Under the Indian Generally Accepted Accounting Principles (IGAAP), AS 21, *Consolidated Financial Statements* defines the mechanism for identification of entities whose financial statements are to be consolidated by a company. This mechanism is based on the principle of control, where ‘control’ is defined as ownership of majority voting rights and/or power to control the board of directors or governing body of the entity. Thus, under IGAAP various entities which were under the authority of the consolidating entity, on which it had ‘substantive rights’, were not consolidated by it, since it did not have any voting rights in them.

Ind AS 110, *Consolidated Financial Statements*, introduces a single consolidation model, which emphasises on power and returns of the entity. While Ind AS 110 continues to base consolidation requirements on the principles of control, it has broadened the definition of control. Accordingly, an investor consolidates an entity when it has power over the entity, exposure to variability in returns, and a linkage between the two.

1. For the purpose of Ind AS 110, substantive rights relating to an investee are the rights that, the holder (investor) has the practical ability to exercise.
With Ind AS being applicable to all Scheduled Commercial Banks, large Non-Banking Financial Companies (NBFCs), and their group companies\(^2\) with effect from 1 April 2018, they are required to take cognisance of the requirements of these standards and how they differ from their current accounting practice (IGAAP). Fund managers which are classified as NBFCs, will be significantly affected by this implementation, specifically with respect to the consolidation of funds which they manage. Fund managers have been delegated with decision-making authority with regard to the procurement and sale of assets, which are critical to the fund’s operations. However, fund managers do not always have a significant holding in these funds. Under IGAAP, the fund managers are not required to consolidate the financial statements of the funds, since they do not ‘control’ the funds, based on ownership/control over voting rights. However, Ind AS 110 includes an explicit concept of delegated power. Hence, the consolidation of funds by the fund managers needs to be evaluated considering whether the fund managers ‘control’ the fund in accordance with the requirements of Ind AS 110.

In this article, we aim to illustrate the major considerations in determining the consolidation of funds by fund managers.

**Facts of the case**

R Asset Management Company Private Limited (R) is registered as an NBFC, and is the fund manager of a real estate fund, C. C has been set up as a trust, whose trustees are independent of R. The trustees have set a broad investment mandate for the trust, and R has the discretion to make investments in companies and projects, within that mandate without any further approval either from the trustees of C or the investors. C has 50 other investors, who have rights in proportion to their fund units held, this includes rights to remove the fund manager without cause. However, the approval of at least two-thirds of the total investors is required to take any such decision. R holds five per cent of the total units in C. As per its terms of appointment, it will receive one per cent management fee, calculated on the net asset value of the fund and a performance fee paying 12 per cent of additional profits after management fees once the fund is able to get an eight per cent return. This remuneration is commensurate with the current industry terms.

**Accounting issue**

To evaluate control, the fund manager needs to consider the following three aspects:

- Whether it has power over the fund;
- Whether it has exposure, or rights to variable returns from its involvement with the fund; and
- Whether it has the ability to use its power over the fund to affect the amount of returns earned by it through the fund (the link between power and returns).

R needs to evaluate all three aspects, before it can determine whether it should consolidate the financial statements of C.

**Accounting guidance**

While the first two aspects are generally discernible, however, it is the third aspect (i.e. the link between power and returns) that requires evaluation. The linkage test determines whether power is deemed to be used:

- For oneself, in which case the fund manager is a principal and should consolidate the fund; or
- For others, in which case the fund manager is an agent and should not consolidate the fund.

Figure 1 illustrates the process for evaluating the linkage between power and returns.

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2. The Companies (Indian Accounting Standards) (Amendment) Rules, 2016 (‘the Rules’) issued a road map for implementation of Ind AS, which would be in a phased manner. As per the Rules, all Scheduled Commercial Banks, NBFCs having a net worth of INR500 crores or more, and its holding, subsidiary, joint venture and associate companies (‘group companies’) would be required to prepare both consolidated and separate financial statements based on Ind AS (‘Ind AS financial statements’) with effect from 1 April 2018. Under phase two, all NBFCs which have their equity or debt securities listed on a recognised stock exchange, and other NBFCs with a net worth of INR250 crores or more, and their group companies are required to prepare Ind AS financial statements with effect from 1 April 2019.
**Analysis**

**Whether fund manager has power over the fund**

To have power, it is necessary for the fund manager to have existing rights that give it the current ability to direct the activities that significantly affect the returns of the fund\(^3\). Whether this power is exercised, is irrelevant, when assessing consolidation requirements. In the current case, R has been given the discretion to invest the funds of C in various real estate projects, within the investment mandate set by the trustees. No approval is required either from the trustees or the investors. Since management of the funds of C is critical to its returns and operations, it can be concluded that R has power to direct the relevant activities of C, and hence has power over the fund.

**Whether the fund manager has exposure, or rights to variable returns from its involvement with the fund**

To assess the variability of returns, fund managers need to assess whether the returns are fixed or have the potential to vary as a result of the performance of the fund. Returns can be only positive, only negative or wholly positive and negative, and can take the form of dividends, interest on debt instruments, changes in value of investments, tax benefits, remuneration, etc.

In the current case, R will receive a management fee and a performance fee, which are both based on the returns of the fund. Further, it has a five per cent investment in the fund, whose value will vary with the change in the net asset value of the fund. Hence, the variability in performance of the fund would affect R’s returns. Thus, the fund manager has exposure, or rights to variable returns from its involvement with the fund.

**Link between power and returns**

The assessment of linkage between power and returns by the fund manager, brings out whether it is acting in its own capacity, as an investor (or a principal), or has been delegated the rights by the investor(s), and is acting as an agent for the investor(s). Ind AS 110 provides a number of tests and indicators to assess whether linkage is present, however, from the perspective of the fund manager, the analysis of the below mentioned indicators are of importance.

**Single party, substantive, without cause removal rights**

Where a single party holds substantive removal rights and can remove the fund manager without cause, this, in isolation, is sufficient to conclude that the fund manager is an agent. However, in the current case study, the consent of at least two-thirds of the total number of investors (i.e. at least 34 investors) is required to remove the fund manager. Thus, R would need to consider other factors when determining consolidation of C under Ind AS 110.

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\(^3\) Activities of the investee that significantly affect the investee’s returns are known as ‘relevant activities’.
Remuneration is ‘at market’
For the fund manager 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.

Considering that C has been set up by an independent set of trustees, and 50 unrelated investors have invested in the fund at arm’s length terms, it would be reasonable to assume that the remuneration is in line with industry norms, absent any other evidence to the contrary. R should now assess the other factors that are relevant to its linkage test, which are kick-out rights and aggregate economic interests in the fund.

Kick-out rights
Kick-out rights represent the power held by other parties (generally investors) to remove the fund manager. When assessing kick-out rights, ‘without cause’ rights are required to be considered, which represent that investors need not give any reason, when removing 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. 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 results in manager being classified as agent.) Figure 2 below explains this relative strength.

Aggregate economic interests
Aggregate economic interests of the fund manager are made up of its remuneration (R’s one per cent management fee and 12 per cent performance fee, when returns exceed eight per cent) and other interests (R’s five per cent investment in C’s fund units). Ind AS 110 requires entities to compute the magnitude of and variability associated with its economic interest, on the basis of returns expected. However, it appears that variability associated with the expected level of returns is the primary measure of aggregate economic interest. Hence, R is required to analyse, if C’s performance was a little better or a little worse than expected, what percentage of that variation does R gain or suffer.

In the current case study, at least two-thirds of the total investors need to vote towards the removal of the fund manager, considering this, R may conclude that the kick-out rights of the investors in C are widely dispersed, and hence are not very strong.
Variability of the fund manager’s performance is calculated at an expected level of performance of the fund. Generally, this would be at a level that includes a performance fee, since the performance fees are set with an intention of being achievable. Variability of the fund manager’s performance is calculated relative to the variability of returns of the fund. This can be computed as below:

Assuming the normal return is INR100 million. With a marginal increase in return of INR10 million, the variability at the level of return, which is above the threshold rate (eight per cent) can be calculated as follows:

(Amount in INR in million)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Fund managers share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assuming a marginal return of INR10 million</td>
<td>10.00</td>
<td></td>
</tr>
<tr>
<td>Less: Management fee (1% of 110)</td>
<td>(1.10)</td>
<td>1.10</td>
</tr>
<tr>
<td>Less: Performance fee as eight per cent return met</td>
<td>(0.11)</td>
<td>0.11</td>
</tr>
<tr>
<td>(12%*(10-1.10-8))</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Amount available to investors</strong></td>
<td><strong>8.79</strong></td>
<td><strong>at 5%</strong></td>
</tr>
<tr>
<td><strong>Variability as percentage of marginal return of 10</strong></td>
<td><strong>1.65/10</strong></td>
<td><strong>16.48%</strong></td>
</tr>
</tbody>
</table>

In other words, for a marginal change of INR10 million above the threshold rate, R receives INR1.65 million more or less. Variability is therefore 16.48 per cent.

**Combining the two indicators**

Stronger kick-out rights favour a conclusion of agent, and a larger aggregate economic interest favours a conclusion of principal. Considering this relation between the two indicators, R should exercise judgement to determine how to apply the relationship to specific cases and conclude whether R is acting as a principal or an agent. Entities may use a matrix approach wherein for each category of kick-out right strength, the fund manager could identify a level of aggregate economic interest for which it is clearly an agent and another for which it is clearly a principal. A marginal zone would then appear between these points. Such a matrix is presented in Figure 3 below.

**Figure 3: Combined evaluation of the two indicators**

![Figure 3: Combined evaluation of the two indicators](Source: KPMG in India’s analysis, 2018 read with IFRS Practice issues-Applying the consolidation model to fund managers, KPMG IFRG Ltd.’s publication dated March 2012)
Ind AS are largely converged with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). In this case, since Ind AS 110 does not provide any further guidance on the extent of relation between kick-out rights and aggregate economic interest that would result in the fund manager being considered as a principal or an agent, we consider the text of IFRS 10, Consolidated Financial Statements for further analysis.

Though IFRS 10 does not provide any bright lines, it provides examples which include combinations of kick-out rights and aggregate economic interests. These examples could be used as a guide to develop a matrix, which can be presented below:

**Figure 4: Matrix for determining principal-agent classification**

<table>
<thead>
<tr>
<th>Kick out strength</th>
<th>Variability of aggregate economic interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Clear agent</td>
</tr>
<tr>
<td>Very Strong</td>
<td>[%] or less</td>
</tr>
<tr>
<td>Strong</td>
<td>[%] or less</td>
</tr>
<tr>
<td>Medium</td>
<td>[%] or less</td>
</tr>
<tr>
<td>Weak</td>
<td>[%] or less</td>
</tr>
<tr>
<td>None</td>
<td>22% or less</td>
</tr>
</tbody>
</table>

(Source: IFRS Practice issues- Applying the consolidation model to fund managers, KPMG IFRG Ltd’s publication dated March 2012)

Cells in the matrix have intentionally been left blank, aside from the suggestion of the no-kick out right cells. However, from the analysis of the above matrix, we may infer that with no kick-out rights, a variability of aggregate economic interest of 22 per cent or less represents that the fund manager is an agent. R needs to ascertain facts pertaining to its case, to determine its classification, where the kick-out rights are not very strong. Considering figures three and four, R may conclude, that it is an ‘agent’, and hence is not required to consolidate the financial statements of C.
Consider this

- If in the above case study, the kick-out rights had been with cause, then R would not give them any weightage, and the principal-agent analysis would be based solely on the variability of aggregate economic interests. This is because Ind AS 110 (in its illustrations) states that with cause kick-out rights are protective only, and hence are not required to be given any weight in the analysis.

- Ind AS 110 requires entities to look only at substantive rights of the investors. This is specific in the case of kick-out rights, where fund managers are also required to consider other barriers to exercising the kick-out right. These include:
  - Financial penalties on the investors who exercise kick-out rights
  - Conditions that narrowly limit the timing of exercise of kick-out rights
  - Absence of mechanism allowing exercise of kick-out rights, for example 75 per cent of the total voting rights should agree to the kick-out of the fund manager, and the fund manager holds 30 per cent of the total voting rights, and
  - 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.

- When performing a combined assessment of the two key factors, there may be cases which fall under the marginal zone. In these cases, a reasoned judgement as to whether the fund manager is a principal or an agent would be required. Other features of the two key indicators may be considered at this point-for example the expected magnitude of the fund manager’s return to the fund’s total return, the likelihood of the expected performance level applied not being reached in all periods, and thus performance fee being paid on an irregular basis, the proportion of investors required to vote together to use a kick-out right, and other such factors.