UNIT 3: IND AS 110: CONSOLIDATED FINANCIAL STATEMENTS

3.1 OBJECTIVE OF IND AS 110

The objective of Ind AS 110 is to provide principles of when an entity should prepare consolidated financial statements and how those consolidated financial statements should be prepared. In particular, Ind AS 110 provides following principles for presentation and preparation of consolidated financial statements:

- A parent that controls one or more subsidiaries should prepare consolidated financial statements
- Guidance on how to apply the principles of control evaluation to determine whether an investor has control over an investee to be able to consolidate that investee
- Principles around accounting requirements for consolidated financial statements
- Definition of an investment entity and consolidation exemptions applicable to them

The principles mentioned above are discussed in this unit except the accounting requirements for consolidated financial statements which is discussed in Unit 4.

Further, Ind AS 110 does not deal with the accounting requirements for business combinations and their effects on consolidation, including goodwill arising on a business combination. Hence, such requirements are also not discussed in this study material. Refer study material 'Business Combination and Corporate Restructuring' for discussion on the same.

3.2 SCOPE OF IND AS 110

Ind AS 110 requires that an entity that is a parent should prepare consolidated financial statements. However, there are certain exemptions and exceptions to this as follows:

Exemption

As per paragraph 4(a) of Ind AS 110, a parent entity that meets **all** of the following conditions need **not present** consolidated financial statements:

(i) The entity is a wholly owned or partly owned subsidiary of another entity and all the owners of the entity are informed, and they do not object to the entity not preparing consolidated financial statements

(ii) The debt or equity instruments of the entity are not traded in a public market (whether domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

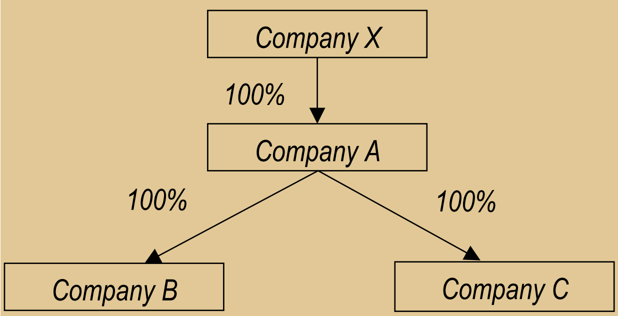
(iii) The entity has not filed nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market

(iv) The entity's ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110

Illustration 1: Exception to prepare consolidated financial statements

Scenario A:

Following is the structure of a group headed by Company X:



Company X is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company A is an unlisted entity and it is not in the process of listing any of its instruments in public market. Company X does not object to Company A not preparing consolidated financial statements.

Whether Company A is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, Company X is a foreign entity and is listed in stock exchange of a foreign country and it prepares its financial statements as per the generally accepted accounting principles (GAAP) applicable to that country.

Will your answer be different in this case?

Scenario C:

Assume the same facts as per Scenario A except, 100% of the investment in Company A is held by Mr. X (an individual) instead of Company X.

Will your answer be different in this case?

Solution:

Scenario A:

In this case, Company A satisfies all the conditions for not preparing consolidated financial statements i.e. it is not a listed entity nor it is in the process of listing, the parent of Company A prepares consolidated financial statements as per Ind AS which is available for public use and parent of Company A does not object Company A not preparing consolidated financial statements.

Hence, Company A is not required to prepare consolidated financial statements.

Scenario B:

In this case, the consolidated financial statements of parent of Company A are not prepared under Ind AS. Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

Scenario C:

In this case, Mr. X (an individual) would not be preparing its financial statements as per the requirements of Ind AS which is available for public use.

Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

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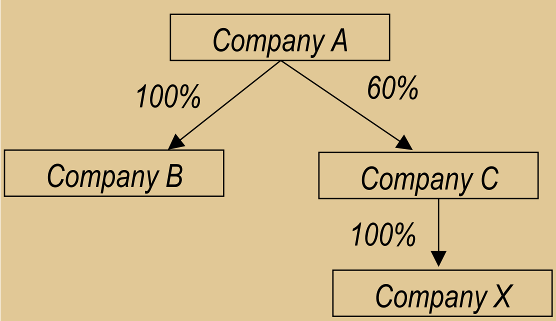
Illustration 2: Exception to prepare consolidated financial statements

Scenario A:

Following is the structure of a group headed by Company A.



Company A is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company C is an unlisted entity and it is not in the process of listing any of its instruments in public market. 60% of the equity share capital of Company C is held by Company A and balance 40% equity share capital is held by other outside investors. Company A does not object to Company C not preparing consolidated financial statements.

Whether Company C is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, the balance 40% of the equity share capital of Company C is held by Company B.

State whether C Limited is required to inform its other owner B Limited (owning 40%) of its intention to not prepare consolidated financial statements as mentioned in paragraph 4(a)(i)?

Solution:

Scenario A:

Company C is a partly owned subsidiary of Company A. In such case, Company C should inform the other 40% equity shareholders about Company C not preparing consolidated financial statements and if they do not object then only Company C can avail the exemption from preparing consolidated financial statements.

Scenario B:

In this scenario, Company C is 100% held by Company A (60% direct investment and 40% investment through Company B). Hence, Company C is not required to inform to Company B of not preparing consolidated financial statements and can avail the exemption from preparing the consolidated financial statements.

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Exception 1

Ind AS 110 does not apply to post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19 *'Employee Benefits'* applies. Therefore, an entity which has set up such plans should not consolidate them.

Example 1

Company A has set up an Employee Gratuity Plan trust for the purpose of giving gratuity benefits to its employees. The gratuity benefit given by the company is a post-employee benefit plan which is accounted as per Ind AS 19 (refer Unit 1 of Chapter 8 for the accounting of employee benefit plans as per Ind AS 19). So, Company A is not required to evaluate whether it controls the trust and should not consolidate it.

Exception 2

An investment entity (explained in section 3.7 of this Unit) that is required to measure all of its subsidiaries at fair value through profit or loss need not present consolidated financial statements. This exception is further explained subsequently in this unit.

Note:

It may be noted that the Indian GAAP (i.e. the accounting standards under The Companies (Accounting Standards) Rules, 2021) contained two exceptions from consolidation, which **are no longer applicable under Ind AS**:

- When control is intended to be temporary; or
- When the subsidiary operates under severe long-term restrictions

3.3 CONTROL EVALUATION

As per Ind AS 110, an investor needs to determine whether it controls an investee and if yes then the investor would be treated as a parent and the investee would be treated as a subsidiary of the parent.

An investor controls an investee if and only if the investor has **all of the following three elements**:

Power over the investee + Exposure, or rights, to variable returns from the investee + Ability to use power over the investee to affect the investor's returns = Control over the investee

After doing an initial assessment of control over an investee, the investor should reassess the control over the investee when there are changes to one or more of the three elements of control mentioned above.

Further, there may be situations where the investor is not the only one who control the investee and it may need to act in co-operation with any other entity. There may also be a situation where there is no investor who individually controls the investee. In such scenario, the investor would account for the interest in such investees in accordance with other applicable Ind AS such as Ind AS 111 for joint arrangement (discussed in Unit 5 of this Chapter), Ind AS 28 for investments in associates (discussed in Unit 6 of this Chapter) or Ind AS 109 for financial instruments (discussed in Chapter 11).

Each of the elements of control evaluation are explained below.

3.3.1 Power

What is power?

The first criterion of control evaluation is to determine whether the investor has power over the investee. An investor gets power over an investee if it has three elements:

A. **existing rights** that give it

B. the **current ability**

C. to direct the **relevant activities** of the investee.

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change. We will move in a reverse order to understand the meaning of 'power' in the context of Ind AS 110. In other words, we will first learn what are 'relevant activities', then we will move to understand what is intended to be covered within the scope of 'current ability' and finally, we will link this understanding with the concept of 'rights'.

How to identify the relevant activities and how the decisions about those activities are made?

Relevant activities are the activities of investee that significantly affect the investee's returns. For a detailed understanding of what encompasses 'returns', please refer to section 3.3.2.

There may be range of operating and financing activities that would significantly affect the returns of an investee. Examples of activities related to operating and financing activities that can be relevant activities include, but not limited to:

- Selling and purchasing of goods and services
- Managing financial assets during their life (including upon default)
- Selecting, acquiring or disposing of assets
- Researching and developing new products or processes
- Determining a funding structure or obtaining funding
- Establishing operating and capital decisions of the investee, including budgets
- Appointing, terminating and remunerating an investee's key management personnel or service providers

The power to direct the relevant activities can be shared by multiple parties but those rights may not meet the definition of joint control.

Example 2

Five parties each own 20 per cent of entity Z, and each has one seat on entity Z's board of directors. All strategic operating and financing decisions (ie decisions in respect of the activities that significantly affect the returns of entity Z) require the consent of any four of the five directors. The five parties do not jointly control entity Z because unanimous consent is not required for decisions relating to the activities of entity Z that significantly affect its returns. Nevertheless, it is clear that the power to direct the activities of entity Z is shared and no single party controls entity Z.

There may be another situation where two or more investors have the rights to unilaterally direct different relevant activities of an investee. In such situation, one has to decide which activities can most significantly affect the returns of the investee and the investor having the ability to direct those activities would be considered to have power over the investee. The investors shall reconsider this assessment in case there is change in the facts or circumstances.

Illustration 3: Different investors have ability to direct different relevant activities

A Ltd. and B Ltd. set up a new company C Ltd. to construct and operate a toll road. A Ltd. is responsible for the construction of the toll road, which is expected to take two years. Thereafter, B Ltd. has authority on all matters related to toll road operation.

Is it possible for B Ltd. to have power over C Ltd. during the construction phase, even though A Ltd. is responsible for construction and has authority to make decisions that need to be made during the construction phase?

Solution

B Ltd. may power during the construction phase, even though it cannot yet exercise its decision-making rights during construction. The investor that has the ability to direct the activities that most significantly affect the returns of the investee has power over the investee. Consideration should be given to the factors that determine profit margin, revenue and valuation of C Ltd. For example, the construction of the road may be under the strict supervision and precise requirements of the regulator say State Road Transport Corporation (SRTC).

A Ltd. will recover its costs plus a fixed percentage of margin. That margin will be returned through adjustment of the amount of tolls that will flow to A Ltd., so that A Ltd. has first call on the cash flows generated by tolls. B Ltd. will manage the toll road operations, including maintenance, and will be able to claim a management fee equivalent to any residual cash in the entity after all operating expenses have been paid, including payments to A Ltd.

Assume that B Ltd. has the ability to set tolls (and not SRTC). In this scenario, A Ltd. merely works like a contractor, earning a fixed margin, and probably a financing income for financing the construction. A Ltd. does not take much of a risk on the cash flows, because the residual risks and rewards belong to B Ltd. Consequently, B Ltd. controls C Ltd. from its inception.

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Illustration 4: Determining the relevant activities

A Ltd. is an asset manager of a venture capital fund i.e. Fund X. Out of the total outstanding units of the fund, 10% units are held by A Ltd. and balance 90% units are held by other investors. Majority of the unitholders of the fund have right to appoint a committee which will manage the day-to-day administrative activities of the fund. However, the decisions related to the investments / divestments to be done by Fund X is taken by asset manager i.e. A Ltd. Based on above, who has power over Fund X?

Solution:

In this case, A Ltd. is able to direct the activities that can most significantly affect the returns of Fund X. Hence, A Ltd. has power over the investee. However, this does not mean that A Ltd. has control over the fund and consideration will have to be given to other elements of control evaluation as well i.e. exposure to variable returns and link between power and exposure to variable returns.

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Current ability to direct relevant activities

An investor would have current ability to direct relevant activities if that investor were able to make decisions at the time those decisions need to be taken. An investor can have the current ability to direct the activities of an investee even if it does not actively direct the activities of the investee.

Having the current ability to direct the activities of an investee is not limited to being able to act today. There may be steps to be taken in order to act - for example, an investor may need to initiate a meeting before it can exercise its voting or other rights that give it power. However, such a delay would not prevent the investor from having power, assuming that there are no other barriers that would prevent the investor from exercising its rights when it chooses to do so.

For some investees, particularly those with most of their operating and financing decisions predetermined, decisions that significantly affect the returns of the investee are not made continuously. Such decisions may be made only if particular events occur or circumstances arise. For such investees, having the ability to make those decisions if and when they arise is a source of a current ability to direct the relevant activities.

It must be borne in mind that the current ability to direct the activities of an investee would, in all cases, arise from rights (voting rights, potential voting rights, rights within other arrangements or a combination of these).

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

Illustration 5: Current ability to direct the relevant activities

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30 per cent of the equity is also the asset manager.

The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor.

Based on the above, who has power over the investment vehicle?

Solution:

Managing the investee's asset portfolio is the relevant activity of the investee.

The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value.

The asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

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3.3.1.1 Rights that give power to an investor

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

The rights that give an investor power over an investee can differ investee by investee. Following are some of the examples (not an exhaustive list) of various forms of rights that, either individually or in combination with other rights, can give power to an investor:

Form of right	Illustration
Voting rights or potential voting rights of an investee (this is further explained subsequently in this unit).	An investor holding majority of the equity share capital of an investee. Concepts of power through voting or potential voting rights are further discussed in detail in section 3.3.1.3 of this unit.
Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities.	An investor having right to appoint majority of the members of the Board of Director who have power to take decisions related to relevant activities.
Rights to appoint or remove another entity that directs the relevant activities.	Right with an investor to appoint or remove an asset manager who takes decisions related to investments / divestments by a venture capital fund.
Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor.	Right with an investor to direct the investee to sell all of its outputs to a group company of the investor at the price determined by investor
Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.	Right related to relevant activities given to a single investor by all other investors through a shareholders' agreement

In most of the case where the investee has a range of relevant activities and decisions are required to be taken on a continuous basis for those activities then it will be voting or similar rights that give an investor power over the investee.

3.3.1.1A Substantive rights vs Protective Rights

For the purpose of determination of power over an investee, an investor shall consider only those rights which are substantive. Protective rights are not considered for the determination of power. Below table summarises the difference between substantive rights and protective rights:

Substantive rights	Protective rights
Substantive rights can give the investor power over the investee.	Protective rights do not give investor power over the investee.
Substantive rights relate to the relevant activities of the investee.	Protective rights relate to protect the interest of the party holding those rights without giving the holder the right over the relevant activities of the investee.

Both the above rights are discussed below in detail.

1. Substantive rights

For a right to be substantive, the holder must have the practical ability to exercise that right.

Assessment of whether the rights are substantive requires judgement taking into consideration all the facts and circumstances. Following are some of the factors (not an exhaustive list) that should be considered while assessing whether the rights are substantive or not:

a) Whether there are any **barriers** that prevent the holder from exercising the rights. Example of such barriers (not an exhaustive list) can be as follows:

- Financial penalties and incentives
- High exercise or conversion price
- Terms and conditions that make it unlikely that the rights would be exercised, like, conditions that narrowly limit the timing of their exercise
- The absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.
- The inability of the holder of the rights to obtain the information necessary to exercise its rights.

- Operational barriers or incentives. For example, in case of a venture capital fund managed by an asset manager, there is absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the existing manager.
- legal or regulatory requirements. For example, where a foreign investor is prohibited from exercising its rights

b) When the exercise of rights requires **agreement of more than one party**, or when the rights are **held by more than one party**, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive.

An independent board of directors may serve as a mechanism for numerous investors to act collectively in exercising their rights.

c) Whether the party or parties that hold the rights would **benefit from the exercise of those rights**. For example, the holder of potential voting rights in an investee shall consider the exercise or conversion price of the instrument. The potential voting rights are more likely to be substantive when the exercise price is lower than the market price or when there are other synergies anticipated between the investor and the investee.

Below are some illustrations that explain the above factors of determining whether the rights held by investors are substantive or not:

Illustration 6: Voting rights are substantive or not

Scenario A:

Following is the voting power holding pattern of B Ltd.

- *10% voting power held by A Ltd.*
- *90% voting power held by 9 other investor each holding 10%*

All the investors have entered into a management agreement whereby they have granted the decision-making powers related to the relevant activities of B Ltd. to A Ltd. for a period of 5 years.

After 2 years of the agreement, the investors holding 90% of the voting powers have some disputes with A Ltd. and they want to take back the decision-making rights from A Ltd. This can be done by passing a resolution with majority of the investors voting in favour of the removal of rights from A Ltd. However, as per the termination clause of the management *agreement, B Ltd. will have to pay a huge penalty to A Ltd. for terminating the agreement before its stated term.*

Whether the rights held by investors holding 90% voting power are substantive?

Scenario B:

Assume the same facts as per Scenario A except, there is no penalty required to be paid by B Ltd. for termination of agreement before its stated term. However, instead of all other investors, there are only 4 investors holding total 40% voting power that have disputes with A Ltd. and want to take back decision-making rights from A Ltd.

Whether the rights held by investors holding 40% voting power are substantive?

Solution:

Scenario A:

If the investors holding 90% of the voting power exercise their right to terminate the management agreement, then it will result in B Ltd. having to pay huge penalty which will affect the returns of B Ltd. This is a barrier that prevents such investors from exercising their rights and hence such rights are not substantive.

Scenario B:

To take back the decision-making rights from A Ltd., investors holding majority of the voting power need to vote in favour of removal of rights from A Ltd. However, the investors having disputes with A Ltd. do not have majority voting power and hence the rights held by them are not substantive.

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Illustration 7: Potential voting rights are substantive or not

Scenario A:

An investor is holding 30% of the voting power in ABC Ltd. The investor has been granted an option to purchase 30% more voting power from other investors. However, the exercise price of the option is too high compared to the current market price of ABC Ltd. because ABC Ltd. is incurring losses since last 2 years and it is expected to continue to incur losses in future period as well. Whether the right held by the investor to exercise purchase option is substantive?

Scenario B:

Assume the same facts as per Scenario A except, the option price is in line with the current market price of ABC Ltd. and ABC Ltd. is making profits. However, the option can be exercised in next 1 month only and the investor is not in a position to arrange for the require *amount in 1 month's time to exercise the option. Whether the right held by the investor to exercise purchase option is substantive?*

Scenario C:

Assume the same facts as per Scenario A except, ABC Ltd. is making profits. However, the current market price of ABC Ltd. is not known since the ABC Ltd. is a relatively new company, business of the company is unique and there are no other companies in the market doing similar business. Hence the investor is not sure whether to exercise the purchase option. Whether the right held by the investor to exercise purchase option is substantive?

Solution:

Scenario A:

The right to exercise purchase option is not substantive since the option exercise price is too high as compared to current market price of ABC Ltd.

Scenario B:

The right to exercise purchase option is not substantive since the time period for the investor to arrange for the requisite amount for exercising the option is too narrow.

Scenario C:

The right to exercise purchase option is not substantive. This is because the investor is not able to obtain information about the market value of ABC Ltd. which is necessary in order to compare the option exercise price with market price so that it can decide whether the exercise of purchase option would be beneficial or not.

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Illustration 8: Removal rights are substantive or not

A venture capital fund is managed by an asset manager who has right to take the investment and divestments decisions related to the fund corpus. The asset manager is also holding some stake in the fund. The other investors of the fund have right to remove the asset manager.

However, in the present scenario, there is absence of other managers who are willing or able to provide specialised services that the current asset manager is providing and purchase the stake that the current asset manager is holding in the fund. Whether the removal rights available with other investors are substantive?

Solution:

If the other investors exercise their removal rights, then it will impact the operations of the fund and ultimately the returns of the fund since there is no substitute of the current asset manager available who can manage the corpus of the fund. Hence the removal rights held by other investors are not substantive.

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For a right to be substantive, it should be exercisable when decisions about the direction of the relevant activities need to be made. In most of the cases a right, to be a substantive right, rights need to be currently exercisable. However, there may be some situations where a right can be substantive, even though it may not be currently exercisable.

Example 3

In case of an investor currently holding only 30% voting rights in a company has an option to purchase additional 40% voting rights to increase its voting rights to 70%. The option can be exercised within next 25 days. Also, there is a meeting of shareholding scheduled to be held after 30 days to take decision about relevant activities of the company. In such case, even though the investor is not currently holding majority voting power, it can exercise the purchase option and increase its voting power to 70% by the time when the decisions about the relevant activities are to be made. Hence such rights are substantive rights.

An investor may be directing relevant activities of an investee and the evidence of that can help determine whether the investor has power. However, such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

While assessing the power, an investor should also consider the substantive rights held by other investors. The other investors may not be able to initiate the decisions about relevant activities on their own, but the rights held by them to approve or block any decision may prevent the investor from taking decision about relevant activities.

Example 4

In case of a company with 5 investors, a meeting of the investors to take decisions about relevant activities can be called if at least 2 members are in favour of calling the meeting. However, to pass any decision in the meeting, unanimous consent of all investors is required. Hence, in such case a single investor may not be able to initiate the meeting, but his consent is required to pass any decision in the meeting.

2. Protective rights

Protective rights are the rights designed to **protect the interest of the party** holding those rights **without giving that party power** over the entity to which those rights relate.

Such rights mainly **relate to fundamental changes** to the activities of an investee or apply in exceptional circumstances. However, not all the rights that apply in exceptional circumstances or are contingent on future events are protective rights. Protective rights do not give its holder power or prevent another party from having power over an investee. The examples of protective rights include, but not limited to, following:

- A right exercisable by an investor only in the event of a fraud or default by other investors having power to take decisions about relevant activities
- *A lender's right to appoint its nominee director in the Board of a borrower to ensure the borrower do not engage in any activities that significantly increase the credit risk of borrower
- Rights held by minority shareholders to approve decisions related to capital expenditure greater than required in normal course of business or to approve issue of equity or debt instruments
- A lender's right to seize the assets of a borrower if the borrower defaults in repayment of loan instalments
- Rights of investors to approve or block decisions related to change in the name of the investee, amendment to constitutional documents of the investee to enter into a new business, change in the registered office of the investee, etc.

***Note:** The 2nd right (illustrated above) is not protective in all circumstances. So far as the nomination doesn't result in majority control over the Board, it can be considered protective.

The effect of substantive and protective rights is summarised below:

Type of rights held by investor		Type of rights held by other parties		Conclusion on 'power'?
Substantive	+	Protective	=	Investor has power
Protective	+	Substantive	=	Other parties have power
Substantive	+	Substantive	=	Further evaluation needed

Franchises

Apart from the examples of protective rights mentioned above, one more example can be of rights of a franchisor in a franchise agreement. In a franchise agreement, the investee i.e. the franchisee usually give the franchisor the rights that are related to protect the franchise brand. Following are some of the salient features of a franchise arrangement which indicates that the rights of a franchisor in a franchise agreement are protective rights:

Salient features of a franchise agreement that indicate that rights of franchisor are protective rights			
Franchisor's right do not give it ability to direct the relevant activities of franchisee	Other parties have current ability to direct the relevant activities of the franchisee	Franchisor's rights do not affect the rights of others to take decisions about relevant activities	Franchisee operates the business for its own account

Note: Control over fundamental decisions as the legal form of the franchisee and its funding structure may be determined by parties other than the franchisor and may significantly affect the returns of the franchisee. <u>The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights.</u>

Illustration 9: Protective rights of a franchisor

ABC Ltd. is a manufacturer of branded garments and is the owner of Brand X. PQR Ltd. has entered into a franchise agreement with ABC Ltd. to allow PQR Ltd. to set up a retail outlet to sell the products of Brand X.

As per the agreement, PQR Ltd. will set up the retail outlet from its own funds, decide the capital structure of the entity, hire employees and their remuneration, select vendors for acquiring capital items, etc. However, ABC Ltd. will give certain operating guidelines like the interior of the retail outlet, uniform of the employees and other such guidelines to protect the brand name of ABC Ltd.

Whether the rights held by ABC Ltd. protective or substantive?

Solution:

The activities that most significantly affect the returns of PQR Ltd. are the funding and capital structure of PQR Ltd., hiring of employees and their remuneration, vendors for capital items, etc. which are exercisable by PQR Ltd. Further, the retails outlet is being set up by PQR Ltd. without any financial support from ABC Ltd. The rights available with ABC Ltd. are to protect the brand name of ABC Ltd. and such rights do not affect the ability of PQR Ltd. to take decisions about relevant activities. Hence, the rights held by ABC Ltd. are protective rights.

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3.3.1.3 Voting rights

Generally, an investor gets power over an investee by way of voting rights that allow it to direct the relevant activities.

However, there can be situations where voting rights (even if the investor holds majority of them) do not give investor power over the investee. This can be in the following situations:

- Voting rights are not substantive (as discussed above).
- If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee

Even if the voting rights do not give power to an investor, there can be other rights which would give an entity power over the investee. In this section we will discuss various scenarios of power through voting rights and power other than through voting rights.

3.3.1.3.1 Power through voting rights

In the most straightforward cases, the investor that holds a majority of voting rights has power over an investee. However, there can be certain cases where an investor can have power even if it holds less than a majority of the voting rights of an investee.

A. Power with a majority of the voting rights

An investor that holds more than half of the voting rights of an investee has power in the following situations:

The relevant activities are directed by a vote of the holder of the majority of the voting rights	OR	A majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights

For example, in case of a company where the decisions related to relevant activities are taken by Board of Directors of the company and the Board members are appointed by shareholder holding majority of the voting rights. Then the shareholder holding majority of the voting rights has power over the company.

B. Power without a majority of voting rights

There can be certain cases where an investor can have power even if it holds less than a majority of the voting rights of an investee. Following are the examples of power without majority voting rights:

Contractual arrangement with other vote holders	Rights from other contractual arrangements	The investor's voting rights	Potential voting rights

Combination of all of above

Contractual arrangement with other vote holders

An investor, who is not holding voting rights that are sufficient to given it power over the investee, may enter into a contract with other vote holders to give the investor rights to exercise voting rights which are **sufficient to have power over the investee**. In such case, the investor would direct the other vote holders on how they should vote whereby the investor gets power to direct the decision related to relevant activities.

Rights from other contractual arrangements

Apart from holding voting rights, an investor might be having decisions-making rights related to relevant activities of the investee pursuant to a contractual arrangement. Such **contractual rights in combination with voting rights** may give investor power to direct the relevant activities like manufacturing process of the investee or other operating and financing activities of the investee.

However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

The investor's voting rights

There may be certain situations where even though an investor is not holding majority of the voting rights, but the voting rights held by it are **sufficient to give it practical ability** to have power over the investee unilaterally. Generally, this is termed as de-facto control.

In assessing the sufficiency of the voting rights of an investor, one should consider the **size of the investor's holding of voting rights** relative to the size and dispersion of holdings of the other vote holders. This is interpreted as follows:

Particulars	Higher number or size	Lower number or size
Number of voting rights held by investor	More likely to have power	Less likely to have power
Size of investor's voting rights relative to voting rights held by other holders	More likely to have power	Less likely to have power
Number of parties required to outvote the investor	More likely to have power	Less likely to have power

Illustration 10: Voting rights of investor are sufficient to give it power

An investor holds 45% of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. Whether the investor holding 45% voting right have power over the investee?

Solution:

On the basis of the absolute size of its holding by the investor and the relative size of the voting rights held by other shareholders, it is more likely that the investor would have power over the investee.

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Illustration 11: Voting rights of investor are sufficient to give it power

ABC Ltd. holds 40% of the voting rights of XYZ Ltd. The remaining voting rights are held by 6 other shareholders, each individually holding 10% each. Whether the investor holding 40% voting right have power over the investee?

Solution:

In this case, it is less likely that ABC Ltd. will have power over XYZ Ltd. since the size of the number of shareholders required to outvote ABC Ltd. is not so high. Additional facts and circumstances should also be considered to determine whether ABC Ltd. has power or not.

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Apart from the size of the investor's voting rights, one should also consider the i) potential voting rights held by investor or other vote holders or parties (discussed subsequently in this section) and ii) rights arising from other contractual arrangements (already discussed above) to determine whether the investor's voting rights are sufficient to give it power over the investee.

Ind AS 110 provides that when the decisions related to relevant activities of an investee are taken by **majority vote holders** and the investor holds sufficiently more voting rights compared to other vote holders and the other shareholdings are widely dispersed then it may be clear from the above factors i.e. i) size of the investor's voting rights, ii) potential voting rights and iii) other contractual arrangements that investor has power over the investee. In such case, there is no need to consider other factors to evaluate who has power over the investee.

- For examples, in the illustration 9 discussed above, the investor holding 45% of voting rights may, on the basis of the absolute size of its holding and the relative size of the other shareholdings, conclude it has power over the investee without the need to consider any other evidence of power.
- However, in illustration 10 above, the absolute size of the ABC Ltd.'s holding and the relative size of the other shareholdings alone are not conclusive in determining whether ABC Ltd. has power over the investee and hence additional facts and circumstances need to be considered.

When it is not clear from the three factors of sufficiency of voting rights of an investor discussed above, the investor should consider additional facts and circumstances such as the **voting patterns at previous shareholders' meetings** to determine whether investor has power over the investee.

Illustration 12: Voting patterns at previous shareholders' meetings

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders' meetings.

Whether the investor's voting rights are sufficient to give it power to direct the relevant activities of the investee?

Solution:

In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

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Ind AS 110 provides that if it is not clear from the above factors of sufficiency of voting rights of an investor that investor has power then the investor does not control the investee.

Potential voting rights

Potential voting rights are rights to obtain voting rights of an investee, such as those arising from **convertible instruments or options or forward contracts**. Those potential voting rights are considered only if the rights are substantive as per the guidance discussed earlier.

When considering potential voting rights, an investor shall consider the purpose and design of the instrument giving those rights as well as any other benefits that the investor would get from the exercise of those rights.

Potential voting rights are to be considered in combination with voting or other decisions-making rights that the investor might have to assess whether investor has power or not.

Illustration 13: Potential voting rights

Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price. The conversion rights are substantive. If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Whether investor A has power over the investee?

Solution:

Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

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3.3.1.3.2 Power other than through voting rights

When voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only the investor shall consider following factors to determine whether it has power over the investee:

- Purpose and design of the investee
- Contractual arrangements
- Special relation between investor and investee

Purpose and design of the investee

Evaluation of purpose and design of the investee helps in:

- identification of relevant activities of the investee,
- how decisions about the relevant activities are made,
- who has the current ability to direct those activities, and
- who receives returns from those activities.

In assessing the purpose and design of an investee, an investor shall consider its **involvement and decisions made at the time of design of the investee** and evaluate whether such involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.

Illustration 14: Purpose and design of the investee

PQR Ltd. has entered into a contract with a state government to construct a power plant and distribute the electricity generated from the plant to the households of the state. For this, PQR Ltd. has set up a new entity XYZ Ltd. PQR Ltd. was involved in the design of XYZ Ltd. The decisions related to the relevant activities of XYZ Ltd. i.e. how much electricity to generate or the price at which units of electricity to be sold to customers, etc. are not determined by the voting rights. Whether PQR Ltd. has power over XYZ Ltd.?

Solution:

PQR Ltd. was involved in the design of XYZ Ltd. Accordingly, its involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee. However, being involved in the design of XYZ Ltd. alone is not sufficient to give PQR Ltd. control over XYZ Ltd. and hence other facts and circumstances, such as other contractual arrangements, should also be considered.

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Contractual arrangements

An investor shall consider contractual arrangements such as call rights, put rights and liquidation rights that give it explicit or implicit decision-making rights that are closely related to the relevant activities of the investee even though they may occur outside the legal boundaries of the investee.

For some investees, decisions about relevant activities are required to be taken only when particular circumstances arise or events occur. The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only those decisions that are required to be taken when those circumstances or events occur would significantly affect its returns and thus be relevant activities. However, it is not necessary for those circumstance or events to actually occur to establish that investor has power over the investee. The fact that the investor has rights to take those decisions whenever required is sufficient to establish power.

Illustration 15: Rights contingent upon future events

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investors. Following is the relevant fact pattern:

- *The servicing on a day-to-day basis includes the collection and passing on of principal and interest payments as they fall due.*
- *Upon default of a receivable the investee automatically puts the receivable to an investor as agreed separately in an agreement between the investee and the investor.*
- *The only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect the investee's returns.*
- *Managing the receivables before default is not a relevant activity because the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors.*

Whether the investor has power over the investee?

Solution:

In this question, the design of the investee ensures that the investor has decision-making power only in case of default of a receivable. The terms of the agreement between investee and investor are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the agreement together with the founding documents of the investee lead to the conclusion that the investor has power over the investee even though the investor takes ownership of the receivables only upon default and manages the defaulted receivables outside the legal boundaries of the investee.

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An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore, a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power.

Illustration 16: Commitment to ensure that an investee operates as designed

A Ltd. is a manufacturer of pharmaceutical products. A Ltd. has invested in share capital of B Ltd. which is a manufacturer of packing material for pharmaceutical products. A Ltd.'s requirements of packing materials for its products are entirely supplied by B Ltd. A Ltd. is not purchasing the packing materials from any other vendors because the materials supplied by other vendors are of inferior quality. Whether A Ltd. has power over B Ltd.?

Solution:

A Ltd. would be the most affected by the operations of B Ltd. since it is dependent on B Ltd. for the supply of packing materials. Therefore A Ltd. would be committed to ensure that B Ltd. operates as designed. This can be an indicator of A Ltd. having power over B Ltd. But it has to consider other facts and circumstances as well to conclude whether it control B Ltd. or not.

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Special relation between investor and investee

Ind AS 110 recognises that the control assessment process described above will not always yield a clear conclusion. To assist in reaching a conclusion in marginal situations, the Standard includes guidance on:

- Evidence of possible power
- Indicators of possible power
- Incentives to obtain power

In some circumstances it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, paragraph B18 of Ind AS 110 provides guidance to enable the assessment of power whereby the investor shall consider **evidence** of whether it has the **practical ability to direct** the relevant activities unilaterally. Following are some of the examples of such evidences:

Evidence	Illustration
The investor can appoint or approve the investee's key management personnel who can direct the relevant activities	An investor holds 40% of the voting rights of an investor. However, the investor has right to appoint majority of the board members of investee and the decisions of relevant activities of investee are taken by its board.
The investor can direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor	A Ltd. and B Ltd. both holds 50% each of voting rights of an investee and also have right to appoint 2 members each in board of investee. The decision of relevant activities of investee are taken in board meetings by majority members. A Ltd. also has right to appoint a chairman of the board who will have a casting vote in case of a deadlock situation.
The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights.	X Ltd. has invested in the share capital of P Ltd. Apart from A Ltd. there are 4 other investors in P Ltd. Each investor has right to appoint one member on the board of P Ltd. who will have right to direct the relevant activities of P Ltd. Out of the 4 other investors, 2 investors are related parties of X Ltd. and hence X Ltd. can direct them to appoint their representative on the board as per X Ltd.'s choice. Accordingly, X Ltd. can appoint majority of the members of the board of P Ltd.
The investee's key management personnel are related parties of the investor	The chief executive officer of the investee and the chief executive officer of the investor are the same person.
The majority of the members of the investee's governing body are related parties of the investor.	The majority of the board members of the investee are also the board members of the investor.

As per paragraph B19 of Ind AS 110, sometimes there will be **<u>indications</u>** that the investor has a special relationship with the investee, which suggests that the **<u>investor has more than a passive interest in the investee</u>**. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that investor has power over an investee. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:

Investee's key management personnel who can direct the relevant activities are current or previous employees of the investor

Investee's operations are dependent on the investor such as in following situations:

- Dependence to fund a significant portion of its operations.
- Guarantee a significant portion of the investee’s obligations.
- Dependence for critical services, technology, supplies or raw materials.
- Assets such as licences or trademarks that are critical to investee’s operations are controlled by investor
- Dependence on for key management personnel, such as when the investor’s personnel have specialised knowledge of the investee’s operations.

A significant portion of the investee’s activities either involve or are conducted on behalf of the investor

Investor’s exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights.

- For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

Further, paragraph B20 of Ind AS 110 provides that the greater an investor’s exposure, or rights, to variability of returns from its involvement with an investee, the greater is the **incentive** for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor’s exposure does not, in itself, determine whether an investor has power over the investee.

When the factors set out in paragraph B18 and the indicators set out in paragraphs B19 and B20 of Ind AS 110 are considered together with an investor’s rights, greater weight shall be given to the evidence of power described in paragraph B18.

3.3.2 Exposure, or rights, to variable returns from an investee

When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to ‘variable returns’ from its involvement with the investee.

Variable returns are returns that are not fixed and have the **potential to vary as a result of the performance of an investee**. Variable returns can be only positive, only negative or both positive and negative. It should be noted that the term used is 'returns' and not 'benefits' which are often interpreted as implying only positive returns.

An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the **substance of the arrangement** and regardless of the legal form of the returns.

- For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of control evaluation because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond.
- Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.
- However, a non-refundable income received from the investee which is not impacted by the credit risk or performance of the investee can be considered as a fixed return.

It must also be noted that the term 'returns' includes within its scope both (a) direct returns (which are mostly financial returns), as well as (b) synergistic returns, which are more indirect.

Following are some of the examples of variable returns:

Variable returns from an investee		
Dividends, other distributions of economic benefits from an investee (eg interest from debt securities) Changes in the value of the investor's investment in that investee.	- Remuneration for servicing an investee's assets or liabilities - Fees and exposure to loss from providing credit or liquidity support - Residual interests in the investee's assets and liabilities on liquidation - Tax benefits - Access to future liquidity	Returns that are not available to other interest holders For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other

Exposure to variable returns is not in itself enough to conclude the assessment of control. An investor should have power over the investee and the ability to use its power to affect the amount of the investor's returns from its involvement with the investee. For example, it is common for a lender to have an exposure to variable returns from a borrower through interest payments that it receives from the borrower, that are subject to credit risk. However, the lender would not control the borrower if it does not have the ability to affect those interest payments (which is frequently the case).

Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Reputational risk

During the financial crisis, some financial institutions provided funding or other support to securitisation or investment vehicles because they established or promoted those vehicles. Rather than allowing them to fail and facing a loss of reputation, the financial institutions stepped in, and in some cases took control of the vehicles. Having reputational risk in isolation is not an appropriate basis for consolidation. The term 'reputational risk' relates to the risk that failure of an investee would damage an investee's reputation and, therefore, that of an investor or sponsor, compelling the investor or sponsor to provide support to an investee in order to protect its reputation, even though the investor or sponsor has no legal or contractual requirement to do so.

Reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. Therefore, when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee.

3.3.3 Link between power and returns

An investor controls an investee if the investor not only has **power** over the investee and **exposure or rights to variable returns** from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.

Thus, an investor with decision-making rights shall **determine whether it is a principal or an agent**. An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

An investor may delegate its decision-making authority to an agent on some specific issues or on all relevant activities. When assessing whether it controls an investee, the investor shall treat the decision-making rights delegated to its agent as held by the investor directly.

A decision maker shall consider the overall **relationship between itself, the investee being managed and other parties involved** with the investee, in particular all the factors below, in determining whether it is an agent:

The scope of the decision-making authority	Rights held by other parties	Remuneration from the investee	Exposure to variable returns from other interests in the investee

Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances.

The scope of the decision-making authority

The scope of a decision maker's decision-making authority is evaluated by considering:

(a) the activities that are permitted according to the decision-making agreement(s) and specified by law, and

(b) the discretion that the decision maker has when making decisions about those activities.

A decision maker shall consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of an investee. For example, if a decision maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

Rights held by other parties

Substantive removal or other rights may indicate that the decision maker is an agent.

Removal rights

Removal rights are rights to deprive the decision-maker of its decision-making authority.

The removal rights held by other should be considered as follows:

Single party holds substantive removal rights and can remove the decision maker **without cause**, this, in isolation, is **sufficient to conclude** that the decision maker is an **agent**.

↓

If **more than one party holds such rights** (and no individual party can remove the decision maker without the agreement of other parties) those rights are **not, in isolation, conclusive** in determining that a decision maker is an agent.

↓

The **greater the number of parties** required to act together to exercise removal rights and the **greater the magnitude** of, and variability associated with, the decision maker's **other economic interests** (ie remuneration and other interests), the **less the weighting** that shall be placed on removal rights.

Other substantive rights

If other parties hold substantive rights that can restrict the decision maker from exercising its discretion shall be considered in similar manner to removal right when evaluating whether the decision maker is an agent.

For example, a decision maker that is required to obtain approval from a small number of other parties for its actions is generally an agent.

Consideration of the rights held by other parties shall include an assessment of any rights exercisable by an investee's board of directors (or other governing body) and their effect on the decision-making authority.

For example, if board of directors (which is appointed by other investors) of an investee has right to remove the decision maker without cause than the decision maker is an agent.

Remuneration from the investee

The relationship between the remuneration of a decision maker and it being an agent is explained below:

Decision maker is a principal

↑ Higher

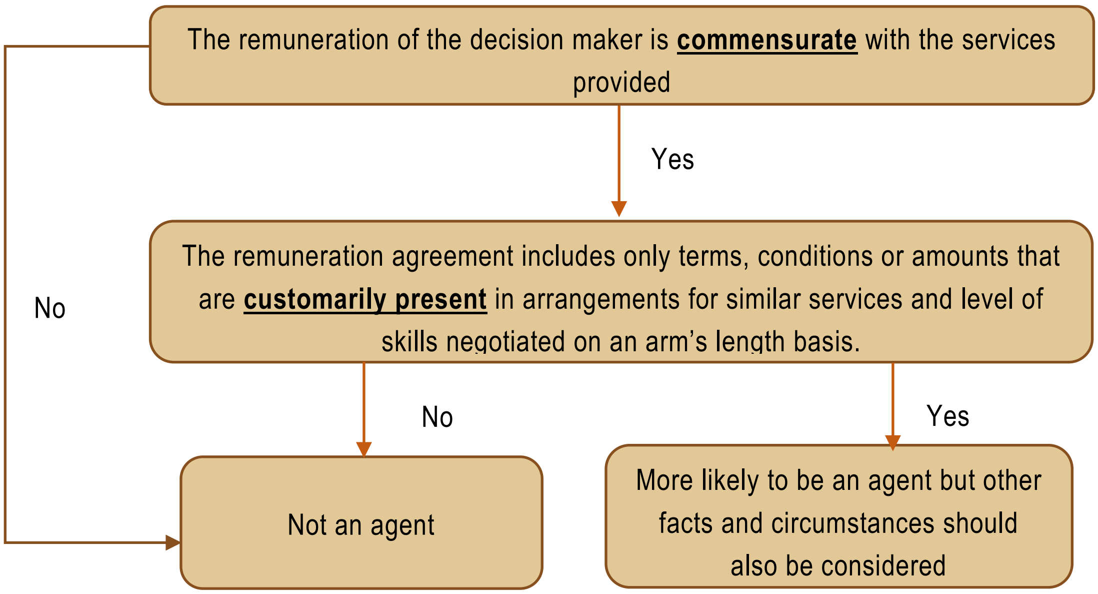
The magnitude of, and variability associated with, the **decision maker's remuneration** relative to the returns expected from the activities of the investee

↓ Lower

Decision maker is an agent

For example, if a variation in investee's returns by 1% causes variation in decision maker's remuneration from investee by less than 1% then the decision maker can be an agent. However, if a variation in investees returns by 1% causes variation in decision maker's remuneration from investee by more than 1% then the decision maker can be a principal.

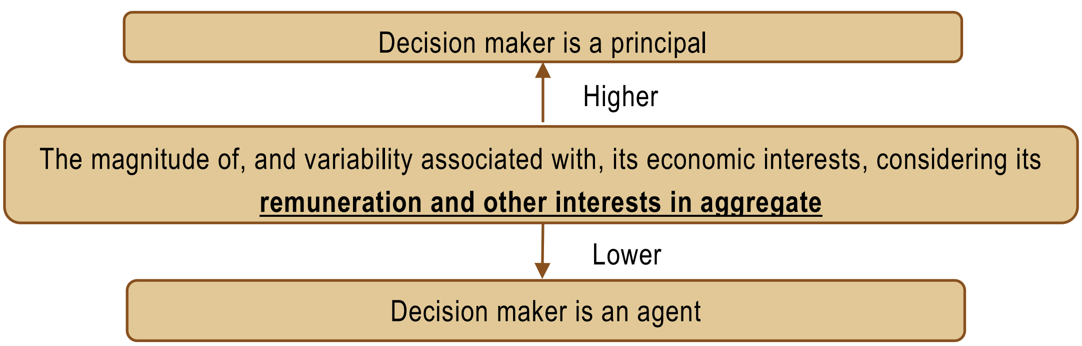
Further, in determining whether it is a principal or an agent the decision maker shall also consider following conditions:



Exposure to variable returns from other interests in the investee

A decision maker that holds other interests in an investee (like investments in the investee or provides guarantees with respect to the performance of the investee), shall consider its exposure to variability of returns from those interests in assessing whether it is an agent. **Holding other interests in an investee indicates that the decision maker may be a principal.**

In evaluating the exposure to variability of returns, the decision maker shall consider the magnitude of variability as follows:



It is to be noted that here the decision maker needs to consider the remuneration and other interests in aggregate. Hence, even though in case the decision maker had concluded in the initial assessment about remuneration that it is an agent, it needs to again consider remuneration in the assessment of exposure to variable returns.

Apart from the magnitude of exposure to variable returns, decision maker shall also consider whether its exposure to **variability of returns is different from that of the other investors**. If yes, then whether this might influence its actions. **For example,** this might be the case when a decision maker holds subordinated interests in, or provides other forms of credit enhancement to, an investee.

The decision maker shall evaluate its **exposure 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 of the investee through other interests that the decision maker holds.

For example, if a variation in investees returns by 1% causes variation in decision maker's returns from investee by less than 1%. However, a variation in investee's returns by ₹ 100 causes variation in decision maker's returns from investee by ₹ 150 because of significant variation in the market price of the equity shares of the investee.

Illustration 17: Link between power and returns

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Following is the relevant fact pattern related to fund manager:

- *Within the defined parameters, the fund manager has discretion about the assets in which to invest.*
- *The fund manager has made a 10% pro rata investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund.*
- *The fees are commensurate with the services provided.*
- *The fund manager does not have any obligation to fund losses beyond its 10% investment.*

The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager but can redeem their interests within particular limits set by the fund.

Whether the fund manager controls the fund?

Solution:

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund — the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this case, consideration of the fund manager's exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

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Illustration 18: Link between power and returns

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to various scenarios described below. Each scenario is considered in isolation. Determine whether the fund manager control the fund?

Scenario A

The fund manager also has a 2% investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2%

investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario B

The fund manager has a more substantial pro rata investment in the fund but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario C

The fund manager has a 20% pro rata investment in the fund but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Solution:

Scenario A

The fund manager's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Scenario B

In this scenario, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20% investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when the level of investment is different.

Scenario C

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager — the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this scenario, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

*****

Illustration 19: Link between power and returns

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee.

The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio.

On formation, the equity instruments represent 10% of the value of the assets purchased. A decision maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee (i.e. 1% of assets under management) and performance-related fees (i.e. 10% of profits) if the investee's profits exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee. The remaining 65% of the equity, and all the debt instruments, are held by *a large number of widely dispersed unrelated third-party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.*

Does the asset manager control the investee?

Solution:

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35% of the equity and from its remuneration.

Although operating within the parameters set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns -the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its equity interest, which is subordinate to the debt instruments. Holding 35% of the equity creates subordinated exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls the investee.

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Following table summarises the above illustrations on link between power and returns by highlighting each of the factors for evaluating link between power and returns:

<table>
<tr><th>Illustration</th><th>Scope of the decision-making authority</th><th>Removal rights held by others</th><th>Remuneration from the investee</th><th>Variable returns from other interests</th><th>Conclusion</th></tr>
<tr><td>16</td><td>Narrowly defined</td><td>No such rights</td><td>1% of the net asset value of the fund</td><td>10% investment in the fund</td><td>Agent</td></tr>
<tr><td>17 (A)</td><td rowspan="2">Extensive decision-making authority</td><td rowspan="2">Removal for cause by simple majority</td><td rowspan="2">1% of assets under management and 20% of all the fund's</td><td>2% investment in the fund</td><td>Agent</td></tr>
<tr><td>17 (B)</td><td>20% investment in the fund</td><td>Principal</td></tr>
</table>

17 (C)		Removal without cause by board	profits if a specified profit level is achieved	20% investment in the fund	Agent
18	Decisions within the parameters set out in the investee's prospectus	Removal without cause by simple majority of widely dispersed investors	1% of assets under management and 10% of profits if the profits exceed a specified level	35% of equity in the investee	Principal

Illustration 20: Link between power and returns

A decision maker (the sponsor) sponsors a fund, which issues short-term debt instruments to unrelated third-party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high quality medium-term asset portfolios to the fund. Each transferor services the portfolio of assets that it sells to the fund and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralisation of the assets transferred to the fund. The sponsor establishes the terms of the fund and manages the operations of the fund for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the fund, approves the assets to be purchased by the fund and makes decisions about the funding of the fund. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual return of the fund and also provides credit enhancement and liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5% of all of the fund's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor. Whether the sponsor has control over the fund?

Solution:

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the fund because of its rights to any residual returns of the fund and the provision of credit enhancement and liquidity facilities (i.e. the fund is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the fund, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that most significantly affect the fund's returns (i.e. the sponsor established the terms of the fund, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the fund (for which new investment must be found on a regular basis)). The right to residual returns of the fund and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the fund that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the fund. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

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3.4 RELATIONSHIP WITH OTHER PARTIES

When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf i.e. they are **'de facto agents'** of the investor. The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.

A de facto agent relationship **does not require a contractual arrangement** between the investor and the de facto agent.

A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the **ability to direct that party** to act on the investor's behalf.

An investor shall consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable returns through the de facto agent **together with its own** when assessing control of an investee.

Further, having a de facto agent does not necessarily mean that the investor controls the investee. The investor still needs to perform the control evaluation as per the detailed guidance discussed above.

When assessing control, an investor would consider its de facto agent's decision-making rights and exposure (or rights) to variable returns together with its own as if the rights were held by the investor directly.

Example 5

An investor holds 30% voting powers in an investee. One of the fellow subsidiaries of the investor also holds 30% voting powers of the investee. If the investor believes that if has the ability to direct the fellow subsidiary to act on behalf of the investor while exercising its voting rights, then the investor may conclude that the fellow subsidiary is a de facto agent of the investor. Accordingly, investor would be able to control the investee with ability to use 60% of the voting rights. However, in case the fellow subsidiary holds just 10% voting rights of the investee then the investor would not be able to control the investee with just 40% voting rights (30% held by investor itself and 10% owned by de facto agent).

Following are the examples of other parties that, by the nature of their relationship, might act as de facto agents for the investor:

- Investor's related parties
- A party that received its interest in the investee as a contribution or loan from the investor
- A party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except in case investor and other party have right of prior approval and rights are based on mutually agreed terms)
- A party that cannot finance its operations without subordinated financial support from the investor
- Investee for which the majority of the members of board or similar body are the same as those of the investor
- A party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

Parties mentioned above are not necessarily de facto agents of the investor. However, the investor needs to evaluate whether the parties following in the above categories are the de facto agents or not.

3.5 CONTROL OF SPECIFIED ASSETS

An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity. A deemed separate entity is often called a **'silo'**.

An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

Determination of whether a portion of an investee is a deemed separate entity		
Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee.	Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets.	In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are **ring-fenced** from the overall investee.

For example, an investee is a mutual fund and under the investee there are multiple sub-funds established with different investment objectives like debt-oriented funds, equity-oriented funds, etc. In such case, an assessment should be made as to whether the sub-funds are deemed separate entities as per the conditions mentioned above.

When the conditions mentioned above are satisfied, an investor shall assess **whether it controls the silo** by applying the guidance of control evaluation i.e. whether the investor has power over the silo, exposure or rights to variable returns from involvement with silo and whether it can use that power to affect the returns of the silo.

If the investor controls the silo, the investor shall consolidate that silo. In that case, other parties exclude that silo when assessing control of, and in consolidating, the investee.

For example, continuing with the above example on identification of a silo, if one of the sub-funds is treated as a silo then the investor that controls that silo will consolidate that sub-fund. Other parties who control other sub-funds will exclude the sub-fund controlled by the investor in their control evaluation and consolidation.

3.6 CONTINUOUS ASSESSMENT

An investor shall reassess whether it controls an investee **if facts and circumstances indicate that there are changes** to one or more of the three elements of control i.e. power, exposure or rights to variable returns and link between power and variable returns.

An investor should reassess the control over an investee in following situations:

Situation	Example
A change in how power over an investee can be exercised	Changes to decision-making rights whereby the relevant activities are no longer directed through voting rights, but instead other agreements, like contracts, give another party or parties power over the investee
An event can cause an investor to gain or lose power over an investee without the investor being involved in that event	An investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed
Changes affecting exposure, or rights, to variable returns from involvement with an investee	An investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive variable returns or to be exposed to obligations (e.g. if a contract to receive performance-related fees is terminated).
Assessment to act as an agent or principal has changed. Changes in the overall relationship between the investor and other parties can mean that an investor no longer acts as an agent, even though it has previously acted as an agent, and vice versa.	If changes to the rights of the investor, or of other parties, occur, the investor shall reconsider its status as a principal or an agent.

An investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g. a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control or changes the overall relationship between a principal and an agent.

3.7 INVESTMENT ENTITIES

3.7.1 Determining whether an entity is an investment entity

A parent shall determine whether it is an investment entity. An entity is an investment entity if it fulfils **all the following conditions**:

- Obtains funds from one or more investors for providing those investor(s) with **investment management services**
- Commits to its investor(s) that its business purpose is to invest funds solely for **returns from capital appreciation, investment income**, or both
- **Measures and evaluates** the performance of substantially all of its **investments on a fair value basis**

In assessing whether an entity meets the definition of investment entity as above, the entity shall consider whether it has the following typical characteristics of an investment entity:

Typical characteristics of an investment entity

More than one investment	More than one investor
Investors are not related parties of the entity	Entity has ownership interests in the form of equity or similar interests

The absence of one or more of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity but indicates that additional judgement is required in determining whether the entity is an investment entity.

If facts and circumstances indicate that there are **changes** to one or more of the three elements that make up the definition of an investment entity or the typical characteristics of an investment entity, a parent shall **reassess whether it is an investment entity**.

Following is the detailed discussion on two of the three elements of the definition of an investment entity (business purpose and fair value measurement) and the typical characteristics of an investment entity. As regards the first element, i.e. provision of investment management services, that essentially differentiates an investment entity from other entities.

3.7.1.1 Business Purpose

The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both.

Documents or other evidence that indicate the entity's investment objectives are include:

- offering memorandum of the entity
- publications distributed by the entity and other corporate
- partnership documents of the entity
- manner in which the entity presents itself to other parties (such as potential investors or potential investees)

For example, an entity may present its business as providing medium-term investment for capital appreciation. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments.

Apart from the business purpose of investing for capital appreciation and investment income, an **investment entity may provide investment-related services** (e.g. investment advisory services, investment management, investment support and administrative services), to third parties as well as to its investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.

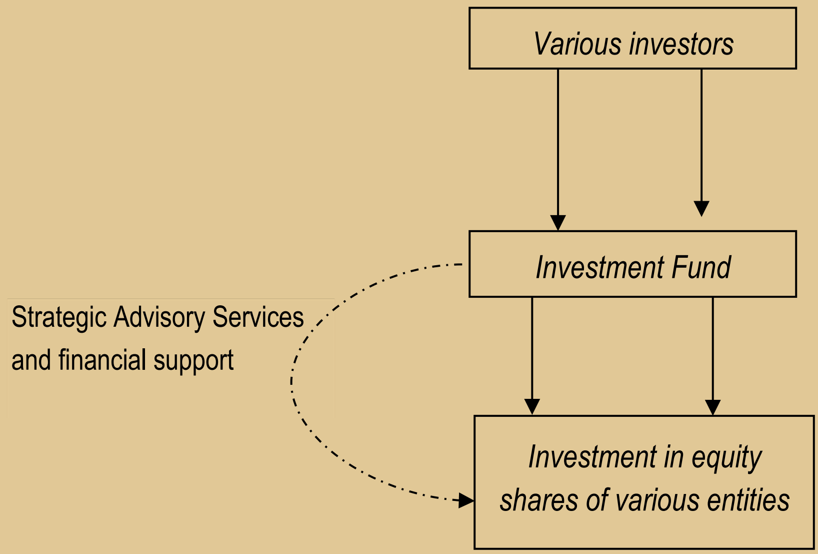
An investment entity may also participate in the following **investment-related activities** if these activities are **undertaken to maximise the investment return** (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:

a) providing management services and strategic advice to an investee; and

b) providing financial support to an investee, such as a loan, capital commitment or guarantee.

Illustration 21: Business purpose of an investment entity

An asset manager has set up and investment fund for the purpose of acquiring capital contributions from various investors (by issuing them units in the fund) and investing those contributions in the equity share capital of various entities for the purpose of earning capital appreciation on those investments. Following is the existing structure of the fund.



Apart from the investments in various entities, the investment fund also provides its investee the strategic advisory services so that it can result in increase in the capital appreciation from investments in those investees. It also provides its investees financial support in the form of loan to provide them with funds for acquiring capital assets. The investment fund does not hold such investments for a period longer than 5 years. The investment fund measures and evaluate the performance of the investments on fair value basis.

Whether the investment fund can be treated as an investment entity?

Solution:

Out of the three elements of the definition of an investment entity, the investment fund fulfils the two elements very clearly i.e. it obtains fund from more than one investor for providing investment management services and measures and evaluates its investments on fair value basis.

The typical characteristics of an investment entity are also present in the structure of the investment fund i.e. more than one investment, more than one investor, investors are unrelated and investment fund issues units in the fund to the investors.

With respect to the business objective of the investment fund, the objective is to earn capital appreciation from its investments. The strategic advisory services and financial support provided to investees are extended with the intention of earning higher capital appreciation from the investees. However, judgement should to be applied that these do not represent substantial business activity or a separate substantial source of income for the investment fund. If the investment fund concludes that these services and financial support to investees are not substantial business activity and substantial source of income for the investment fund, then only the investment fund can be treated as an investment entity.

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3.7.1.2 Exit strategies

One feature that differentiates an investment entity from other entities is that an **investment entity does not plan to hold its investments indefinitely**; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity **shall have an exit strategy** documenting how the entity plans to realise capital appreciation from substantially all of its equity investments and non-financial asset investments.

An investment entity shall also have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. The entity need not document specific exit strategies for each individual investment but shall identify different **potential strategies for different types or portfolios of investments**, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

Exit strategies can vary by type of investment.

- **For investments in private equity securities**, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee).

- **For equity investments that are traded in a public market**, examples of exit strategies include selling the investment in a private placement or in a public market.
- **For real estate investments**, an example of an exit strategy includes the sale of the real estate through specialized property dealers or the open market.

An investment entity may have an **investment in another investment entity** that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the **investment entity investor need not have an exit strategy** for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

Illustration 22: Exit strategies of an investment entity

ABC Ltd. Is established with primary objective of investing in the equity shares of various entities across various industries based on the detailed research about each industry and entities within that industry being done by the investment manager of the company.

The investment manager decides the timing as to when the investments should be made considering the current market situation. Sometimes, the investment manager decides to invest the idle funds into short-term to medium-term debt instruments with fixed maturity. The exit strategies are in place for the investments done in equity shares but the same is not there for investments done in debt instruments.

Determine whether the entity fulfils the exit strategy condition of being classified as investment entity?

Solution:

The exit strategies are in place for investments done in equity shares. But not in place for investments done in debt instruments. However, it should be noted that the debt instruments have fixed maturity period and they cannot be held for indefinite period. Hence, there is no need for having exit strategies for such instruments. Accordingly, the exit strategy condition is fulfilled for being classified as investment entity.

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3.7.1.3 Earnings from investments

To be an investment entity, an entity must commit to its investors that its business purpose is to invest funds solely for **returns from capital appreciation, investment income**, or both.

An entity is **not an investment entity if** the entity, or another member of the group containing the entity **obtains**, or has the objective of obtaining, **other benefits from the entity's investments** that are not available to other parties unrelated to the investee.

Such other benefits include following:

Acquisition, use, exchange or exploitation of the **processes, assets or technology of an investee**. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, etc. of any investee

Joint arrangements or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;

Financial guarantees or assets provided by an investee for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)

An **option held by a related party** of the entity **to purchase**, from that entity or another group member, an **ownership interest** in an investee of the entity;

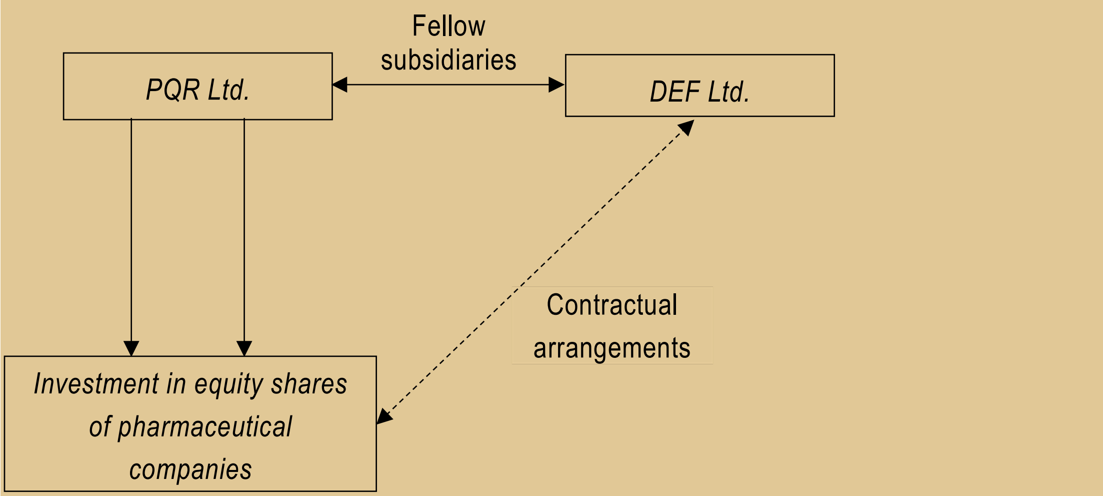
Transactions (except as mentioned in next paragraph) between the entity or another group member and an investee that are

- on terms that are unavailable to unrelated parties; or
- not at fair value; or
- represent a substantial portion of the investee's or the entity's or other group entities' business

An investment entity may have a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees. An entity is not disqualified from being classified as an investment entity merely because such investees trade with each other.

Illustration 23: Earnings from investments of an investment entity

PQR Ltd. is established with primary objective of investing in the equity shares of various pharmaceutical companies which are involved in the research and development of medicine for a critical illness. DEF Ltd. is a fellow subsidiary of PQR Ltd. and DEF Ltd. has entered into contractual arrangements with all the investees of PQR Ltd. that in case they are successful in developing the medicine then they will transfer the patent and distribution rights for that medicine to DEF Ltd. at less then market price. This arrangement is explained in following diagram:



Determine whether PQR Ltd. can be classified as investment entity?

Solution:

PQR Ltd. and DEF Ltd. are part of same group. Further, DEF Ltd. have exclusive right to acquire the patent and distributions rights from the investees of PQR Ltd. and that too at less than the market price. Hence, the related party of PQR Ltd. is in position to obtain benefits other than capital appreciation and investment income from the investees that are not available to other parties unrelated to the investee. Accordingly, PQR Ltd. cannot be classified as investment entity.

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3.7.1.4 Fair value measurement

An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because **using fair value results in more relevant information** than, for example, consolidating its subsidiaries or using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

Provides investors with **fair value information and measures substantially all of its investments at fair value** whenever fair value is required or permitted in accordance with Ind ASs

AND

Reports fair value information internally to the entity's key management personnel, who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

In order to meet the requirement of measuring investments at fair value, an investment entity would:

a) elect the exemption from applying the equity method in Ind AS 28 for its investments in associates and joint ventures (exemptions from applying the equity method is discussed in detail in unit 6); and

b) measure its financial assets at fair value using the requirements in Ind AS 109.

An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity applies to an investment entity's investments. Accordingly, an investment entity **need not measure its non-investment assets or its liabilities at fair value**.

3.7.1.5 More than one investment

An investment entity **typically holds several investments** to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

There may be times when the entity holds a single investment. However, **holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity**. For example, an investment entity may hold only a single investment when the entity:

- is in its **start-up period** and has not yet identified suitable investments and, therefore, has not yet executed its investment plan
- has **not yet** made other investments to **replace those it has disposed** of
- is **established to pool investors' funds** to invest in a single investment when that investment is unobtainable by individual investors (e.g. when the required minimum investment is too high for an individual investor)
- is in the process of **liquidation**

3.7.1.6 More than one investor

An investment entity would have **<u>several investors who pool their funds</u>** to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income.

Alternatively, an investment entity may be formed by, or for, a **<u>single investor that represents or supports the interests of a wider group of investors</u>** (e.g. a pension fund, government investment fund or family trust).

There may also be times when the entity temporarily has a single investor. For example, an **<u>investment entity may have only a single investor</u>** when the entity:

(a) is within its **<u>initial offering period</u>**, which has not expired and the entity is actively identifying suitable investors;

(b) has not yet **<u>identified suitable investors to replace ownership interests</u>** that have been redeemed; or

(c) is in the process of **<u>liquidation</u>**

3.7.1.7 Unrelated investors

An investment entity has **<u>several investors that are not related parties</u>** of the entity or other members of the group containing the entity. Having unrelated investors would make it **<u>less likely</u>** that the entity, or other members of the group containing the entity, would **<u>obtain benefits other than capital appreciation or investment income.</u>**

However, an entity may still qualify as an investment entity even though its investors are related to the entity.

<u>For example</u>, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

3.7.1.8 Ownership interests

An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity are typically in the form of **<u>equity or similar interests</u>** (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, **having different classes of investors**, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, **does not preclude an entity from being an investment entity**.

Example 6

An entity has issued two types of equity shares to its investors i.e. class A shares and class B shares. Holders of class A shares are entitled to receive 10% of the profits of the entity at the end of each year. After distribution of such amount, the balance amount is distributed proportionately between holders of class A shares and class B shares. Such method of distribution of profits to shareholders would not preclude the entity from being an investment entity if other conditions are satisfied.

In addition, an entity that has significant **ownership interests in the form of debt** that, in accordance with other applicable Ind AS, does not meet the definition of equity, may still qualify as an investment entity, **provided that the debt holders are exposed to variable** returns from changes in the fair value of the entity's net assets.

Example 7

An entity has issued compulsorily convertible bonds with fixed interest payments to the investors. Such bonds are convertible into variable numbers of equity shares and hence classified as financial liability in accordance with Ind AS 32 *'Financial Instruments: Presentation'*. The compulsorily convertible bonds expose the investors to variable returns because after conversion, the investors will have rights in the net assets of the entity which is dependent on the fair value of investments done by the entity.

3.7.2 Exemptions to investment entities

An investment entity **shall**

- **not consolidate its subsidiaries** or apply Ind AS 103 *'Business Combinations'* when it obtains control of another entity; **and**
- **measure an investment in a subsidiary at fair value through profit or loss** in accordance with Ind AS 109.

If an investment entity has a subsidiary **that is not itself an investment entity** and whose main purpose and activities are **providing services related** to the investment entity's **investment activities**, it shall **consolidate that subsidiary** and apply the requirements of Ind AS 103 to the acquisition of any such subsidiary. If the subsidiary that provides the investment-related services or activities is itself an investment entity then the investment entity parent shall measure that subsidiary at fair value through profit or loss.

A **parent of an investment entity shall consolidate** all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity. This is explained in following diagram form:

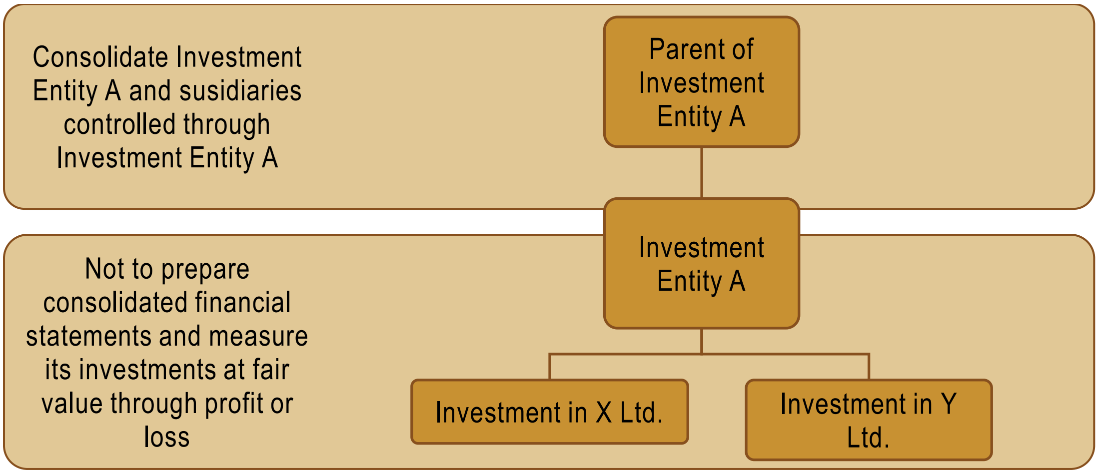

Illustration 24

HTF Ltd. was formed by T Ltd. to invest in technology start-up companies for capital appreciation. T Ltd. holds 70 percent interest in HTF Ltd. and controls HTF Ltd. The other 30 percent ownership interest in HTF Ltd. is owned by 10 unrelated investors. T Ltd. holds options to acquire investments held by HTF Ltd., at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of T Ltd. No plans for exiting the investments have been identified by HTF Ltd. HTF Ltd. is managed by an investment adviser that acts as agent for the investors in HTF Ltd.

Determine whether HTF Ltd. is an investment entity or not.

Solution:

Even though HTF Ltd.'s business purpose is investing for capital appreciation and it provides investment management services to its investors, HTF Ltd. is not an investment entity because of the following arrangements and circumstances:

(a) T Ltd., the parent of HTF Ltd. holds options to acquire investments in investees held by HTF Ltd. if the assets developed by the investees would benefit the operations of T Ltd. This provides a benefit in addition to capital appreciation or investment income; and

(b) the investment plans of HTF Ltd. do not include exit strategies for its investments, which are equity investments. The options held by T Ltd. are not controlled by HTF Ltd. and do not constitute an exit strategy.

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