


Applying IFRS in Banking and Capital Markets

IFRS 10 Consolidated Financial Statements

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Challenges for banks and
their structured entities
in adopting and applying
IFRS 10

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Introduction

In May 2011, the International Accounting Standards Board (the IASB) issued two new standards: IFRS 10 *Consolidated Financial Statements*, and IFRS 12 *Disclosure of Interests in Other Entities*. These new standards are effective for annual periods beginning on or after 1 January 2013, and must be adopted retrospectively.

IFRS 10 establishes a single control model that applies to all entities, including special purpose entities (SPEs) or 'structured entities' as they are now referred to. This is a major difference from the two models that existed previously under IAS 27 *Consolidated and Separate Financial Statements* for operating entities and SIC 12 *Consolidation - Special Purpose Entities*. IFRS 10 replaces SIC 12 and the portion of IAS 27 that addressed when and how to consolidate an entity. The IASB issued the new standards partly in response to the financial crisis, during which there was significant criticism of accounting rules that permitted certain entities to remain off-balance sheet. In June 2009, the US Financial Accounting Standards Board (FASB) responded to this criticism by changing US GAAP to improve the financial reporting by entities that are involved with variable interest entities (or VIEs, as structured entities are referred to in US GAAP), and is proposing further changes to US GAAP with respect to principal-agency situations.¹ If the FASB approves principal-agency requirements that are the same as those in IFRS 10, the boards have indicated that they expect the requirements for consolidating structured entities and VIEs to be substantially converged. However, because the IFRS and US GAAP requirements for structured entities are not identical, differences may emerge as IFRS 10 and the amendments to US GAAP are implemented.

The main change introduced by IFRS 10 compared with SIC 12 is a greater focus on which party has power over the structured entity's activities rather than who has the majority of the risks and rewards. While the consolidation assessment will not change for many structured entities, the effect will depend on the specific terms of each structure.

The changes introduced in IFRS 10 will require management to exercise significant judgement to determine which entities it controls and hence which entities are required to be consolidated by the parent. This is recognised by the IASB, which has, therefore, introduced significant new disclosure requirements in IFRS 12, to explain how this judgement has been applied. These disclosures also require an entity to disclose, among other things, the risks to which it is exposed as a result of its involvement with structured entities, including those situations where it does not consolidate them. The IFRS 12 disclosure requirements are likely to be significant for all entities that sponsor or are involved with structured entities.

In this publication, we explore the impact of IFRS 10 on a bank's typical involvement with structured entities. It supplements the EY publication *IFRS 10 Consolidated Financial Statements - Challenges in Adopting and Applying the New Standard*, which explores the control model with respect to all types of entities, and also deals with the disclosure requirements of IFRS 12.

Control

An investor consolidates any entity that it controls.

IFRS 10 states, "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".² This requires all three of the following:

1. **Power** over the investee, which is described as having existing rights that give the current ability to direct the **relevant activities**, i.e., the activities that most significantly affect the investee's returns
2. Exposure, or rights, to **variable returns** from the investor's involvement with the investee
3. The ability to use its power over the investee to **affect** the amount of the investor's returns

A structured entity is defined in IFRS 12 as "An entity that has been designed so that voting rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements."³ A structured entity normally has restricted activities, a narrow or well-defined objective, very little equity and is financed by multiple contractually linked instruments. Examples include securitisation vehicles, asset-backed financings and some investment funds.

¹ FASB proposed Accounting Standards Update *Principal versus Agent*.

² Paragraph 6.

³ Paragraph B21.

Purpose and design

When assessing control of an investee, an investor is required to understand the purpose and design of an investee, which will provide the answers to the following questions:

- ▶ What are the relevant activities?
- ▶ How are decisions about these relevant activities made?
- ▶ Who has the current ability to direct the relevant activities?
- ▶ Which parties have exposure to variable returns from the investee?
- ▶ How do the relevant activities affect returns?
- ▶ Do the parties that have power, and have exposure to variable returns, have the ability to use that power to affect the returns?

Through this exercise, it may be clear that where an entity is controlled by means of equity instruments such as ordinary shares that give the holder voting rights, the majority shareholder controls the investee. However, in the case of structured entities, where voting rights are not the dominant factor in determining who controls the investee, or relate only to administrative tasks, further analysis of the purpose and design is required. Factors to consider, as set out in IFRS 10, include:

- ▶ Consideration of the risks to which the investee was designed to be exposed
- ▶ The risks the investee was designed to pass onto the parties involved
- ▶ Whether the investor is exposed to some or all of those risks

In making the consolidation assessment, IFRS 10 notes that the investor may have “more than a passive relationship with the investee”. While, on its own, this does not mean the power criterion is met, in combination with other rights it may indicate that the investor has power. Examples of having more than a passive interest mentioned in IFRS 10 include when key personnel of the investee are ex-employees of the investor, the investor funds a significant portion of the investee, the investor provides guarantees, or a significant portion of the investee’s activities are conducted on behalf of the investor.

1.0 Power to direct the relevant activities

The determination of power depends on the relevant activities, how those activities are directed and the rights of the “investors” to direct those activities. The term “investor” includes all parties who have an involvement with the structured entity. The relevant activities are defined as those that “significantly affect the investees’ returns”.⁴ In general, where there is a range of operating and financial activities and substantive decision making is required, it will be voting or similar rights that give the investor control. Where voting rights do not have a significant effect on the investee’s returns, then contractual arrangements often determine the direction of the relevant activities.

When identifying the relevant activities and which investor has the right to direct those activities, consideration is given to the purpose and design of the investee. Examples of relevant activities for structured entities might include:

- ▶ Managing financial assets during their life (including upon default)
- ▶ Selecting, acquiring or disposing of assets
- ▶ Setting the interest rate on assets with discretionary variable rates
- ▶ Determining a funding structure or obtaining funding
- ▶ Appointing, remunerating and terminating key management personnel (if any)
- ▶ Appointing, remunerating and terminating service providers that direct the relevant activities

SIC 12 gives as an example of a decision making activity, “the power to unilaterally dissolve an SPE”.⁵ IFRS 10 is silent on this issue, but presumably the ability to liquidate a structured entity could be a relevant activity under IFRS 10, if it can significantly affect the structured entity’s returns. The power to bring a structured entity’s activities to an end may be similar to an entity’s power to close out a trading position. However, it is only likely to be the activity that most significantly affects returns if the rest of the structured entity’s activities are pre-designated and run on ‘autopilot’. Also, the ability to liquidate a structured entity may have significance in determining whether decision makers who hold power to direct the relevant activities are acting as an agent or as a principal, as discussed in Section 3.1 of this publication.

⁴ IFRS 10, paragraph 10.

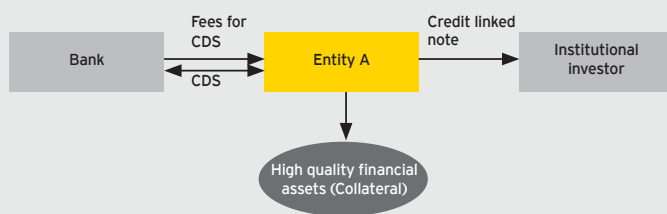
⁵ Guidance on implementing SIC 12, paragraph (b).

A further factor to consider is whether the sponsoring and designing of a structured entity can in itself be a relevant activity. An investor's involvement in the design of a structured entity does not, in and of itself, mean that investor necessarily has control, even if that involvement was significant. Rather, an investor has control of a structured entity when all three criteria of control are met, considering the purpose and design of the investee. Thus, an investor's involvement in the design of a structured entity is part of the context when concluding whether it controls the structured entity, but it is not determinative.

1.1 No relevant activities

There are relatively few structured entities for which there is no substantive decision-making. However, if a structured entity truly has no decision-making and is actually on autopilot, then

Example 1



Fact pattern

A structured entity A is created for the benefit of an investor who wishes to obtain exposure to the credit risk of Entity B (an entity which is unrelated to any party involved in the structure). The structured entity obtains funding by issuing a note that is linked to Entity B's credit risk. The proceeds are used to acquire a portfolio of high quality financial assets. The structured entity obtains exposure to Entity B's credit risk by entering into a credit default swap (CDS) at market rates with a bank in return for a fee paid by the bank.

The structured entity operates virtually on autopilot and there are very few, if any, decisions to be made after initial set up. The bank can switch the collateral assets within pre-defined parameters, but that ability only affects the returns of the structured entity to a small extent.

no investor would control that structured entity, even if the investor sponsored or designed the structured entity. This is because no investor has power over the structured entity, that is, no investor has the current ability to direct the activities that significantly affect the structured entity's returns. As a result of the focus on control rather than risks and rewards, it is likely that there will be structured entities that were consolidated under SIC 12, but now will not be consolidated.

This interpretation is consistent with the following example, which was included in the IASB's publication, *Effect analysis IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities*.⁶

Analysis

There are no "relevant activities" in this example as no activities occur after inception that can significantly affect the structured entity's returns. Although the bank has the ability to switch the collateral, since this collateral is required to be of high quality, this ability affects the returns of the structured entity only to a small extent. Despite the fact that the structured entity was created to provide tailored investment opportunities for this investor, the investor has no power over the structured entity and so would not have control over it. As a result, no party would consolidate the structured entity.

If the fact pattern was varied such that the investor had the unilateral power to dissolve the structured entity at any time, then it would most likely be considered to have power over a relevant activity and so would be required to consolidate the entity.

Comparison with SIC 12

It is likely that the structured entity would be consolidated by the investor, since the structured entity was established for the investor's benefit and the investor is exposed to the majority of the risks related to the structured entity.

1.2 Relevant activities that are directed by different investors

It is possible that two or more investors each have rights that give them the ability to direct different relevant activities. In this case, IFRS 10 states that the investor that has the ability to direct the activities that **most significantly** affect the investee's returns has power over the investee. This issue is illustrated in the multi-seller conduit example in the Appendix at the end of this publication.

⁶ Published in September 2011.

1.3 Substantive rights

To convey power, rights must be substantive, in that the holder must have the practical ability to exercise the rights. IFRS 10 provides a number of examples of factors that need to be considered in making this determination. These include, amongst others:

- ▶ Economic barriers
- ▶ Financial penalties or incentives
- ▶ Exercise or conversion prices
- ▶ Other legal or regulatory barriers

Consider a bank that undertakes a securitisation and as part of the securitisation, transfers mortgage assets to a structured entity. The bank has a call option to repurchase the assets under certain conditions. If the exercise price of the call option is deeply- out-of- the money, such that the bank is unlikely ever to exercise that call option, then the call option would likely not be considered a substantive right.

1.4 Protective rights

When assessing whether it has power, an investor must consider whether its rights are protective. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. As these rights are designed to protect the interests of the holder without giving that party power over the investee, or prevent another party from having power, they do not give the holder power.

Examples of protective rights given in IFRS 10 include a lender's right to:

- ▶ Restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender
- ▶ Approve investment decisions for amounts greater than required in the ordinary course of business, or to approve the issue of new financing instruments
- ▶ Seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions

The ability to veto normal investment decisions or the appointment of key personnel would not be a protective right and may give the holder power.

The explicit reference in IFRS 10 to protective rights is a change from IAS 27 and SIC 12. While many may have considered this concept when evaluating control under IAS 27, an assessment should be made based on the individual facts and circumstances and the requirements of IFRS 10.

2.0 Exposure or rights to variable returns

When assessing control, an investor determines whether it has exposure or rights to variable returns from its involvement with the investee. Variable returns are not fixed and have the potential to vary as a result of the performance of the investee and can be positive, negative or both. Examples of exposures to variable returns in IFRS 10 include:

- ▶ Dividends, other distributions and changes in the value of the investment
- ▶ Interest payments, even if fixed, because they are potentially subject to default risk
- ▶ Fees for managing or 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
- ▶ Access to future liquidity that an investor has from its involvement with an investee
- ▶ Returns that are not available to other interest holders, such as 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 assets

IFRS 10 states that the right to receive fixed interest payments on a loan or bond are exposures to variable returns because they expose the investor to credit risk. The amount of variability will depend on the credit risk of the instrument. Similarly, the right to receive repayments of principal of a debt instrument are also an exposure to a variable return.

The returns do not have to arise in the investee itself, but could be earned directly by an investor from its involvement with the investee. Examples include when the investor provides credit protection to the investee, generates economies of scale from its involvement with the investee or has access to future liquidity through its involvement with the investee. A challenge in applying IFRS 10 is that some of the returns can be easily quantified, such as the value and variability of dividends and fees, but some, such as the access to future liquidity, are qualitative; this makes it more difficult to determine which activity most significantly affects returns.

An investor can generally disregard variable returns if they are insignificant or only vary to an insignificant extent. First, as we saw in the previous section, the investor can only have control if he has power to direct a relevant activity which significantly affects returns. Second, assuming that he does have power to direct a relevant activity but he shares the returns with other parties then, as we will see in the next section, he would be regarded as acting as an agent if his return is relatively insignificant or varies insignificantly, and so he does not use his power to affect his returns.

2.1 Derivatives and exposure to variable returns

In many transactions involving structured entities, an investor may enter into derivatives with the structured entity. It is not explicitly clear under IFRS 10 whether the counterparty to a swap or option has an exposure to a variable return. In our view, a derivative that introduces risk to a structured entity would generally not be considered an exposure to variable returns under IFRS 10. Only a derivative that exposes a counterparty to risks that the structured entity was designed to create and pass on would be considered an exposure to variable returns.

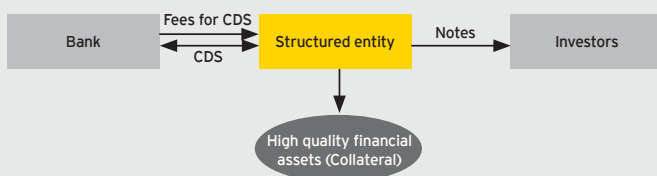
This view is consistent with the IASB's intentions (as noted in paragraphs BC65 to BC67 of the Basis for Conclusions). In

addition, this view would in most cases result in consistent treatment with that under US GAAP. The IASB and FASB have stated that they believe that they have achieved convergence with respect to evaluating control of a structured entity, and it would be difficult to reach converged solutions on many fact patterns involving derivatives and structured entities if the alternative view (that all derivatives create an exposure to variable returns) were taken.

The example given in paragraph BC66 is similar to that in Example 1 of this publication: a structured entity (entity A) obtains exposure to the credit risk of a reference entity by entering into a credit default swap (CDS), in which the credit risk is passed to the structured entity in return for a fee payable by the counterparty to the swap. BC 66 concludes, "The swap counterparty does not have involvement with entity A that exposes it to variability of returns from the performance of entity A because the CDS transfers variability to entity A rather than absorbing variability of returns from entity A."

In other words, a party who purchases a CDS from a structured entity would not have a variable return (see Example 2), whereas one which sells the equivalent CDS to the structured entity would (as illustrated in Example 3).

Example 2: Structured entity that writes a CDS



Fact pattern

A bank establishes a structured entity that enables investors to gain exposure to the credit risk of a portfolio of debt securities. The structured entity uses the proceeds of credit linked notes issued to investors to purchase high quality assets, and enters into a written CDS with the bank, which references the credit risk of the securities portfolio. This fact pattern is similar to that in Example 1 except for two amendments: there is more than one investor and, more importantly, the bank has the right to vary the debt securities which constitute the CDS reference portfolio, within certain constraints. As in Example 1, the bank also has the right to substitute the collateral.

Analysis

There are two activities that affect the returns of the structured entity: the bank's ability to substitute the CDS reference assets and its right to substitute the collateral. However, the bank's right to substitute the assets referred to by the CDS is determined to be the relevant activity as it may significantly affect the structured entity's returns, while

the ability to switch the collateral only affects the structured entity's returns to a small extent. On that basis, the bank would have power as it has the current ability to direct the relevant activity. However, the bank is not exposed to variability of returns of the structured entity, because it transfers risk to the structured entity through the CDS, rather than absorbing risk from the structured entity. Therefore, the bank does not control or consolidate the structured entity.

Comparison with SIC 12

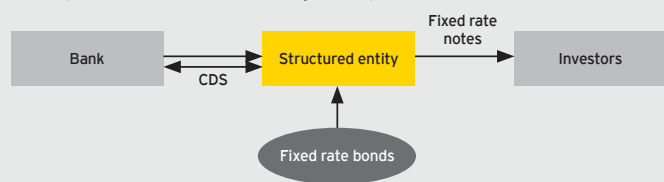
This fact pattern would meet three out of the four indicators set out in SIC 12 and would probably lead to the bank consolidating the structured entity:

- ▶ The bank would not be exposed to the majority of the risks related to the structured entity
- ▶ The activities of the structured entity are being conducted on the bank's behalf as the bank explicitly created the structure to transfer the credit risk of debt securities to third party investors
- ▶ The bank has the majority of the benefits of the structured entity as it is the recipient of payments under the CDS should any of the reference assets default
- ▶ The bank has decision making powers with respect to the structured entity as it has the right to substitute the CDS reference assets and the collateral assets (i.e., the only activities that affect the returns of the structured entity)

In its Effect analysis, *IFRS 10 Consolidated Financial Statements* and *IFRS 12 Disclosure of Interest in Other Entities*, published in September 2011, the IASB included a similar example, although without the substitution rights. It noted that if the assets held by the structured entity served as more than just collateral, the bank may have power over a relevant activity and may also

(although the mechanism is not specified) have a variable return affected by that power, leading to it controlling the structured entity. One possible mechanism would be if the return on the collateral was paid to the bank through the CDS and the bank paid, in return, a fixed rate to the structured entity to fund the interest paid on the notes.

Example 3: Structured entity that purchases a CDS⁷



Fact pattern

A bank establishes a structured entity that purchases fixed rate bonds from the market. The structured entity issues fixed rate notes to investors, which pay a return based on the cash flows generated from the bond portfolio. To reduce the structured entity's exposure to credit risk from the bonds, the structured entity purchases a CDS from the bank. The structured entity delegates management of bonds in default to the bank.

Analysis

The bank has decision-making rights over the management of defaults by the bonds, which is the only activity that is subject to ongoing decision-making and not pre-determined at the outset. As a result, this is likely to be the relevant activity (i.e., the activity that most significantly affects the returns of the structured entity).

However, in practice, the bank's role in managing the default on the bonds may be limited to voting at creditors' meetings, as an independent administrator would be appointed to manage the bond default on behalf of all bond holders. Whether the bank has power (i.e., the current ability to direct the management of defaults) or not will probably depend on the size of the structured entity's holding in the individual bonds that have defaulted. The greater the holding, the more likely the bank will be able control decision making in a creditor's meeting either on its own or in conjunction with other bond holders.

The bank has involvement with the structured entity that exposes it to variable returns from the performance of the structured entity, because the bank absorbs the variability of returns through the CDS. If the bank has rights that give it the current ability to direct the management of defaulted bonds, this power will affect the amount of its variable returns. Therefore, depending on individual facts and circumstances, the nature of the bank's involvement with the structured entity is such that it could meet all three elements of the control definition, and it could therefore be required to consolidate the structured entity.

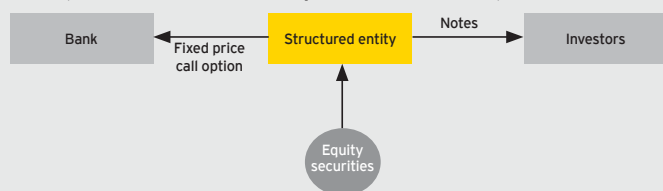
Comparison to SIC 12

Since the bank has the majority of the risks associated with the structured entity and has decision making powers over its activities, it is likely that the bank would consolidate.

Having analysed the impact of CDSs in Examples 1 – 3, Examples 4 and 5 illustrate the assessment of options as a source or not of variable returns, depending on whether they absorb or create variability.

⁷ Example 3 is based broadly on the fact pattern provided in IFRS 12.B8.

Example 4: Structured entity that sells a call option to a bank



Fact pattern

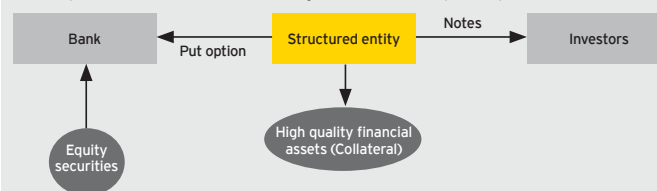
A bank sets up a structured entity that acquires equity securities from the market using the proceeds of the issue of notes to investors. In addition, the bank purchases a fixed price call option over those securities. The call option is a substantive right (for example, it is not deeply out of the money and no other factors cause the call option to be regarded as non-substantive). The notes pay a high coupon, since it includes the option premium paid by the bank, and on maturity or on exercise of the call option (if earlier), will repay at their par amount less any decline in value of the securities.

Analysis

In reality, there are likely to be activities that could significantly affect the structured entity's returns. However, taking account of all facts and circumstances, including the bank's call option, it is likely that the bank would be deemed to have the power to direct the relevant activities of the structured entity. Meanwhile, it has exposure to variable returns through any appreciation in the market value of the securities.

The bank is able to use its power over the structured entity to affect the amount of the bank's returns by buying the equities from the structured entity and subsequently selling them. As such, the nature of the bank's involvement with the structured entity means that it meets all three elements of the control definition. Therefore, it has control and consolidates the structured entity.

Example 5: Structured entity that sells a put option to a bank



Fact pattern

A structured entity sells a put option to a bank, which gives the bank the right to put a pre-defined portfolio of equity securities to the structured entity. The put option is a substantive right (for example, it is not deeply out of the money and no other factors cause the put option to be non-substantive). The structured entity issues notes that pay a high coupon, since it includes the option premium paid by the bank, and on maturity or on exercise of the put option (if earlier) will repay at their par amount less any decline in value of the securities. The proceeds from issuing the notes are invested in high quality collateral until the option is exercised. The bank has the power to substitute the collateral but this does not significantly affect the returns of the structured entity.

Analysis

There are no ongoing activities within this fact pattern that can be considered 'relevant activities'. As a result, possession of the put option may be considered the relevant activity, since its exercise by the bank will significantly affect the structured entity's returns.

However, the bank is not exposed to variable returns, since, by exercising the put option, the bank is introducing risk into the structured entity, rather than absorbing it, in a similar manner to the CDS in Examples 1 and 2 and as set out in paragraphs BC 65 to 67 of IFRS 10. Absent any other exposure to variable returns from its involvement with the structured entity, the bank would not have control over the structured entity. Therefore, the bank would not consolidate it.

2.1.1 Plain vanilla foreign exchange swaps and interest rate swaps

It is more difficult to apply the principle of creation versus absorption of variable returns to a plain vanilla foreign exchange or interest rate swap, since the swap creates an equal, but opposite risk to each party. Neither is clearly the creator or absorber of variable returns.

It is our preliminary view that an exposure to variable returns generally absorbs or receives the variability created by the investee's assets, liabilities or other contracts, and the risks the investee was designed to pass along to its investors. In contrast, interests that introduce risk to the investee are generally not exposures to variable returns in the investee. Therefore, a derivative that exposes a counterparty to risks that the investee was designed to create and pass on would be considered an exposure to variable returns under IFRS 10.

In contrast, if a derivative is entered into to reduce the variability of a structured entity's cash flows (such as might arise from movements in foreign currency or interest rates), it is not a common risk that the structured entity was designed to be exposed to, nor a risk that the structured entity was designed to pass on to the counterparty. Instead, the derivative is entered into to **align** the cash flows of the assets of the structured entity with those of the investors and so **reduce** the risks to which the investors in the structured entity are exposed. Accordingly, the counterparty would **not** have an exposure to a variable return.

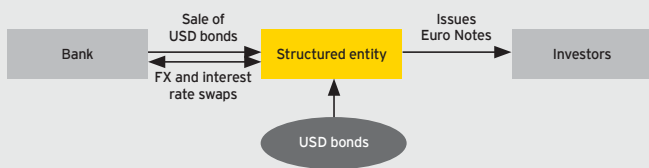
Meanwhile, a counterparty to a foreign exchange or interest rate swap typically has a senior claim on any cash flows due under the swap relative to any note holders. Consequently, it is unlikely to be exposed to the credit risk of the assets held by the structured entity, or else that risk will be deemed to be insignificant (i.e., losses on the assets would need to be so large that there would be insufficient funds in the structured entity to settle the derivatives). Accordingly, even if the swap

counterparty has the power to manage the assets of the structured entity, it is unlikely to be exposed to a variable return which is affected by that power. Meanwhile, the hedging of risks such as movements in foreign exchange and interest rates is normally pre-determined in the design of a structured entity, and so is unlikely to be considered a relevant activity.

However, if payments on a swap were subordinate to the rights of note holders, or contractually referenced to the performance of the underlying assets in the structured entity, the structured entity's ability to fulfil its obligations under the swap would be dependent on the performance of the underlying assets and that performance risk is a risk that the structured entity is designed to create and pass on. If the swap counterparty had power over the structured entity because it has the ability to manage its assets, it is likely that it would be deemed to have the ability to affect its variable returns and so would control the structured entity.

The treatment of swaps is illustrated by Examples 6 and 7.

Example 6: Structured entity that enters into foreign currency and interest rate swaps



Fact pattern

A structured entity is designed by a bank to meet the requirements of European investors who wish to be exposed to US corporate bonds without the foreign exchange risk. The structured entity buys dollar-denominated debt securities through the bank, issues Euro-denominated notes and hedges the cash flow differences through a series of swaps entered into with the bank. Subsequently, the structured entity collects and pays the resultant cash flows. The bonds will be held by the structured entity to maturity and cannot be substituted. The bank manages the assets, including in the event of their default and earns a fixed 1% fee for its services. The right to receive the fee ranks more senior than the notes.

Analysis

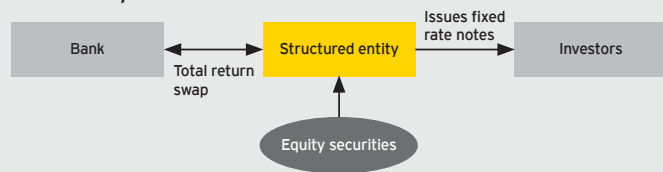
It is possible that the relevant activity is the management of the assets in the event of default, although the reader should refer to the discussion on this matter in the analysis of Example 3. If this is the case, power is held by the bank, since it has the existing rights that give it the current ability to direct this activity.

In evaluating the bank's exposures to variable returns from its involvement with the structured entity:

- ▶ The foreign currency and interest rate risks were not risks that the structured entity was designed to be exposed to or to pass on to the bank
- ▶ The bank's exposure to movements in foreign exchange and interest rate risks is not affected by its power over the relevant activity
- ▶ The fixed fee that the bank earns is not considered a variable return as its payment is unlikely to be affected by the credit risk of the bonds
- ▶ The bank's exposure to potential credit risk on its derivatives is considered insignificant as that risk would only arise if losses on the bonds were so large that there were insufficient funds in the structured entity to settle the derivatives

In conclusion, even if the bank has power by virtue of managing the defaults (i.e., the relevant activity), the bank has no exposure to variable returns and thus would not consolidate the structured entity.

Example 7: Structured entity that enters into a total return swap



Fact pattern

A structured entity acquires a portfolio of equity securities from the market, issues fixed rate notes and hedges the mismatch in cash flows between the equity securities and the notes through entering into a total return swap with a bank. The choice of equity securities that make up the portfolio is pre-agreed by the bank and the note investors, however, the bank also has substitution rights over the equity securities held by the structured entity within certain parameters. The terms of this swap are that the structured entity pays the bank any increase in value of the securities and any dividends received from them, while the bank pays the structured entity any decline in the value of the securities and interest at a fixed rate.

Analysis

The structured entity was designed to give equity risk to the bank while the note holders earn a fixed rate of interest. The bank's substitution rights over the equity securities is probably the relevant activity, because it may significantly affect the structured entity's returns; therefore, the bank has power. The bank also has an exposure to variable returns since it absorbs the equity risk. Since it has the ability to use its power to affect its returns from the total return swap, all three criteria for control are met and the bank would consolidate the structured entity.

Comparison with SIC 12

The bank would probably be regarded as meeting all four of the criteria in SIC 12 and so would consolidate the structured entity.

Example 8: Structured entity that enters into a total return swap with the transferor

Fact pattern

Assume the same facts as in Example 7, except that the bank originally sold the equity securities to the structured entity.

Analysis

As the bank has, through the total return swap, retained substantially all of the risks and rewards of ownership of the securities, it would not derecognise them. Consequently, the structured entity would not recognise the securities but, instead recognises a loan to the bank, collateralised by the securities. As the bank has not derecognised the securities, it has no variable return from its involvement with the structured entity. Hence, it would not consolidate the structured entity. The investors have no power, so they would not consolidate it either.

2.3 Reputational risk

The term 'reputational risk' often refers to the risk that failure of an entity could damage the reputation of an investor or sponsor. To protect its reputation, the investor or sponsor might be compelled to provide support to the failing entity, even though it has no legal or contractual obligation to do so. During the financial crisis, some financial institutions stepped in and provided financing for securitisation vehicles that they sponsored, and in some cases took control of these vehicles.

The IASB concluded that reputational risk 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.⁸ Accordingly, reputational risk alone would not be regarded as a source of variable returns and so would not require a bank to consolidate a structured entity that it sponsors. There are, however, disclosure requirements under IFRS 12 that require the provider of financial support to a structured entity to disclose the type and amount of support, including situations in which the entity assisted the structured entity in obtaining financial support, plus the reasons for providing the support. If financial support is not provided but the sponsor/investor intends to do so or intends to assist the structured entity in obtaining financial support, disclosure is also required.

2.2 Interaction of IFRS 10 with the derecognition requirements in IAS 39/IFRS 9

In evaluating whether an entity has an exposure to the variable returns of a structured entity, it is also necessary to consider the interaction with the derecognition requirements set out in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) and IFRS 9 *Financial Instruments* (IFRS 9) and, specifically, whether non-derecognition will impact on whether a transferor has exposure to variable returns arising from its involvement with a structured entity. The following example will help illustrate this issue.

⁸ BC39.

3.0 Investor's ability to use its power over investee to affect returns

If an investor has power and exposure or rights to variable returns from its involvement in an investee, to conclude that it controls an investee, the investor must have the ability to use that power to affect the amount of its returns. This is relatively straightforward if the investor is the only party that has exposure to the variable returns of an investee, but more difficult if other investors also have rights or are exposed to the same variable returns. How large do a decision maker's variable returns have to be, relative to the variable returns of other investors, that it is considered to exercise its power primarily on its own behalf rather than on behalf of the other investors?

3.1 Consideration of the principal vs agent guidance

When assessing whether a decision maker controls an investee, IFRS 10 requires a determination of whether a decision maker acts as a principal or an agent. An agent is a party whose primary purpose is to act on behalf and for the benefit of another party and therefore does not control the investee. A principal may delegate its decision making authority on some specific issues or on all relevant activities. Consideration is given to the overall relationship between the decision maker, the investee and other parties. In particular, all of the following factors are evaluated to determine whether the decision maker is an agent or a principal:

- ▶ The scope of its decision making authority
- ▶ The rights held by other parties, including their ability to appoint or replace ("kick out") the decision maker
- ▶ Its remuneration
- ▶ Its exposure to variability of returns through other interests

To reach a conclusion on whether a decision maker is acting as principal or agent, each of the four factors is weighted according to the facts and circumstances of each case, which will require judgement. The only situation that is likely to be conclusive on its own is when kick-out rights are held by a single investor and the decision maker can be removed without cause. These issues are explained in more detail in our recent publication, *Applying IFRS, IFRS 10 Consolidated Financial Statements – Challenges in Adopting and Applying the New Standard*.

In a typical structured entity, the scope of a decision maker's authority is evaluated by considering the activities that it is permitted to manage and the discretion that it has when making decisions about those activities. In the Basis for Conclusions, it is noted that the IASB rejected the idea that a decision maker would always be an agent if the breadth of its authority is narrow since, in part, this "would inappropriately lead to many investees, such as securitisation vehicles, not being classified as a controlled entity by a decision maker even though it might have a significant economic interest in the investee as well as discretion in making decisions about the relevant activities of the investee".⁹

In respect of the second factor, the other investors, such as the other note holders, are unlikely to possess the practical ability to remove the decision maker unless a single note holder possesses kick out rights or a small number of note holders possess such rights and those rights are considered substantive. (Note that if one party has the unilateral ability to liquidate the structure that would also be considered equivalent to a kick-out right). In respect of remuneration, the decision maker usually earns a relatively modest fixed fee for sponsoring and managing the structured entity, which has a higher seniority than the notes issued by the structured entity and so its payment is very unlikely to be affected by the entity's returns. In contrast, a fund manager will often earn a variable fee that depends on the performance of the fund. As a result, remuneration of the decision maker in a structured entity is not expected to be determinative in the evaluation unless the fee that the decision maker earns is significant and is not considered commensurate with the services provided and includes terms and conditions that are not customarily present in arrangements for similar services. In practice, the second and third factors mentioned above are less likely to be decisive in the evaluation as to whether a decision maker in a structured entity is acting as principal or agent.

When evaluating the exposure to variability of returns through other interests (the fourth factor), a decision maker needs to consider both the magnitude and variability of its exposure to variable returns and whether its exposure to variability of returns is different from that of other investors. In doing this, it must evaluate its exposure relative to the total variability of returns of the investee.

⁹ BC138.

At one extreme, it is noted in the Basis for Conclusions that, “If a decision maker receives a return that is relatively insignificant or varies insignificantly, most would be comfortable concluding that the decision maker uses any decision making authority delegated to it to affect the returns received by others”.¹⁰ This logic can be applied to the credit risk on a loan made by a decision maker to a structured entity (assuming that the decision maker has no other exposure to variable returns from the entity). As long as there is adequate loss-absorbing equity in a structured entity, the level of variability of returns associated with the loan will often be deemed sufficiently low as to indicate that the decision maker acts as an agent. But if the decision maker’s exposure or rights to returns is not insignificant and does not vary insignificantly, where should we draw the line?

There are several examples in IFRS 10 that illustrate whether a decision maker is likely to act as an agent or as a principal, although they do not provide any “bright lines”.

For instance, Example 14B of IFRS 10 deals with a fund manager who cannot effectively be kicked out (since he can only be removed ‘for cause’), has wide decision making discretion and receives a 1% fixed fee and a 20% performance fee and holds a 20% direct interest in the fund *pari passu* with other investors. According to the example, the fund manager “might consider a 20% investment to be sufficient to conclude that it controls the fund”.

It is possible to use this example, by analogy, to help assess whether a decision maker has control over a single tranche structured entity. It will be a matter of judgement as to how much emphasis is given to each of the indicators, but if the decision maker cannot effectively be removed, has a narrow scope of discretion and earns only a modest fixed fee, it is possible that if it also holds a direct investment of, say, 40% of the notes issued by the structured entity it would almost certainly consider itself to be acting as a principal and so control the structured entity.

Meanwhile, as IFRS 10 requires the consideration of the variability of returns of a decision maker compared with that of other investors, it is likely that a decision maker with a similar scope of discretion, ability to be kicked out and remuneration, might hold substantially more of a **senior tranche** of a structured entity and yet the variability of returns could be deemed to be sufficiently low as to indicate that the decision maker is acting as an agent.

In contrast, in Example 15 in IFRS 10, a fund manager has only a 3.5% direct investment in an investee that is created to purchase fixed rate asset-backed securities, funded by debt and equity instruments. It cannot, in effect, be kicked out (since the right to replace it is held by many investors), it has narrow discretion and receives a 1% fixed fee and a 10% performance fee. But the decision maker’s direct investment is a 35% share of the equity instruments, which on formation represent 10% of the value of the assets of the fund.. This subordinate exposure is deemed to be sufficient to make the manager a principal, and hence, it would control the entity.

By analogy, an investor who has power over a structured entity will often be deemed to control the structured entity if it holds a significant portion of the **equity** and/or **junior tranches**. The determination will depend on the decision maker’s scope of authority, the rights held by other parties, its remuneration, the size of the tranches, the variability of returns likely to be generated by the structured entity and the extent of any other interests held by the decision maker. (See Example 9 below).

In all cases, a decision maker may have control even when it does not have the “majority of the risks and rewards” indicators set out in SIC 12.¹¹ Consequently, decision makers will need to reconsider their consolidation assessments if these indicators were a major factor when applying SIC 12.

3.2 Relationship with other parties

IFRS 10 also requires an investor to consider whether there are other parties who are acting on behalf of the investor by virtue of their relationship with it. That is, IFRS 10 requires consideration of whether the other parties are acting as *de facto* agents for the investor. Such relationships need not be contractual.

IFRS 10 lists several examples of parties that *may* be considered *de facto* agents. These include a party that has received its interest in the investee as a contribution or loan from the investor, a party that cannot finance its operations without subordinated financial support from the investor, or an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor.

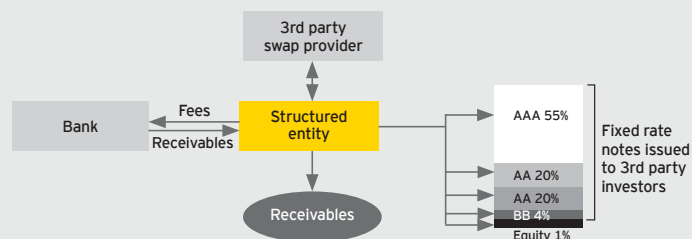
If a party is determined to be a *de facto* agent, then its rights and exposures to variable returns are considered together with those of the investor when evaluating whether an investor has control of an investee.

Given the breadth of the parties that might be a *de facto* agent in IFRS 10, there are likely to be numerous parties that need to be evaluated to determine if they are actually *de facto* agents, which requires careful evaluation of the facts and circumstances, including the purpose and design of the investee.

¹⁰ BC132.

¹¹ Paragraphs 10(c) and (d).

Example 9: Securitisation



Fact pattern

A bank establishes a structured entity to facilitate a securitisation. It transfers floating rate receivables to the structured entity. The structured entity issues tranching fixed rate notes to investors (rated AAA, AA, A and BB) and an equity tranche to the bank. The AAA tranche is the most senior and the equity tranche is the most junior in the event that there is insufficient cash to meet the payments under the terms of the notes.

The bank services the receivables on behalf of the structured entity including the management of defaults (if any), and has substitution rights over the receivables within certain parameters (for example, asset quality).

The bank receives a 1% fixed fee for managing the receivables that is commensurate with the level of work performed and only includes market terms. The investors are not able to remove the bank from performing this function, other than in exceptional circumstances, such as negligence by the bank.

A third party provides an interest rate swap to convert the cash flows of the receivables into the cash flows required to be paid to meet the terms of the notes.

As the bank retains only the equity tranche, it concludes that it is no longer exposed to substantially all the risks and rewards of ownership and can derecognise the receivables on transfer to the structured entity and recognises just the equity tranche as its continuing involvement in the receivables.

Analysis

Purpose and design

The structure was established for two purposes:

1. To enable the bank to generate external funding through the securitisation structure
2. To provide investors with an attractive investment opportunity

Identification of relevant activities

The activities of the structured entity that significantly affect its returns are:

1. Selection and transfer of assets at inception
2. Determining which assets are held by the structured entity (i.e., asset substitution)
3. Management of defaults on the receivables

Power over relevant activities

The bank has decision making rights over all of the relevant activities in its capacity as sponsor and service provider, so it has power.

Variable returns

The bank has exposure to variable returns through its holding of the equity tranche of the notes. The fixed fee that the bank earns is not considered a variable return as its payment is unlikely to be affected by the performance of the assets.

Ability to use its power to affect its returns

The bank has power over, and is also exposed to, variable returns from the equity tranche. However, the question arises as to whether the bank is using that power as principal or as agent, as discussed in Section 3.1. To make that determination, the four factors (scope of decision making authority, rights of other investors, remuneration and other interests) need to be evaluated. The scope of the bank's decision making authority is narrow, but it cannot easily be removed by the other investors. In respect of remuneration, the bank earns a modest fixed fee for services rendered that is commensurate with the services provided. Taking account of all the factors, the variability of returns of the equity tranche is likely to be significant relative to the total returns of the entity, such that the bank would be considered to exercise its power as principal rather than as agent. As a result, it is likely that the bank would be considered to use its power to affect its returns.

In conclusion, the bank has control and therefore consolidates the structured entity.

Comparison to SIC 12

It is likely that, under SIC 12, the bank would not be considered to be exposed to the majority of the risk or rewards. Consequently, it may not consolidate the structured entity.

4.0 Control of specified assets (silos)

IFRS 10 clarifies that an investor may have control over a *silo*. A silo is part of an entity, for which control is assessed as if it were a separate entity, when all of the following criteria are met:

- ▶ Specified assets of the entity are the only source of payment for specified liabilities of (or other interests in) the entity
- ▶ 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 the 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, effectively, the assets and liabilities are ring-fenced from the overall investee.¹²

An investor considers whether it treats a portion of an investee as a deemed separate entity (silo) and hence whether it controls that silo.

5.0 Continuous assessment

SIC 12 is silent on whether control is reassessed if circumstances change. Ordinarily, for a structured entity, changes in control are not expected after inception. However, in our view, reassessment of whether an entity continues to control a structured entity under SIC 12 is required when there is a change in the contractual arrangements between the parties to the structured entity; or any of the parties take steps to strengthen its position and, in doing so, takes control or acquires a larger holding in a structured entity which it already controls. But, SIC 12 is less clear on whether and how to respond to changes in the value of the assets of the structured entity, such that there is a shift in the balance of the risks and rewards that accrue to different investors. IFRS 10 clarifies that an investor must reassess whether it controls an entity if facts and circumstances indicate that there are changes to one or more of the three elements of control (that is, power, exposure to variable returns and the ability to use power to affect those returns).

The need to reassess control could be triggered, for instance, by one party's decision-making rights lapsing, a contract to receive performance-related fees terminating, or by the alteration of the overall relationship between investors so that the determination of whether an investor acts as an agent or as principal needs to be reconsidered.

IFRS 10 specifically says that an assessment of whether an investor acts as principal or agent "would not change simply because of a change in market conditions unless the change in market conditions changes one or more of the three elements of control"¹³ (one of which is an investor's exposure to variable returns). The question is how should this be interpreted?

As an example, an entity might be structured so that it has an equity tranche and various debt tranches. It is our view that consolidation would not be re-assessed just because losses on the entity's assets are so significant that they exceed the value of the equity tranche. This is because the equity tranche continues to exist and there is still an exposure to variable returns, due to the possibility that there could be recoveries on the underlying assets at some point in the future. But if, concurrent with the deterioration of the value of the equity tranche, there are other changes in facts and circumstances (e.g., the equity holder loses its ability to direct the relevant activities), this would most likely trigger a re-assessment. In this case, the trigger is actually the change in facts and circumstances, not the decrease in equity itself.

However, if the losses are so great that the equity holder determines that there is no reasonable expectation that any future cash flows will be derived from the tranche, it may be possible to conclude that the equity holder no longer has an exposure to variable returns and would cease to consolidate.

Consolidation will also usually need to be reassessed if there is a credit event that forces an entity to appoint a receiver, administrator or liquidator or restructure its debt. Depending on local laws and whether it is expected that the entity will emerge from the process and continue as a going concern, or whether it will be wound down, it will be necessary to determine on whose behalf the receiver, administrator or liquidator, or company management is now acting (that is, who has the exposure to variable returns), and so who should consolidate.

¹² IFRS 10 paragraph B77.

¹³ Paragraph B85 of IFRS 10.

Example 10: Troubled debt restructuring

A makes a loan to B and the loan agreement includes specific loan covenants that B is required to comply with. Subsequently, B encounters financial difficulties and consequently breaches certain covenants. Instead of calling the loan into default, A and B agree to restructure the loan. During the restructuring, A determines which assets will be sold to repay the loan, with management and the equity investors agreeing to this plan. In addition, management agrees to an incentive scheme under which payments are based on asset sale and loan repayment targets.

Upon restructuring the loan, A would need to evaluate whether determining which assets should be sold to repay the loan gives A power. This might be the case if voting rights do not give power over B, because management is required to comply with the asset sale plan mandated by A.

Before concluding which investors, if any, control B, consideration would also be given to what rights the equity investors have, if any, to direct the relevant activities of B, and also to whether A and the equity investors have exposure to variable returns from B.

6.0 Transition

IFRS 10 and IFRS 12 are effective for annual periods beginning on or after 1 January 2013. The new standards may be adopted early, but must be adopted together, as of the same date, except that an entity may early adopt the disclosure provisions for IFRS 12 without adopting IFRS 10. IFRS 10 and IFRS 12 are applied on a retrospective basis, although certain practical exceptions are given, the key one being that an investor need not make adjustments to the accounting for its involvement with an entity that was disposed of, or whose control was lost, in the comparative period(s).

As a result, an investor that did not previously consolidate a structured entity under SIC 12, but is required to do so under IFRS 10, need not adjust its opening balance sheet (i.e., 1 January 2012 for a non-SEC filer and 1 January 2011 for a SEC filer) if the interest in that structured entity is disposed of or control is lost (based on IFRS 10's requirements) in the comparative period (i.e., anytime before 1 January 2013).¹⁴ Similarly, an investor that consolidated a structured entity under SIC 12, but is not required to do so by IFRS 10, will not need to retrospectively adjust its financial statements if it sold the entity prior to 1 January 2013.

7.0 Business impact

Adopting IFRS 10 will require time and effort, and external assistance may be needed. Identifying the population of potential entities that require reconsideration is often a time-consuming and difficult task. Historically, some organisations may not have maintained a centralised system or process to record all their investments. Hence, identifying these entities including those interests that may be captured by the IFRS 12 disclosures and ensuring the completeness of the population may be arduous. Management should plan accordingly and begin the process early, considering the items below.

Increased use of judgement

A common feature throughout IFRS 10 is the increased reliance on judgement in assessing control, for example, determining whether:

- ▶ A particular activity is a 'relevant activity'
- ▶ A right is substantive or protective
- ▶ A derivative contract represents a variable return
- ▶ A decision maker is acting as agent or principal.

In addition, it will be necessary to ensure consistency across the various areas of judgement given the volume and complexity of deals.

Systems and processes

New processes and systems (or modifications to existing processes and systems) may be needed to gather information necessary to make judgements and to comply with the required disclosures, both at transition and on an ongoing basis. Facts and circumstances that impact the reassessment of control may change over time – processes should be adjusted accordingly.

Also, summary documentation of the individual deals may be focused on the SIC 12 risks and rewards analysis. As a result, organisations will need to obtain and review detailed legal documentation to determine whether there are any relevant activities and whether any investors have power over the relevant activity. To compound this issue, such legal documentation may not be easily available given the age of certain deals or if the documentation is not centrally stored.

¹⁴ This paragraph is based on the clarification proposed in the IASB's Exposure Draft *Transition Guidance Proposed Amendments to IFRS 10* issued in December 2011.

Estimates and valuation

Management may need to make new estimates to value the assets acquired and liabilities assumed, for example, to consolidate entities that are considered to be controlled under IFRS 10, or to measure retained interests upon deconsolidation. In some cases, the fair value of non-controlling interests may need to be determined, which can be complex. Management should plan for how it will obtain the information that will be required to make these estimates.

Key financial metrics

When there will be changes to the components of a group (i.e., new entities are consolidated, or previously consolidated entities are de-consolidated), management should consider how key financial metrics will be impacted. For example, total assets and total liabilities may increase or decrease, as will interest income and interest expense.

Management should assess how such changes will be presented on analyst calls, in earnings releases and other shareholder communications. When bonuses, share-based payment vesting conditions and other compensation plans are based on financial measures, management may need to reassess whether the original targets continue to be appropriate (i.e., can they still be met), considering the impact on such metrics from the adoption of IFRS 10.

Regulatory considerations

Changes in the group (i.e., which entities are controlled) could affect compliance with regulatory requirements, such as capital. Also, maintaining auditor independence, which is a joint responsibility of the auditor and management, may become more complex as a result of consolidating new entities (depending on how independence is defined for local requirements).

Internal controls

When there is a regulatory requirement to report on internal controls of the group, management should evaluate the internal controls it has in place related to newly-consolidated entities, and any effects of de-consolidation on the materiality of remaining entities, plus its controls over the new disclosure requirements.

Income taxes

In many cases, changes to the group (either adding new entities, or deconsolidating entities that were previously consolidated) will not affect the amount of income tax payable. However, in some cases, there might be a taxable gain or loss. Management should take steps to ensure that book and tax bases of newly consolidated assets and liabilities are carefully tracked, so that the presentation of deferred tax assets and liabilities is correct.

Structuring transactions and arrangements

Management needs to consider the requirements of the new IFRS when negotiating new arrangements or modifying existing ones. If management has historically structured arrangements in a manner that achieved a particular accounting treatment, it will need to consider whether the same results are achieved under the new standards. Although the effective date of these new standards is not until 1 January 2013, management is required to disclose the impact of adopting the new IFRS even before they become effective. An early analysis will help management avoid surprises and ease transition.

How will an investee's business be affected?

Under the new standards, investors are likely to request more information from an investee. This information will allow investors to assess whether they have control over the investee (or whether control is held by other investors), and it will also allow investors to comply with the additional disclosure requirements of the new standards.

If an investee itself also has investments in other entities, it will need to obtain this same information.

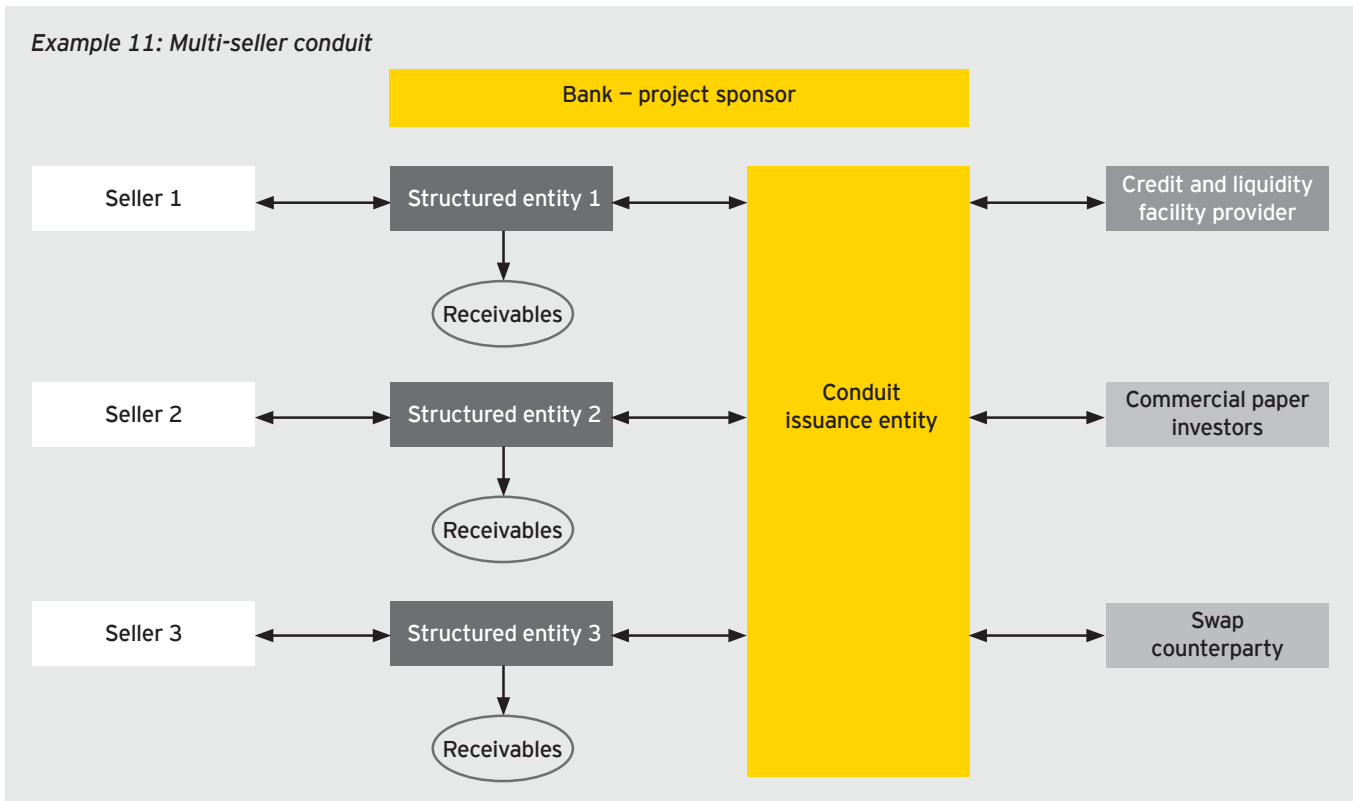
How Ernst & Young may be able to help

Ernst & Young has an experienced team of accounting, IFRS adoption, finance process, tax, and IT professionals to advise you in assessing how IFRS 10 and IFRS 12 will affect your business and to raise your level of preparedness. In the chart below, we outline the challenges that you are likely to face when preparing for IFRS 10 and IFRS 12 adoption, and we describe how Ernst & Young may be able to help.

Challenges	How Ernst & Young may be able to help
Understanding the technical accounting requirements of IFRS 10 and IFRS 12	<ul style="list-style-type: none"> ▶ Design and help deliver training sessions for your personnel on the accounting and financial statement disclosure implications of IFRS 10 and IFRS 12 ▶ Share insights and updates from the IASB and evolving market views
Determining the impact of IFRS 10 and IFRS 12 on the financial statements	<p>Advise you with:</p> <ul style="list-style-type: none"> ▶ Structured approaches to gathering the necessary scoping information to implement the new standards, including providing assistance with identifying the population of entities to be considered ▶ Identifying shortfalls in available information to adopt the new standards ▶ Assessing the impact of implementing IFRS 10 on key financial ratios, performance measures and regulatory capital ▶ Developing a process for managing the significant judgements and estimates that would be necessary ▶ Identifying potential events that could trigger a re-assessment of a consolidation conclusion ▶ Developing a process to embed these consolidation re-assessment triggers into the financial statement close process
Understanding the specific impact of IFRS 10 on the structured solutions business	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ Evaluating existing contractual arrangements for structured entities to determine the potential impact on your business ▶ The effects of IFRS 10's requirements as you design new structured trades for customers ▶ Analysing tax positions of existing structured trades with your customers
Understanding how your peer group is addressing the challenges of adoption	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching IFRS 10 and IFRS 12, problems they have encountered and solutions developed ▶ Assist in the evaluation of your position relative to your peers by sharing with you the results of our recent survey on the expected impact of IFRS 10 and IFRS 12 on an entity's financial statement close process
Assessing the impact on your key consolidation, reporting and disclosures preparation processes	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ Assessing your entity data collection and reporting processes against our leading practice model and identifying recommendations for enhancement ▶ Assessing your disclosure management processes and supporting infrastructure against our leading practice model and identifying potential efficiency and quality enhancements. ▶ Identifying necessary changes to other key Finance outputs and related processes and systems, including budgeting, planning and forecasting and risk reporting

Challenges	How Ernst & Young may be able to help
Assessing the impact on tax positions arising from the adoption of IFRS 10	<ul style="list-style-type: none"> ▶ Advise you in analysing changes to tax positions arising from the adoption of IFRS 10 and strategically managing the resulting impact
Planning for adoption of IFRS 10 and IFRS 12	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ The design of the adoption timeline ▶ Identifying and agreeing specific changes to entity data collection and reporting processes with local and group management ▶ Identifying and implementing changes to supporting IT systems ▶ Revising financial statements and other impacted reports
Understanding the areas to which management judgement needs to be applied	<ul style="list-style-type: none"> ▶ Advise management on those areas within IFRS 10 and IFRS 12 that require the careful use of judgement ▶ Provide input into accounting manuals and policies selected by management ▶ Provide you with coordinated support to Ernst & Young subject-matter resources (Regulatory, Tax, Finance, Transformation, etc.) on a global basis
Improving your adoption readiness	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ The effectiveness of your IFRS 10/12 adoption project and your overall state of readiness ▶ Your data collection and reporting processes, governance and resulting reports, including areas needing improvement in advance of adoption on 1 January 2013 ▶ Your remediation plans for any areas identified as requiring improvement
Stakeholder management	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan for appropriate education and briefing of key internal stakeholders ▶ Engage with your external reporting and investor relations teams regarding development of a communications plan

Appendix – Multi-seller conduit



Fact pattern

A bank establishes a multi-seller conduit to enable its clients to gain access to financing from third party investors (such as money market funds) at attractive rates.

The clients transfer assets in return for cash to separate structured entities, established to hold the assets transferred by each client. The classes of assets transferred are pre-approved by the bank (for example, vehicle finance receivables or credit card receivables). The structured entities borrow funds from a programme conduit issuance entity (the conduit) in order to finance the purchase of the receivables. The conduit finances the loans to the structured entities by issuing asset backed commercial paper (ABCP) to third party investors. The ABCP has a six-month term and pays a fixed rate of interest. At the end of each six-month period, the bank arranges for new commercial paper to be issued to finance the redemption of the previous issue. The conduit enters into an interest rate swap with a third party in order to mitigate the basis risk between the cash flows on the receivable collateral and the coupon payable on the ABCP. The bank earns a 100 basis-point fee for its role as programme arranger, which is paid by the conduit. Each seller services the assets that it transfers to the structured entity and manages them in the event of default for a market-based fee.

In order to support the credit rating of the ABCP, certain programme enhancement measures are entered into. First, the sellers (i.e., the clients) provide credit enhancement through over-collateralisation, whereby the value of the assets transferred exceeds the value of the ABCP issued. This over-collateralisation is sufficient to absorb the first 7% of losses experienced on the receivables. The sellers receive further consideration if the receivables repay with lower losses. A further credit enhancement facility is provided to the conduit by a third-party guarantor in return for a market-based fee. If losses exceed the value of protection provided by the over-collateralisation and the credit enhancement facility, then any further credit losses are absorbed by the ABCP investors.

There is also a liquidity facility that guarantees payment of the ABCP up to the lower of the par value of the ABCP and the amortised cost of the receivable collateral (excluding any receivables which have defaulted). This is needed as the maturity profile of the ABCP is shorter than that of the collateral, resulting in a risk that the refinancing of the ABCP may not be successful (for example, if there is a lack of demand for new issuances or a market disruption event).

The bank has the substantive ability to kick out the third-party service providers.

Scenario 1

The third party guarantor also provides the liquidity facility to the conduit.

Analysis

The following tables summarise the key roles undertaken by the bank as project sponsor and third party service providers:

Bank – programme sponsor

- ▶ Sponsors and establishes structure (i.e., is involved in the design)
- ▶ Approves new sellers
- ▶ Appoints service providers
- ▶ Approves classes of assets sold
- ▶ Administers day to day activities of the conduit
- ▶ Manages the commercial paper issuance programme

Third party service providers

- ▶ Liquidity facility provider
- ▶ Programme-wide credit enhancement provider
- ▶ Swap counterparty

The structured entities

Before proceeding to the consolidation analysis, it is necessary to determine whether the individual sellers would derecognise the assets that they have transferred to the structured entities. Under IAS 39/IFRS 9, it is likely that the sellers would fail derecognition due to their 'first loss' exposure (i.e., the sellers absorb the first 7 % of losses by transferring assets with a nominal value in excess of the value of the notes issued by the conduit). They retain substantially all of the risks and rewards associated with the assets. Consequently, the structured entities would not be permitted to recognise the underlying assets but, instead, will record loans to the sellers which are only exposed to losses to the extent that the losses exceed the level of over-collateralisation. As a result of non-derecognition of the assets, the question also arises as to whether the sellers have any exposure to variable returns of the structured entities.

In our opinion, a variable return does not exist from the sellers' involvement with the structured entities because the 'first loss' exposure did not arise from their involvement with the structured entities but pre-existed. That is, the sellers were always exposed to the credit risk of the assets and they continue to be exposed by virtue of non-derecognition.

As a result, the sellers would not consolidate the structured entities even though they may have power over the relevant activity by, for example, servicing the assets and managing them in the event of default.

The bank may, arguably, have power over the structured entities if approving new clients and the type of assets to be transferred was considered the activity that most significantly affects returns, but they too will not have an exposure to variable returns as they only earn a fixed 100 basis point fee for sponsoring the programme. Consequently, no entity would consolidate the structured entities, which would be viewed as passing on the cash flows of the assets to the conduit.

The conduit

The conduit serves as a vehicle to issue ABCP to third-party investors. The bank is responsible for setting up and managing the conduit. The conduit's balance sheet consists primarily of loans to the respective structured entities and ABCP issued to investors. The relevant activities of the conduit could be the following:

- ▶ Approving new clients (i.e., sellers) and the type of assets to be transferred
- ▶ Appointing and managing service providers (such as credit enhancement and liquidity providers)
- ▶ Managing the issue of commercial paper
- ▶ Servicing the assets and managing defaults since this will affect the cash flows receivable by the conduit
- ▶ Establishing and maintaining programme rules and guidelines (such as client and asset class approval criteria)

All of the above are performed by the bank with the exception of 'servicing the assets and managing defaults' which is carried out by the respective sellers.

Power over relevant activities

As described above, there are several relevant activities that are related to the operations of the conduit. However, arguably, the two most relevant activities are “servicing the assets and managing defaults” and “approving new clients and the type of assets to be transferred”, since these affect the conduit’s returns if credit losses are higher than the level of over- collateralisation provided by the sellers. Given that these two activities are performed by the individual sellers and the bank, respectively, the question arises as to which party has power.

In our opinion, the fact that the bank is unilaterally responsible for “selecting new clients and approving the type of assets to be transferred” would indicate that the bank has power when compared to multiple sellers who are responsible for servicing the different pools of assets and managing defaults, hence, no single seller would have power over the conduit.

Exposure to variable returns

As with the structured entities, the bank has no exposure to variable returns (i.e., it receives a fixed 100 basis point fee for arranging the programme which is protected from credit losses on the assets).

The sellers have exposure to variable returns by having access to future liquidity through the ABCP issuance programme.

The providers of the credit enhancement facility and liquidity facilities also have variable returns.

Ability to use power over the investee to affect the amount of the investor’s returns

The bank has power over the conduit with no exposure to variable returns while the sellers and third party providers have exposure to variable returns but do not appear to possess power.

Conclusion

As a result, no party would consolidate the conduit.

Scenario 2

Consider the same facts as in Scenario 1 above, except that the bank provides the liquidity facility and the credit enhancement facility. How would this change the consolidation analysis for the conduit?

Analysis

Similar to Scenario 1, the bank has power over the conduit, but in these circumstances, the bank also has exposure to variable returns as it bears the liquidity risk which is absorbed by the liquidity facility and the credit risk that is absorbed by the credit enhancement facility.

The bank is able to use its power to affect its returns by virtue of the fact that it is responsible for selecting new clients and approving the type of assets to be transferred. The bank would probably consolidate the conduit in these circumstances.

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