

Technical Accounting Alert

Impact of AASB 10 on asset managers

Introduction

On 29 August 2011, the Australian Accounting Standards Board (AASB) issued AASB 10 *Consolidated Financial Statements* which is applicable to for-profit entities for financial years beginning on or after 1 January 2013. AASB 10 provides a revised definition of control and provides additional application guidance on a number of areas where control is difficult to assess (such as de facto control, principal/agent relationships and potential voting rights).

While de facto control was implied in AASB 127 *Consolidated and Separate Financial Statements* (which has now been superseded by AASB 10), AASB 10 makes it explicit that control can exist with less than 50% ownership. This means that asset managers who in the past concluded that the control did not exist because they did not have majority of ownership may now need to consolidate their funds.

AASB 10 also provides additional guidance on principal/agent relationships or delegated rights. Principal/agent relationships are very common in the asset management sector, hence the impact of AASB 10 is likely to be significant for entities in this sector. Accordingly, it is paramount that asset managers carefully evaluate the likely impact of AASB 10 before it becomes mandatory for financial years ending 31 December 2013 and 30 June 2014.

The objective of this Technical Accounting Alert (TA Alert) is to:

- assist asset managers in better understanding the principal/agent guidance in AASB 10; and
- highlight what we think will be the key considerations when making principal/agent assessments in practice.

For more general guidance on AASB 10 in its entirety, please refer to our previous publication [Under control?: A Practical guide to applying IFRS 10 Consolidated Financial Statements](#) (note that IFRS 10 is the international equivalent of AASB 10).

Revised definition of control

‘Control’ is defined in AASB 10 as follows:

“An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.”

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There are three elements in the definition of control:

- i. power over the investee ('power');
- ii. exposure, or rights, to variable returns from investor's involvement with the investee ('return'); and
- iii. the ability to use investor's power over the investee to affect the amount of the investor's returns ('link between power and return').

All these three elements must be satisfied in order for control to exist.

While it is generally clear that asset managers satisfy the 'power' element (e.g. through asset management agreements which give power over the fund's relevant activities, being the day to day management of the fund) and 'return' element (e.g. through direct investments in the fund, management fees, performance fees and loans to the fund), the assessment of whether asset managers have the ability to use their power to affect returns has long been a particular challenge for fund managers. AASB 127 provided no specific guidance on this issue. This void has now been filled by AASB 10 which provides detailed guidance on how control principles should be applied in circumstances involving delegated rights. However, the challenge now for asset managers is to operationalize the AASB 10 guidance as it requires consideration of many factors and involves significant judgment. There are simply no bright line rules in determining whether an asset manager is a principal (in which case consolidation would be required) or an agent (where the asset manager would not need to consolidate its fund).

Principal versus agent assessment

AASB 10 explains an agent as a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore an agent does not control the investee when it exercises its decision making authority. Accordingly, an asset manager that is an agent does not consolidate the fund when it exercises decision making rights delegated to it by the principal.

When determining whether it is an agent, an asset manager should consider the overall relationship between itself, the fund it manages and other parties involved with the fund. In making this assessment, an asset manager should consider:

- i. the scope of its decision making authority over the fund;
- ii. the rights held by other parties;
- iii. the remuneration to which it is entitled in accordance with the remuneration agreements; and
- iv. its exposure to variability of returns from other interests it holds in the fund.

Scope of asset manager's decision-making authority

When evaluating the scope of decision-making authority, asset managers should consider the following factors:

Activities that are permitted according to decision-making agreements and specified by laws and regulations:

Investment mandates, laws and regulations generally mandate the activities that asset managers are permitted to perform (such as making decisions about the acquisition, management and disposal of investments). Such activities will in most cases be the 'relevant activities' of the fund. It will be rare for an asset manager to conclude that it does not have power over the relevant activities of the entity.

Level of discretion asset managers have when making decisions about those activities:

The level of discretion is likely to vary across asset managers. Some managers may have wide ranging decision making discretion whereas others might have discretion within defined parameters of the investment mandate.

While having limited discretion might indicate that the asset manager's ability to control the relevant activities of the fund is limited, this is unlikely to result in a conclusion that the asset manager does not have power. For example, a manager of an index fund (which replicates the performance of a market index) is likely to have much less discretion compared to an emerging markets equity fund manager. However, the index fund manager would still have the ability to make decisions that affect the returns of the index fund as they will be making decisions as to how best to track the index.

Purpose and design of the fund, and the level of asset manager's involvement in designing the fund:

Consideration should be given to the role of an asset manager and other investors in establishing the fund. Asset managers would usually have significant involvement in this design process, unless they take on or acquire a pre-existing fund.

Where an asset manager is significantly involved in the design of a fund (including in determining the scope of decision-making authority), that involvement may indicate that the asset manager had the opportunity and incentive to obtain rights that result in the asset manager having the ability to control the relevant activities.

Involvement of other investors in determining the purpose and design of a fund may indicate that the asset manager's power is limited or that the asset manager did not have the opportunity to obtain power over the fund.

Risks to which the fund was designed to be exposed and those that are passed on to the parties involved:

Consideration should also be given to the particular risks to which the fund was designed to be exposed and those risks that are passed on to the parties involved. For example, where an asset manager guarantees the investment returns of a fund it manages, this may indicate the asset manager has the incentive to obtain power and that it may have higher variability of returns compared to the other parties involved.

Rights held by other parties

Asset manager's power over the fund can be restricted by rights held by others. Such rights may include removal rights, right to change the fund's investment mandate and right to liquidate or exit the fund (through redemption).

When assessing rights held by others, asset managers should only consider substantive rights (i.e., rights that are not protective). Protective rights are designed to protect the interest of the party holding those rights without giving that party power over the fund to which those rights relate. To be substantive, the holder of the right must have the practical ability to exercise that right. Determining whether a right is substantive is highly judgemental and requires consideration of, for example:

- whether there are any barriers (economic or otherwise) that prevent the holder from exercising the right (e.g. financial penalties such as six months' notice period with a further six months' fees, absence of other managers willing or able to provide specialised services, terms and conditions narrowly limiting the exercise timing);
- how many parties need to agree and whether there is mechanism in place for those parties to coordinate themselves; and
- whether the parties holding the right would benefit from exercising those rights.

The number of parties that need to act together to exercise the removal rights would be a key indicator of the strength of such removal rights. The lower the number of parties holding the removal rights, the greater the strength of removal rights.

When a single party holds substantive removal rights that can be exercised to remove the asset manager without cause, this in itself would result in the conclusion that the asset manager is an agent. However, removal rights held by multiple parties are not sufficient to conclude that the asset manager is an agent. In such circumstances, all other factors (including how many parties need to get together to exercise the removal rights) should be considered.

Where a board of directors or a committee (e.g., an independent board of a listed investment trust) holds substantive removal rights that may limit an asset manager's power, the board or committee will not be considered a single party for the purposes of assessing the strength of removal rights. Accordingly, such rights will not be sufficient on their own to conclude that the asset manager is an agent. In these circumstances, the number of members on the board or committee would be a key consideration in determining the strength of removal rights.

Asset manager's remuneration

Remuneration of asset managers generally includes:

- fixed percentage of gross or net asset value;
- performance fee linked to a hurdle rate or benchmark; or
- a combination of the above

It is important to consider the magnitude of, and variability associated with, the asset manager's remuneration relative to the fund's returns. The greater the magnitude and variability of the asset managers' remuneration, the more likely the asset manager is a principal.

An asset manager cannot be an agent unless the following two factors are present:

- The remuneration of the asset manager is commensurate with the services provided; and
- The remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis (i.e., market terms).

However, meeting these factors in isolation is not sufficient to conclude that an asset manager is an agent.

Where an asset manager's remuneration is at arm's length and has customary terms and conditions, it is unlikely to indicate, on its own, exposure to variable returns. Consideration of the size and variability of remuneration would only be necessary when remuneration is considered in addition to any direct interest the asset manager may have in the fund.

Exposure to variable returns

An asset manager's interest in a fund may be in the form of direct investment, management fees, performance fees, loans and guarantees with respect to the performance of the fund. When assessing whether it is an agent, the asset manager should consider its exposure to variability of returns from all such interests in the fund. The asset manager's exposure should be assessed relative to the variability of the fund's returns.

While AASB 10 does not provide detailed guidance as to how exposure to variability should be assessed, it appears variability is a measure of how much the asset manager's return varies as the fund's performance varies (from fund's expected level of return). While variability needs to be measured at the expected level of return from fund's activities, it should not ignore the asset manager's maximum exposure to variability of returns of the fund through other interests that the asset manager holds. The expected level of return should be at a level that includes a performance fee. This is because performance fees are generally set at an achievable level (e.g., if a performance fee is payable when a hurdle rate of 10% is achieved, then 10% is most likely to be the appropriate level of expected return). If there is more than one hurdle rate, higher rates could be considered as a qualitative factor in the overall assessment.

The asset manager should also consider whether its exposure to variable returns is different from other investors and, if so, whether this might influence its actions (e.g., when the asset manager holds subordinated interests in, or provides other forms of credit enhancement to, the fund). Furthermore, an asset manager should consider whether its employees or related parties (e.g., the parent of the asset manager) hold any significant interests/entitlements in the fund it manages. Depending on the facts and circumstances, units held by employees and/or related parties may need to be taken into consideration in the assessment of whether the asset manager is a principal or agent.

AASB 10 contains no bright lines as to what level of return constitutes control. Assessment of whether an asset manager is a principal or an agent should take into account all facts and circumstances unless a single party holds substantive removal rights and can remove the asset manager without cause, in which case the conclusion would always be that the asset manager is an agent.

In practice, rights held by others and the exposure to variable returns are likely to be the key indicators in principal/agent assessments. The scope of decision making authority is not likely to be a distinguishing feature as asset managers will usually have power over the relevant activities of the fund irrespective of whether its activities are wide or narrow. While remuneration is likely to be a key consideration in the overall assessments, it is unlikely to be a determining factor on its own.

There are no bright line rules in AASB 10 as to what level of return constitutes control. When making an overall assessment of whether they are principal or agent, asset managers will need to take into consideration all the facts and circumstances (including their level of power and exposure to return), having regard to the conclusions in the AASB 10 examples which are summarised below.

Summary of relevant AASB 10 examples:

	Example 13	Example 14A	Example 14B	Example 14C	Example 15
Fixed fee	1% of net asset value	1% of net asset value	1% of net asset value	1% of net asset value	1% of net asset value
Performance fee	-	20% if a specific profit level is achieved	20% if a specific profit level is achieved	20% if a specific profit level is achieved	10% if a specific profit level is achieved
Direct investment in the fund	10%	2%	20%	20%	35%
Removal rights	None	Removal rights with cause only (for breach of contract)	Removal rights with cause only (for breach of contract)	Substantive removal rights held by an independent board	Removal rights without cause, but held by large number of unrelated investors
Conclusion	Agent	Agent	Principal	Agent	Principal

Further information

For further information on any of the information included in this TA Alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at nationalaudit.support@au.gt.com.