

Query No. 27

Subject: *Accounting for Portfolio Management Services (PMS) fee under Ind AS framework.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) is a private sector registered Non-Banking Financial Company (NBFC) involved in investing activities which prepares its financial statements as per Ind AS Division III of Schedule III to the Companies Act, 2013. The Company has outsourced a part of its investment to a Portfolio Management Service Organisation (hereinafter referred to as ‘PMS House’). PMS House charges following fees from the Company:

Particulars of Fees	Basis of Fees
Management Fees (Fixed)	1% of Portfolio value
Performance Fees (Variable)	10% on annual profits above hurdle rate of 10%

The PMS fees is as per the PMS agreement between the Company and the PMS House (a copy of sample PMS agreement has been supplied by the querist for the perusal of the Committee) and the same is approved by SEBI.

2. The querist has stated that *generally*, the investments made by the PMS House are for a long-term perspective; hence gains earned by the PMS House for the Company is in the nature of capital gains and offered to tax accordingly.

Example: Net Asset Value (NAV) of fund as at 01.04.2023 is Rs. 1 Crore and NAV as at 31.03.2024 is Rs. 1.25 Crore, i.e., Portfolio earned 25% in financial year (F.Y.) 2023-24. Therefore, PMS fees for F.Y. 2023-24 would be as under:

Particulars of Fees	Amount of Fees	Remarks
Management Fees (Fixed)	1,00,000	1% of Portfolio value
Performance Fees (Variable)	1,50,000	10% on annual profits above hurdle rate of 10%
TOTAL	2,50,000	

Accounting followed by the Company

3. The Company feels that since the PMS fees is directly attributable to the PMS activity, the same should form part of the value of shares as cost of acquisition (fixed fees) and cost of improvement (performance fees). Accordingly, the Company is of the view that the said PMS fees should be capitalised in the books under the head ‘Investments’. Currently, the Company is debiting the fees charged as an expense in the Statement of Profit and Loss.

4. The querist has also provided the following clarifications/information:

- (a) The Company is allocating funds to the PMS House where the portfolio manager at his discretion is managing the funds and investments of the Company with an

¹ Opinion finalised by the Committee on 22.11.2024.

aim of generating returns during the placement period. Hence, the Company believes that the PMS House is not acting as an agent of the Company. However, the Board of Directors review the investments made by the PMS House at regular intervals.

- (b) The basis of measurement of investment in equity securities in the financial statements of the Company is 'Fair Value through Other Comprehensive Income (FVOCI)'. The basis of the classification of investment in equity securities at Fair Value through Other Comprehensive Income (FVOCI) is due to the business model of the Company, i.e. to collect contractual cash flows and selling financial assets; and the assets' contractual cash flows representing solely payments of principal and interest. The Company's management has elected to irrevocably designate the same as equity instruments at FVOCI upon initial recognition.
- (c) The fee illustration model has been supplied by the querist separately for the perusal of the Committee. For ease of understanding, it can be stated as follows:
 - (i) NAV of fund as at 01.04.2023 is Rs. 1 Crore and NAV as at 31.03.2024 is Rs. 1.25 Crore, i.e., Portfolio earned 25% in F.Y. 2023-24. Hence, fees charged is Rs. 3.75 lakhs (15% of Rs. 0.25 crore).
 - (ii) NAV of fund as at 01.04.2024 is Rs. 1.25 Crore and NAV as at 31.03.2025 is Rs. 1.40 Crore, i.e., Portfolio earned 12% in F.Y. 2024-25 (the base of the calculation will be Opening NAV for the financial year). Hence, fees charged is Rs. 2.25 lakhs (15% of Rs. 0.15 crore).

In case, a portion of the portfolio is sold and the funds invested in new investments, the calculations shall not be subject to change. The calculations will be made on the closing portfolio value at the anniversary date.

B. Query

5. In view of the above, the querist has sought the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India on whether the practice proposed to be followed by the Company to capitalise PMS fees under the head 'Investments' is correct.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to accounting for PMS fee (fixed fee and performance fee) paid by the Company to Portfolio Management Service Organisation (PMS House). The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, the business model of the Company, whether the PMS House is an agent of the Company, any other fee or expenses charged by the PMS House, accounting in the financial statements of PMS House, etc. The Standards hereinafter referred to are Indian Accounting Standards (Ind AS), notified under the Companies (Indian Accounting Standards) Rules, 2015. The Committee has also not examined the appropriateness of determination or calculation of fee and the Illustration provided by the querist. The Committee's opinion and analysis is based on the sample agreement shared by the querist. Further, the opinion is purely from accounting perspective and

not from legal perspective, such as legal interpretation of PMS Agreement, or income tax/GST compliances, etc.

7. At the outset, the Committee examines the nature of PMS fee in the extant case. In this regard, the Committee notes the following requirements of Ind AS 109, 'Financial Instruments':

“transaction costs Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.”

“Transaction costs

B5.4.8 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.”

From the above, the Committee notes that transaction costs include only those costs that are directly attributable to the acquisition, issue or disposal of a financial asset or issue of a financial liability. They are incremental costs that would not have been incurred if the instrument had not been acquired, issued or disposed of e.g. fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

In the extant case, the Committee notes that the PMS agreement states that “The Fixed Management Fee is payable, notwithstanding any withdrawals within the period of one year. In case of additions *during the year*, the Fixed Management Fee is payable on a pro-rata basis *for the year*”. Further, the Committee notes that as per PMS agreement, “In addition to the Portfolio Management Fee, all legal costs, fees, charges and expenses...of whatsoever nature incurred by the Portfolio Manager or any other person appointed by the Portfolio Manager arising out of or in connection with or in relation to the management, acquisition, holding, custody, sale and/or transfer, of the Assets or the rendering of the Discretionary Portfolio Management Services or ... including, ... expenses and cost of safe keeping of Assets, charges of any Depository, Participant and/or custodian, registration and transfer charges in respect of Securities, including legal fees of the Portfolio Manager incurred on behalf of the Client, brokerage and stamp duty, ... shall be paid or reimbursed by the Client”. From this, it appears that the portfolio management fee is in addition to expenses or charges or costs directly incurred in relation to the acquisition, issue or disposal of the securities/investments in the extant case and the fixed management fee (which is chargeable based on opening NAV of portfolio value) is payable for management of the funds/portfolio entrusted by the Company to the PMS House during the year on pro rata basis and is not payable for acquisition of a financial asset. The quantum of fee depends on the duration for which the funds/portfolios are managed by the PMS house, irrespective of transactions of acquisition or sale of instruments. Therefore, the fixed PMS fee cannot be considered as incremental cost directly attributable to the acquisition, issue or disposal of a financial asset. Therefore, fixed PMS fee will not qualify as transaction cost, as per the requirements of Ind AS 109.

Further, the variable performance fee (charged on profit and based on the NAV, 12 months from the date of inception) is also not incurred for the acquisition of the investments and would not be considered as those “directly attributable to the acquisition or issue of the asset or liability”. The fee represents “administrative or holding costs” instead and is contingent on the achievement of performance and therefore, the same also does not qualify as transaction cost that can be included in the initial measurement of financial asset as per paragraph 5.1.1 of Ind AS 109 as reproduced below:

“Initial measurement

5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.”

8. The Committee further notes that in the extant case, the basis of measurement of investment in equity securities in the financial statements of the Company is ‘Fair Value through Other Comprehensive Income (FVOCI)’ and the Company’s management has elected to irrevocably designate the same as equity instruments at FVOCI on initial recognition. In this regard, the Committee notes that as per Ind AS 109, ‘Financial Instruments’, an irrevocable election to present in other comprehensive income subsequent changes in the fair value, with no recycling through profit or loss, is available for certain investments in equity instruments as per the following requirements of Ind AS 109, ‘Financial Instruments’:

“5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. (See paragraph B5.7.3 for guidance on foreign exchange gains or losses.)”

9. In this context, the Committee notes that in the extant case, as per the agreement with the PMS House, “Securities means only long equity shares of companies and specifically does not include shorting or derivatives”. Thus, it is presumed that the portfolio comprises only equity shares. Now, the Committee examines, whether the investments in equity shares in the given case should be classified as financial assets at fair value through profit or loss (FVTPL) or whether these can be designated as financial assets at fair value through other comprehensive income (FVOCI). In this regard, the Committee notes that as per the sample PMS Agreement (as may also be observed from the clauses of Agreement reproduced below), the securities are being managed by the PMS House on behalf of the Company, the transactions are being entered into on behalf of the Company and the Company has entrusted the securities to the PMS House to facilitate performance of the required services. In the absence of detailed information, the opinion is based on the assumption that the equity shares purchased through the PMS House represent financial assets of the Company. While the portfolio is being managed by the PMS House, the Company is the legal and beneficial owner of the equity shares. In this context, the Committee notes from the requirements of paragraph 5.7.5 of Ind AS 109 that the irrevocable election to present in other comprehensive income, changes in the fair value of an investment

in an equity instrument can be made only if such equity instrument is not held for trading. In this regard, the Committee notes the following requirements of Ind AS 109:

“**held for trading** A financial asset or financial liability that:

- (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- (c) is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).”

“B4.1.6 A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets’ performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model’s objective. Consequently, such portfolios of financial assets must be measured at fair value through profit or loss.”

“BA.6 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer’s margin.”

Further, the Committee notes the following clauses from the sample PMS Agreement:

“3.7 The investment objective of the Portfolio Manager in carrying out the Discretionary Portfolio Management shall be to undertake, on behalf of the Client, the management and administration of the Funds and Portfolio of the Client with the aim of generating a return on the Assets, while at the same time endeavouring to reduce the risk of capital loss. However, the Client agrees and acknowledges that while the aforesaid is the objective, there is no guarantee of such returns or, of there being no capital loss ...

3.8(i) The Client agrees that the Portfolio Manager shall subject to the terms and conditions of this Agreement, be entitled to do all acts to invest and manage the Assets, including but not limited to investing the Funds in Securities, selling, redeeming or liquidating Securities or changing the Securities forming part of the Portfolio, appointing intermediaries for the sale and purchase of Securities in such manner as the Portfolio Manager may in its discretion consider appropriate ...”

“5.1 Subject to Clause 5.5, the Assets placed by the Client with the Portfolio Manager for Discretionary Portfolio Management Services under this Agreement shall be

placed for a period of one year. The Client shall either prematurely withdraw or renew the Funds/ Securities with the Portfolio Management Services again.”

“5.3 In the event that the Client does not place its Assets again with the Portfolio Manager it shall on the completion of the placement period mentioned in Clauses 5.1, withdraw its Assets from the Portfolio Manager at the Client’s risk and cost by sending the Portfolio Manager a notice of withdrawal, as mentioned in Clause 5.2. Upon expiry of this Agreement ... The Client shall be entitled to choose to receive the Securities forming part of the Assets in the form of Securities or the equivalent cash amount representing the Securities, by informing the Portfolio Manager in this regard ...”

“7.3 (i) The Client agrees and accepts that the Portfolio Manager may, from time to time

(a) Acquire, have and/or maintain a position in any security similar to the Securities held, purchased or sold for the Client forming part of the Portfolio of Client

(b) Purchase or sell on behalf of the Client any Security which forms part of the Portfolio of the Portfolio Manager or its other clients or which is otherwise purchased, sold or traded in by the Portfolio Manager on its own account or on account of its other client(s)

(c) Purchase or sell on its own account or on behalf of any other client, any Security which forms part of the Portfolio

....

(e) Deal on the Client’s behalf with any Affiliate of the Portfolio Manager as long as the terms are as favourable to the Client as would be ordinarily obtained from a concern which is not an Affiliate

(f) Purchase or sell Securities from or to anyone with whom the Portfolio Manager has a commercial or other relationship or agreement, including selling or purchasing the Securities to or from the account of the Portfolio Manager or another client of the Portfolio Manager

...

(ii) The Portfolio Manager may receive commissions and other payments from mutual funds and other issuers in respect of purchase, sale or other dealings in Securities pursuant to this Agreement.”

Based on the holistic and harmonious reading of the various clauses of the Sample Agreement especially those reproduced above, the Committee notes the following:

- The objective of the arrangement is to maximise the return on the investments. Further, a large part of the PMS House fee is performance based (chargeable on profits based on closing NAV, 12 months from the date of inception). Such an objective and fee structure would typically result in frequent sales and purchases of securities. The PMS House is primarily focused on fair value information and is expected to use that information to make investment decisions which will entail purchase and sale of securities. Undertaking such transactions is part of the basic service which the PMS

House is expected to provide under the agreement - the agreement not only permits but expects that the PMS House will sell the investments and reinvest in different securities in an effort to optimise its fair value.

- The PMS House has wide and discretionary powers to undertake transactions involving purchase and sale of equity shares. There is no clause or conditions in the agreement which restricts the ability of the PMS House to undertake transactions. In the absence of any restriction or conditions or framework for making decisions, it cannot be presumed that purchase and sale of securities will be infrequent and/or will not result in short-term profit making. The cash flows (or the final portfolio of securities) that would be received by the Company at the end of the agreement would be the net result of the trading transactions.
- The fixed tenure of the agreement is only 1 year; there is no auto renewal and there is no evidence of certainty of renewal (and/or the number of such renewals). Considering that the remuneration of the PMS House is linked to the increase in fair value of the portfolio, the PMS House would have incentive to undertake as many transactions as may be required within each term of one year. Such decision may also be influenced by the commissions etc. received from mutual funds and other issuers. Thus, the frequency and nature of the transactions may be high and/or result in short-term profit making.

From the above, the Committee is of the view that the arrangement may result in acquisition of equity principally for the purpose of selling. Further, the frequency and nature of the transactions related to the portfolio may be high and/or result in short-term profit making. Considering this, in the extant case, it cannot be concluded that the investments in equity shares made through the PMS House are not held for trading and therefore, these should be classified as at FVTPL. Accordingly, the issue of recognition of transaction costs (other than PMS fee) through other comprehensive income (as part of change in fair value at the next remeasurement) also does not arise.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the PMS fee in the extant case does not qualify as transaction cost that can be included in the initial measurement of financial asset as per paragraph 5.1.1 of Ind AS 109, as discussed in paragraph 7 above. Further, the investments in equity shares in the given case do not meet the criteria for classification as fair value through other comprehensive income. Accordingly, the issue of recognition of transaction costs (other than PMS fee) through other comprehensive income (as part of change in fair value at the next remeasurement) also does not arise, as discussed in paragraph 9 above.
