficient exposure to returns</b>	 <b>Not sufficient exposure to returns</b>	 <b>Not sufficient exposure to returns</b>	 <b>Sufficient exposure to returns</b>	 <b>Sufficient exposure to returns</b>

The asset manager is exposed to variable returns in all of the examples in IFRS 10. In all but one (example 14 base case), the asset manager has a direct interest in the fund in addition to its management fees. The manager has the same level of returns in examples 14B and 14C. However, in only one of the cases (example 14B) does the manager have control of the fund, when returns are considered alongside power.

### PwC observation

An asset manager is almost always exposed to some variable returns and in most cases has power that can be used to vary the returns. However, the conclusion is not always that the asset manager controls the fund. These examples illustrate that the IFRS 10 framework requires exposure to variable returns to be of a sufficient significance before control can exist.

The examples demonstrate that there is no ‘bright line’ level of returns where the asset manager must conclude that it controls the fund. The analysis depends on the interaction of all the factors. This is consistent with the principle of control: this requires the presence of power, exposure to returns and the ability to use power to affect returns. [IFRS 10 para 7].

A simplistic conclusion from the examples would be that an asset manager entitled to a 1% management fee that holds a 2% investment does not control the fund; it does control the fund when it has the same management fee with a 20% performance fee and 20% investment. However, the analysis is likely to be more complex, depending, for example, on the interaction of the fund’s expected returns and the hurdle-rate required to achieve the performance fee, as well as an assessment of the power that the asset manager has.

There is no discussion in the examples of how to assess exposure to variability. Paragraph B72 refers to magnitude and variability, and also to expected and maximum levels. The examples only conclude that, in conjunction with the level of power, the exposure from variability to returns either is or is not sufficient to conclude that the asset manager has control over the fund. Asset managers will need to interpret how much variability is implied in the examples and make their own assessment of magnitude and variability in particular circumstances.

### Conclusion

*The extent of exposure to variability of returns will almost always play a role in an asset manager’s assessment of control for the funds that it manages. The assessment might be straightforward in some cases. For example, even if the asset manager has power from the investment management agreement, but holds no investment in the fund, has no implicit or explicit promise of support and charges fees at a market rate, it does not seem to control. The asset manager will have some exposure to variability through its fees, but this in itself will not generally be sufficient to indicate that it controls the fund. It might be that an asset manager has no*



*substantive limits on its power and is also a majority investor in the fund – in which case, it will be clear that it controls the fund. The most challenging assessments will be the cases in the middle, where indicators are mixed and significant judgement is needed.*

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## ***Further points to consider***

In this publication, we have discussed the principle of IFRS 10 and the application guidance for determining whether an entity (a manager) is a principal or an agent. As the standard applies a single concept of control, it contains other parts that are likely to be relevant to assessing whether or not an asset manager controls a fund that it manages. These areas should be considered when making the control assessment. For example:

### *Relationships with other parties*

An investor needs to consider its relationship with other parties and whether they might be acting on the investor's behalf, using its judgement to assess the nature of the relationship and how it operates in practice. [IFRS 10 para B74]. Such parties are known as 'de facto agents'. In cases where the asset manager or those that direct the manager's activities have the ability to direct another party, it should consider the decision-making rights and exposure to returns of its de facto agent along with its own when assessing control.

There are at least two situations where this may be relevant to asset managers.

#### *Units held by employees*

It is not uncommon for employees of an asset manager to own, or to have employee benefit arrangements entitling them to, shares or units in the funds managed by the asset manager. These arrangements might be made through the asset manager entity itself or through other entities such as 'carried interest partnerships', the partners of which are also employees of the fund manager. Employees may have an interest in a fund through various means: a direct ownership funded with their own cash; an interest funded by the manager; or options or units granted and dependent on employment or performance.

An employee is, prima facie, directed by his or her employer; so interests held by employees may need to be treated as interests held by de facto agents of the manager when the asset manager determines whether it is principal or agent. An asset manager will have to carefully consider units held by its employees. An asset manager is not able to shield some of its own power and exposure to benefits by placing units with employees.

#### *Units held by other parts of a reporting entity*

An asset manager that has an interest in a fund might be part of a wider corporate group – for example, an asset manager entity that is owned by an insurance or banking group. The parent of the asset manager or another entity within the group might have a direct interest in a fund that is managed by the asset manager. Careful consideration will be required to determine which, if any, of the parent and either the other entity or the asset manager, will need to consolidate the fund.

### *Commitments and guarantees in relation to managed funds*

An investor might have an explicit or an implicit commitment to make sure that an investee operates in a particular way. This might increase the investor's exposure to variability of returns and might therefore increase the investor's incentive to get sufficient power over the investee. It does not in itself give the investor power. [IFRS 10 para B54].

An asset manager might provide investors with guaranteed returns from a fund that it manages. This might or might not be accompanied by an explicit commitment from the fund manager to meet any shortfall in returns earned by the fund. The asset manager should consider how this affects its power and how it might affect its exposure to variability of returns.

### *Continuous assessment of control*

An investor should reassess whether it controls an investee when facts and circumstances indicate that there are changes to one or more of the three elements of control: power, exposure to variable returns and the ability to use power to affect returns. [IFRS 10 para 8]. Changes in the overall relationship between an investor and other parties might indicate that an investor is no longer an agent or has become an agent. However, a change in market conditions alone would not change an investor's initial assessment of whether it is principal or agent, unless that change indicated a change to either power, exposure to variable returns or the ability to use power to affect returns. [IFRS 10 paras B84-B85].

#### *Example*

*An asset manager manages a private equity fund. The terms of the management agreement are that the asset manager cannot be removed for the first five years of the fund's operations. This clause has been included in the agreement in order to allow the asset manager to develop a track record and to provide it with some protection against the costs it incurred when initially setting up the fund.*

*For the first five years of the fund, the asset manager has power and no other parties have substantive rights. The asset manager should reassess whether it has power when the investors in the fund potentially have the ability to remove it as manager when decisions over relevant activities need to be made. Depending on how substantive the removal right is, the asset manager might conclude that it no longer has power over the fund after this reassessment has been made.*

#### *Example*

*An asset manager seeds a fund, initially owning 100% of the fund's units. The manager has power and sufficient exposure to variability and concludes that it is acting as principal and controls the fund.*

*The manager should reassess both its power and the extent of its exposure to returns as investors join the fund and the manager's interest is diluted.*

An asset manager should consider whether its exposure to variable returns has changed. This might be challenging in practice: the asset manager's absolute share of returns are likely to be larger or smaller depending on the performance of the fund and the stage of the economic cycle. As IFRS 10 para B85 notes, the manager's status as agent or principal does not change only because of a change in economic conditions. However, it might be that a longer term shift in returns – or a period of returns outside what was expected in the initial assessment (which included the maximum level of returns) – has changed the assets manager's relationship to the fund.



## ***Bringing all the factors together***

### ***Specific guidance for asset managers***

IFRS 10 includes, for the first time, guidance on control and consolidation that is specifically relevant to asset managers. The 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. Key to this assessment for asset managers will be determining whether the manager is acting as agent (that is, on behalf of others) or as principal (that is, for itself); only in the latter case will the asset manager control the entity. For example, an asset manager may be agent if other investors in a fund have substantive rights that limit its power to act on its own behalf, even where it has exposure to variability of returns. The asset manager may also be an agent if it has power (with no restrictions) but its level of returns is not sufficient to indicate that it is using its power for its own benefit.

### ***IFRS 10 doesn't define bright lines, so significant judgement will be needed in many cases***

The standard sets out various criteria to help assess whether the asset manager is agent or principal. The criteria are only definitive in the cases of single-party removal rights or off-market fees. Single-party removal rights are viewed as conclusive evidence that the asset manager is agent; off-market fees for management services indicate it is principal.

Outside these two scenarios, management will need to use judgement in most cases and consider all factors in aggregate. For instance, example 14C of IFRS 10 considers a board with substantive rights that limit the power of the asset manager. However, rather than suggesting that the asset manager has no power and does not therefore control, the example concludes that the substantive rights in combination with the asset manager's decision-making power and the level of its exposure to the fund's variable returns indicate that it does not control the fund. Identical facts, except for a greater level of exposure to the fund's returns, could lead to a different conclusion.

### ***Scope of decision-making and remuneration are likely to have less weight than the rights of others and exposure to variable returns***

The principal-agent assessment is least likely to depend on criteria relating to the scope of decision-making authority and the asset manager's remuneration. In most cases, an asset manager will have power over a fund due to the scope of the decision-making authority it has from investment management contracts with the fund. Exposure to market-based variable returns from fees for services alone will generally be insufficient to indicate that the asset manager is principal.

The factors that are more likely to impact the assessment are the rights of other parties (for example, kick-out rights held by investors) and the asset manager's overall exposure to variable returns (that is, from both its ownership interests in the fund and fees it receives for services).

### ***An asset manager will almost always have power***

We believe that an asset manager will almost always have power over a fund it manages under the criteria in the new standard. The asset manager must then determine what limitations have been placed on its power, such as substantive kick-out rights, and what level of returns it is exposed to in order to determine whether it is acting as principal or as agent.

### ***Removal or other rights need to be substantive***

While investor removal rights might indicate that an asset manager is an agent rather than acting as principal, all of the relevant factors will need to be considered to establish whether the rights are substantive and the extent of limitation they place on the power of the asset manager. Even in the case where power is somewhat limited, exposure to returns may be sufficient to convey control.

### ***Exposure to returns may indicate that the asset manager is an agent***

The level of exposure to returns, including those from fees and ownership interests, should be considered in conjunction with the asset manager's power. If the asset manager's exposure to returns is insufficient to indicate control, power becomes irrelevant, as any power is being exercised primarily on behalf of others; the asset manager would not therefore control the fund.

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