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IFRS PRACTICE ISSUES

Applying the consolidation model to fund managers

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Delegated power is not control

Determining whether or not a fund manager has to consolidate its managed funds has long been an issue. The delegation of decision-making authority to an expert fund manager is central to the funds business model. However, the problem for fund managers was that this was not contemplated in previous consolidation standards.

The new consolidation standard shakes up consolidation accounting, introducing a single control model that includes an explicit concept of delegated power. This means that fund managers now have specific literature to refer to when assessing their relationship with the funds under their authority. Under this guidance, a fund manager will not consolidate a fund when there is no link between the power it exercises over the fund and its returns from the fund.

However, this new linkage guidance, which is the focus of this publication, involves many indicators, much judgement, and few bright lines – all of which will make it a challenge to operationalise. The aim of this publication is to help fund managers rise to the challenge, by focusing on what we believe will be the key factors that drive the analysis. Whilst the analysis cannot be reduced to a simple quantitative process, we believe that a focus on the key factors can help to reduce the population that needs more qualitative analysis.

Put simply, fund managers had a problem that needed to be answered. The new consolidation standard is an answer that needs to be operationalised. We hope that this publication takes you along the path to doing just that.

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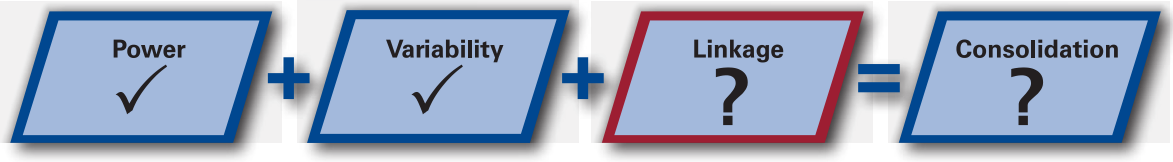
1. Simplifying the model for fund managers

1.1 Control requires a link between power and returns

Our previous publication on IFRS 10 *Consolidated Financial Statements*[1] discusses the new consolidation model in its entirety, taking readers through the standard step by step. In this publication we focus in more detail on the key issue for fund managers: should a fund manager consolidate its managed funds?

IFRS 10.7

The diagram below is a reminder of the three elements in the control model. With its delegated power, and usually with an incentive fee paying a share of returns or with a co-investment, the fund management business model will usually meet the first two elements. So it is the third element, the link between power and returns, that is usually key for fund managers. On the assumption that the fund manager has power and exposure to variability, consolidation is then required only when the fund manager has the ability to use its power to affect its returns.



The linkage test determines whether power is deemed to be used:

- for oneself, in which case the fund manager is a principal and will consolidate the fund; or

IFRS 10.17

- for others, in which case the fund manager is an agent and will not consolidate the fund.

1.2 Not all indicators of linkage are equal

IFRS 10 provides a number of tests and indicators to assess whether linkage is present. However, it appears that the analysis for fund managers will come down to a combined assessment of just two key indicators: kick-out rights and aggregate economic interests. Appendix 1 addresses the other tests and indicators, and why we do not consider them to be practical focus areas.

Indicator	Aggregate economic interest	Kick-out rights
Meaning of the indicator	The aggregate economic interest is made up of remuneration plus other interests. The fund manager's remuneration includes items such as management fees (e.g. 1 percent per annum of total net asset value) and performance fees (e.g. 20 percent of returns when a certain percentage performance is achieved). The fund manager's other interests represent items such as any equity investment. The key attribute of aggregate economic interest appears to be the fund manager's variability at the expected level of fund performance. In other words, if the fund does a little better or a little worse than expected, what percentage of that variation does the fund manager gain or suffer?	Kick-out rights represent the power held by another party to remove the fund manager. The key attribute of the strength of kick-out rights is the number of investors who need to act together to exercise such a right.

1 *First Impressions: Consolidated financial statements*, available at kpmg.com/ifrs

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Indicator	Aggregate economic interest	Kick-out rights
Relevance of the indicator	The greater the variability of a fund manager's interest in a fund, then: • the greater the weighting placed on its aggregate economic interest; and • the higher the likelihood that the fund manager is a principal.	The smaller the number of investors who must act together, then: • the greater the weighting placed on their kick-out rights; and • the lower the likelihood that the fund manager is a principal.

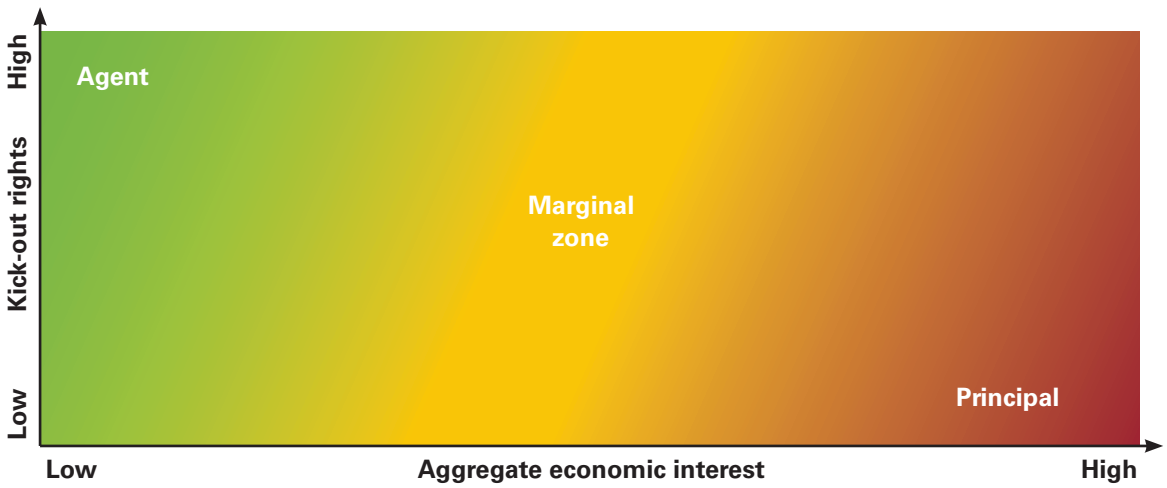
1.3 There is a trade-off between kick-out rights and aggregate economic interest

The indicators are required to be considered together. So, the stronger the kick-out rights, the more aggregate economic interest can be accepted while still being an agent. Conversely, the weaker the kick-out rights, the less aggregate economic interest can be accepted while still being an agent.

The chart below provides a way of visualising a general scheme for the result of combining different strengths of each indicator:

- In the green zone, the combination of strong kick-out rights and low aggregate economic interest suggests that the fund manager is an agent.
- In the red zone, the combination of weak kick-out rights and high aggregate economic interest suggests that the fund manager is a principal.
- In the marginal zone, the combination does not give a clear outcome.

For those cases that fall into the marginal zone, the fund manager will need to consider certain other aspects of these indicators to determine if it is an agent or a principal. These aspects are discussed later in this publication. The question of where the central, marginal zone starts and finishes is not clear; there are no bright lines.



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2. Aggregate economic interest – remuneration plus other interests

Look at the variability in expected returns

The fund manager needs to identify a key measure of aggregate economic interest. It appears that this measure is the variability of expected returns, measured at performance levels at which a performance fee kicks in.

2.1 What is in the aggregate?

IFRS 10.B72(a)

The first key indicator is 'remuneration and other interests in aggregate'. (We refer to this as the 'aggregate economic interest'). It appears from the words quoted that this amount is simply the sum of remuneration and other interests.

2.2 Variability around expected returns – the leading measure of this aggregate

IFRS 10.B72

IFRS 10 asks for an evaluation of "the *magnitude* of, and *variability* associated with, its economic interests … relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns *expected* from the activities of the investee but shall not ignore the decision maker's *maximum* exposure to variability of returns" (emphasis added).

Of these measures, it appears that the variability associated with the *expected* level of returns ('expected variability') is the primary measure of aggregate economic interest. This is because, first of all, the standard is clear that the assessment is based primarily on the fund manager's expected returns. Second, we believe that *variability* (at expected return level) is the leading measure, for the following reasons.

IFRS 10.7(b), 15

- It is a key element of the definition of returns in IFRS 10; the standard focuses on returns as being those that have the potential to vary as a result of the investee's performance.

IFRS 10.B60, B71, B72

- It is identified as a headline factor to assess when performing the principal-vs-agent assessment – e.g. the decision maker's exposure to variability of returns.

IFRS 10.B72 Ex.13–16

- All of IFRS 10's examples, bar one, refer exclusively to variability; magnitude, however, is mentioned in only one example. Furthermore, from the facts given in the examples, variability is the only measure that could be calculated (see 2.3).

The guidance also requires consideration of magnitude and the maximum. We believe, as explained below and further in 4.2, that these measures only become important in analysing marginal cases. For the calculation of magnitude, see 4.2.2.

2.3 How is variability measured?

IFRS 10.B72

IFRS 10 requires an assessment of the "variability associated with its economic interests … relative to the total variability of returns of the investee". This is asking: how much, relatively, does the fund manager's total income vary as fund performance varies?

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From this, it appears that variability is the marginal increase/decrease in the fund manager's returns relative to a marginal increase/decrease in the fund's returns. Put simply, if the fund's performance, starting from a particular level, increases or decreases, how much of that increase or decrease does the fund manager gain or suffer; or how geared to changes in fund performance are changes in the fund manager's income? We believe that this can be calculated relatively simply, as shown by the following example.

Example 1 – calculation of variable interest

Suppose that an investment manager has:

- a 1% management fee calculated on net asset value (NAV); plus
- a performance fee paying 20% of additional profits after management fees once an 8% (profits after management fee) hurdle is reached; plus
- a 10% investment.

The variability at any level of return at which a performance fee is due can be calculated as follows[2].

	Total		Manager share
Marginal return, say 1	1.000		
Less management fee (1% x 1)	(0.010)		0.010
Less performance fee as hurdle met (20% x (1 - 0.010))	(0.198)		0.198
Available to investors	0.792	at 10%	0.079
			0.287
Variability		0.287 / 1	28.7%

In other words, for every 1 more or less of fund performance, the fund manager receives 0.287 more or less. Variability is therefore 28.7%. The calculation can be done in a short-cut way as follows: 1% + 20% x 99% + 10% x (80% x 99%) = 28.7%.

The use of the term 'expected' might suggest a different calculation – that is, the expected (i.e. probability weighted) value of the fund manager's income divided by the expected value of the fund performance. However, it appears that this would not calculate the kind of measure required by the standard. This is because it would not measure how much the fund manager's income varies as fund performance varies. Instead, it would be a measure of total fund manager return as a percentage of total fund return. That kind of measure is, we believe, what IFRS 10 separately refers to as magnitude (see 4.2.2).

2 This might also be expressed mathematically as:

$$\frac{\Delta(M + P + U)}{\Delta R}$$

Where, Δ/Δ = rate of change with respect to
M= income from management fee
P = income from performance fee
U = income (including capital appreciation) from units held
R = returns from the activities of the fund – i.e. before fees

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2.4 The expected return level at which to measure variability

As noted in 2.2, it appears that variability is measured at the expected level of fund returns. The question is: what is this level? After all, there may be different rates of remuneration at different levels of performance – usually, there is a hurdle return above which a performance fee is paid – and the fund manager's marginal income (variability) will differ accordingly.

In answer, it appears that the expected performance level should be at a level that includes a performance fee. There are several reasons for this.

- *Performance fees are set with the intention of being achievable.* Therefore, the expected range of performance cannot be below the level at which a performance fee kicks in. To calculate the aggregate economic interest at performance levels below the performance fee would, in effect, disregard the performance fee altogether. That would not seem appropriate, particularly when considered in combination with the bullet below – i.e. that the performance fee incentivises the manager to uses its power to affect its own returns.

IFRS 10.17, 18

- *The incentive effect of the performance fee is important.* IFRS 10 asks whether the fund manager has the ability to use its power to affect its own returns from the fund. The fee incentivises the fund manager to behave so as to obtain this return. For this reason, we believe that it is the incentive effect of the fee, not whether it is achieved, that is the more important feature.
- *IFRS 10's examples ignore the hurdle.* These examples note that the performance fee is paid after a hurdle rate, but the rate is unspecified. The existence of the hurdle, in the sense of a barrier to payment of the performance fee, is seemingly disregarded. That is also consistent with the preceding bullet points. On that basis, we do not believe that the standard and its examples intend that performance fees be routinely disregarded.

Focussing on the level at which performance fees arise is also a practical approach. The calculation is simple and is not sensitive to the precise level of performance above the hurdle, assuming that the fee has only one rate/hurdle. Once the fee has become payable, the fund manager's share of further changes in the fund performance is always the same. If there is more than one performance fee level, then the decision, as to which performance fee band to build into the quantitative measure, will need to be more precise (i.e. determine which hurdle level is expected and build that into the initial calculation). The existence of higher bands may still need to be taken into account later as a qualitative feature of the aggregate economic interest – see 4.2.

If a performance fee was not expected to be reached in all periods, then this might be factored into the overall assessment, qualitatively, as noted in 4.2.

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3. Kick-out rights

Number of investors required to act together is key

It appears that the strength of kick-out rights may be assessed by categorising without-cause kick-out rights into several classes of strength. The number of investors that need to act together would be the main factor in determining those categories.

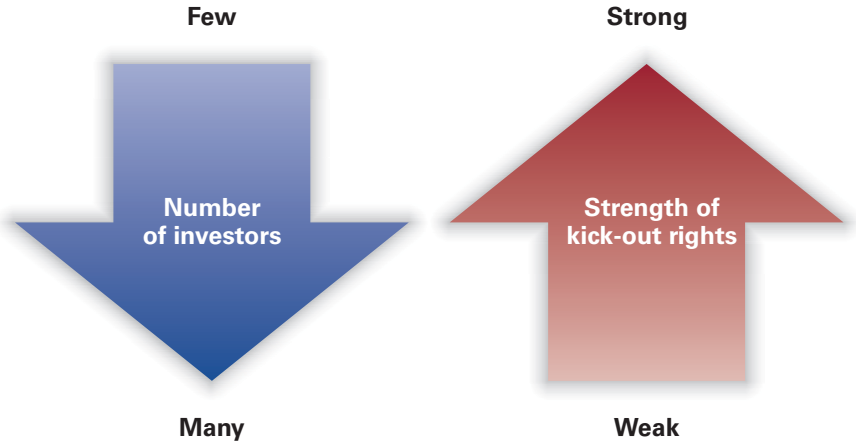
While the numbers of investors is most important, barriers to exercising the rights also need to be considered when determining the strength of a kick-out right.

3.1 The sliding scale of strength

The second key indicator is kick-out rights, which are assessed on a sliding scale of their strength. We expect that the most significant factor in determining their strength will typically be the number of investors that would need to agree to exercise the rights. In other words, consider how many investors would need to act together.

IFRS 10.B65

The standard is clear that the greater the number of parties, the less weighting is placed on their kick-out rights. (At the other end of the scale, single party, without-cause kick-out rights always result in the manager being classified as agent. See Appendix 1.)



IFRS 10.B65, B72 Ex.14A

It is also clear from the standard that a complete lack (or zero weighting) of a kick-out right is not fatal to being an agent. IFRS 10 gives examples of such cases, some of which are agents and some principals. We explore these examples in Section 4.

IFRS 10.B23(b), B65, BC139

It also appears that rights exercisable by an independent governing body (such as the board of directors) are considered at the board level, and are therefore implied to be very strong. This is because a board would generally comprise only a few members; once the investors' rights have been transferred to the board members, it is, we believe, the number of board members that matters. For example, there may be hundreds of investors in a fund but only a very few directors; if those directors have the ability to remove the fund manager without-cause, then the kick-out right strength would be assessed at the board level. Naturally, the board needs to be independent, and there should be no other barriers to exercise that would weaken the force of that right (see 3.3).

Aside from a few private equity funds with very small numbers of investors, the lowest number needing to act together will usually be the members of a board of certain funds. For example, listed investment

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trusts usually have independent boards with the power to remove and replace the manager. As noted above, a board right is very strong.

Typically, in the retail fund sector there could be thousands of investors needing to act together, which would result in kick-out rights being considered very weak. In the private equity sector, funds with dozens or perhaps a few hundred investors would fill the ranges in the middle.

3.2 With-cause rights have zero weight

The standard clearly indicates that kick-out rights should be without-cause if they are to be considered in the analysis; otherwise they are given zero weight. This is apparent because:

- the rule about the single party removal rights requires them to be without-cause (see Appendix 1); and

IFRS 10.B65, B72 Ex.14A, 14B

- the standard gives two examples in which a number of investors have removal rights that are exercisable with cause; in both cases, it concludes that the rights are protective only and they are given no weight in the analysis.

3.3 Barriers to exercising the kick-out right

IFRS 10.B22, B64, BC139

As a general rule, IFRS 10 requires one to look only at substantive rights. This is confirmed specifically in relation to kick-out rights.

The standard provides a number of factors to consider in relation to this. The funds sector will recognise these factors as the types of matters considered in the past – for example:

- financial penalties;
- conditions narrowly limiting the timing of exercise;
- absence of a mechanism allowing exercise; and

IFRS 10.B23, B24

- inability to obtain the information necessary for exercise.

However, as with kick-out rights generally, it appears that these are not simple yes/no tests. So while some barriers might be so significant as to accord zero weight to the kick-out rights, others may simply weaken the sliding-scale strength of a kick-out right. If there are no barriers, then there is clearly no effect at all on the strength.

Insight – Occasions for casting votes

It appears that the lack of an annual general meeting (AGM) may be seen as weakening the investors' practical ability to exercise kick-out rights, unless there is another mechanism in place.

Private equity investment funds might have no AGM, but usually have instead alternative mechanisms that give investors the practical ability to exercise kick-out rights. For example:

- there may be quarterly calls and annual meetings at which the investors are provided with information;
- an investor will usually necessarily know who the other investors are – e.g. they will be named in the partnership documents available to all investors; and
- there could be a right to call an extraordinary meeting – often requiring just five percent investment – to vote on removal. The ability to call such a meeting and exercise a right may even be stronger than awaiting an AGM in order to exercise a right.

As a result, the lack of an annual voting opportunity does not necessarily require zero weight to be accorded to kick-out rights.

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Insight – Notice periods

Notice periods can also represent barriers to exercising kick-out rights. It appears that a notice period covering the whole of the life of a limited life fund (or penalties equivalent to total fees for the life of the fund) would result in zero weighting of the kick-out rights; however, other cases may not be so clear cut.

For example, a typical arrangement in the private equity sector is to give six months' notice plus payment of a further six months' fees – in effect a combined one-year notice/fees period. However, at the outset the fund life will be five or seven years. It appears that the effect on the strength of the kick-out right is material, but not so great that the kick-out right has no weight.

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4. Combining the two key indicators

Matrix approach to assessment

It may be appropriate to use a matrix, grouping together categories of kick-out right strength. For each category, the fund manager could identify a level of aggregate economic interest for which the entity is clearly an agent and another for which it is clearly a principal. A marginal zone would then appear between these points.

If a combined assessment of the key indicators mapped into the marginal zone, then other features of aggregate economic interest and kick-out rights would be taken into account. The other features to consider include expected magnitude, a second tier of performance fee, the proportion of investors required to vote together and nature of variability compared with that of other investors.

4.1 The challenge is finding appropriate combinations

Stronger kick-out rights favour a conclusion of agent, and a larger aggregate economic interest favours a conclusion of principal. The basic relationship between these two indicators is easily understood. The challenge is in determining how to apply the relationship to specific cases and conclude whether the fund manager is principal or agent.

The standard (as well as the *Effect Analysis*[3]) provides examples of combinations of kick-out rights and aggregate economic interest, as shown below. From these examples, we can see some fixed points about certain combinations and derive a general approach.

Example	Variability[4]	Kick-out rights	Agent/Principal
13	11%	Zero	Agent
14A	22%	Zero	Agent
14B	37%	Zero	Principal
14C	37%	Without-cause	Agent
15	42%	Widely dispersed	Principal
Effect Analysis	45%	Zero	Principal

Although these examples do not provide any bright lines, they do narrow the areas in which significant judgement is required to operationalise the model. By presenting them in the format below, the concept of a marginal zone between agent and principal becomes clearer. We do not suggest that such a chart can be used as a quantitative tool, but merely that it illustrates the basic idea.

3 Published by the IASB in September 2011 and republished in January 2012.
4 In IFRS 10, the examples do not quote figures for aggregate economic interests. The figures in this table are the variability calculated in the manner explained in 2.3. See Appendix 2 for more information.

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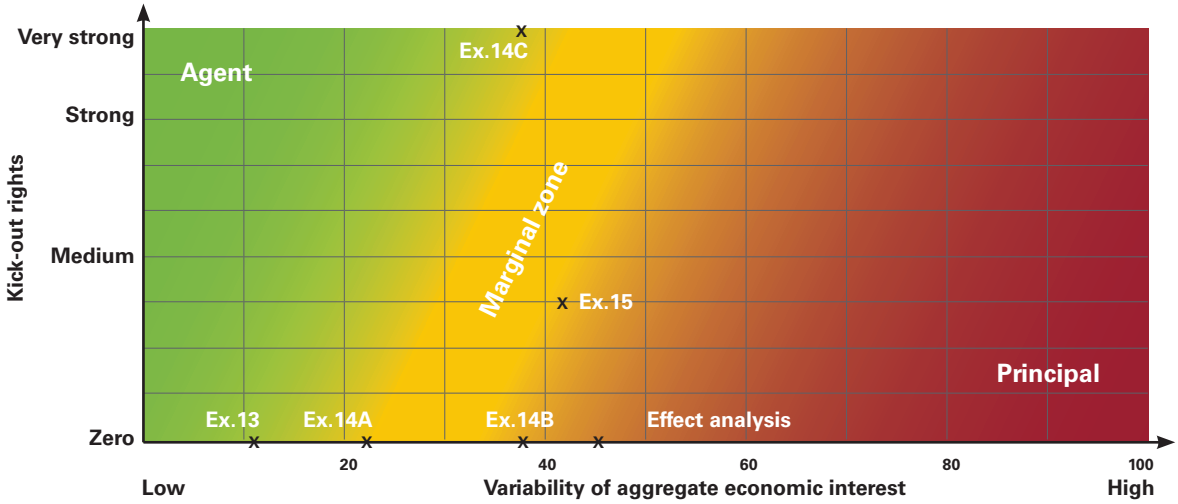

When no kick-out rights exist, then, deriving figures from IFRS 10's examples, the changeover from agent to principal occurs between approximately 22 and 37 percent (the marginal zone between Examples 14A and 14B).

When stronger kick-out rights exist, a higher variability might still support an agent outcome. For instance, Example 14C has without-cause, board-level, kick-out rights (a very strong case) and can withstand 37 percent aggregate economic interest, while still being deemed an agent. In Example 14B, which has the same variability but no kick-out rights, the manager is deemed a principal.

These examples could be used as a guide to develop a matrix. For each category of kick-out rights strength, zones of variability of aggregate economic interest would be identified, to correspond with clear agent, clear principal and marginal cases. Such a matrix could be presented as follows.

Kick-out strength	Variability of aggregate economic interest		
	Clear agent	Marginal	Clear principal
Very strong	[ ]% or less	[ ]% - [ ]%	[ ]% or more
Strong	[ ]% or less	[ ]% - [ ]%	[ ]% or more
Medium	[ ]% or less	[ ]% - [ ]%	[ ]% or more
Weak	[ ]% or less	[ ]% - [ ]%	[ ]% or more
None	22% or less	22% - 37%	37% or more

The cells in this matrix have been left intentionally blank, aside from the suggestion of the no-kick-out right zones based on Examples 14A and 14B. As there are no bright lines, it appears that fund managers would need to judge and justify their own assessments of zones.

4.2 Analysing marginal cases

If a case falls within or along the edges of the marginal zone identified above, then a reasoned judgement as to whether the fund manager is a principal or an agent would be required. It appears that other features of the two key indicators would be considered at this point – for example:

- the expected magnitude (see 4.2.2);
- the likelihood of the expected performance level applied not being reached in all periods (see 4.2.1);

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IFRS 10.B72

- a performance fee having a second tier applying above the expected performance level, which would increase maximum variability; while the standard asks for the assessment to be made primarily on the basis of variability at the expected return, it requires that the maximum also be considered;
- the proportion of investors required to vote together to use a kick-out right – i.e. majority or super majority, with the latter being more difficult to achieve; and
- any difference in the nature of the variability as compared with that of other investors, if this was not enough on its own to result in an outcome of principal (see Appendix 1).

When it is concluded that a fund manager is the principal as a result of seeding a fund (high co-investment), the interaction with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* would need to be considered. That is outside the scope of this publication.

4.2.1 Non-cumulative performance fees

In some fund structures, the performance fee is cumulative over the whole life of the fund – e.g. in private equity. In other cases, the fee is determined and paid based on annual performance with no clawback in subsequent years if cumulative performance falls.

It appears that the possibility of an annual, non-cumulative fee not being due may occasionally be a *qualitative* factor that would be taken into account in deciding marginal cases. If a fee has been designed to be due only occasionally, then this may, in marginal cases, weight the scales towards being an agent. This is because it cannot be factored in *quantitatively* without converting the variability measure into a figure that does not represent the actual marginal rate at which the fund manager benefits/suffers as performance changes. For example, a probability weighting across several years would become a blended figure.

IFRS 10.17, 18, B72, Ex.14

Such a blended figure would inevitably incorporate cases of a zero performance fee, effectively partially disregarding the fee. It appears difficult to view such an approach as consistent with IFRS 10. The standard is asking for the size of the fee to be assessed in order to decide whether the fund manager has the ability to use its power to affect its own returns from the fund. The fee exists to incentivise the fund manager to behave in a certain way in order to achieve the fee. Therefore, we believe that it is the incentive effect of the fee, not whether it is achieved, that is the more important feature; this conclusion is supported by the fact that IFRS 10's examples seem unaffected by questions of the possibility of not meeting the hurdle (see 2.4). Accordingly, a blended figure seems difficult to view as consistent with IFRS 10.

Reverting to qualitative matters, it should not be overlooked that performance fees may have a somewhat different nature from the other investors' interests (see Appendix 1), adding some weight in favour of principal. For example, the existence of the hurdle makes the fund manager's return at that point more sensitive to changes in fund returns than are those of the investors.

4.2.2 Considering the fund manager's expected magnitude

IFRS 10.B72

One of the other features of the aggregate economic interest referred to in IFRS 10 is its magnitude. IFRS 10 asks for an evaluation of the "magnitude of … its economic interest … relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee".

IFRS 10.B72

Magnitude is a feature of the aggregate economic interest that can help decide a marginal case. This is because it appears that IFRS 10 requires both variability and magnitude to be sufficiently high to conclude that the manager is a principal. This is because the standard notes that, "the greater the magnitude of, *and* variability .... the more likely the decision maker is a principal" (emphasis added). So if magnitude is low, then it may tip the scales for a marginal case to be an agent, and vice versa.

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Turning to the calculation of the expected magnitude, it appears that this is the fund manager's total return as a percentage of the fund's total return measured at the expected performance level (see 2.4). This is because it has to be different from variability, yet still be a measure of fund manager returns relative to fund returns. In other words, while variability is the marginal share of return, magnitude is the absolute share of return.

Example 2 – Calculating magnitude

Assume that the fund in Example 1 in 2.3 begins with a value of 100, and then has a performance level of 10%. The magnitude would be 21.5%, determined as follows.

	Total		Manager share
Return	10.00		
Less management fee (1% x 110)	(1.10)		1.10
Less performance fee (20% x (10 - 1.1 - 8[1]))	(0.18)		0.18
Available to investors	8.72	at 10%	0.87
			2.15
As a % of the total return of 10			21.5%

[1] The hurdle below which no performance fee is received being 8%.

If magnitude were calculated at low performance levels, then very high magnitude figures would result. Continuing with the above example, if fund performance were 1 percent, then the fund manager would take 100% of it through the management fee, leaving nothing for investors.

Fortunately, IFRS 10 asks for magnitude to be assessed at expected levels of return (the same as the expected performance level at which variability is measured, see 2.4); it appears that these are at much higher levels, at which such extreme measures do not usually arise. In fact, as returns increase, the magnitude will tend to pull towards being to the same figure as variability. This is because the distortion of the average, by management fees (fixed component) as a percentage of low level performance, is gradually less and less significant as performance increases. In its place, the marginal aggregate income rate increasingly dominates the calculation.

It is also worth noting that this relationship between variability and magnitude means that, in practice, it appears that magnitude does not need to be considered outside the marginal zone even though, we believe, IFRS 10 requires both variability and magnitude to be sufficiently high to reach a conclusion of principal. Beneath the marginal zone, this is because if variability is sufficiently low, then it does not matter what the magnitude is. Above it, this is because if variability is sufficiently high, then magnitude calculated at the expected performance level will usually also be sufficiently high (i.e. magnitude moves towards variability as returns increase).

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5. Conclusion

This publication identifies what we think at this stage are the two key indicators that fund managers will need to consider in assessing whether they are a principal or an agent under IFRS 10. It also provides some comment as to how these indicators could be operationalised.

The following table summarises the key steps in operationalising the assessment. Overall the analysis highlights that while significant judgement cannot be avoided, nevertheless an initial assessment can be focussed on a more simplified set of indicators than might at first be apparent from the standard's complexity. This will leave a more manageably sized population at the margins that requires significant judgement.

Measure aggregate economic interest	The fund manager needs to identify a key measure of aggregate economic interest. It appears that this measure is the variability of expected returns, measured at performance levels at which a performance fee kicks in.
Assess strength of kick-out rights	It appears that the strength of kick-out rights may be assessed by categorising without-cause kick-out rights into several classes of strength. The number of investors that need to act together would be the main factor in determining those categories. While the numbers of investors is most important, barriers to exercising the rights also need to be considered when determining the strength of a kick-out right.
Assess key indicators in combination	It may be appropriate to use a matrix, grouping together categories of kick-out right strength. For each category, the fund manager could identify a level of aggregate economic interest for which the entity is clearly an agent and another for which it is clearly a principal. A marginal zone would then appear between these points.
Significant judgement still required at the margins	If a combined assessment of the key indicators mapped into the marginal zone, then other features of aggregate economic interest and kick-out rights would be taken into account. The other features to consider include expected magnitude, a second tier of performance fee, the proportion of investors required to vote together and nature of variability compared with that of other investors.

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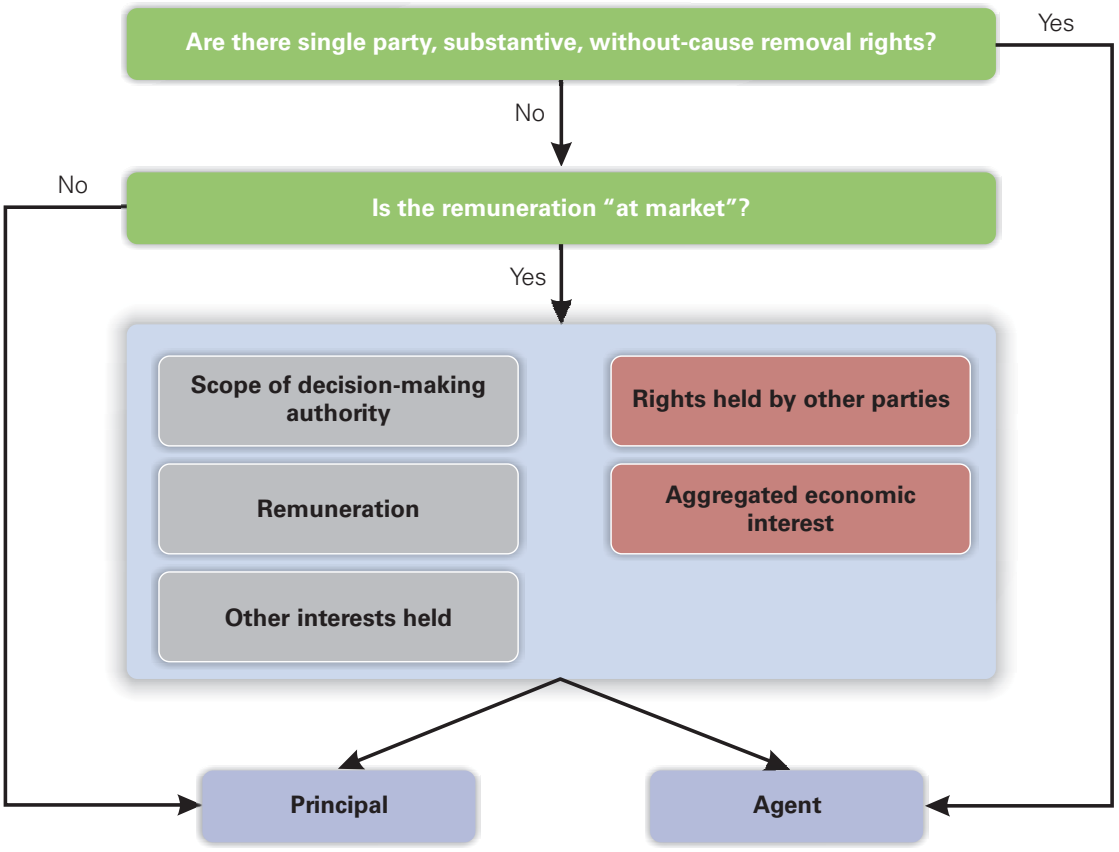
Appendix 1: Why some tests/indicators are not key in practice

The main part of this publication discusses the indicators of the model that we think will be most relevant to the funds sector. This appendix addresses the other components of the model and why we do not consider them to be practical focus areas.

As shown in the diagram below, the model has only two determinative tests. One is positive, relating to kick-out rights; the other is negative, relating to off-market remuneration. If neither of these tests has resolved the case, then the fund manager considers four indicators in making its assessment: scope of authority; kick-out rights; remuneration; and other interests. Remuneration and other interests held (the 'aggregate economic interest'), should also be considered together. These effectively become a fifth indicator.



The two determinative tests, shown in green above, are clearly important. However, as explained below it appears that they will not often be of practical assistance. Of the main group of indicators, those shown in red above are the key ones addressed in the main part of this publication. As explained below, the remaining, shown in grey, appear to be of limited practical relevance.

The positive determinative test – single party kick-out rights: rarely met

IFRS 10.B65, BC139

A decision maker is an agent without further analysis when:

- a single party holds removal rights;

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- those rights are substantive – i.e. they give their holder the practical ability to prevent the decision maker from directing the activities of the investee; and
- they are exercisable without-cause.

IFRS 10.B65

It is clear that this determinative test is met only when a single party holds removal rights. If two parties are required to agree to exercise removal rights, then "those rights are not, in isolation, conclusive". A single party, however, does not necessarily mean a single entity. It appears that removal rights held by several entities under common control would be regarded as held by a single party.

IFRS 10.B23(b), B65, BC135, BC139

The standard indicates that rights exercisable by a board of directors or equivalent body are not equivalent to rights held by a single party. However, rights held by an independent governing body are implied to be very strong, as discussed in 3.1.

In our experience, it is rare in practice for a single party to hold substantive, without-cause removal or similar rights.

The negative determinative test – at-market remuneration: rarely failed

IFRS 10.B69

For the decision-maker to be an agent, its remuneration needs:

- to be commensurate with the services provided; and
- to include only terms, conditions or amounts customarily present in arrangements for similar services and level of skill, negotiated on an arm's length basis.

If there is sufficient investment from independent investors, then it appears that the remuneration is generally at market. This is because arm's length investors should have transacted at arm's length terms. In order to rely on such an analysis, the outside investors have to hold a material interest. They also need to be genuine third parties: their interest should not be linked to and compensated by, or given as compensation for, some other transaction.

This approach means that there is no need to benchmark fee rates against peers. In any event, it could be difficult for some funds to find comparable funds – for example, due to their specific structure/ strategy.

Note also that the standard's focus is on whether the remuneration was negotiated at an arm's length basis. So if the fees were fixed in such a way some years ago, then it does not matter that market norms for new funds have now changed.

Scope of decision-making authority: not a distinguishing feature

IFRS 10.B62

When assessing the scope of its decision-making authority, the manager considers:

- the activities that are permitted according to the decision-making agreement(s) and specified by law; and
- its level of discretion.

If a case is being assessed for linkage, then it must be the case that one has already concluded that the fund manager has power. That being so, it appears that this indicator will always give the same result for a fund manager. That is, it will generally always be assessed that the fund manager has all of the discretion within the designed activities of fund. Therefore, the fund manager will inevitably have power over the decisions that significantly affect investment returns (the relevant activities).

IFRS 10.7, 10

After all, the whole purpose of investing in a fund is to delegate decision-making, over matters that significantly affect the investment returns, to an expert fund manager who, it is expected, will generate superior returns or, for trackers, reliably close-tracked returns at the lowest cost. Therefore, the fund manager will inevitably have power over the decisions that significantly affect investment returns (the relevant activities); this is regardless of whether the fund's range of activities is broad or narrow. Indeed, if it did not have power over the relevant activities, then the principal-vs-agent linkage analysis would not be necessary, because without power the IFRS 10 definition of control cannot be met.

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We do not think that this necessarily means that the fund manager is a principal. If it did, then all fund managers would be principals. The purpose of the linkage test is to decide whether power is deemed to be used for oneself (in which case the fund manager is a principal) or for others (in which case the fund manager is an agent). As a result, it appears that this indicator is not a distinguishing feature in the principal-vs-agent analysis. In effect, it may be left out of the analysis.

In November 2011 the FASB[5] issued an exposure draft on principal-vs-agent evaluation. It is directionally consistent with the conclusions in IFRS 10. It is interesting to note that its exposure draft does not retain 'scope of decision-making authority' as a factor to be evaluated in assessing whether a decision maker is a principal or an agent. It appears that being a decision maker in the first place has been looked upon – or this is the inference – as having the scope of decision-making authority, making that indicator redundant as a distinguishing feature.

Remuneration: always counted, but no need to count it on its own

IFRS 10.B68

The standard requires the fund manager to assess its level of remuneration. The larger the fund manager's at-market remuneration, the more likely it is that the fund manager is a principal.

Two observations of principle arise from this.

IFRS 10.B70

- The standard is clear that the fact of at-market remuneration is not sufficient on its own to conclude that the fund manager is an agent. This may be one of most unwelcome points for the investment funds sector. However, that is what IFRS 10 requires.

IFRS 10.B56, B57

- It follows that at-market remuneration can be too large for the fund manager to be an agent. This is because remuneration of the fund manager, which varies depending on the fund's performance, is a form of return; the more significant this remuneration, the more likely it is that the fund manager is primarily using its decision-making authority over the fund for its own benefit and not for the benefits of others.

The standard requires the quantum of remuneration to be tested twice: once for remuneration alone, and a second time as part of the aggregate economic interest. Therefore, it appears that in practice the test need only be done once, at the aggregate economic interest level. This is because if the level of remuneration alone resulted in a principal conclusion, then the same conclusion would be reached when assessed in aggregate. Conversely, if the assessment did not result in a principal assessment on a stand-alone basis, then the remuneration would still be required to be tested as part of a larger aggregate.

Other interests: always counted, but no need to count them on their own

IFRS 10.B71

If a fund manager holds other interests in the fund – e.g. a co-investment – then this may be an indication of its being a principal. However, this is not a yes/no test. It depends on the quantum of the interest, although no particular lower limit for consolidation is set. The standard asks the fund manager to assess its exposure to variability of returns from its other interests.

The standard requires the quantum of other interests to be tested twice: once alone, and a second time as part of the aggregate economic interest. Once again, in practice it appears that the test need only be done once at the aggregate economic interest level, for similar reasons as stated above in respect of remuneration.

Strong divergence of fund manager's and investors' interests: rare

IFRS 10.B72(b)

If the aggregate economic interest of the manager is different from that of other investors, then this indicates that the fund manager is a principal. In such a case, the fund manager is incentivised to use its power for itself and not for other investors, because the incentive scheme does not align the fund manager's and the investors' interests.

[5] US Financial Accounting Standards Board

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IFRS 10.B72, Ex.16

IFRS 10 gives an example from outside of the funds sector: a multi-seller conduit where the decision-maker has a subordinated residual interest and provides credit enhancement. It concludes that the decision-maker is a principal by reference solely to the different nature of this interest, i.e. regardless of all other factors. We expect that such an arrangement is unlikely to be common in the funds sector.

The sector may occasionally, however, have some fee structures that may not be closely aligned with the investors' interests – for example, if performance fees from one year cannot be clawed back if cumulative performance to the end of the next year falls but the investors cannot realise any gain until the end of the fund life. An example of more significant divergence from investors' interests might be a geared property fund. If management fees are based on the gross value of the properties, with the manager able to gear up the fund, then there is clearly a difference between the variability to which the geared investor is exposed and that to which the gross-basis management fee is exposed. Such structures were seen before the crisis but are not favoured by investors nowadays.

It appears that, if the variability to which the manager is exposed is strongly different from that to which other investors are exposed – e.g. the geared fees cases – then this might be a sufficiently strong indicator to conclude that the manager is a principal. This is based on IFRS 10's example (noted above), where the conclusion is for principal on the strength of a different interest alone.

If, on the contrary, the variability to which the manager is exposed is only a little different from that to which other investors are exposed, then it appears that this is taken into account after combining aggregate economic interest and kick-out rights (see 4.2) – i.e. it might be enough to tip a marginal case to being a principal.

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Appendix 2: Summary of the IASB examples

The standard as well as the related *Effect Analysis* provide examples of combinations of kick-out rights and aggregate economic interest. These are summarised in the table below.

Example	Fee	Performance fee	Interest held	Removal rights	Total economic interests (variability)	Agent/ Principal?
13	1%	-	10%	None	1% + 10% x 99% = 11%	Agent
14A	1%	20% over unspecified hurdle	2%	None (with cause only)	1% + 20% x 99% + 2% x (80% x 99%) = 22%	Agent
14B	1%	20% over unspecified hurdle	20%	None (with cause only)	1% + 20% x 99% + 20% x (80% x 99%) = 37%	Principal
14C	1%	20% over unspecified hurdle	20%	Yes (held by a board)	1% + 20% x 99% + 20% x (80% x 99%) = 37%	Agent
15	1%	10% over unspecified hurdle	35%	Yes, but little weight as largely dispersed	1% + 10% x 99% + 35% x (90% x 99%) = 42%	Principal
16	-	-	5% second loss piece (different from other investors), liquidity facility	None	5% second loss piece, credit enhancement (i.e. different from other investors)	Principal
Effect analysis p. 27	Immaterial (inferred)	Immaterial (inferred)	45%	None (inferred)	45%	Principal

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