# Article

# Securitisation vehicles: Does unconsolidated status become easier under IFRS 10 and IFRS 12?

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# *Article*

IFRS 10 on consolidation and IFRS 12 on disclosures in certain entities were recently made applicable. The earlier standards on consolidation, particularly in case of special purpose vehicles (SIC 12) looked at the exposure of transferor to risks and returns of the special purpose vehicle and in most cases, consolidation was mandatory. However, IFRS 10 rewrites the requirements under a common standard, where the condition of control and exposure are cumulative. In addition, IFRS 12 puts an additional disclosure requirement in case of unconsolidated structured entities. It is notable that the question of whether the SPV gets consolidated with the transferor is quite significant even from the viewpoint of off-balance sheet accounting, as there is no de-recognition if the SPV is consolidated.

This article takes a quick look at the revised consolidation requirement and examines whether the new criteria will make it easier for SPVs to remain unconsolidated.

## Consolidation under IFRS 10:

IFRS 10 as a single consolidation standard was issued in May 2011, and applies to accounting periods commencing on or after 1st Jan 2013. IASB explains that "The standard was published to deal with divergence in practice when applying IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation—Special Purpose Entities. While the basic consolidation model and principles in IAS 27 and SIC-12 were sound, they were not always applied consistently"[1]. Thus, IFRS 10 has been explained as a consolidation of IAS 27 and SIC 12.

In addition, IASB also issued IFRS 12, Disclosure of Interest in Other Entities, which requires entities to disclose the risks due to variability of returns in other entities, to which the reporting entity is subjected.

While the basic determinant of consolidation requirement is still control, IAS 27 hinged on control, that is, the power to govern operating and financial policies so as to derive economic benefit from the activities of the subsidiary. The primary indicators of control, as per para 13 of IAS 27 were voting power and management control. SIC -12 extended the concept to residual risks of the enterprise, since in case of non-substantive SPVs; voting power is never of any importance.

As per IFRS 10, there are 3 indicators of control - power, exposure to variable returns, and an investor's ability to use power to affect its amount of variable returns [Para 7, IFRS 10]. ALL the 3 elements must be present in order to lead to consolidation. These indicators are explained in details in para 10 – 18.

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[1] http://www.ifrs.org/Current-Projects/IASB-Projects/Consolidation/Consol-disclosure/Documents/Effect-Analysis-IFRS%2010-and-IFRS-12-Updated-July-2013.pdf, last visited 2 Jan 2014.

## Power to direct returns-producing activities:

The first determinant of control is the power to direct the income-producing activities of the investee. Generally, the power arises from a right either attached with voting rights, or contractual right to direct activities. Power to direct policy-making must be distinguished from power to participate – participation right is considered as *significant influence*, and not control. Para 14 also clarifies that protective rights, such as veto rights or negative control rights, do not mean right to control.

Para B8 clarifies that some entities may be so designed that voting rights are not significant. In that case, the exposure to risks of the investee will be important.

## Exposure to variability of returns:

An investor has exposure to variability of returns when the investor's returns vary based on the investee's performance. Holders of non-controlling share in the investee will also be exposed to variability of returns – however, since all the 3 elements are cumulative, the exposure to variability has to exist along with control.

## Power to use control as principal:

The third condition connects the prior two – the investor has the ability to use the investor's power over the investee to affect the investor's returns from the investment or involvement. Such use of power should be in the capacity of a principal, and not agent. There is an elaborate guidance in paras B58 to B73 on the exercise of control as principal or agent, but the long and short of the story is that if the control is being exercised by the controller as agent of some principal, then the consolidation will be done by the principal and not by the agent. Whether the controller is exercising control in his own right, or as agent, will be visible from several factors, such as the scope of the decision-making authority, remuneration of the agent being unconnected with performance of the entity, right of third parties to remove the controller, the controller's exposure to variability of returns, etc.

## Combination of 3 conditions:

What is needed for consolidation is the combination of all the 3 elements above – that is, existence of power, exposure to variability of returns, and the use of the power to affect the variability of returns. A mere existence of control, without exposure to variability, will not make the controller a holding company. Likewise, a mere exposure to variability exists in case of every investor, but then the first element – control – is also necessary.

## Consolidation where all the conditions satisfied:

Where all the above conditions are satisfied, the parent, that is, the entity satisfying each of the 3 conditions above, consolidates the subsidiary.

An important exception in IFRS 10 is that an investment entity that fair values its investments is not required to do a consolidation. Instead, it would report the investment in subsidiary at fair value through profit and loss account, as per IFRS 9.

## Disclosure of exposure under IFRS 12:

While IFRS 10 provides for consolidation in circumstances where control and exposure to variability of returns exist, IFRS 12 requires certain disclosures to be made in respect of subsidiaries, joint ventures, joint operations, associates, as well as unconsolidated structured entities. Thus, structured entities may be consolidated, if the conditions of IFRS 10 are satisfied, or not consolidated, if such conditions are not satisfied.
A structured entity is defined as "an entity that has been designed so that voting or similar 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." Para B22 further lays some specific attributes of structured entities:

a. restricted activities.
b. a narrow and well-defined objective, such as to effect a tax-efficient lease, carry out research and development activities, provide a source of capital or funding to an entity or provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.
c. insufficient equity to permit the structured entity to finance its activities without subordinated financial support.
d. financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).

B23 specifically mentioned securitisation vehicles as an example of structured entities.

In case of all consolidated entities, that is subsidiaries, the parent is required to disclose the details given in Para 12 – these are essentially performance-related details of subsidiaries.

In case of consolidated structured entities, in addition to the details required for subsidiaries, the parent shall also disclose the financial support which it has provided, and that which it is required contractually to provide. For example, in case of ABCP conduits, the sponsor may be required to provide liquidity facility.

In case of unconsolidated structured entities, IFRS 12, para 24 requires disclosure of nature and extent of interests in unconsolidated structured entities, and nature of risks associated with such entities. Some of the details required are nature, purpose, size and activities of the structured entity and how the structured entity is financed. However, more important is the disclosure about the risks to which the reporting entity is exposed, pertaining to the unconsolidated structured entity. This disclosure requires the following:

- the carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities;
- the line items in the statement of financial position in which those assets and liabilities are recognised;
- the amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it shall disclose that fact and the reasons;
- a comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities.

## Impact on securitization transactions:

It has been explained that the introduction of IFRS 10 removes the "bright lines" that were earlier pertinent under SIC 12: "Another criticism of IAS 27 and SIC-12 was that the requirements led to a focus on 'bright lines' and provided structuring opportunities rather than focusing on the nature of a reporting entity's relationship with an investee"[2]. For example, under SIC 12, entities will typically compute whether the investor entity was exposed to risks and rewards to the extent of 50% or more. With this bright-line test going away, there is possibly a greater sense of responsibility on the accountant and auditor in treating the entity as a subsidiary.

However, since the focus shifts to control, and not merely variability of returns, it may be such, in fact, that SPVs are able to slip out of the formerly-open-ended approach of SIC 12. On the contrary, since IFRS 12 provides for disclosures pertaining to unconsolidated structured entities, originators may find the disclosure option better. It is important to understand that since off-balance sheet treatment will itself be seen from a group perspective, the ability to not consolidate the structured entity, even if one has to make disclosures, will be quite important.

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[2] http://www.ifrs.org/Current-Projects/IASB-Projects/Consolidation/Consol-disclosure/Documents/Effect-Analysis-IFRS%2010-and-IFRS-12-Updated-July-2013.pdf, last visited 3rd Jan 2013.