



CA
PAKISTAN

Topic wise Selected Opinions

**IFRS 10 - Consolidated Financial
Statements**

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1. Applicability of IFRS 10 on Modaraba Management Companies and Modarabas

Brief facts of the enquiry:

The Accounting Standards Board (the Board) received enquiries regarding:

- A. Application of IFRS 10 requirements to a modaraba management company and modaraba; and
- B. Preparation of consolidated financial statements by modaraba management company under the Companies Act, 2017.

Opinion:

The Board based on the enquired fact pattern discussed the following matters:

- Considering the typical structure of modaraba management companies in Pakistan, where these are required to hold 10% units of modarabas and charge management fees up to 10% of profits of modarabas (i.e. total stake of 20% in modaraba):
 - Whether modaraba management companies fulfill the requirements of 'control' as given under IFRS 10?
 - What should be the acceptable benchmark (i.e. 20% or more) when a modaraba management company assesses its control over a modaraba?
- If a modaraba management company meets the requirements of 'control' under IFRS 10:
 - Can it be construed that the directives of the Companies Act override the requirements of IFRS 10 and treat a modaraba management company and modaraba as associates, only; and require modaraba management company and modaraba(s) to submit separate financial statements, and hence override the requirements of IFRS 10 for consolidation of modaraba and modaraba management company?

A. Application of IFRS 10 requirements to a modaraba management company and modaraba

Paragraph 6 of IFRS 10 states that "an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."

The Board noted that in context of the submissions shared in the enquiry, under IFRS 10 a modaraba management company having control over a modaraba, would be required to prepare consolidated financial statements.

The Board noted that based on paragraph 7 of IFRS 10 a modaraba management company would have control of a modaraba if it has all the following elements:

- (a) Power over the modaraba;
- (b) Exposure, or rights, to variable returns from its involvement with the modaraba; and
- (c) The ability to use its power over the modaraba to affect the amount of its returns.

The Board noted that the three elements are cumulative, therefore absence of any element fails the control assessment.

The Board also noted that, in general, two elements i.e.,

- (i) power over the modaraba, and

(ii) exposure or rights to variable returns from its involvement with the modaraba, appear to be present between a modaraba management company and modaraba.

(a) **Power over the modaraba:** The Board noted that under the regulatory framework applicable to modarabas and modaraba management companies, the power to manage the affairs of a modaraba rests solely with the modaraba management company. The board of directors of modaraba company performing the governance role, approve all major decisions relating to operating and financial policies of modaraba. Further, the key management personnel of the modaraba is appointed by and accountable to the board of directors of the modaraba management company.

(b) **Exposure, or rights, to variable returns from its involvement with the modaraba:** The Board observed that under IFRS 10, variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee.

With regards to a modaraba management company, in general, it obtains following returns in the capacity of a management company and investor.

Dividend: Modaraba management company is required to hold at least 10% of total modaraba certificates at all times. Accordingly, modaraba management company would earn dividend income at par with the other modaraba certificate holders.

Management fee: Modaraba management company is entitled to a remuneration for the management services rendered up to a maximum of 10% per annum of the net annual profits of the modaraba, under the statutory framework.

The management fee and dividend on investment of a modaraba management company are linked to performance and profit of modaraba, therefore are variable returns in accordance with IFRS 10.

(c) **The ability to use its power over the modaraba to affect the amount of the modaraba management company's returns:** The third element of control (paragraph 17 of IFRS 10) is the link between power and returns. This is reflected by an investor's ability to use its power over an investee to affect the amount of the investor's returns. This involves assessing whether an investor acts as a principal or an agent.

The Board noted that in the enquired matter, the key factor would be modaraba management company's ability to use its power over the modaraba to affect the amount of its returns (i.e. variability of returns).

Paragraph B60 of IFRS 10 explains that all of following factors are to be considered in assessing if an investor acts as a principal or an agent:

- (a) the scope of the decision maker's authority over the investee;
- (b) the rights held by other parties, including substantive removal rights;
- (c) the remuneration to which the decision maker is entitled; and
- (d) the decision maker's exposure to variability of returns from other interests it holds in the investee.

The factors consider the nature of the decision-maker's rights and its incentives to act primarily on its own behalf or on behalf of others.

In terms of IFRS 10, two of the above factors are determinative regardless of other indicators; (a) a single party holds substantive kick-out rights; (b) the decision maker's remuneration is not commensurate with the services provided. While judgment is required in assessing the other

factors for determination of relationship between modaraba management company and modaraba.

In the context of modaraba management company and its relationship with modaraba, the Board observed that:

- (a) **The scope of the decision maker's authority over the investee:** The modaraba management company has decision-making authority and the ability to undertake the relevant activities of the modaraba within the regulatory parameters. The affairs of the modaraba are governed by the board of directors of the modaraba management company.
- (b) **the rights held by other parties, including substantive removal rights:** The modaraba certificate holders do not hold any substantive rights to remove the modaraba management company. The modaraba certificate holders can redeem their certificates within particular limits set by the governing documents of modaraba. The modaraba certificate holders also do not have the power to modify the investment/lending mandate or windup the modaraba.
- (c) **the remuneration to which the decision maker is entitled:** Modaraba management company is entitled to a fee for management of modaraba (up to a maximum of 10% of the modarabas annual net profit), and is considered to be commensurate with the level of services.
- (d) **the decision maker's exposure to variability of returns from other interests it holds in the investee:** The existence of this factor would depend on the particular facts and circumstances of each modaraba management company.

The Board while analyzing the exposure to variability of returns, in context of the enquired fact pattern noted that investment of 10% along with a 10% management fee exposes the modaraba management company to 20% variable return (i.e. economic interest).

The Board noted that:

Although paragraphs B72 of IFRS 10 note that a greater magnitude of economic interest is associated with a greater likelihood of the investor acting as a principal. However, IFRS 10 through paragraphs BC141 and BC142 makes it clear that for determination of principal/ agent no quantitative threshold of variability of returns exists.

IFRS 10 also contains Application Guidance, and the examples 13 to 15 of this guidance indicate that the decision-maker needs to consider all relevant factors to determine control.

IFRS 10 does not specify any quantitative benchmarks/thresholds (i.e. percentages of economic interest) that are conclusive evidence for determining control of an investee. However, IFRS 10 through Application Examples at least indicate to the IASB's thinking, possibly narrowing the range for level of aggregate economic interest in which judgement about significance of exposure to variability of returns has to be made.

In the application example 14A of IFRS 10, an investor despite extensive decision-making authority to direct relevant activities of the fund, but with exposure to 22% variability of economic interest is considered to be an agent. In context of the enquired matter, modaraba management company's aggregate variable economic interest of 20% is below 22%. As per the guidance provided in IFRS 10 (through Application Examples), this exposure to variability of economic interest indicates that the modaraba management company is an agent.

On the other hand, IFRS 10 in the Application Example 14B, explains that an investor having 37% variable economic interest is considered a principal (the 37% variable return is based on 20% direct investment, 1% fee, and 20% of profits if a specified profit level is achieved). Example

14B also notes that *“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 level of investment is different.”*

The Board also observed that under the statutory provisions, 10% investment by a modaraba management company in the modaraba is the minimum level of investment. A modaraba management company with higher level of investment in the modaraba, could be a principal, based on the principle outlined in IFRS 10. The relevant facts and circumstances of each case must be carefully considered, to conclude on whether a modaraba management company's exposure to variability of returns is of significance leading to establishment of principal relationship with the modaraba.

The Board, based on the information provided in the enquiry and above discussion, concluded that:

- (a) IFRS 10 provides three elements of control and absence of any element fails the control assessment.
- (b) IFRS 10 does not specify any quantitative benchmarks/thresholds (i.e. percentages of economic interest and variability) that are conclusive evidence for determining control of an investee. The decision-maker needs to consider all relevant factors to determine control.
- (c) Based on guidance provided in the IFRS 10 and more specifically the Application Examples 14A and 14B, a modaraba management company's 10% investment in modaraba and 10% management fee do not appear to create exposure to variability of returns of such significance to conclude that it controls the modaraba.

Modaraba management companies with higher level of investments in modarabas (more than minimum 10% investment in modaraba) or other interests, would have higher exposure to variability of returns. In such cases, the variability of returns and other factors, could result in establishing control of a modaraba.

B. Preparation of consolidated financial statements by modaraba management company under the Companies Act

The Board noted that differing views could exist on the requirement to prepare consolidated financial statements by a modaraba management company under the Companies Act.

IFRS 10 adopted by SECP, determines whether an investor is required to consolidate an interest in an investee. IFRS 10 is part of the financial reporting framework applicable to a modaraba management company. While, the Companies Act also specifies financial reporting requirements for the preparation of consolidated financial statements. Further, the Companies Act also contains a specific section related to the financial statements of modarabas and modaraba management companies.

The Board also observed that it is well understood that the provisions of Companies Act and other statutory laws that are applicable to modaraba management company and modaraba override the requirements of IFRS.

In context of the enquired matter, the divergent views primarily originate from varied understanding of the definitions and statutory requirements of the Companies Act. Therefore, the enquired matter is primarily a legal matter rather than an accounting matter.

The requirement to prepare consolidated financial statements by a modaraba management company (under the Companies Act) in essence results from differences between IFRS and the Companies Act. The Companies Act and IFRS have different definitions/concept of 'Associated

companies/undertakings', 'Holding company' and 'Subsidiary', and criteria for determination of control.

The Board observed that the financial reporting framework should guide and determine the applicability of accounting principles and basis of preparation of financial statements for companies/entities. Based on this principle, the requirements and guidance contained in IFRS 10 should be followed for determination of control and preparation of consolidated financial statements. This approach would eliminate the departures from IFRS requirements and would also ensure common understanding and application of financial reporting provisions.

Application of IFRS with additional disclosures, when necessary, is presumed to result in financial statements that achieve fair presentation.

Accordingly, the Board concluded that:

- (a) IFRS 10 is a part of the financial reporting framework applicable to modaraba management company. However, specific provisions/directives of statutory law override the requirements of the applicable financial reporting framework.
- (b) In principle, the applicable financial reporting framework should determine the application of accounting principles and basis of preparation of financial statements of entities. This approach would eliminate the departures from IFRS and would also ensure common understanding and application of financial reporting provisions. Based on this principle-based approach, the requirements and guidance contained in IFRS 10 should be followed.
- (c) In view of the provisions of the Companies Act, the requirement to prepare consolidated financial statements by a modaraba management company is primarily a legal matter rather than an accounting matter. Varied understanding and differing views on the enquired matter can be eliminated by following the above principle-based approach to financial reporting.

(September 2020)

2. Consolidation of Subsidiary - Private Brokerage Company

Enquiry:

A listed modaraba has 100% wholly owned subsidiary which is a private brokerage company.

The subsidiary (incorporated in Dec 2015) has not yet commenced its operations as Trading Right Entitlement Certificate (which is in the name of Modaraba) is pending transfer by PSX to brokerage subsidiary.

The question is that whether:

1. The subsidiary needs to be consolidated on each reporting period? i.e. Quarterly, Half yearly and annually.
2. Either whole set of financial statements will be made? i.e. BS, P&L, CF, SOCE, Notes for each reporting period or any of these can be omitted?

Please note that the subsidiary is a private brokerage company duly incorporated in Dec 2015 and has not yet commenced its operations due to pending transfer of TREC by PSX.

Opinion:

The Committee understands that the Modaraba is registered under Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980 (Modaraba Ordinance).

The financial statements of the Modaraba are prepared in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Modaraba Ordinance, Modaraba Rules 1981 and Prudential Regulations for Modaraba. Further, the Modaraba Ordinance does not contain a provision for the preparation of consolidated financial statements.

However, section 503 of the Companies Ordinance 1984 (the Companies Ordinance) explains that the provisions and requirements of the Companies Ordinance are applicable to companies governed by special enactments including modarabas. The relevant clause of section 503 of the Companies Ordinance is reproduced as under:

“503. Application of Ordinance to companies governed by special enactments.

—

- (1) The provisions of this Ordinance shall apply-
- (c) to modaraba companies and modarabas, except in so far as the said provisions are inconsistent with the provisions of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (XXXI of 1980)

The Committee would also like to refer following requirements of section 237 of the Companies Ordinance and paragraph 4 of IFRS 10 ‘*Consolidated Financial Statements*’, which are self-explanatory: (underline is ours)

237. Consolidated financial statements. (1) There shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company’s financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirements of the Fourth schedule and International Accounting Standards notified under sub-section (3) of section 234.

(3) Every auditor of a holding company appointed under section 252 shall also report on consolidated financial statements and exercise all such powers and duties as are vested in him under section 255.

(4) All interim financial statements of a subsidiary as required under sub-section (3) shall be reviewed by the auditors of that subsidiary appointed under section 252 who shall report on such financial statements in the prescribed form.

IFRS 10

4. An entity that is a parent shall present consolidated financial statements. This IFRS applies to all entities, except as follows (we understand that these exceptions are not applicable in your case):

(a) a parent need not present consolidated financial statements if it meets all the following conditions:

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

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

(iii) it did not file, 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; and (iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS.

Based on the information provided to the Committee, it understands that your Modaraba is not an investment entity, and the exemption given for the requirements of section 237 of the Companies Ordinance through SECP's SRO 56(1)/2016 and IFRS 10 are not applicable.

Your attention is also drawn to the requirements of IAS 34 '*Interim Financial Reporting*':

IAS 34

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.

Conclusion:

Based on above, the Committee's view to your queries is as follows:

1. A subsidiary of listed Modaraba should be consolidated at each reporting period despite the fact that it has not yet commenced the operations. Accordingly, the consolidated financial statements shall be prepared at the interim period/s in accordance with the requirements of the Companies Ordinance.

2. Complete set of financial statements as defined under paragraph 10 of IAS 1, should be made annually, whereas, for interim financial reporting, either a complete set of financial statements (as described in IAS 1) or a condensed set of financial statements can be made (as described in IAS 34).

IAS 34 defines the minimum content of an interim financial report which includes condensed financial statements and selected explanatory notes. IAS 34 does not prohibit or discourage an entity from publishing a complete set of financial statements in its interim financial report, nor does it prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard.

(May 25, 2017)

3. Query on Consolidation

Enquiry:

SL needs your technical advice regarding existence of control over an associated company PL and consolidation of financial Statement.

Both the companies have common Chief Executive Officer (CEO). The information regarding the associated company is as below.

- (1) SL holds 49.24% shares of PL.
- (2) Number of directors on behalf of SL on the board of PL are three out of seven directors.

PL does not meet the definition of a subsidiary company for SL as per section 3 of the Company Ordinance 1984. Majority of the Directors are not representing SL, and the decisions are made by majority of the Board.

Your technical advice is sought, whether the accounts of SL will be consolidated with the accounts of PL (an unquoted Limited Company) for publication or SL will show its investment in PL on equity Basis.

Opinion:

The Committee would like to draw your attention to the following paragraphs of **IFRS 10 'Consolidated Financial Statements'**:

6. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
7. Thus, an investor controls an investee if and only if the investor has all the following:
 - (a) power over the investee (see paragraphs 10–14);
 - (b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and
 - (c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

B18 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, to enable the assessment of power to be made, the investor shall consider evidence of whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to the following, which, when considered together with its rights and the indicators in paragraphs B19 and B20, may provide evidence that the investor's rights are sufficient to give it power over the investee:

- (a) The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities.
- (b) The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.
- (c) 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.

- (d) The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person).
- (e) The majority of the members of the investee's governing body are related parties of the investor.

B38 An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:

- (a) a contractual arrangement between the investor and other vote holders (see paragraph B39);
- (b) rights arising from other contractual arrangements (see paragraph B40);
- (c) the investor's voting rights (see paragraphs B41–B45);
- (d) potential voting rights (see paragraphs B47–B50); or
- (e) a combination of (a)–(d).

IFRS 10 explicitly includes the concept of 'de facto' control, where an investor with less than a majority of voting rights has power over an investee. The primary focus of the analysis under IFRS 10 remains on whether an investor has sufficient voting rights to give that investor the practical ability to direct the relevant activities. This involves an assessment of the size of its holding of voting rights relative to the size and dispersion of holdings of the other vote holders. An investor therefore needs to consider the indicators given in B42:

B42 When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances including:

- (a) the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders noting that:
 - (i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct relevant activities;
 - (ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
 - (iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
- (b) potential voting rights held by the investor, other vote holders or other parties (see paragraph B47-B50)
- (c) rights arising from contractual arrangements (see paragraph B40)
- (d) any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

The Committee would like to draw your attention to following additional facts and circumstances to consider which includes:

- Voting patterns at previous shareholders' meetings
- Whether the investor has the practical ability to direct the relevant activities unilaterally (e.g., the investee and the investor have the same key management)
- Whether the investor has a special relationship with the investee (e.g., the investee depends on the investor to fund a significant part of its operations)

- Whether the investor has a large exposure to variable returns (which may be an indicator that the investor had an incentive to obtain rights sufficient to give it power)

There is an important distinction to be drawn about voting patterns. IFRS 10 makes it clear that the focus is on the number of vote holders that have participated in the past and the absolute proportion of voting rights that have historically been exercised. It is not on whether other vote holders have voted in the same way as the investor.

If the criteria set out below are met, it may be clear that that the investor has power over the investee, and no further analysis is needed (refer example 4 of the standard):

- Direction of relevant activities is determined by majority vote
- The investor holds significantly more voting rights than any other vote holder or organised group of vote holders
- Other shareholdings are widely dispersed (IFRS 10. B43/B44).

In other situations, the guidance above is not conclusive and further analysis of additional facts and circumstances is required. The fewer voting rights the investor holds, and the fewer parties that would need to act together to outvote the investor, the more reliance is placed on additional facts and circumstances to assess whether the investor's rights are sufficient to give it power (IFRS 10. B45). An Investor has no power if additional facts and circumstances still do not provide a clear answer (IFRS 10. B46).

Additional facts and circumstances also need to be analysed which include indicators of a special relationship with the investee, which suggest more than a passive interest and voting patterns. As noted above, when voting patterns of previous shareholders' meetings are analysed, the standard requires only the number of other shareholders that attended (to calculate the majority of votes required to unilaterally make decision) to be considered, but not their voting patterns. Examples 5 to 8 from the standard illustrate how additional rights, and voting patterns, are taken into consideration.

Conclusion:

In the light of above, an investor can control an investee with less than the majority of voting rights. The Committee considers that common directorship is not a conclusive factor for determining control. Other factors like contractual arrangements and circumstances discussed above may also require judgment and need to be considered carefully.

Based on all the information provided to us, including the shareholder's agreement, the Committee concludes that:

1. SL does not directly or indirectly controls, beneficially owns or holds more than fifty per cent of PL voting.
2. Group A comprising SL, APL and their subsidiaries has power under shareholders' agreement to appoint four directors out of seven (including chief executive). Under the same shareholders' agreement, the rights of board of directors have significantly been reduced from the usual statutory rights and even most of the ordinary matters to be decided by the general meeting with a majority of at least 2/3rd, with other annual matters requiring approval of the general meeting with 85% voting. This shows that most significant decisions that affect the business cannot be taken without a greater majority.
3. While SL is entitled to variable returns, prima facie it does not have the power over the investee in a host of key matters. Accordingly, based on the information and facts available the Committee is of the view that PL is not the subsidiary of SL.

(May 16, 2016)

4. IFRS 10 exemption from Consolidation

Enquiry:

Paragraph 4(a) of IFRS 10 - "Consolidated Financial Statements" - allows that an entity with subsidiaries need not present consolidated financial statements, if a number of detailed conditions are met. The aforesaid paragraph of IFRS 10 is as follows:

"a parent need not present consolidated financial statements if it meets all the following conditions:

- i. it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;*
- ii. its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);*
- iii. it did not file, 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; and*
- iv. its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs."*

How should the requirement that the entity's parent produces financial statements that "comply with IFRSs" be interpreted? Does it mean that the criteria in IFRS 10.4(a) are only met, if the entity's parent produces financial statements that comply "as-is" with IFRSs as issued by the IASs? Is the condition (iv) above considered to be met in the local environment when an explicit and unreserved statement of compliance with IFRSs is not made in the financial statements locally?

Opinion:

With reference to your query relating to interpretation of para 4(a)(iv) that qualifying for the exemption, the reporting entity should be compliant of full IFRS; the Committee is of the view that since while adopting IFRS 10 in Pakistan, no modification to the requirement of compliance with IFRS for the consolidated financial statements of the parent was made, therefore the exemption is only available when the parent prepares IFRS compliant financial statements having an explicit and unreserved statement of compliance with IFRSs.

Further the Committee would like to draw your attention to the requirements of Section 237 of the Companies Ordinance 1984 reproduced below: (underline is ours)

237. **Consolidated financial statements.** - (1) There shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company's financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirement of the Fourth Schedule and an International Accounting Standards notified under sub-section (3) of section 234.

(January 04, 2016)

5. Implementation of IFRS 10 ‘Consolidated Financial Statements’ on Mutual Funds in Pakistan

Enquiry:

We refer to ICAP circular 2008/01 wherein it was stated that "the matter is under consideration of the Professional Standards and Technical Advisory Committee of ICAP and joint committee of the ICAP & MUFAP, therefore, till the outcome of the decision of both the committees, members are advised not to consolidate their funds" and the recent introduction of consolidation under IFRS 10 which is creating confusion in the Industry.

The industry’s viewpoint is that IFRS 10 should not be applicable on the mutual funds industry. Asset management companies should not consolidate the funds under their management along with their financial statements, as consolidation may lead to serious distortion and volatility in the financial statements of the Management Company which will be grossly misleading.

While IASB's exception for Investment Entities clearly excludes mutual funds from consolidation, the asset management companies need to be examined on the definition of control. We have examined the same and have the view that asset management companies operating in Pakistan fall under the role of Agent and therefore should be classified as investment entities.

Consolidating mutual funds into asset management companies will create serious distortion and volatility in the financial statements of the Management Company which will be grossly misleading. That when consolidated into the management companies into their sponsor entities will lead to further distortion and as most of those sponsors are listed will mislead the investors. As explained by IASB, the fair value information is more useful for decision making than consolidated information. The consolidated information with regards to mutual funds industry will have no purpose whatsoever as mutual funds are pooled investments and the right of ownership is pari passu for all investors in the fund and not the asset management companies or their sponsors.

In this regards, a clarification/ circular similar to circular 2008/01 should be issued by ICAP that all mutual funds and asset management companies are "investment entities" and therefore consolidation under IFRS 10 will not be applicable on the industry. We are available for further discussion in this regard so that the same can be addressed before the end of the financial year.

Opinion:

Issue

After the introduction of IFRS 10 ‘Consolidated Financial Statements’ (“IFRS 10”), the Institute has been approached by number of practicing members for seeking opinion on whether:

- The Asset Management Companies (“AMCs”) meets the definition of Investment Entity under the requirements of IFRS 10;
- AMC controls the Mutual Funds (“MFs”); and
- MF should be consolidated with the AMC under the requirements of IFRS-10.

1. Investment Entity

Requirements of IFRS 10	Yes / No	Basis of Opinion
27. "...A parent shall determine whether it is an investment entity. An investment entity is an entity that:		<p>When evaluating whether AMCs satisfy the definition of investment entities, first we need to understand that MFs and AMCs are two distinct and separate legal entities. The majority of investors of MFs are substantially different from the shareholders of AMCs, although the shareholders of AMCs may also invest in MFs to whom the AMCs provide asset management services.</p> <p>In assessing whether the entity meets the definition of an investment entity, an entity is required to consider the requirements of paragraphs 27 and 28 and the criteria given in B 85 of IFRS 10.</p>
(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;	No	<p>AMCs do not obtain funds directly on their own account but invite funds for investment schemes (MFs), which are separate legal entities. The AMCs in Pakistan do not satisfy the typical characteristics required in paragraph 28 of IFRS 10. While the investees (investment schemes) can be more than one, the shareholders of AMCs are generally very few/one who are its related parties (e.g. banks are parent companies of AMCs). Most of the AMCs operating in Pakistan are public unlisted companies which are closely held by a few investors.</p> <p>As per the guidance given in paragraphs B85Q to B85S of IFRS 10, typically an investment entity would have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have access to individually. This is generally what happens in a MF but not in the case of an AMC.</p>
(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and	No	<p>MFs commits to the unit holders that its business purpose is to invest funds in various investment portfolios solely for returns based on capital appreciation, investment income, or both.</p> <p>This is not true in case of AMCs. AMCs primary business and principal source of income, is asset management services to MFs managed by it. AMCs (investor) may also invest surplus funds in the MFs (investee) managed by it and benefit from payout and capital appreciations. However, such investment is not its core business.</p>
(c) measures and evaluates the performance of substantially all of its investments on a fair value basis..."	Yes	<p>As per B85K of IFRS 10, 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. In order to demonstrate that it meets the</p>

Requirements of IFRS 10	Yes / Basis of Opinion No
	<p>definition, an investment entity:</p> <p>(a) provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements; and</p> <p>(b) reports fair value information internally to the entity's key management personnel (as defined in IAS 24), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.</p> <p>As explained above primary business of AMCs is provision of asset management services and its performance is evaluated with reference to the size of assets under its management and the fee income therefrom. However, AMCs also measure their investment at fair value.</p> <p>CONCLUSION: AMCs in Pakistan do not meet all the criteria as laid down by IFRS 10.27. Therefore, in our opinion, AMCs are not Investment Entities.</p> <p>In our view, AMCs shall be required to consolidate those MFs under its management which meet the criteria discussed above.</p> <p>If AMC is acting as principal, then only it needs to consolidate unless exemptions under para 31 and 33 of IFRS 10 are claimed. In Pakistan majority of AMCs are subsidiaries of banks and are presented in the consolidated financial statements of the parent.</p>

2. Control of Asset Management Company

Requirements of IFRS 10	Yes / No	Basis of Opinion
<p>7. "...An investor controls an investee if and only if the investor has all the following:</p>		
<p>(a) <i>power over the investee;</i></p>	<p>Yes</p>	<p>In order to establish control, first criteria is to assess power of AMCs (investor) over schemes (investee) under its management.</p> <p>Power is the current ability to direct the relevant activities. Power arises from rights, which may include:</p> <ul style="list-style-type: none"> - voting rights - potential voting rights - rights to appoint key personnel - decision making rights within a management contract - removal or kick-out rights <p>However, power does not arise from protective rights.</p> <p>The AMCs in Pakistan establish market and manage a publicly regulated MF in accordance with narrowly defined parameters set out in the investment mandate governed by local laws and regulations (<i>Non- Banking Finance And Notified Entities Regulations, 2008</i>).</p> <p>In Pakistan, MFs are not required to establish, and have not established, an independent board of directors.</p> <p>In Pakistan, the unit holders do not hold any substantive rights that would affect the decision-making authority of the AMCs, but can redeem their interest at the NAV of that day.</p> <p>Although AMCs are operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, it has decision-making rights that give it the current ability to direct the relevant activities of the MF.</p> <p><i>Thus, AMCs (investors) has power over the investment schemes (MFs/Investee).</i></p>
<p>(b) <i>exposure, or rights, to variable returns from its involvement with the investee; and</i></p>	<p>Case-to-Case basis</p>	<p>In order to establish control, second criteria is to assess whether the investor (AMC) is exposed, or has rights, to variable returns from its involvement with the scheme (investee).</p> <p>Returns can be positive, negative or both. Example</p>

Requirements of IFRS 10	Yes / No	Basis of Opinion
		<p>of returns include:</p> <ul style="list-style-type: none"> - Dividends (from direct interest in the fund either directly or potentially through certain related parties) - Remuneration (as result of earning management fees and performance fees) <p>As per section 61 of Non- Banking Finance And Notified Entities Regulations, 2008:</p> <p><i>“An Asset Management Company shall be entitled to an accrued remuneration equal to an amount not exceeding three percent of the average annual net assets of the Collective Investment Scheme that has been verified by the trustee and is paid in arrears on monthly basis during the first five years of existence of the Collective Investment Scheme and thereafter of an amount equal to two per cent of such assets or such other amount as may be specified by the Commission:</i></p> <p><i>Provided that an Asset Management Company may charge performance based or fixed fee or the combination of both which shall not exceed the limit prescribed in this Regulation and such fee structure shall be disclosed in the Offering Document.”</i></p> <p>AMCs in Pakistan are entitled to remuneration (i.e. management fee) as per the above regulation. In addition, AMCs may also invest surplus funds in units of the schemes and earn return similar to those of other unit holders of the scheme (i.e. investment return).</p> <p>If the AMC has no investment return than variability of returns from the activities of the fund will be nil. Thus, second criteria for control establishment will not be met, therefore, control will not be established.</p> <p>However, if the AMC is earning management fee as well as investment return, then AMC will be exposed to the variability of returns from the activities of the mutual fund.</p> <p><i>Thus, the assessment of exposure to variable returns will need to be assessed on case to case basis. However, considering the general practice in Pakistan, most of the AMCs are exposed to the variability of returns from the activities of the mutual fund as these AMCs have also invested in units of MFs to which it is providing management services.</i></p>
<p>(c) <i>the ability to use its power over the investee to affect the amount of the investor's returns...</i></p>	<p>Case-to-Case basis</p>	<p>In order to establish control, third criteria is to evaluate whether the investor (AMC) has the ability to use its power to affect the returns from its involvement with the investee (MFs). These criteria</p>

Requirements of IFRS 10	Yes / No	Basis of Opinion
		<p>require to determine whether the AMC is acting as a Principal or Agent to the unit holders of MF by considering following factors:</p> <ul style="list-style-type: none"> - scope of its decision-making authority over the fund, - rights held by other parties (including removal rights), - remuneration to which the fund manager are entitled in accordance with the remuneration agreement, - exposure to variability from other interests that it holds in the mutual funds. <p>Thus AMCs in Pakistan:</p> <ul style="list-style-type: none"> - have wide scope of decision- making power over the unit holders, - will be removed only if there is willful contravention of trust deed, liquidation, appointment of receiver, etc. These rights are considered to be the protective rights. - are entitled to remuneration. - are exposed to variability of interest through their investments, if any, in the units of MFs managed by it. <p><i>After analyzing relevant illustrative examples of IFRS 10, it should be assumed that if AMC exposure to variability of returns is 20% or more than relationship of Principal is established with unit holders of MF.</i></p>

Conclusion:

In our opinion, majority of AMCs in Pakistan would meet the first two requirements of control definition that is power and exposure to variability of returns. However, keeping in mind the illustrative examples of IFRS 10 and to avoid subjectivity, if AMCs exposure to variability to returns is 20% or more then the AMCs' exposure to variability of returns from the activities of the fund is of such significance that it indicates that the AMC is a Principal to the unit holders of MF as the AMC meet all criteria laid down by IFRS 10.7 for control establishment. Therefore, parent and subsidiary relationship will be established between AMC and MF, unless it is proved that AMC is acting as an Agent to the unit holders of MF.

We consider that management of AMC will also have to assess on case to case basis for each MF that they manage as to whether they have control over the MF.

(June 23, 2015)