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11 March 2005

Clerk to Bills Committee on Companies (Amendment) Bill 2004
(Attn: Ms. Connie Szeto)
Legislative Council Secretariat
3/F, Citibank Tower
3 Garden Road, Hong Kong

Dear Connie,

Companies (Amendment) Bill 2004
Proposed legislative amendments to the definition of "subsidiary"

Accounting Standards

1. Subsequent to the 5th Bills Committee meeting on 24 February 2005, we write to provide the information sought by the Bills Committee. Accordingly, copies of the following are attached as ***Annex 1***:

(a) Hong Kong Accounting Standard ("**HKAS**") 27; and
(b) Hong Kong Accounting Standard – Interpretation 12 ("**HKAS-Int** 12"); and
(c) Financial Reporting Standard ("**FRS**") 5.

2. HKAS 27 and HKAS-Int 12 are the local equivalents of the international accounting standards which deal with consolidation of subsidiaries (IAS 27) and special purpose entities (SIC-12). FRS 5 is the UK accounting standard dealing with linked presentation.

German True Sale Initiative

3. A member requested further information regarding the True Sale Initiative in Germany mentioned on page two of the submission from Ms. Ann Rutledge[1]. We enclose copy of a press release issued by KFW Bankengruppe dated 30 April 2004 (***Annex 2***) providing some background to the True Sale Initiative, which was launched in early 2003 and completed in June 2004. The Initiative established a common securitisation platform (i.e., special purpose entity ("**SPE**"))

[1] LC Paper No. CB(1)938/04-5(08)

available to all market participants to facilitate securitisation in Germany. However, we understand that to date the True Sale Initiative has only had limited success (see attached Financial Times article dated 20 January 2005 – ***Annex 3***).

Specific impact of the Bill on Hong Kong's securitisation industry

4. We refer to your letter dated 3 March 2005 requesting further information on the following two issues:

(a) the type(s) of "control" that a transferor (or originator) needed to exercise over its securitisation SPE, including a situation where the SPE was set up under the "auto-pilot" mechanism; and

(b) other possible alternatives to address the issue, e.g. whether a mechanism could be devised in such a way that securitisation SPEs would not fall within the proposed definition of "subsidiary" and hence would not be subject to consolidation in companies' group accounts.

5. We would first like to clarify the effect of the proposed legislative amendments which introduce the HKAS test of "control" into the Companies Ordinance ("**CO**"). Secondly, we will address the issues raised in paragraph 4 above. Our conclusion is that any securitisation structure or transaction which can be devised to avoid being caught by the proposed amendments would be devoid of the typical characteristics of a securitisation, deprive the originator of the majority of the incentives for securitisation and be tantamount to requiring an outright sale of assets to a third party.

Tests to determine existence of parent-subsidiary relationship

6. The Companies (Amendment) Bill 2004 will introduce a new test of "**right to exercise a dominant influence**" as a test of a parent-subsidiary relationship. Footnote No. 2 to the Legislative Council Brief[2] explains the reasons for the amendment, which is to align the CO with international accounting standards.

7. Under the accounting standards, there is a singular test for determining whether a parent-subsidiary relationship exists between two entities. Paragraph 4 of HKAS 27 sets out the following definitions, from which it can be seen that the test is one based on the concept of "control":

> A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).
>
> Control is the **power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.**

[2] File Ref.:C2/1/57/2(04) Pt. 5

"Dominant influence" test under the Companies Ordinance

8. Section 5 of the proposed Twenty-third Schedule to the CO provides that "dominant influence" is "the right to give directions with respect to the operating and financial policies of that other undertaking which the directors are, or a majority of the directors is, obliged to comply with whether or not they are for the benefit of that other undertaking."

Introduction of "control-based" test into Companies Ordinance

9. It can be seen that the proposed new test of "dominant influence" is almost identical in wording to the test for determining a parent-subsidiary relationship set out in HKAS 27, i.e., the power to govern the financial and operating polices of the entity so as to obtain benefits from its activities. Accordingly, the effect of the legislative amendments will be to introduce the accounting concept of "control" and the various examples of what constitutes control, as set out in HKAS 27 and HKAS-Int 12, into the CO test for determining the existence of a parent-subsidiary relationship.

10. In light of the foregoing, the answer to the second issue raised by legislators as to whether transaction originators could structure a securitisation SPE in such a way that it does not fall under the definition of "subsidiary" cannot be made in isolation solely with reference to the CO and must also take into account the requirements of the relevant accounting standards.

"Control-based" test as applied to special purpose entities under HKAS-Int 12

11. In relation to an SPE, paragraph 10 of HKAS-Int 12 sets out a series of further circumstances which may indicate the existence of a parent-subsidiary relationship between an entity and an SPE, even where little or none of the SPE's equity is held by the controlling entity:

(a) the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operations (the "**activities test**");

(b) the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the entity has delegated those decision-making powers (the "**decision-making test**");

(c) the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE (the "**benefits test**"); or

(d) the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities (the "**risks test**").

12. Additional guidance as to the indicators of control over an SPE is given in the Appendix to HKAS-Int 12, which gives some further examples of situations which would tend to indicate the existence of control.

Type(s) of "control" exercised over securitisation SPEs

13. For ease of reference, we set out in ***Annex 4*** a table of the typical characteristics of a securitisation structure or transaction. Each characteristic is assessed against the four "control" tests in HKAS-Int 12 (set out in paragraph 11 above) to see whether it would be caught by any test and therefore require the SPE to be consolidated.

14. The table demonstrates that every one of the features would be caught by at least one test and accordingly would have to be removed in order for the SPE not to fall within the proposed definition of "subsidiary". However, if all the offending features were removed, the transferor would effectively have no specific role other than as a seller/buyer counterparty and all the typical securitisation options would have to be outsourced to or obtained from third party service providers. Moreover, such third party service providers might themselves end up having to consolidate the SPE if they retained significant risks/benefits. This would greatly reduce the incentives for securitisation transactions, not only on the part of the transferor but also on the part of the third party service providers, since consolidation of the SPE might affect their financial ratios. Finally, the inability to offer any of the options would reduce the attractiveness of asset-backed securities to investors and require a higher yield to compensate, thereby increasing the cost of issuance to the transferor and further reducing the incentive for securitisation.

15. A securitisation structure that could avoid being caught by the tests in HKAS-Int 12 would generally be devoid of the typical characteristics of a securitisation, deprive the originator of the majority of the incentives for securitisation and be tantamount to requiring an outright sale of assets to a third party. In other words, it is foreseeable that there will not be much left of the "genuine securitisation transaction" as contended by the Hong Kong Institute of Certified Public Accountants.

16. It is for the above reasons that the securitisation industry has requested a carve-out from the proposed amendments.

Yours sincerely,

The Hong Kong Mortgage Corporation Limited

Submissions to the Bills Committee dated 11 March 2005

Annexes

Annex 1(a)	Hong Kong Accounting Standard ("**HKAS**") 27; and
Annex 1(b)	Hong Kong Accounting Standard – Interpretation 12 ("**HKAS-Int 12**")
Annex 1(c)	Financial Reporting Standard ("**FRS**") 5
Annex 2	Press release issued by KFW Bankengruppe dated 30 April 2004
Annex 3	Financial Times article dated 20 January 2005
Annex 4	Table assessing the characteristics of a typical securitisation transaction with the "control" tests under HKAS-Int 12

Hong Kong Accounting Standard 27

Consolidated and Separate Financial Statements

Contents

Hong Kong Accounting Standard 27

Consolidated and Separate Financial Statements

Hong Kong Accounting Standard 27 *Consolidated and Separate Financial Statements* (HKAS 27) is set out in paragraphs 1-45 and the Appendix. All the paragraphs have equal authority. HKAS 27 should be read in the context of the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 27

Consolidated and Separate Financial Statements

Scope

1. ***This Standard shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.***

2. This Standard does not deal with methods of accounting for business combinations and their effects on consolidation, including goodwill arising on a business combination (see HKFRS 3 *Business Combinations*).

3. ***This Standard shall also be applied in accounting for investments in subsidiaries, jointly controlled entities and associates when an entity elects, or is required by local regulations, to present separate financial statements.***

3A. This Standard defines a subsidiary as "an entity that is controlled by another entity". For this purpose, control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This definition of subsidiary could result in an investee entity being classified as a subsidiary when it does not meet the definition of a subsidiary as set out in section 2(4) of the Companies Ordinance.

3B. In issuing this Standard, the ~~Hong Kong Society of Accountants~~Hong Kong Institute of Certified Public Accountants has obtained legal advice on the legality of introducing a requirement in this Standard to consolidate certain entities which are not subsidiaries as defined by section 2(4) of the Companies Ordinance in group accounts of a Hong Kong incorporated company. The legal opinion states that the definitions of "subsidiary" and "holding company" in sections 2(4) and 2(7) of the Companies Ordinance are exhaustive for the purposes of group accounts as defined by section 124(1) of the Companies Ordinance. Accordingly, a Hong Kong incorporated company may not consolidate a company that does not meet the definition of a subsidiary in the Companies Ordinance.

3C. The principles laid down in this Standard are applicable to Hong Kong incorporated companies except to the extent that the legal constraints do not permit them to include in their consolidated financial statements an entity which does not meet the definition of a subsidiary in the Companies Ordinance. However, this Standard requires Hong Kong incorporated companies to disclose certain additional information to enable users of the consolidated financial statements to assess the effects as if this Standard had been fully complied with.

Definitions

4. ***The following terms are used in this Standard with the meanings specified:***

***Consolidated financial statements** are the financial statements of a group presented as those of a single economic entity.*

***Control** is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.*

*The **cost method** is a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.*

*A **group** is a parent and all its subsidiaries.*

***Minority interest** is that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.*

A parent is an entity that has one or more subsidiaries.

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

5. A parent or its subsidiary may be an investor in an associate or a venturer in a jointly controlled entity. In such cases, consolidated financial statements prepared and presented in accordance with this Standard are also prepared so as to comply with HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures*.

6. For an entity described in paragraph 5, separate financial statements are those prepared and presented in addition to the financial statements referred to in paragraph 5. Separate financial statements need not be appended to, or accompany, those statements.

7. The financial statements of an entity that does not have a subsidiary, associate or venturer's interest in a jointly controlled entity are not separate financial statements.

8. A parent that is exempted in accordance with paragraph 10 from presenting consolidated financial statements may present separate financial statements as its only financial statements.

Presentation of Consolidated Financial Statements

9. A parent, other than a parent described in paragraph 10, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with this Standard.

10. A parent need not present consolidated financial statements if and only if[1]:

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

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

(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

11. A parent that elects in accordance with paragraph 10 not to present consolidated financial statements, and presents only separate financial statements, complies with paragraphs 37-42.

[1] Section 124(2) of the Hong Kong Companies Ordinance (CO) permits a holding company not to prepare group accounts if the company is a wholly-owned subsidiary of another company at the end of its financial year. Accordingly, a Hong Kong incorporated parent company can only take advantage of the exemption under paragraph 10 of this Standard if it also satisfies the exemption allowed under Section 124(2) of the CO.

Scope of Consolidated Financial Statements

12. ~~*Consolidated financial statements shall include all subsidiaries of the parent, except those referred to in paragraph 16.*~~ ***Consolidated financial statements shall include all subsidiaries of the parent.***[2]

13. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is: [3]

    (a) power over more than half of the voting rights by virtue of an agreement with other investors;

    (b) power to govern the financial and operating policies of the entity under a statute or an agreement;

    (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

    (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

14. An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

15. In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert.

16. ~~*A subsidiary shall be excluded from consolidation when there is evidence that (a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its disposal within twelve months from acquisition and (b) management is actively seeking a buyer. Investments in such subsidiaries shall be classified as held for trading and accounted for in accordance with HKAS 39* Financial Instruments: Recognition and Measurement.~~[Deleted]

17. ~~When a subsidiary previously excluded from consolidation in accordance with paragraph 16 is not disposed of within twelve months, it shall be consolidated as from the date of acquisition (see HKAS 22). Financial statements for the periods since acquisition shall be restated.~~ [Deleted]

18. ~~Exceptionally, an entity may have found a buyer for a subsidiary excluded from consolidation in accordance with paragraph 16, but may not have completed the sale within twelve months of acquisition because of the need for approval by regulators or others. The entity is not required to consolidate such a subsidiary if the sale is in process at the balance sheet date and there is no reason to believe that it will not be completed shortly after the balance sheet date.~~[Deleted]

19. A subsidiary is not excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or similar entity.

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[2] If on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it shall be accounted for in accordance with that Standard.

[3] See also HKAS-Int 12 *Consolidation—Special Purpose Entities*.

20. A subsidiary is not excluded from consolidation because its business activities are dissimilar from those of the other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by HKAS 14 *Segment Reporting* help to explain the significance of different business activities within the group.

21. A parent loses control when it loses the power to govern the financial and operating policies of an investee so as to obtain benefit from its activities. The loss of control can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when a subsidiary becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

Specific provisions for Hong Kong incorporated companies

21A. ***In preparing consolidated financial statements of a Hong Kong incorporated company, only companies that fall within the definition of a subsidiary as set out in section 2(4) of the Companies Ordinance may be consolidated. Therefore, for the purposes of applying this Standard, Hong Kong incorporated companies should use the definition of a subsidiary as set out in section 2(4) of the Companies Ordinance where it conflicts with the definition in paragraph 4 above.***

21B. ***In the circumstances where a company is a subsidiary as defined by section 2(4) of the Companies Ordinance but the parent does not have unilateral control over it, it should not be dealt with in the consolidated financial statements as a subsidiary. Where a subsidiary is excluded on the grounds of lack of effective control, it should be accounted for as a jointly controlled entity in accordance with HKAS 31*** **Interests in Joint Ventures** ***or an associate in accordance with HKAS 28,*** **Investments in Associates,** ***as appropriate.***

Consolidation Procedures

22. In preparing consolidated financial statements, an entity combines the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single economic entity, the following steps are then taken:

    (a) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated (see HKFRS 3, which describes the treatment of any resultant goodwill);

    (b) minority interests in the profit or loss of consolidated subsidiaries for the reporting period are identified; and

    (c) minority interests in the net assets of consolidated subsidiaries are identified separately from the parent shareholders' equity in them. Minority interests in the net assets consist of:

        (i) the amount of those minority interests at the date of the original combination calculated in accordance with HKFRS 3; and

        (ii) the minority's share of changes in equity since the date of the combination.

23. When potential voting rights exist, the proportions of profit or loss and changes in equity allocated to the parent and minority interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights.

24. ***Intragroup balances, transactions, income and expenses shall be eliminated in full.***

25. Intragroup balances and transactions, including income, expenses and dividends, are eliminated in full. Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full. Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. HKAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

26. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same reporting date. When the reporting dates of the parent and a subsidiary are different, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.

27. When, in accordance with paragraph 26, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a reporting date different from that of the parent, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements. In any case, the difference between the reporting date of the subsidiary and that of the parent shall be no more than three months. The length of the reporting periods and any difference in the reporting dates shall be the same from period to period.

28. Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

29. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements.

30. ~~The income and expenses of a subsidiary are included in the consolidated financial statements from the date of acquisition as defined in HKAS 22.~~The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date, as defined in HKFRS 3. The income and expenses of a subsidiary are included in the consolidated financial statements until the date on which the parent ceases to control the subsidiary. The difference between the proceeds from the disposal of the subsidiary and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the subsidiary recognised in equity in accordance with HKAS 21 *The Effects of Changes in Foreign Exchange Rates*, is recognised in the consolidated income statement as the gain or loss on the disposal of the subsidiary.

31. An investment in an entity shall be accounted for in accordance with HKAS 39 from the date that it ceases to be a subsidiary, provided that it does not become an associate as defined in HKAS 28 or a jointly controlled entity as described in HKAS 31.

32. The carrying amount of the investment at the date that the entity ceases to be a subsidiary shall be regarded as the cost on initial measurement of a financial asset in accordance with HKAS 39.

33. Minority interests shall be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. Minority interests in the profit or loss of the group shall also be separately disclosed.

34. The profit or loss is attributed to the parent shareholders and minority interests. Because both are equity, the amount attributed to minority interests is not income or expense.

35. Losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the subsidiary's equity. The excess, and any further losses applicable to the minority, are allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses. If the subsidiary subsequently reports profits, such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

36. If a subsidiary has outstanding cumulative preference shares that are held by minority interests and classified as equity, the parent computes its share of profits or losses after adjusting for the dividends on such shares, whether or not dividends have been declared.

Accounting for Investments in Subsidiaries, Jointly Controlled Entities and Associates in Separate Financial Statements

37. ~~*When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates shall be accounted for either:*~~

~~*(a) at cost, or*~~

~~*(b) in accordance with HKAS 39.*~~

~~*The same accounting shall be applied for each category of investments.*~~

When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 shall be accounted for either:

(a) at cost, or

(b) in accordance with HKAS 39.

The same accounting shall be applied for each category of investments. Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 shall be accounted for in accordance with that HKFRS.

38. This Standard does not mandate which entities produce separate financial statements available for public use. Paragraphs 37 and 39-42 apply when an entity prepares separate financial statements that comply with Hong Kong Financial Reporting Standards. The entity also produces consolidated financial statements available for public use as required by paragraph 9, unless the exemption provided in paragraph 10 is applicable.

39. ~~*Investments in subsidiaries, jointly controlled entities and associates that are accounted for in accordance with HKAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.*~~*Investments in jointly controlled entities and associates that are accounted for in accordance with HKAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.*

Disclosure

40. *The following disclosures shall be made in consolidated financial statements:*

(a) ~~*the fact that a subsidiary is not consolidated in accordance with paragraph 16;*~~[Deleted]

(b) ~~*summarised financial information of subsidiaries, either individually or in groups, that are not consolidated, including the amounts of total assets, total liabilities, revenues and profit or loss;*~~ [Deleted]

(c) *the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;*

(d) *the reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control;*

(e) *the reporting date of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent, and the reason for using a different reporting date or period; and*

(f) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances.

41. When separate financial statements are prepared for a parent that, in accordance with paragraph 10, elects not to prepare consolidated financial statements, those separate financial statements shall disclose:

(a) the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards have been produced for public use; and the address where those consolidated financial statements are obtainable;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b).

42. When a parent (other than a parent covered by paragraph 41), venturer with an interest in a jointly controlled entity or an investor in an associate prepares separate financial statements, those separate financial statements shall disclose:

(a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b);

and shall identify the financial statements prepared in accordance with paragraph 9 of this Standard, HKAS 28 and HKAS 31 to which they relate.

Specific disclosures for Hong Kong incorporated companies

42A. When a Hong Kong incorporated company holds an entity which would be a subsidiary as defined in paragraph 4 but is not accounted for as a subsidiary as a result of paragraph 21A, it should disclose in the notes details of the effect on the consolidated financial statements had the exemption given in paragraph 21A not applied.

Effective Date

43. An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact and apply Hong Kong Accounting Standards Interpretation (HKAS-Int 12) **Consolidation – Special Purpose Entities** *at the same time.*

43A. If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the same effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).

Withdrawal of Other Pronouncements

44. This Standard supersedes SSAP 32 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (issued in 2001).

45. This Standard supersedes Interpretation 18 *Consolidation and Equity Method — Potential Voting Rights and Allocation of Ownership Interests.*

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at ~~August~~ December 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 27.

The International Accounting Standard comparable with HKAS 27 is IAS 27 *Consolidated and Separate Financial Statements.*

The following sets out the major textual differences between HKAS 27 and IAS 27 and the reason for the differences.

Differences	Reason for the Differences
Provisions for Hong Kong incorporated companies Additional paragraphs are inserted: a. to give the background on why Hong Kong incorporated companies should use the definition of subsidiary as set out in section 2(4) of the Companies Ordinance (see paragraphs 3A to 3C); b. to include specific provisions for Hong Kong incorporated companies in applying this Standard (see paragraphs 21A and 21B); and c. to require specific disclosures for Hong Kong incorporated companies (see paragraph 42A).	The Standard recognises that, in preparing consolidated financial statements, a company incorporated under the Hong Kong Companies Ordinance does not consolidate an entity that does not meet the definition of a subsidiary under that Ordinance. The Standard also takes the view that in the circumstances where a company is a subsidiary as defined by the Companies Ordinance but the parent does not have unilateral control over it, it should not be dealt with in the consolidated financial statements as a subsidiary but as a jointly controlled entity.

Appendix

Amendments to Other Pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

As explained in the introduction to this Standard, the accounting standard and paragraph references that appear below may differ from those found in the existing SSAPs as they have taken into account the changes to be made to the name, number, paragraph numbering as well as appendix referencing of the existing SSAPs in order to conform to those of the equivalent IASs.

A1. [Not used]

A2. [Not used]

A3. [Not used]

A4. In Hong Kong Financial Reporting Standards, including Hong Kong Accounting Standards and Interpretations, applicable at December 2003, references to the current version of SSAP 32 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* are amended to HKAS 27 *Consolidated and Separate Financial Statements.*

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, HKAS 27.

HKAS 27 is based on IAS 27, *Consolidated and Separate Financial Statements*. In approving HKAS 27, the Council of the Hong Kong ~~Society of Accountants~~Institute of Certified Public Accountants considered and agreed with the IASB's basis for conclusions on IAS 27 (as revised 2003). Accordingly, there are no significant differences between HKAS 27 and IAS 27. The IASB's basis for conclusions is reproduced below for reference. The paragraph numbers of IAS 27 referred to below generally correspond with those in HKAS 27.

Introduction

BC1. This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2. In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 27. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3. Because the Board's intention was not to reconsider the fundamental approach to consolidation established in IAS 27, this Basis for Conclusions does not discuss requirements in IAS 27 that the Board has not reconsidered.

Presentation of Consolidated Financial Statements

Exemption from Preparing Consolidated Financial Statements

BC4. Paragraph 7 of the previous version of IAS 27 required consolidated financial statements to be presented. However, paragraph 8 permitted a parent that is a wholly-owned or virtually wholly-owned subsidiary not to prepare consolidated financial statements. The Board considered whether to withdraw or amend this exemption from the general requirement.

BC5. The Board decided to retain an exemption, so that entities in a group that are required by law to produce financial statements available for public use in accordance with International Financial Reporting Standards, in addition to consolidated financial statements, would not be unduly burdened.

BC6. The Board noted that in some circumstances users can find sufficient information for their purposes regarding a subsidiary from either its separate financial statements or consolidated financial statements. In addition, the users of financial statements of a subsidiary often have, or can get access to, more information.

BC7. Having agreed to retain an exemption, the Board decided to modify the circumstances in which an entity would be exempt and considered the following criteria.

Unanimous agreement of the owners of the minority interests

BC8. The Exposure Draft proposed to extend the exemption to a parent that is not wholly-owned if the owners of the minority interest, including those not otherwise entitled to vote, unanimously agree.

BC9. Some respondents disagreed with the proposal for unanimous agreement of minority shareholders to be a condition for exemption, in particular because of the practical difficulties in obtaining responses from all of those shareholders. The Board decided that the exemption

should be available to a parent that is not wholly-owned when the owners of the minority interests have been informed about, and do not object to, consolidated financial statements not being presented.

Exemption available only to non-public entities

BC10. The Board believes that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market are best served when investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IASs 27, 28 *Investments in Associates* and 31 *Interests in Joint Ventures*. The Board therefore decided that the exemption from preparing such consolidated financial statements should not be available to such entities or to entities in the process of issuing instruments in a public market.

BC11. The Board decided that a parent that meets the criteria for exemption from the requirement to prepare consolidated financial statements should, in its separate financial statements, account for those subsidiaries in the same way as other parents, venturers with interests in jointly controlled entities or investors in associates account for investments in their separate financial statements. The Board draws a distinction between accounting for such investments as equity investments and accounting for the economic entity that the parent controls. In relation to the former, the Board decided that each category of investment should be accounted for consistently.

BC12. The Board decided that the same approach to accounting for investments in separate financial statements should apply irrespective of the circumstances for which they are prepared. Thus, parents that present consolidated financial statements, and those that do not because they are exempted, should present the same form of separate financial statements.

Scope of Consolidated Financial Statements

Scope Exclusions

BC13. Paragraph 13 of the previous version of IAS 27 required a subsidiary to be excluded from consolidation when control is intended to be temporary or when the subsidiary operates under severe long-term restrictions.

Temporary control

BC14. The Board considered whether to remove this scope exclusion and thereby converge with other standard-setters that had recently eliminated a similar exclusion. The Board decided to consider this issue as part of a comprehensive standard dealing with asset disposals. It decided to retain an exemption from consolidating a subsidiary when there is evidence that the subsidiary is acquired with the intention to dispose of it within twelve months and that management is actively seeking a buyer. The Board's Exposure Draft ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* proposes to measure and present assets held for sale in a consistent manner irrespective of whether they are held by an investor or in a subsidiary. Therefore, ED 4 proposes to eliminate the exemption from consolidation when control is intended to be temporary and contains a draft consequential amendment to IAS 27 to achieve this*.

Severe long-term restrictions impairing ability to transfer funds to the parent

BC15. The Board decided to remove the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that impair a subsidiary's ability to transfer funds to the parent. It did so because such circumstances may not preclude control. The Board decided that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent. In themselves, such restrictions do not preclude control.

Venture capital organisations, private equity entities and similar organisations

BC16. The Exposure Draft of IAS 27 proposed to clarify that a subsidiary should not be excluded from consolidation simply because the entity is a venture capital organisation, mutual fund, unit trust

* In March 2004, the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 removes this scope exclusion and now eliminates the exemption from consolidation when control is intended to be temporary. See IFRS 5 Basis for Conclusions for further discussion.

or similar entity. Some respondents from the private equity industry disagreed with this proposed clarification. They argued that private equity entities should not be required to consolidate the investments they control in accordance with the requirements in IAS 27. They argued that they should measure those investments at fair value. Those respondents raised varying arguments—some based on whether control is exercised, some on the length of time that should be provided before consolidation is required, and some on whether consolidation was an appropriate basis for private equity entities or the type of investments they make.

BC17. Some respondents also noted that the Board decided to exclude venture capital organisations and similar entities from the scope of IASs 28 and 31 when investments in associates or jointly controlled entities are measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. In the view of these respondents, the Board was proposing that similar assets should be accounted for in dissimilar ways.

BC18. The Board did not accept these arguments. The Board noted that these issues are not specific to the private equity industry. It confirmed that a subsidiary should not be excluded from consolidation on the basis of the nature of the controlling entity. Consolidation is based on the parent's ability to control the investee, which captures both the power to control (ie the ability exists but it is not exercised) and actual control (ie the ability is exercised). Consolidation is triggered by control and should not be affected by whether management intends to hold an investment in an entity that it controls for the short term.

BC19 The Board noted that the exception from the consolidation principle in the previous version of IAS 27, when control of a subsidiary is intended to be temporary, might have been misread or interpreted loosely. Some respondents to the Exposure Draft had interpreted "near future" as covering a period of up to five years. The Board decided to remove these words and to restrict the exception to subsidiaries acquired and held exclusively for disposal within twelve months, providing that management is actively seeking a buyer.

BC20. —The Board did not agree that it should differentiate between types of entity, or types of investment, when applying a control model of consolidation. It also did not agree that management intention should be a determinant of control. Even if it had wished to make such differentiations, the Board did not see how or why it would be meaningful to distinguish private equity investors from other types of entities.

BC21. The Board believes that the diversity of the investment portfolios of entities operating in the private equity sector is not different from the diversification of portfolios held by a conglomerate, which is an industrial group made up of entities that often have diverse and unrelated interests. The Board acknowledged that financial information about an entity's different types of products and services and its operations in different geographical areas—segment information—is relevant to assessing the risks and returns of a diversified or multinational entity and may not be determinable from the aggregated data presented in the consolidated balance sheet. The Board noted that IAS 14 *Segment Reporting* establishes principles for reporting segment information by entities whose equity or debt instruments are publicly traded, or any entity that discloses segment information voluntarily.

BC22. The Board concluded that for investments under the control of private equity entities, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control. The Board noted that a parent can either present information about the fair value of those investments in the notes to the consolidated financial statements or prepare separate financial statements in addition to its consolidated financial statements, presenting those investments at cost or at fair value. By contrast, the Board decided that information needs of users of financial statements would not be well served if those controlling investments were measured only at fair value. This would leave unreported the assets and liabilities of a controlled entity. It is conceivable that an investment in a large, highly geared subsidiary would have only a small fair value. Reporting that value alone would preclude a user from being able to assess the financial position, results and cash flows of the group.

Minority Interests

BC23. Minority interest is defined in IAS 27 and ~~IAS 22~~ IFRS 3 *Business Combinations* as that part of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent. Paragraph 26 of the previous version of IAS 27 required minority interests to be presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.

BC24. The Board decided to amend this requirement and to require minority interests to be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. The Board agreed that a minority interest is not a liability of a group because it does not meet the definition of a liability in the *Framework for the Preparation and Presentation of Financial Statements*.

BC25. Paragraph 49(b) of the *Framework* states that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Paragraph 60 of the *Framework* further indicates that an essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The Board noted that the existence of a minority interest in the net assets of a subsidiary does not give rise to a present obligation of the group, the settlement of which is expected to result in an outflow of economic benefits from the group.

BC26. Rather, the Board noted that a minority interest represents the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group, and therefore meets the *Framework*'s definition of equity. Paragraph 49(c) of the *Framework* states that equity is the residual interest in the assets of the entity after deducting all its liabilities.

BC27. The Board acknowledged that this decision gives rise to questions about the recognition and measurement of minority interests but it concluded that the proposed presentation is consistent with current standards and the *Framework* and would provide better comparability than presentation in the consolidated balance sheet with either liabilities or parent shareholders' equity. It decided that the recognition and measurement questions should be addressed as part of its project on business combinations.

Measurement of Investments in Subsidiaries, Jointly Controlled Entities and Associates in Separate Financial Statements

BC28. Paragraph 29 of the previous version of IAS 27 permitted investments in subsidiaries to be measured in any one of three ways in a parent's separate financial statements. These were cost, the equity method, or as available-for-sale financial assets in accordance with IAS 39. Paragraph 12 of the previous version of IAS 28 permitted the same choices for investments in associates in separate financial statements, and paragraph 38 of the previous version of IAS 31 mentioned that IAS 31 did not indicate a preference for any particular treatment for accounting for interests in jointly controlled entities in a venturer's separate financial statements. The Board decided to require use of cost or IAS 39 for all investments included in separate financial statements.

BC29. Although the equity method would provide users with some profit and loss information similar to that obtained from consolidation, the Board noted that such information is reflected in the investor's economic entity financial statements and does not need to be provided to the users of its separate financial statements. For separate statements, the focus is upon the performance of the assets as investments. The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39 or the cost method would be relevant. Using the fair value method in accordance with IAS 39 would provide a measure of the economic value of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. For example, they may be needed only by particular parties to determine the dividend income from subsidiaries.

BC30. For investments in subsidiaries that are not consolidated in accordance with paragraph 16 of IAS 27 (ie because control is temporary), paragraph 30 of the previous version of IAS 27 permitted the same alternatives as were permitted in paragraph 29 of the previous version of IAS 27 for those that were consolidated—cost, the equity method, or as available-for-sale financial assets in accordance with IAS 39. The Board considered whether to eliminate one or more of these choices and decided that these subsidiaries should be accounted for consistently in both the consolidated and separate financial statements.

Dissenting Opinion

DO1. Mr Yamada dissents from this Standard because he believes that the change in classification of minority interests in the consolidated balance sheet, that is to say, the requirement that it be shown as equity, should not be made as part of the Improvements project. He agrees that minority interests do not meet the definition of a liability under the *Framework for the Preparation and Presentation of Financial Statements*, as stated in paragraph BC25 of the Basis for Conclusions, and that the current requirement, for minority interests to be presented separately from liabilities and the parent shareholders' equity, is not desirable. However, he does not believe that this requirement should be altered at this stage. He believes that before making the change in classification, which will have a wide variety of impacts on current consolidation practices, various issues related to this change need to be considered comprehensively by the Board. These include consideration of the objectives of consolidated financial statements and the accounting procedures that should flow from those objectives. Even though the Board concluded as noted in paragraph BC27, he believes that the decision related to the classification of minority interests should not be made until such a comprehensive consideration of recognition and measurement is completed.

DO2. Traditionally, there are two views of the objectives of consolidated financial statements; they are implicit in the parent company view and the economic entity view. Mr Yamada believes that the objectives, that is to say, what information should be provided and to whom, should be considered by the Board before it makes its decision on the classification of minority interests in IAS 27. He is of the view that the Board is taking the economic entity view without giving enough consideration to this fundamental issue.

DO3. Step acquisitions are being discussed in the second phase of the Business Combinations project, which is not yet finalised at the time of finalising IAS 27 under the Improvements project. When the ownership interest of the parent increases, the Board has tentatively decided that the difference between the consideration paid by the parent to minority interests and the carrying value of the ownership interests acquired by the parent is recognised as part of equity, which is different from the current practice of recognising a change in the amount of goodwill. If the parent retains control of a subsidiary but its ownership interest decreases, the difference between the consideration received by the parent and the carrying value of the ownership interests transferred is also recognised as part of equity, which is different from the current practice of recognising a gain or a loss. Mr Yamada believes that the results of this discussion are predetermined by the decision related to the classification of minority interests as equity. The changes in accounting treatments are fundamental and he believes that the decision on which of the two views should govern the consolidated financial statements should be taken only after careful consideration of the ramifications. He believes that the amendment of IAS 27 relating to the classification of minority interests should not be made before completion of the second phase of the Business Combinations project.

Implementation Guidance

Guidance on implementing HKAS 27 *Consolidated and Separate Financial Statements*, HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures.*

This guidance accompanies HKAS 27, HKAS 28 and HKAS 31, but is not part of them.

Consideration of Potential Voting Rights

Introduction

IG1. Paragraphs 14, 15 and 23 of HKAS 27 *Consolidated and Separate Financial Statements* and paragraphs 8 and 9 of HKAS 28 *Investments in Associates* require an entity to consider the existence and effect of all potential voting rights that are currently exercisable or convertible. They also require all facts and circumstances that affect potential voting rights to be examined, except the intention of management and the financial ability to exercise or convert potential voting rights. Because the definition of joint control in paragraph 3 of HKAS 31 *Interests in Joint Ventures* depends upon the definition of control, and because that Standard is linked to HKAS 28 for application of the equity method, this guidance is also relevant to HKAS 31.

Guidance

IG2. Paragraph 4 of HKAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Paragraph 2 of HKAS 28 defines significant influence as the power to participate in the financial and operating policy decisions of the investee but not to control those policies. Paragraph 3 of HKAS 31 defines joint control as the contractually agreed sharing of control over an economic activity. In these contexts, power refers to the ability to do or effect something. Consequently, an entity has control, joint control or significant influence when it currently has the ability to exercise that power, regardless of whether control, joint control or significant influence is actively demonstrated or is passive in nature. Potential voting rights held by an entity that are currently exercisable or convertible provide this ability. The ability to exercise power does not exist when potential voting rights lack economic substance (eg the exercise price is set in a manner that precludes exercise or conversion in any feasible scenario). Consequently, potential voting rights are considered when, in substance, they provide the ability to exercise power.

IG3. Control and significant influence also arise in the circumstances described in paragraph 13 of HKAS 27 and paragraphs 6 and 7 of HKAS 28 respectively, which include consideration of the relative ownership of voting rights. HKAS 31 depends on HKAS 27 and HKAS 28 and references to HKAS 27 and HKAS 28 from this point onwards should be read as being relevant to HKAS 31. Nevertheless it should be borne in mind that joint control involves contractual sharing of control and this contractual aspect is likely to be the critical determinant. Potential voting rights such as share call options and convertible debt are capable of changing an entity's voting power over another entity—if the potential voting rights are exercised or converted, then the relative ownership of the ordinary shares carrying voting rights changes. Consequently, the existence of control (the definition of which permits only one entity to have control of another entity) and significant influence are determined only after assessing all the factors described in paragraph 13 of HKAS 27 and paragraphs 6 and 7 of HKAS 28 respectively, and considering the existence and effect of potential voting rights. In addition, the entity examines all facts and circumstances that affect potential voting rights except the intention of management and the financial ability to exercise or convert. The intention of management does not affect the existence of power and the financial ability of an entity to exercise or convert is difficult to assess.

IG4. An entity may initially conclude that it controls or significantly influences another entity after considering the potential voting rights that it can currently exercise or convert. However, the entity may not control or significantly influence the other entity when potential voting rights held by other parties are also currently exercisable or convertible. Consequently, an entity considers all potential voting rights held by it and by other parties that are currently exercisable or convertible when determining whether it controls or significantly influences another entity. For

example, all share call options are considered, whether held by the entity or another party. Furthermore, the definition of control in paragraph 4 of HKAS 27 permits only one entity to have control of another entity. Therefore, when two or more entities each hold significant voting rights, both actual and potential, the factors in paragraph 13 of HKAS 27 are reassessed to determine which entity has control.

IG5. The proportion allocated to the parent and minority interests in preparing consolidated financial statements in accordance with HKAS 27, and the proportion allocated to an investor that accounts for its investment using the equity method in accordance with HKAS 28, are determined solely on the basis of present ownership interests. The proportion allocated is determined taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, give access at present to the economic benefits associated with an ownership interest.

IG6. In some circumstances an entity has, in substance, a present ownership as a result of a transaction that gives it access to the economic benefits associated with an ownership interest. In such circumstances, the proportion allocated is determined taking into account the eventual exercise of those potential voting rights and other derivatives that give the entity access to the economic benefits at present.

IG7. HKAS 39 *Financial Instruments: Recognition and Measurement* does not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with HKAS 27, HKAS 28 and HKAS 31 respectively. When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of HKAS 39. In all other cases, instruments containing potential voting rights are accounted for in accordance with HKAS 39.

Illustrative Examples

IG8. The five examples below each illustrate one aspect of a potential voting right. In applying HKAS 27, HKAS 28 or HKAS 31, an entity considers all aspects. The existence of control, significant influence and joint control can be determined only after assessing the other factors described in HKAS 27, HKAS 28 and HKAS 31. For the purpose of these examples, however, those other factors are presumed not to affect the determination, even though they may affect it when assessed.

Example 1: Options are out of the money

Entities A and B own 80 per cent and 20 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity C. Entity A sells one-half of its interest to Entity D and buys call options from Entity D that are exercisable at any time at a premium to the market price when issued, and if exercised would give Entity A its original 80 per cent ownership interest and voting rights.

Though the options are out of the money, they are currently exercisable and give Entity A the power to continue to set the operating and financial policies of Entity C, because Entity A could exercise its options now. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of HKAS 27, are considered and it is determined that Entity A controls Entity C.

Example 2: Possibility of exercise or conversion

Entities A, B and C own 40 per cent, 30 per cent and 30 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entity A also owns call options that are exercisable at any time at the fair value of the underlying shares and if exercised would give it an additional 20 per cent of the voting rights in Entity D and reduce Entity B's and Entity C's interests to 20 per cent each. If the options are exercised, Entity A will have control over more than one-half of the voting power. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of HKAS 27 and paragraphs 6 and 7 of HKAS 28, are considered and it is determined that Entity A controls Entity D.

Example 3: Other rights that have the potential to increase an entity's voting power or reduce another entity's voting power

Entities A, B and C own 25 per cent, 35 per cent and 40 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entities B and C also have share warrants that are exercisable at any time at a fixed price and provide potential voting rights. Entity A has a call option to purchase these share warrants at any time for a nominal amount. If the call option is exercised, Entity A would have the potential to increase its ownership interest, and thereby its voting rights, in Entity D to 51 per cent (and dilute Entity B's interest to 23 per cent and Entity C's interest to 26 per cent).

Although the share warrants are not owned by Entity A, they are considered in assessing control because they are currently exercisable by Entities B and C. Normally, if an action (eg purchase or exercise of another right) is required before an entity has ownership of a potential voting right, the potential voting right is not regarded as held by the entity. However, the share warrants are, in substance, held by Entity A, because the terms of the call option are designed to ensure Entity A's position. The combination of the call option and share warrants gives Entity A the power to set the operating and financial policies of Entity D, because Entity A could currently exercise the option and share warrants. The other factors described in paragraph 13 of HKAS 27 and paragraphs 6 and 7 of HKAS 28 are also considered, and it is determined that Entity A, not Entity B or C, controls Entity D.

Example 4: Management intention

Entities A, B and C each own 331/3 per cent of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entities A, B and C each have the right to appoint two directors to the board of Entity D. Entity A also owns call options that are exercisable at a fixed price at any time and if exercised would give it all the voting rights in Entity D. The management of Entity A does not intend to exercise the call options, even if Entities B and C do not vote in the same manner as Entity A. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of HKAS 27 and paragraphs 6 and 7 of HKAS 28, are considered and it is determined that Entity A controls Entity D. The intention of Entity A's management does not influence the assessment.

Example 5: Financial ability

Entities A and B own 55 per cent and 45 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity C. Entity B also holds debt instruments that are convertible into ordinary shares of Entity C. The debt can be converted at a substantial price, in comparison with Entity B's net assets, at any time and if converted would require Entity B to borrow additional funds to make the payment. If the debt were to be converted, Entity B would hold 70 per cent of the voting rights and Entity A's interest would reduce to 30 per cent.

Although the debt instruments are convertible at a substantial price, they are currently convertible and the conversion feature gives Entity B the power to set the operating and financial policies of Entity C. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of HKAS 27, are considered and it is determined that Entity B, not Entity A, controls Entity C. The financial ability of Entity B to pay the conversion price does not influence the assessment.

Table of Concordance

This table shows how the contents of the superseded SSAP 32 and the current HKAS 27 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

The table also shows how the requirements of Interpretation 18 have been incorporated into the current HKAS 27.

Superseded SSAP 32 paragraph	Current HKAS 27 paragraph
1	1
2	3
3	3A
4	3B
5	3C
6	None
7	2
8	4
9	9
10	10, 41
11	None
12	None
13	12
14	13
15	None
16-22	HKAS-Int-12
23	16
24-25	17-19
26	20
27	21A
28	21B
29	22
30	None
31	24
32	25
33	26
34	27
35	28
36	29

Superseded SSAP 32 paragraph or Interpretation	Current HKAS 27 paragraph
37	30
38	31
39	32
40	33
41	35
42	36
43	37
44	39
45	40
46	42A
47	43
Interpretation ~~8~~18	14, 15
None	5-8
None	11
None	21
None	23
None	34
None	38
None	41, 42
None	44, 45

Interpretation HKAS-INT – 12
Consolidation - Special Purpose Entities

Paragraph 14 of HKAS 1, Presentation of Financial Statements, requires that financial statements should not be described as complying with Hong Kong Financial Reporting Standards (HKFRSs) unless they comply with all the requirements of HKFRSs. Interpretations are not intended to apply to immaterial items.

Reference: HKAS 27 *Consolidated and Separate Financial Statements*

ISSUE

1. An entity may be created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitisation of financial assets). Such a special purpose entity ("SPE") may take the form of a corporation, trust, partnership or unincorporated entity. SPEs often are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so-called "autopilot").

2. The sponsor (or entity on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other parties ("capital providers") may provide the funding to the SPE. An entity that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE.

3. A beneficial interest in an SPE may, for example, take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Some beneficial interests may simply provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the entity on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.

4. HKAS 27 requires the consolidation of entities that are controlled by the reporting entity. However, the Standard does not provide explicit guidance on the consolidation of SPEs.

5. The issue is under what circumstances an entity should consolidate an SPE.

6. This Interpretation does not apply to post-employment benefit plans or equity compensation plans.

7. A transfer of assets from an entity to an SPE may qualify as a sale by that entity. Even if the transfer does qualify as a sale, the provisions of HKAS 27 and this Interpretation may mean that the entity should consolidate the SPE. This Interpretation does not address the circumstances in which sale treatment should apply for the entity or the elimination of the consequences of such a sale upon consolidation.

CONSENSUS

8. An SPE should be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.

9. In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on "autopilot") or otherwise. HKAS 27.13 indicates several circumstances which result in control even in cases where an entity owns one half or less of the voting power of another entity. Similarly, control may exist even in cases where an entity owns little or none of the SPE's equity. The application of the control concept requires, in each case, judgement in the context of all relevant factors.

10. In addition to the situations described in HKAS 27.13, the following circumstances, for example, may indicate a relationship in which an entity controls an SPE and consequently should consolidate the SPE (additional guidance is provided in the Appendix to this Interpretation):

    (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation;

    (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the entity has delegated these decision making powers;

    (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or

    (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

11. [Deleted]

BASIS FOR CONCLUSIONS

12. HKAS 27.12 states that "consolidated financial statements shall include all subsidiaries of the parent". HKAS 27.04 defines a parent as "an entity that has one or more subsidiaries", a subsidiary as "an entity including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)", and control as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". Paragraph 35 of the Framework and HKAS 8.10(b)(ii) require that transactions and other events are accounted for in accordance with their substance and economic reality, and not merely their legal form.

13. Control over another entity requires having the ability to direct or dominate its decision-making, regardless of whether this power is actually exercised. Under the definitions of HKAS 27.04, the ability to govern decision-making alone, however, is not sufficient to establish control. The ability to govern decision-making must be accompanied by the objective of obtaining benefits from the entity's activities.

14. SPEs frequently operate in a predetermined way so that no entity has explicit decision-making authority over the SPE's ongoing activities after its formation (i.e., they operate on "autopilot"). Virtually all rights, obligations, and aspects of activities

that could be controlled are predefined and limited by contractual provisions specified or scheduled at inception. In these circumstances, control may exist for the sponsoring party or others with a beneficial interest, even though it may be particularly difficult to assess, because virtually all activities are predetermined. However, the predetermination of the activities of the SPE through an "autopilot" mechanism often provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated.

Date of Issue: March 2004

Effective Date: This Interpretation becomes effective for annual financial periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies should be accounted for in accordance with HKAS 8.

Appendix

The purpose of the appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

INDICATORS OF CONTROL OVER AN SPE

The examples in paragraph 10 of this Interpretation are intended to indicate types of circumstances that should be considered in evaluating a particular arrangement in light of the substance-over-form principle. The guidance provided in the Interpretation and in this Appendix is not intended to be used as "a comprehensive checklist" of conditions that must be met cumulatively in order to require consolidation of an SPE.

(a) *Activities*

The activities of the SPE, in substance, are being conducted on behalf of the reporting entity, which directly or indirectly created the SPE according to its specific business needs.

Examples are:

- the SPE is principally engaged in providing a source of long-term capital to an entity or funding to support an entity's ongoing major or central operations; or
- the SPE provides a supply of goods or services that is consistent with an entity's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself. Economic dependence of an entity on the reporting entity (such as relations of suppliers to a significant customer) does not, by itself, lead to control.

(b) *Decision-making*

The reporting entity, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision making powers may have been delegated by establishing an "autopilot" mechanism.

Examples are:

- power to unilaterally dissolve an SPE;
- power to change the SPE's charter or bylaws; or
- power to veto proposed changes of the SPE's charter or bylaws.

(c) *Benefits*

The reporting entity, in substance, has rights to obtain a majority of the benefits of the SPE's activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an entity that is engaged in transactions with an SPE and that entity stands to gain those benefits from the financial performance of the SPE.

Examples are:

- rights to a majority of any economic benefits distributed by an entity in the form of future net cash flows, earnings, net assets, or other economic benefits; or
- rights to majority residual interests in scheduled residual distributions or in a liquidation of the SPE.

(d) *Risks*

An indication of control may be obtained by evaluating the risks of each party engaging in transactions with an SPE. Frequently, the reporting entity guarantees a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the entity retains residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited.

Examples are:

- the capital providers do not have a significant interest in the underlying net assets of the SPE;
- the capital providers do not have rights to the future economic benefits of the SPE;
- the capital providers are not substantively exposed to the inherent risks of the
- underlying net assets or operations of the SPE; or
- in substance, the capital providers receive mainly consideration equivalent to a lender's return through a debt or equity interest.

Financial Reporting Standard 5 is set out in paragraphs 1–39.

The Statement of Standard Accounting Practice set out in paragraphs 11–39 should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2–10 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The Application Notes specify how some of the requirements of FRS 5 are to be applied to transactions that have certain features.

The Explanation set out in paragraphs 40–103 and the Application Notes shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix III 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on FRS 5.

[FRS 5]
Reporting the substance of transactions

(Issued April 1994, amended December 1994 and September 1998)

Contents

Reporting the substance of transactions

Summary

GENERAL

Financial Reporting Standard 5 'Reporting the Substance of Transactions' requires an entity's financial statements to report the substance of the transactions into which it has entered. The FRS sets out how to determine the substance of a transaction (including how to identify its effect on the assets and liabilities of the entity), whether any resulting assets and liabilities should be included in the balance sheet, and what disclosures are appropriate. The FRS also contains some provisions in respect of how transactions should be reported in the profit and loss account and the cash flow statement. a

The FRS will not change the accounting treatment and disclosure of the vast majority of transactions. It will mainly affect those more complex transactions whose substance may not be readily apparent. The true commercial effect of such transactions may not be adequately expressed by their legal form and, where this is the case, it will not be sufficient to account for them merely by recording that form. b

Transactions requiring particularly careful analysis will often include features such as – c

(i) the party that gains the principal benefits generated by an item is not the legal owner of the item,
(ii) a transaction is linked with others in such a way that the commercial effect can be understood only by considering the series as a whole, or
(iii) an option is included on terms that make its exercise highly likely.

The FRS sets out principles that will apply to all transactions. In addition, there are five Application Notes that describe the application of the FRS to transactions with certain features: consignment stock; sale and repurchase agreements; factoring; securitised assets; and loan transfers. The Application Notes need not be referred to in all cases. At the start of each Note there is a 'Features' section that may serve as a quick reference point to determine whether further study is required. In addition, each Note concludes with a table summarising its main provisions. d

Identification and recognition of the substance of transactions

A key step in determining the substance of any transaction is to identify whether it has given rise to new assets or liabilities for the entity and whether it has increased or decreased the entity's existing assets or liabilities. Assets are, broadly, rights or other access to future economic benefits controlled by an entity; liabilities are, broadly, an entity's obligations to transfer economic benefits. e

f The future economic benefits inherent in an asset are never completely certain in amount; there is always some risk that the benefits will turn out to be greater or less than expected. Whether the entity gains or suffers from such variations in benefits is evidence of whether it has an asset.

g The definition of a liability requires an obligation to transfer benefits. Evidence that an entity has such an obligation is given if there is some circumstance in which the entity is unable to avoid an outflow of benefits.

h Once identified, an asset or liability should be recognised (ie included) in the balance sheet, provided that there is sufficient evidence that an asset or liability exists, and the asset or liability can be measured at a monetary amount with sufficient reliability.

i Following its recognition, an asset may be affected by a subsequent transaction. Where the transaction does not significantly alter the entity's rights to benefits or its exposure to risks, the entire asset should continue to be recognised. Conversely, where the transaction transfers to others all significant rights to benefits and all significant exposure to risks, the entity should cease to recognise the asset in its entirety. Finally, in other cases where not all significant benefits and risks have been transferred, it may be appropriate to amend the description or monetary amount of an asset and, where necessary, recognise a liability for any obligations it has assumed.

Linked presentation for certain non-recourse finance arrangements

j A special form of presentation, termed a 'linked presentation', should be used for certain non-recourse finance arrangements. This presentation shows, on the face of the balance sheet, the finance deducted from the gross amount of the item it finances. It should be used where, although the entity has significant rights to benefits and exposure to risks relating to a specific item, the item is financed in such a way that the maximum loss the entity can suffer is limited to a fixed monetary amount. For there to be a linked presentation it is necessary that both –

(i) the finance will be repaid only from proceeds generated by the specific item it finances (or by transfer of the item itself) and there is no possibility whatsoever of a claim on the entity being established other than against funds generated by that item (or the item itself), and

(ii) there is no provision whatsoever whereby the entity may either keep the item on repayment of the finance or re-acquire it at any time.

Disclosure of the substance of transactions

k Adequate disclosure of a transaction is important to an understanding of its commercial effect. For most transactions, the disclosures currently required

sufficient for this purpose. However, where the nature of any recognised asset or liability differs from that of items usually found under the relevant balance sheet heading, the differences should be explained. Furthermore, to the extent that a transaction has not resulted in the recognition of assets or liabilities, disclosure may nevertheless be required in order to give an understanding of its commercial effect.

Quasi-subsidiaries

l Sometimes assets and liabilities are placed in an entity (a 'vehicle') that is in effect controlled by the reporting entity but does not meet the legal definition of a subsidiary. Where the commercial effect for the reporting entity is no different from that which would result were the vehicle a subsidiary, the vehicle will be a 'quasi-subsidiary'.

m The FRS requires the assets, liabilities, profits, losses and cash flows of any quasi-subsidiary to be included in the consolidated financial statements of the group that controls it in the same way as if they were those of a subsidiary. However, where a quasi-subsidiary is used to finance a specific item in such a way that the provisions of paragraph j above are met from the point of view of the group, the assets and liabilities of the quasi-subsidiary should be included in consolidated financial statements using the linked presentation described in paragraph j.

n Disclosure is required, in summary form, of the financial statements of quasi-subsidiaries.

Financial Reporting Standard 5

Objective

1 The objective of this FRS is to ensure that the substance of an entity's transactions is reported in its financial statements. The commercial effect of the entity's transactions and any resulting assets, liabilities, gains or losses, should be faithfully represented in its financial statements.

Definitions

The following definitions shall apply in this FRS and in particular in the Statement of Standard Accounting Practice set out in paragraphs 11–39.

2 ... or other access to future economic benefits controlled by an entity as a result of transactions or events.

3 *Control in the context of an asset:-*
The ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits.

4 *Liabilities:-*
An entity's obligations to transfer economic benefits as a result of past transactions or events.

5 *Risk:-*
Uncertainty as to the amount of benefits. The term includes both potential for gain and exposure to loss.

6 *Recognition:-*
The process of incorporating an item into the primary financial statements under the appropriate heading. It involves depiction of the item in words and by a monetary amount and inclusion of that amount in the statement totals.

7 *Quasi-subsidiary:-*
A quasi-subsidiary of a reporting entity is a company, trust, partnership or other vehicle that, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives rise to benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary.

8 *Control of another entity:-*
The ability to direct the financial and operating policies of that entity with a view to gaining economic benefit from its activities.

9 *Subsidiary:-*
A subsidiary undertaking as defined by companies legislation.

10 *Companies legislation:-*

(a) In Great Britain, the Companies Act 1985;
(b) in Northern Ireland, the Companies (Northern Ireland) Order 1986; and
(c) in the Republic of Ireland, the Republic of Ireland Companies Acts 1963–1990 and the European Communities (Companies: Group Accounts) Regulations 1992.

Statement of Standard Accounting Practice

SCOPE

11 Subject to paragraph 12, Financial Reporting Standard 5 applies to all transactions of a reporting entity whose financial statements are intended to give a true and fair

view of its financial position and profit or loss (or income and expenditure) for a period. In the FRS, the term 'transaction' includes both a single transaction or arrangement and also a group or series of transactions that achieves or is designed to achieve an overall commercial effect.

12 The following are excluded from the scope of the FRS, unless they are a part of a transaction that falls within the scope of the FRS:

(a) forward contracts and futures (such as those for foreign currencies or commodities);
(b) foreign exchange and interest rate swaps;
(c) contracts where a net amount will be paid or received based on the movement in a price or an index (sometimes referred to as 'contracts for differences');
(d) expenditure commitments (such as purchase commitments) and orders placed, until the earlier of delivery or payment; and
(e) employment contracts.

13 Where the substance of a transaction or the treatment of any resulting asset or liability falls not only within the scope of this FRS but also directly within the scope of another FRS, a Statement of Standard Accounting Practice ('SSAP'), or a specific statutory requirement governing the recognition of assets or liabilities, the standard or statute that contains the more specific provision(s) should be applied.

APPLICATION TO SMALLER ENTITIES

13A Reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt from this accounting standard unless preparing consolidated financial statements, in which case they should apply the FRS to such statements as required by the FRSSE.

GENERAL

The substance of transactions

14 A reporting entity's financial statements should report the substance of the transactions into which it has entered. In determining the substance of a transaction, all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole.

Quasi-subsidiaries

15 Where the entity has a quasi-subsidiary, the substance of the transactions entered into by the quasi-subsidiary should be reported in consolidated financial statements.

THE SUBSTANCE OF TRANSACTIONS

Identifying assets and liabilities

16 To determine the substance of a transaction it is necessary to identify whether the transaction has given rise to new assets or liabilities for the reporting entity and whether it has changed the entity's existing assets or liabilities.

17 Evidence that an entity has rights or other access to benefits (and hence has an asset) is given if the entity is exposed to the risks inherent in the benefits, taking into account the likelihood of those risks having a commercial effect in practice.

18 Evidence that an entity has an obligation to transfer benefits (and hence has a liability) is given if there is some circumstance in which the entity is unable to avoid, legally or commercially, an outflow of benefits.

19 Where a transaction incorporates one or more options, guarantees or conditional provisions, their commercial effect should be assessed in the context of all the aspects and implications of the transaction in order to determine what assets and liabilities exist.

Recognition of assets and liabilities

20 Where a transaction results in an item that meets the definition of an asset or liability, that item should be recognised in the balance sheet if –

(a) there is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur), and
(b) the item can be measured at a monetary amount with sufficient reliability.

Transactions in previously recognised assets

Continued recognition of an asset in its entirety

21 Where a transaction involving a previously recognised asset results in no significant change in –

(a) the entity's rights or other access to benefits relating to that asset, or

(b) its exposure to the risks inherent in those benefits,

the entire asset should continue to be recognised. In particular this will be the case for any transaction that is in substance a financing of a previously recognised asset, unless the conditions for a linked presentation given in paragraphs 26 and 27 are met, in which case such a presentation should be used.

Ceasing to recognise an asset in its entirety

22 Where a transaction involving a previously recognised asset transfers to others –

(a) all significant rights or other access to benefits relating to that asset, and
(b) all significant exposure to the risks inherent in those benefits,

the entire asset should cease to be recognised.

Special cases

23 Paragraphs 21 and 22 deal with most transactions affecting items previously recognised as assets. In other cases where there is a significant change in the entity's rights to benefits and exposure to risks but the provisions of paragraph 22 are not met, the description or monetary amount relating to an asset should, where necessary, be changed and a liability recognised for any obligations to transfer benefits that are assumed. These cases arise where the transaction takes one or more of the following forms:

(a) a transfer of only part of the item in question;
(b) a transfer of all of the item for only part of its life; and
(c) a transfer of all of the item for all of its life but where the entity retains some significant right to benefits or exposure to risk.

24 In the special cases referred to in paragraph 23, where the amount of any resulting gain or loss is uncertain, full provision should be made for any probable loss but recognition of any gain, to the extent it is in doubt, should be deferred. In addition, where the uncertainty could have a material effect on the financial statements, this fact should be disclosed in the notes to the financial statements.

The meaning of 'significant'

25 In applying paragraphs 21–23 above and paragraph 26 below, 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks.

Linked presentation for certain non-recourse finance arrangements

26 Where a transaction involving an item previously recognised as an asset is in substance a financing – and therefore meets the condition of paragraph 21 regarding

no significant change in the entity's access to benefits or exposure to risks – but the financing 'ring-fences' the item such that –

(a) the finance will be repaid only from proceeds generated by the specific item it finances (or by transfer of the item itself) and there is no possibility whatsoever of a claim on the entity being established other than against funds generated by that item (or the item itself),
(b) there is no provision whatsoever whereby the entity may either keep the item on repayment of the finance or re-acquire it at any time, and
(c) all of the conditions given in paragraph 27 are met,

the finance should be shown deducted from the gross amount of the item it finances on the face of the balance sheet within a single asset caption (a 'linked presentation'). The gross amounts of the item and the finance should be shown on the face of the balance sheet and not merely disclosed in the notes to the financial statements. A linked presentation should also be used where an item that is financed in such a way that all of the above three conditions are met has not been recognised previously as an asset.

27 A linked presentation should be used only where all of the following are met:

(a) the finance relates to a specific item (or portfolio of similar items) and, in the case of a loan, is secured on that item but not on any other asset of the entity;
(b) the provider of the finance has no recourse whatsoever, either explicit or implicit, to the other assets of the entity for losses and the entity has no obligation whatsoever to repay the provider of finance;
(c) the directors of the entity state explicitly in each set of financial statements where a linked presentation is used that the entity is not obliged to support any losses, nor does it intend to do so;
(d) the provider of the finance has agreed in writing (in the finance documentation or otherwise) that it will seek repayment of the finance, as to both principal and interest, only to the extent that sufficient funds are generated by the specific item it has financed and that it will not seek recourse in any other form, and such agreement is noted in each set of financial statements where a linked presentation is used;
(e) if the funds generated by the item are insufficient to pay off the provider of the finance, this does not constitute an event of default for the entity; and
(f) there is no provision whatsoever, either in the financing arrangement or otherwise, whereby the entity has a right or an obligation either to keep the item upon repayment of the finance or (where title to the item has been transferred) to re-acquire it at any time. Accordingly:
    (i) where the item is one (such as a monetary receivable) that directly generates cash, the provider of the finance will be repaid out of the resulting cash receipts (to the extent these are sufficient); or
    (ii) where the item is one (such as a physical asset) that does not directly generate cash, there is a definite point at which either the item will be sold to a third party and the provider of the finance repaid from the proceeds (to the extent these are sufficient) or the item will be transferred to the provider of the finance in full and final settlement.

Where all of these conditions hold for only part of the finance, a linked presentation should be used for only that part. In such cases, the maximum future payment that the reporting entity could make (other than from funds generated by the specific item being financed) should be excluded from the amount deducted on the face of the balance sheet.

In respect of an arrangement for which a linked presentation is used, profit should be recognised on entering into the arrangement only to the extent that the non-returnable proceeds received exceed the previous carrying value of the item. Thereafter, any profit or loss deriving from the item should be recognised in the period in which it arises. The net profit or loss recognised in each period should be included in the profit and loss account and separate disclosure of its gross components should be given in the notes to the financial statements. 28

Offset

Assets and liabilities should not be offset. Debit and credit balances should be aggregated into a single net item where, and only where, they do not constitute separate assets and liabilities, ie where, and only where, all of the following conditions are met: 29

(a) The reporting entity and another party owe each other determinable monetary amounts, denominated either in the same currency, or in different but freely convertible currencies. For this purpose a freely convertible currency is one for which quoted exchange rates are available in an active market that can rapidly absorb the amount to be offset without significantly affecting the exchange rate;
(b) The reporting entity has the ability to insist on a net settlement. In determining this, any right to insist on a net settlement that is contingent should be taken into account only if the reporting entity is able to enforce net settlement in all situations of default by the other party; and
(c) The reporting entity's ability to insist on a net settlement is assured beyond doubt. It is essential that there is no possibility that the entity could be required to transfer economic benefits to another party whilst being unable to enforce its own access to economic benefits. For this to be the case it is necessary that the debit balance matures no later than the credit balance. It is also necessary that the reporting entity's ability to insist on a net settlement would survive the insolvency of the other party.

Disclosure of the substance of transactions

Disclosure of a transaction in the financial statements, whether or not it has resulted in assets or liabilities being recognised or ceasing to be recognised, should be 30

sufficient to enable the user of the financial statements to understand its commercial effect.

31 Where a transaction has resulted in the recognition of assets or liabilities whose nature differs from that of items usually included under the relevant balance sheet heading, the differences should be explained.

QUASI-SUBSIDIARIES

Identification of quasi-subsidiaries

32 In determining whether another entity (a 'vehicle') gives rise to benefits for the reporting entity that are in substance no different from those that would arise were the vehicle a subsidiary, regard should be had to the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them.

33 In determining whether the reporting entity controls a vehicle regard should be had to who, in practice, directs the financial and operating policies of the vehicle. The ability to prevent others from directing those policies is evidence of control, as is the ability to prevent others from enjoying the benefits arising from the vehicle's net assets.

34 Where the financial and operating policies of a vehicle are in substance predetermined, contractually or otherwise, the party possessing control will be the one that gains the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them.

Accounting for quasi-subsidiaries

35 Subject to paragraph 37, the assets, liabilities, profits, losses and cash flows of a quasi-subsidiary should be included in the group financial statements of the group that controls it in the same way as if they were those of a subsidiary. Where an entity has a quasi-subsidiary but no subsidiaries and therefore does not prepare group financial statements, it should provide in its financial statements consolidated financial statements of itself and the quasi-subsidiary, presented with equal prominence to the reporting entity's individual financial statements.

36 Paragraph 35 should be applied by following the requirements regarding the preparation of consolidated financial statements set out in companies legislation and in FRS 2 'Accounting for Subsidiary Undertakings'. However, quasi-subsidiaries should be excluded from consolidation only where the interest in the quasi-subsidiary is held exclusively with a view to subsequent resale* and the quasi-subsidiary has not previously been included in the reporting entity's consolidated financial statements.

Where a quasi-subsidiary holds a single item or a single portfolio of similar items and the effect of the arrangement is to finance the item in such a way that the provisions of paragraphs 26 and 27 are met from the point of view of the group, the quasi-subsidiary should be included in consolidated financial statements using a linked presentation. 37

Disclosure of quasi-subsidiaries

Where one or more quasi-subsidiaries are included in consolidated financial statements, this fact should be disclosed. A summary of the financial statements of each quasi-subsidiary should be provided in the notes to the financial statements, unless the reporting entity has more than one quasi-subsidiary of a similar nature, in which case the summary may be given on a combined basis. These summarised financial statements should show separately each main heading in the balance sheet, profit and loss account, statement of total recognised gains and losses and cash flow statement for which there is a material item, together with comparative figures. 38

DATE FROM WHICH EFFECTIVE

Subject to paragraph 39A, the accounting practices set out in the FRS should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 22 September 1994.† Earlier adoption is encouraged but not required. 39

(a) The requirements of paragraph 29 in so far as they relate to balances arising either from insurance broking transactions or, for insurers (including Lloyd's syndicates), from insurance transactions placed through brokers, and 39A
(b) the accounting practices set out in the FRS, in so far as they relate to financial reinsurance accounted for by Lloyd's syndicates as at 31 December 1993,

should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 22 September 1996. Where, in accordance with the previous sentence, the accounting practices set out in the FRS are not applied for accounting periods ending on or after 22 September 1994, this fact and, where available, a quantification of the effect should be disclosed.

** As defined in FRS 2, paragraph 11.*

† Editor's note: The effective date for Application Note F Private Finance Initiative and Similar Contracts is accounting periods ending on or after 10 September 1998.

Explanation

SCOPE

40 The scope of the FRS, as set out in paragraph 11, extends to all kinds of transactions, subject only to the exclusions given in paragraph 12. Most transactions are straightforward, giving rise to a number of standard rights and obligations with the result that their substance and commercial effect are readily apparent. Applying established accounting practices will be sufficient to ensure that the substance of such transactions is properly reported in the financial statements, without the need to refer to the FRS.

41 Conversely, applying established accounting practices may not be sufficient to portray the substance of more complex transactions whose commercial effect may not be readily apparent. For such transactions it will be necessary to refer to the FRS in order to ensure that their substance is correctly identified and properly reported.

Exclusions from the FRS

42 Paragraph 12 excludes from the FRS certain contracts for future performance except where they are merely a part of a transaction (or of a group or series of transactions) that falls within the FRS. For example, an interest rate swap forming part of a securitisation would fall to be considered under the FRS in relation to its role in the securitisation. Conversely, an interest rate swap that was no more than a part of an entity's overall treasury management activities would fall outside the scope of the FRS.

Other standards

43 The FRS sets out general principles relevant to reporting the substance of all transactions. Other accounting standards, the Application Notes of the FRS and companies legislation apply general principles to particular transactions or events. It follows that where a transaction falls within the scope of both the FRS and another accounting standard or statute, whichever contains the more specific provisions should be applied. Nevertheless, the specific provisions of any standard or statute should be applied to the substance of the transaction and not merely to its legal form and, for this purpose, the general principles set out in FRS 5 will be relevant.

44 Pension obligations are an example of an item falling within the scope of both FRS 5 and another standard, the latter being SSAP 24 'Accounting for pension costs'. As SSAP 24 contains the more specific provisions on accounting for pension obligations and does not require consolidation of pension funds, such funds should not be consolidated as quasi-subsidiaries. FRS 5, however, contains the more specific provisions

in respect of certain other transactions that may take place between an entity and its pension fund, for example a sale and repurchase agreement relating to one of the entity's properties.

The relationship between SSAP 21 'Accounting for lease and hire purchase contracts' and FRS 5 is particularly close. In general, SSAP 21 contains the more specific provisions governing accounting for stand-alone leases that fall wholly within its parameters, although the general principles of the FRS will also be relevant in ensuring that leases are classified as finance or operating leases in accordance with their substance. However, for some lease arrangements, and particularly for those that are merely one element of a larger arrangement, the FRS will contain the more specific provisions. An example is a sale and leaseback arrangement where there is also an option for the seller/lessee to repurchase the asset; in this case the provisions of Application Note B are more specific than those of SSAP 21. 45

THE SUBSTANCE OF TRANSACTIONS

General principles

Paragraph 14 of the FRS sets out general principles for reporting the substance of a transaction. Particularly for more complex transactions, it will not be sufficient merely to record the transaction's legal form, as to do so may not adequately express the commercial effect of the arrangements. Notwithstanding this caveat, the FRS is not intended to affect the legal characterisation of a transaction, or to change the situation at law achieved by the parties to it. 46

Features of more complex transactions

Transactions requiring particularly careful analysis will often include features such as – 47

(a) the separation of legal title to an item from rights or other access to the principal future economic benefits associated with it and exposure to the principal risks inherent in those benefits,*
(b) the linking of a transaction with others in such a way that the commercial effect can be understood only by considering the series as a whole, or
(c) the inclusion of options or conditions on terms that make it highly likely that the option will be exercised or the condition fulfilled.

(a) Separation of legal title from benefits and risks

A familiar example of the separation of legal title from benefits and risks is a finance lease. Another is goods sold under reservation of title. In both cases, the location of 48

**For ease of reading, 'rights or other access to future economic benefits' are frequently referred to hereafter as 'rights to benefits' or 'benefits', and 'exposure to the risks inherent in those benefits' is frequently referred to hereafter as 'exposure to risks' or 'risks'.*

legal title will not normally be expected to have a commercial effect in practice. Thus the party having the benefits and risks relating to the underlying property should recognise an asset in its balance sheet even though it does not have legal title. Arrangements involving the separation of legal title from benefits and risks are dealt with in detail in Application Note B.

(b) Linking of transactions

49 The linking of two or more transactions extends the possibilities for separating legal title from benefits and risks. A sale of goods linked with a commitment to repurchase may leave the original owner with the principal benefits and risks relating to the goods if the repurchase price is set at the costs, including interest, incurred by the other party in holding the goods. In such a case, application of the FRS will result in the transaction being accounted for as a financing rather than a sale, showing the asset and a corresponding liability on the balance sheet of the original owner.

(c) Inclusion of options

50 Some sale transactions are accompanied by an option, rather than a commitment, for either the original owner to repurchase or the buyer to resell. Often the commercial effect of such an arrangement is that an economic penalty (such as the forgoing of a profit) would be suffered by the party having the option if it failed to exercise it. Some transactions incorporate both a put option for the buyer and a call option for the original owner, in such a way that it will almost certainly be in the commercial interests of one of the parties to exercise its option (as for example where both options have the same exercise price and are exercisable on the same date). In such cases, there will be no genuine commercial possibility that the original owner will fail to repurchase the item and application of the FRS will again result in the transaction being accounted for as a financing rather than a sale.

Assessing commercial effect by considering the position of other parties

51 Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed.

52 It follows that in assessing the commercial effect of a transaction, it will be important to consider the position of all of the parties to it, including their apparent expectations and motives for agreeing to its various terms. In particular, where one party to the transaction receives a lender's return but no more (comprising interest on its investment perhaps together with a relatively small fee), this indicates that the substance of the transaction is that of a financing. This is because the party that

receives a lender's return is not compensated for assuming any significant exposure to loss other than that associated with the creditworthiness of the other party, nor is the other party compensated for giving up any significant potential for gain.

Identifying assets and liabilities

In accounting terms, the substance of a transaction is portrayed through the assets and liabilities, including contingent assets and liabilities, resulting from or altered by the transaction. A key step in reporting the substance of any transaction is therefore to identify its effect on the assets and liabilities of the entity. 53

Assets – control of access to benefits

The definition of an asset requires that access to future economic benefits is controlled by the entity. Access to future economic benefits will normally rest on a foundation of legal rights, although legally enforceable rights are not essential to secure access. Control is the means by which the entity ensures that the benefits accrue to itself and not to others. Control can be distinguished from management (ie the ability to direct the use of an item that generates the benefits) and, although the two often go together, this need not be so. For example, the manager of a portfolio of securities does not have control of the securities, as he does not have the ability to obtain the economic benefits associated with them. Such control rests with his appointer who has delegated to the manager the right to take day-to-day decisions about the composition of the portfolio. 54

Assets – risk

The future economic benefits inherent in an asset are never completely certain in amount; there is always the possibility that the actual benefits will be greater or less than those expected, or will arise sooner or later than expected. For instance, the value of stocks may rise or fall as market conditions change; foreign currency balances may become worth more or less because of exchange rate movements; debtors may default or be slow in paying. This uncertainty regarding the eventual benefit is referred to as 'risk', with the term encompassing both an upside element of potential for gain and a downside element of exposure to loss. 55

The entity that has access to the benefits will usually also be the one to suffer or gain if these benefits turn out to be different from those expected. Hence, evidence of whether an entity has access to benefits (and hence has an asset) is given by whether it has the risks inherent in those benefits. 56

Liabilities – obligations to transfer benefits

The definition of liabilities requires an obligation to transfer economic benefits. Whilst most obligations are legally enforceable, a legal obligation is not a necessary 57

condition for a liability. An entity may be commercially obliged to adopt a certain course of action that is in its long-term best interests in the widest sense, even if no third party can legally enforce that course. As illustrated in paragraph 50 above, the prospect of a commercial or economic penalty if a certain action is not taken may negate a legal right to refrain from taking that action.

58 The notion of obligation implies that the entity is not free to avoid an outflow of resources. Where there is some circumstance in which the entity is unable to avoid such an outflow whether for legal or commercial reasons, it will have a liability. However, in accordance with SSAP 18 'Accounting for contingencies' if the entity's obligation is contingent on the occurrence of one or more uncertain future events (as under a stand-alone guarantee given by the entity) its liability may not be recognised.

Options

59 On its own, an option to acquire an item of property in the future represents a different asset from ownership of the property itself. For example, when an option to purchase shares at a future date is acquired, the only asset is the option itself; the asset 'shares' will be acquired only on exercise of the option. Similarly, an unconditional obligation is not the same as a contingent commitment to assume such an obligation at another party's option. Although both are liabilities, they are different liabilities and if recognised in the balance sheet their descriptions will be different.

60 Where an option is part of a more complex transaction, it may not necessarily represent a separate asset or liability of the type discussed in paragraph 59. For example, an option may serve, in conjunction with the other aspects of the transaction, to give one party access to the future benefits arising from an item of property without legal ownership. Alternatively the terms of an option, together with other aspects of the overall transaction, may in effect create an unconditional obligation even though the legal obligation is expressed as being conditional on the exercise of the option. Options of this kind should be accounted for by considering the substance of the transaction as a whole.

61 In determining the substance of a transaction incorporating options, in accordance with paragraph 14, greater weight must be given to those aspects and implications more likely to have a commercial effect in practice. This will involve considering the extent to which there is a genuine commercial possibility that the option will be exercised or, alternatively, that it will not be exercised. In extreme cases, there will be no genuine commercial possibility that the option will be exercised, in which case the existence of that option should be ignored; alternatively, there will be no genuine commercial possibility that an option will fail to be exercised, in which case its future exercise should be assumed. For example, a transaction may be structured in such a way that the cost of exercising an option will almost inevitably be lower (or, alternatively, higher) than the benefits obtained from its exercise. As another

example, there may be a combination of put and call options such that it will almost certainly be in the commercial interests of one or other party to exercise its option. In both these cases, the substance of the overall transaction is that the parties have outright, and not optional or conditional, obligations and access to benefits. In less extreme cases, further analysis will be required. It may be necessary to consider the true commercial objectives of the parties and the commercial rationale for the inclusion of such options in the transaction. This may reveal either that the parties in substance have outright obligations and access to benefits, or, alternatively, that the parties' obligations and access to benefits are genuinely optional or conditional.

62 In assessing the commercial effect of an option, all the terms of the transaction and the circumstances of the parties that are likely to be relevant during the exercise period of the option should be taken into account. It should be assumed that each of the parties will act in accordance with its economic interests. Any actions that the parties would take only in the event of a severe deterioration in liquidity or creditworthiness should not be anticipated but should be taken into account only when such a deterioration occurs (for example, when creditworthiness has declined because of the prospect of imminent cash flow difficulties).

Guarantees and conditional provisions

63 Paragraphs 59–62 should also be applied to guarantees and other conditional provisions. The commercial effect of such provisions should in all cases be determined in the context of the overall transaction.

Recognition of assets and liabilities

64 Once it appears from analysis of a transaction that an asset or liability has been acquired or assumed by an entity, it is necessary to apply various recognition tests to determine whether the asset or liability should be included in the balance sheet.

65 The general criteria set out in paragraph 20* require that an asset or liability should be recognised only where it can be measured with 'sufficient' reliability. The effect of prudence is that less reliability of measurement is acceptable when recognising items that involve decreases in equity (eg increases in liabilities) than when recognising items that do not (eg increases in assets). It follows that, particularly for liabilities, where a reasonable estimate of the amount of an item is available, the item should be recognised.

Transactions in previously recognised assets

66 Following its recognition, an asset may be affected by a subsequent transaction and it will be necessary to consider whether, as a result of the transaction, the description

These criteria are drawn from Chapter 4 of the Board's draft Statement of Principles.

or monetary amount of the asset needs to be changed. In this regard paragraphs 21–28 and 67–88 will apply.

Continued recognition of an asset in its entirety

67 Paragraph 21 requires that where there is no significant change in the entity's rights to benefits, its previously recognised asset should continue to be recognised. In the same way, the entity will continue to have an asset where its exposure to the risks inherent in the benefits of the asset is not significantly altered. Even if the proceeds generated by the asset are directed in the first instance to another party, provided the entity gains or suffers from all significant changes in those proceeds it should be regarded as having the benefits of the asset and should continue to recognise it. For example, a 'sale' of debts with recourse to the seller for all bad debts and provision for the seller to pay a finance charge that reflects the speed of payment by debtors leaves the seller with all significant risks relating to the debts (the risks being the speed of payment and the degree of non-payment). This is so even if actual cash receipts are collected directly by the buyer and only a net surplus or deficit settled with the seller. In such cases the seller would continue to recognise an asset equal in amount to the debts, although the transfer of legal title would be disclosed.

68 Thus, under paragraph 21, it will not be appropriate to cease to recognise any part of an asset where the transaction entered into is in substance a financing of that asset, even if the financing is without recourse. Such financing transactions leave the entity with those rights to benefits and exposures to risks (including potential for gain) that are likely to have a commercial effect in practice, as well as creating a liability to repay the finance. The only exception to this is non-recourse finance arrangements that meet the conditions for a linked presentation given in paragraphs 26–27. Although such arrangements are in substance financings, their particular features are such that a linked presentation is required to portray all the effects of the arrangement. This is explained further in paragraphs 76–80 below.

Ceasing to recognise an asset in its entirety

69 Conversely, paragraph 22 requires that where a transaction transfers to others all significant rights to benefits and all significant exposure to risks that relate to a previously recognised asset, the entire asset should cease to be recognised. An example would be a sale of debts for a single non-returnable cash payment.

Special Cases

70 Paragraphs 21 and 22 deal with the great majority of transactions affecting previously recognised assets. However, in other cases there may be a significant change in the entity's rights to benefits and exposure to risks but not a complete transfer of all significant benefits and risks. In such cases, it will be necessary to consider whether the description or monetary amount of the asset needs to be changed and

also whether a liability needs to be recognised for any obligations assumed or risks retained. These special cases arise where the transaction takes one or more of the following forms:

(a) a transfer of only part of the item in question;
(b) a transfer of all of the item for only part of its life; and
(c) a transfer of all of the item for all of its life but where the entity retains some significant right to benefits or exposure to risk.

(a) Transfer of only part of an item

71 Transfer of part of an item that generates benefits may occur in one of two ways. The most straightforward is where a proportionate share of the item is transferred. For example, a loan transfer might transfer a proportionate share of a loan (including rights to receive both interest and principal), such that all future cash flows, profits and losses arising on the loan are shared by the transferee and transferor in fixed proportions. A second, less straightforward way of transferring a part of an item arises where the item comprises rights to two or more separate benefit streams, each with its own risks. A part of the item will be transferred where all significant rights to one or more of those benefit streams and associated exposure to risks are transferred whilst all significant rights to the other(s) are retained. An example would be a 'strip' of an interest-bearing loan into rights to two or more different cash flow streams that are payable on different dates (for instance 'interest' and 'principal'), with the entity retaining rights to only one of those streams (for instance 'principal'). In both these cases, the entity would cease to recognise the part of the original asset that has been transferred by the transaction, but would continue to recognise the remainder. A change in the description of the asset might also be required.

(b) Transfer of an item for only part of its life

72 Paragraph 23 also applies to a transaction that transfers all of an item that generates benefits for only part of its life. Provided that the entity's access to benefits and exposure to risks following the transaction are both significantly different from those it had before the transaction, the description or monetary amount of the asset previously recognised would need to be changed. For example, an entity may sell an item of property but agree to repurchase it in a substantially depreciated form (as for example where the item will be used for most of its life by the buyer). In this case the entity's original asset has changed from being the original item of property to a residual interest in that item and, in addition, the entity has assumed a liability of its obligation to pay the repurchase price. Sale and repurchase agreements are dealt with further in Application Note B.

(c) Transfer of an item for all of its life with some benefit or risk retained

73 Finally, paragraph 23 applies to a transaction that transfers an item that generates benefits for all of its life, but leaves the entity with significant rights to benefits or

exposure to risks relating to that item. Whilst control has passed to the transferee, the retention of significant rights to benefits or exposure to risks has the result that the transaction fails to meet the conditions in paragraph 22 for ceasing to recognise an asset in its entirety. For example, an entity may sell an investment in a subsidiary with the consideration including an element of deferred performance-related consideration. Provided that significant rights to benefits and exposure to risks associated with the subsidiary have passed to the buyer (as will be the case where the deferred consideration is only a portion of the subsidiary's profits arising in only a limited period), both the description and the monetary amount of the asset will need to be changed. This reflects the fact that the asset is no longer an investment in a subsidiary but rather is a debtor for the performance-related consideration (although, under the provisions of SSAP 18, the debtor may be measured at nil and therefore not recognised but merely disclosed). As another example, an entity may sell equipment subject to a warranty in respect of the condition of the equipment at the time of sale, or subject to a guarantee of its residual value. This would normally transfer all significant rights to benefits and some significant exposure to risks to the buyer (these being those arising from the equipment's future use and resale), but leave the seller with some significant risk in the form of obligations relating to the equipment's future performance or residual value. The seller would therefore cease to recognise the equipment as an asset, but would recognise a liability for its warranty obligation or guarantee (with the liability being accounted for in accordance with the provisions of SSAP 18*).

Measurement and profit recognition

74 In any of the above three classes of transaction, there arises the issue of how to measure the change in the entity's assets or liabilities and any resulting profit or loss. This measurement process requires that the previous carrying value of the asset is apportioned into an amount relating to those benefits and risks disposed of and an amount relating to those retained. In some cases, measurement will be relatively easy; for instance this might be the case where a proportionate share of the original asset is retained as described in paragraph 71 above or where there are similar and frequent transactions in liquid and freely accessible markets. In other cases, measurement may be more difficult with the result that the amount of any gain or loss is uncertain. In such cases, in accordance with the provisions of SSAP 18*, paragraph 24 requires a prudent approach to be adopted, with full provision being made for any probable loss but recognition of any gain, to the extent it is in doubt, being deferred.

The meaning of 'significant'

75 In applying paragraphs 21–23 and 26 it may be necessary to determine whether certain rights to benefits or exposure to risks are 'significant'. When this is done,

**Editor's note: SSAP 18 was superseded by FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' issued September 1998.*

greater weight should be given to what is likely to have a commercial effect in practice. In particular, whether any retained risk is 'significant' should be judged not against the total possible variation in benefits, but against that variation which is likely to occur in practice. For instance, if for a portfolio of debts of 100, bad debts are expected to be 2 and the debts are sold with recourse to the entity for bad debts of up to 5, the seller will have retained all significant risk of non-payment. Thus the debts would continue to be recognised in their entirety (unless the conditions for a linked presentation are met).

Linked presentation for certain non-recourse finance arrangements

General principles

Sometimes an entity finances an item on terms that the provider of the finance has recourse to only the item it has financed and not to the entity's other assets. It is sometimes argued that the effect of such arrangements is that the entity no longer has an asset in respect of the item, nor does it have a liability for the finance. For the purpose of determining the appropriate accounting treatment, non-recourse finance arrangements can be classified into two types. 76

Separate presentation of an asset and liability

The first type of arrangement is where, although in the event of default the provider of the finance can obtain repayment only by enforcing its rights against the specified item, the entity retains rights to all the benefits generated by the item and can repay the finance from its general resources in order to preserve those rights. In such a case the entity has both an asset (its access to all the benefits generated by the item) and a liability (its obligation to repay the finance) and they should be included in the balance sheet in the normal way. 77

Linked presentation

The second type of non-recourse finance arrangement is where the finance will be repaid only from benefits generated by the specified item. Although the entity has rights to any surplus benefits remaining after repayment of the finance, it has no right or obligation to keep the item or to repay the finance from its general resources. In these cases the entity does not have an asset equal to the gross amount of the item (as it does not have access to all the future benefits generated by it), nor a liability for the full amount of the finance (as the financier will be repaid only from benefits generated by the specific item and not from benefits generated by any other assets of the entity). However, the entity does retain rights to those benefits and exposure to those risks that are likely to have a commercial effect in practice – ie the significant benefits and risks. It is retention of the significant benefits and risks that distinguishes this type of non-recourse financing from the transactions described in paragraph 23 that transfer a part of an asset. Where there is no transfer of significant benefits and 78

risks the transaction is in substance a financing arrangement and the other party would usually receive a lender's return and no more. Conversely, the transactions described in paragraph 23 involve a transfer of significant benefits and risks. Indications of such transactions are where the other party has rights to benefits greater than those associated with a lender's return and has corresponding exposure to some significant risk.

79 For example, assume an entity transfers title to a portfolio of high quality debts of 100 in exchange for non-returnable proceeds of 90. The entity cannot be required to repay these non-returnable proceeds in any circumstance or in any form, nor can it be required to make any other payment in respect of the debts. In addition, the entity retains rights to a further sum (calculated as 10 less any bad debts and a finance charge) whose amount depends on whether and when the debtors pay. In this situation the entity does not have a liability for the non-returnable proceeds of 90 (as it can never be required to repay them except out of cash generated by the debts portfolio), nor an asset of 100 (as the first 90 of benefits generated by the debts must be passed to the transferee). However, the entity does have a new asset in its rights to future benefits of up to 10, which depends principally on the performance of the entire portfolio of 100. If any one debt proves to be completely bad or if all debts prove to be partly bad, the entity bears the entire loss (subject to the ceiling of 10) as its future cash receipts are reduced accordingly. Although it has transferred catastrophe risk (of benefits being less than 90), the entity has retained all the variation in benefits likely to occur in practice – ie the significant benefits and risks. The catastrophe risk that is transferred is not significant since, although the potential losses involved are large in absolute terms, it is extremely unlikely that such losses will occur in practice.

80 For this type of arrangement, a special presentation (a 'linked presentation') is required to give a true and fair view of the entity's position. This presentation involves giving additional information on the face of the balance sheet about the entity's new net asset (of 10 in the above example). In the above example, the linked presentation would be as follows:

Debts subject to financing arrangements:	
Debts (after providing for expected bad debts of 1)	99
Less: non-returnable amounts received	(90)
	9

This linked presentation shows both that the entity retains significant benefits and risks relating to all the debts, and that the claim of the provider of the finance is limited strictly to the funds generated by them.

Detailed conditions for use of a linked presentation

81 A linked presentation is appropriate only where the commercial effect for the entity is that the item is being sold but the sale process is not yet complete. Thus there must

be no doubt whatsoever that the claim of the provider of the finance is limited strictly to funds generated by the specific item it finances. It must be clear that there is no legal, commercial or other obligation under which the entity may fund any losses (from whatever cause) on the items being financed or transfer any economic benefits (apart from those generated by the item). In addition, the entity must have no right or obligation to repay the finance from its general resources, to keep the item on repayment of the finance or to re-acquire it in the future. These principles are reflected in the detailed conditions for use of a linked presentation set out in paragraph 27.

82 Condition 27(a) requires that the finance relates to a specific item or group of similar items. A linked presentation should not be used where the finance relates to two or more items that are not part of a portfolio, or to a portfolio containing items that would otherwise be shown under different balance sheet captions. Similarly, a linked presentation should not be used where the finance relates to any kind of business unit, or for items that generate the funds required to repay the finance only by being used in conjunction with other assets of the entity. The item must generate the funds required to repay the finance either by unwinding directly into cash (as in the case of a debt), or by its sale to a third party.

83 Conditions 27(b)–(e) require that there is no recourse and no other condition (legal, commercial or other) that could result in the entity supporting losses, from whatever cause, on the items being financed (or, as discussed in the next paragraph, supporting such losses beyond a fixed monetary ceiling). Recourse could take a number of forms, for instance: an agreement to repurchase non-performing items or to substitute good items for bad ones; a guarantee given to the provider of the finance or any other party (of performance, proceeds or other support); a put option under which items can be transferred back to the entity; a swap of some or all of the amounts generated by the item for a separately determined payment; or a penalty on cancelling an ongoing arrangement such that the entity bears the cost of any items that turn out to be bad. Normal warranties given in respect of the condition of the item at the time the non-recourse finance arrangement is entered into would not breach this condition; however, warranties relating to the condition of the item in the future or to its future performance would do so.

84 If there is partial recourse for losses up to a fixed monetary ceiling, a linked presentation may still be appropriate in respect of that part of the finance for which there is no recourse. However, where the entity provides any kind of open-ended guarantee (ie one that does not have a fixed monetary ceiling) a linked presentation should not be used. An example of such an open-ended guarantee would be a guarantee of completion provided by a property developer.

85 The following example illustrates the effect of partial recourse. An entity transfers title to a portfolio of debts of 100 (for which expected bad debts are 4) in return for proceeds of 95 plus rights to a future sum whose amount depends on whether and when debtors pay. In addition, there is recourse to the entity for the first 10 of any

losses. Assuming the conditions set out in paragraphs 26–27 are met, the arrangement would be presented as follows:

Debts subject to financing arrangements:	
Gross debts (after providing for bad debts)	96
Less: non-returnable proceeds	(85)
	11

The remaining 10 of the finance would be included within liabilities.

86 Condition 27(f) requires there to be no provision for the entity to repurchase the item being financed. For instance, where legal title to the item has been transferred, a linked presentation should not be used to the extent that one party has a put or a call option to effect repurchase, or where there is an understanding between the parties that the item will be re-acquired in the future.

Profit or loss recognition and presentation

87 Where a linked presentation is used, profits or losses should be recognised in the period in which they arise so as to reflect the fact that the entity continues to gain or suffer from the performance of the underlying gross item. For example, on entering into the arrangement, a gain will arise only to the extent that the non-returnable proceeds received exceed the previous carrying value of the item. In subsequent periods, a gain (or loss) will arise to the extent that the income from the item exceeds (or falls short of) the amounts due to the provider of finance in respect of that period. Finally, any gain resulting from an onward sale of the item to a third party will arise only in the period in which the onward sale occurs.

88 Where a linked presentation is adopted in the balance sheet, normally it will be sufficient for only the net amount of any income or expense recognised in each period to be included in the profit and loss account, with the gross components being disclosed by way of note. However, the gross components should be shown on the face of the profit and loss account by using a linked presentation where the effect of the arrangement on the performance of the entity is so significant that to include merely the net amount of income or expense within the captions shown on the face of the profit and loss account would not be sufficient to give a true and fair view.

Offset

89 Offsetting is the process of aggregating debit and credit balances and including only the net amount in the balance sheet. In order to present the commercial effect of transactions, it is necessary that any separate assets and liabilities that result are not offset.

90 Offset is permissible, and indeed necessary, between related debit and credit balances that are not separate assets and liabilities as defined in the FRS. For this to be the case, it is necessary that all of the conditions given in paragraph 29 are met, such that there is no possibility that the entity could be required to pay another party and later find it was unable to obtain payment itself. In this respect, the requirement in condition (c) in paragraph 29 that the debit balance matures no later than the credit balance will be met if, at its own discretion, the reporting entity can ensure that result by accelerating the maturity of the debit balance or deferring the maturity of the credit balance. Where the reporting entity or the other party is a group, particular care must be taken to ensure that the reporting entity, through its constituent legal entities, can insist on a net settlement of the amounts to be offset in all situations of default and that this ability would survive the insolvency of any of the separate legal entities that constitute the other party.

91 Where the conditions for a linked presentation given in paragraphs 26–27 are met, the entity's asset is the net amount. Such a presentation does not constitute offset of an asset and a liability; rather it is the provision of additional information about an asset (which is the net amount), necessary in order to give a true and fair view.

Disclosure of the substance of transactions

92 Paragraph 30 requires that disclosure of a transaction should be sufficient to enable the user of the financial statements to understand its commercial effect. For the vast majority of transactions this involves no more than those disclosures currently required. However, this may not be sufficient to portray fully the commercial effect of more complex transactions, in which case further information will need to be disclosed.

93 Assets and liabilities resulting from more complex transactions will not necessarily be exactly the same as those resulting from more straightforward transactions. The greater the differences the greater the need for disclosure. For example, certain assets may not be available for use as security for liabilities of the entity; or certain liabilities, whilst not qualifying for the linked presentation set out in paragraphs 26–27 may, in the event of default, be repayable only to the extent that the assets on which they are secured yield sufficient benefits.

94 Even where a transaction does not result in any items being recognised in the balance sheet, the need for disclosure should still be considered. The transaction may give rise to guarantees, commitments or other rights and obligations which, although not sufficient to require recognition of an asset or liability, require disclosure in order that the financial statements give a true and fair view.

QUASI-SUBSIDIARIES

Identification of quasi-subsidiaries

95 An entity may directly control access to future economic benefits or may control such access through the medium of another entity, normally a subsidiary. Control

through the medium of another entity is of such widespread significance that it underlies the statutory definition of a subsidiary undertaking and is reflected in the requirement for the preparation of consolidated accounts. However, such control is not confined to cases where another entity is a subsidiary as defined in statute. 'Quasi-subsidiaries' are sometimes established by arrangements that give as much effective control over another entity as if that entity were a subsidiary.

Benefits

96 In deciding whether or not an entity is a quasi-subsidiary, access to the whole of the benefit inflows arising from its gross assets and responsibility for the whole of the benefit outflows associated with its liabilities are not the key considerations. In practice, many subsidiaries do not give rise to a possible benefit outflow for their parent of an amount equal to their gross liabilities – indeed, the limiting of benefit outflows in the event of losses occurring may have been a factor for the parent in establishing a subsidiary. In addition, as the liabilities of a subsidiary have a prior claim on its assets, the parent will not have access to benefit inflows of an amount equal to those gross assets. For this reason, it is necessary to focus on the benefit flows associated with the net assets of the entity. Often evidence of where these benefits lie is given by which party stands to suffer or gain from the financial performance of the entity – ie which party has the risks inherent in the benefits.

Control

97 Control is the means by which one entity determines how the assets of another entity are employed and by which the controlling entity ensures that the resulting benefits accrue to itself and not to others. Control may be evidenced in a variety of ways depending on its basis (eg ownership or other rights) and the way in which it is exercised (interventionist or not). Control includes the ability to restrict others from directing major policies, but a power of veto will not of itself constitute control unless its effect is that major policy decisions are taken in accordance with the wishes of the party holding that power. One entity will not control another where there is a third party that has the ability to determine all major issues of policy.

98 In some cases, arrangements are made for allocating the benefits arising from the activities of an entity such that active exercise of control is not necessary. The party or parties who will gain the benefits (and bear their inherent risks) are irreversibly specified in advance. No party has direct control in the sense of day-to-day direction of the entity's financial and operating policies, since all such matters are predetermined. In such cases, control will be exercised indirectly via the arrangements for allocating the benefits and it will be necessary to look at the effects of those arrangements to establish which party has control. It follows that, for the reasons set out in paragraph 96 above, the party possessing control will be the one that gains the benefits arising from the net assets of the entity.

Accounting for quasi-subsidiaries

99 In essence, consolidation is founded on the principle that all the entities under the control of the reporting entity should be incorporated into a single set of financial statements. Applying this principle has the result that the assets, liabilities, profits, losses and cash flows of any entity that is a quasi-subsidiary should be included in group financial statements in the same way as if they were those of a member of the statutory group (this is referred to below as 'inclusion of a quasi-subsidiary in group financial statements').

100 The entities that constitute a group are determined by companies legislation. Companies legislation also requires that where compliance with its provisions would not be sufficient to give a true and fair view, the necessary additional information shall be given in the accounts or in a note to them* . Inclusion of a quasi-subsidiary in group financial statements is necessary in order to give a true and fair view of the group as legally defined and thus constitutes provision of such additional information.

101 Companies legislation and FRS 2 'Accounting for Subsidiary Undertakings' permit or require subsidiaries to be excluded from consolidation in certain circumstances. However, as inclusion of a quasi-subsidiary in group financial statements is required in order that those financial statements give a true and fair view of the group, these exclusions are generally not appropriate for a quasi-subsidiary. The following considerations are relevant.

(a) An immaterial quasi-subsidiary is outside the scope of this FRS, which need not be applied to immaterial items.

(b) Where severe long-term restrictions substantially hinder the exercise of the rights of the reporting entity over the assets or management of another entity, the reporting entity will not have the control necessary for the definition of a quasi-subsidiary to be met. Where the financial and operating policies of another entity are predetermined, this affects the manner in which control of that entity is exercised, but does not preclude the entity from being a quasi-subsidiary.

(c) Disproportionate expense or undue delay in obtaining information justifies excluding a quasi-subsidiary only if it is immaterial.

(d) Where there are significant differences between the activities of a quasi-subsidiary and those of the group that controls it, these should be disclosed. However, the quasi-subsidiary should nevertheless be included in the consolidation in order that the group financial statements present a true picture of the extent of the group's activities.

** In Great Britain section 227(5) of the Companies Act 1985. Equivalent references for Northern Ireland and the Republic of Ireland are given in paragraphs 5 and 6 respectively of Appendix I 'Note on legal requirements'.*

It is appropriate to exclude a quasi-subsidiary from consolidation only where the interest in the quasi-subsidiary is held exclusively with a view to subsequent resale and the quasi-subsidiary has not previously been included in the reporting entity's consolidated financial statements. In determining if this exclusion is appropriate in a particular instance, reference should be made to FRS 2.

102 Some arrangements for financing an item on a non-recourse basis involve placing the item and its finance in a quasi-subsidiary as a means of 'ring-fencing' them. Where, as a result, the conditions of paragraphs 26 and 27 are met from the point of view of the group as legally defined, the item and its finance should be included in the group financial statements by using a linked presentation. As noted above, the inclusion of a quasi-subsidiary in group financial statements forms additional information, necessary in order to give a true and fair view of the group as legally defined – the quasi-subsidiary is not part of that group. Where an item and its finance are effectively ring-fenced in a quasi-subsidiary, a true and fair view of the position of the group is given by presenting them under a linked presentation. In this situation, the group does not have an asset equal to the gross amount of the item, nor a liability for the full amount of the finance. However, where the item and its finance are similarly ring-fenced in a subsidiary, a linked presentation may not be used. This is because the subsidiary is part of the group as legally defined – hence the item and its finance, being an asset and a liability of the subsidiary, are respectively an asset and liability of the group. The subsidiary would be consolidated in the normal way in accordance with companies legislation and a linked presentation would not be used (unless a linked presentation were appropriate in the subsidiary's individual financial statements).

Disclosure of quasi-subsidiaries

103 When one or more quasi-subsidiaries are included in the consolidated financial statements of a statutory group, companies legislation requires the fact that such additional information has been included, and the effect of its inclusion, to be clearly disclosed.*

*In Great Britain section 227 of the Companies Act 1985. Equivalent references for Northern Ireland and the Republic of Ireland are given in paragraphs 5 and 6 respectively of Appendix I 'Note on legal requirements'.

Application notes

These Application Notes specify how the requirements of FRS 5 are to be applied to transactions that have certain features. For such transactions, observance of the Notes will normally be sufficient to ensure compliance with the requirements of FRS 5.

The tables, flow chart and illustrations shown in the shaded areas are provided as an aid to understanding and shall not be regarded as part of the Statement of Standard Accounting Practice.

It is not intended that the accounting treatment determined by FRS 5 or the terminology used in the Application Notes should change the situation at law achieved by the parties. Accordingly, it is not intended that the legal effectiveness of any transfer should be affected.

Contents

APPLICATION NOTE A – CONSIGNMENT STOCK

NB: Although this Application Note is drafted in terms of the motor trade it applies equally to similar arrangements in other industries.

Features

Consignment stock is stock held by one party (the 'dealer') but legally owned by another (the 'manufacturer'), on terms that give the dealer the right to sell the stock in the normal course of its business or, at its option, to return it unsold to the legal owner. The stock may be physically located on the premises of the dealer, or held at a car compound or other site nearby. The arrangement has a number of commercial advantages for both parties: the dealer is able to hold or have faster access to a wider range of stock than might otherwise be practicable; the manufacturer can avoid a build-up of stock on its premises by moving it closer to the point of sale; and both benefit from the greater sales potential of the arrangement. A1

The main features of a consignment stock arrangement are as follows: A2

(a) The manufacturer delivers goods to the dealer, but legal title does not pass until one of a number of events takes place, eg the dealer has held the goods for a specified period, adopts them by using them as demonstration models, or sells them to a third party. Until such a crystallising event, the dealer is entitled to return the goods to the manufacturer or the manufacturer is able to require their return or insist that they are passed to another dealer.

(b) Once legal title passes, the transfer price becomes payable by the dealer. This price may be fixed at the date goods are delivered to the dealer, it may vary with the period between delivery and transfer of title, or it may be the manufacturer's list price at the date of transfer of title.

(c) The dealer may also be required to pay a deposit to the manufacturer, or to pay the latter a display or financing charge. This deposit or charge may be fixed for a period (eg one year) or may fluctuate. Its amount is usually set with reference to the dealer's past sales of the manufacturer's goods or to average or actual holdings of consignment stock. It may (or may not) bear interest. In some cases, a finance company will pay the deposit or charge to the manufacturer and will charge interest thereon to the dealer.

(d) Other terms of the arrangement will usually cover items such as inspection and access rights of the manufacturer, and responsibility for damage, loss or theft and related insurance. These are usually of minor importance in determining the accounting treatment.

Analysis

A3 The purpose of the analysis below is to determine whether, at any particular time, the dealer has an asset in the stock and a corresponding liability to pay the manufacturer for it. To this end, it is necessary to identify whether the dealer has access to the benefits of the stock and exposure to the risks inherent in those benefits. From the dealer's perspective, the principal benefits and risks of consignment stock are as follows:

Benefits:

(i) the future cash flows from sale to a third party and the right to retain items of stock in order to achieve such a sale;

(ii) insulation from changes to the transfer price charged by the manufacturer for its stock (eg because the manufacturer has increased its list price); and

(iii) the right to use the stock (eg as a demonstration model) by adopting it.

Risks:

(i) the risk of being compelled to retain stock that is not readily saleable or is obsolete, resulting in no sale or a sale at a reduced price; and

(ii) the risk of slow movement, resulting in increased costs of financing and holding the stock and an increased risk of obsolescence.

Paragraphs A5–A10 show how the various features of a consignment stock agreement will determine where the above benefits and risks lie. The stock should be

included on the dealer's balance sheet where the dealer has access to its principal benefits and bears the principal risks inherent in those benefits.

In determining the substance of an agreement, it will be necessary to look at all its features and give greater weight to those that are more likely to have a commercial effect in practice. In addition, it will be necessary to consider the interaction between the features and to evaluate the arrangement as a whole. A4

Manufacturer's right of return (benefit (i))

The dealer's access to the benefits of the stock will be constrained by any right of the manufacturer to require goods to be returned or transferred to another dealer. The likely commercial effect of this constraint should be assessed. For instance, if a high proportion of the consignment stock is returned or transferred without compensation, this indicates that the stock is not an asset of the dealer. Conversely, if the dealer is able to resist requests made by the manufacturer for transfers and in practice actually does so, or in practice the manufacturer compensates the dealer for agreeing to transfer stock in accordance with the manufacturer's wishes, this indicates that the stock is an asset of the dealer. A5

Dealer's right of return (risk (i))

If the dealer has a right to return stock without payment of a penalty, it will not bear obsolescence risk. This indicates that the dealer has neither the asset 'stock', nor a liability to pay the manufacturer for it. Again, the likely commercial effect of any such right of return and the significance of obsolescence risk should be considered. If the right of return is exercised frequently or the manufacturer regularly provides a significant incentive (such as a price discount or a free extension to the consignment period) to persuade the dealer not to return stock where it would otherwise do so, this indicates that the stock is not an asset of the dealer. Conversely, if the dealer either has no right to return stock, or in practice does not exercise its right or is charged a significant penalty for doing so, this indicates that the dealer bears the principal risks relating to the stock and the stock is an asset for it. In such cases the dealer will also have a corresponding liability (legal or commercial) to pay for the stock. A6

Stock transfer price and deposits (benefit (ii), risk (ii))

Whether the dealer is insulated from changes in the prices charged by the manufacturer for its stock depends on how the stock transfer price is determined. Where the price is based on the manufacturer's list price at delivery, then the manufacturer is unable to pass on any subsequent price changes, which indicates that the stock became an asset of the dealer at the date of delivery. Conversely, if the price charged to the dealer is the manufacturer's list price at the date of the transfer of legal title, A7

this indicates that the stock remains an asset of the manufacturer until legal title is transferred.

A8 The stock transfer price will also affect the incidence of slow movement risk and who bears the variable cost of financing the stock until sold. In a simple arrangement where there is no deposit and stock is supplied for a fixed price that is payable by the dealer only when legal title is transferred it will be clear that the manufacturer bears the slow movement risk. The manufacturer will bear the slow movement risk wherever the transfer price is not determined by reference to the length of time for which stock is held (such as where the transfer price is the manufacturer's list price at either delivery or transfer of legal title). Conversely, if in the same basic arrangement, the price to be paid by the dealer increases by a factor that varies with the time the stock is held and approximates to commercial interest rates, then it will be equally clear that the dealer bears the slow movement risk. This may be so even where the financing element of the price charged to the dealer is based on average past movements of stocks held by that dealer (eg for administrative convenience), or is levied in another form (eg a display charge).

A9 The existence of a deposit complicates the analysis. The main question to be answered is whether the effect of the deposit is that the dealer, rather than the manufacturer, bears variations in the stock financing costs that are due to slow movement. For example, this could be achieved by a substantial, interest-free deposit whose amount is related to levels of stock held by the dealer. Alternatively, a finance company might advance the deposit to the manufacturer and charge interest thereon (in whatever form) to the dealer.

Dealer's right to use the stock (benefit (iii))

A10 Whilst a right for the dealer to use the stock in its business will not, of itself, be sufficient to make the stock an asset of the dealer, the exercise of the right will usually have this effect. Such exercise will usually cause the transfer of legal title to the dealer and give rise to an unconditional obligation for it to pay the manufacturer.

Required accounting

Substance of the transaction is that the stock is an asset of the dealer

A11 Where it is concluded that the stock is in substance an asset of the dealer, the stock should be recognised as such on the dealer's balance sheet, together with a corresponding liability to the manufacturer. Any deposit should be deducted from the liability and the excess classified as a trade creditor. The notes to the financial statements should explain the nature of the arrangement, the amount of consignment stock included in the balance sheet and the main terms under which it is held, including the terms of any deposit.

Substance of the transaction is that the stock is not an asset of the dealer

A12 Where it is concluded that the stock is not in substance an asset of the dealer, the stock should not be included on the dealer's balance sheet until the transfer of title has crystallised. Any deposit should be included under 'other debtors'. The notes to the financial statements should explain the nature of the arrangement, the amount of consignment stock held at the year-end, and the main terms under which it is held, including the terms of any deposit.

Table

Indications that the stock is not an asset of the dealer at delivery	Indications that the stock is an asset of the dealer at delivery
Manufacturer can require the dealer to return stock (or transfer stock to other dealer) without compensation, or penalty paid by the dealer to prevent returns/transfers of stocks at the manufacturer's request	Manufacturer cannot require dealer to return or transfer stock, or Financial incentives given to persuade dealer to transfer stock at manufacturer's request
Dealer has unfettered right to return stock to the manufacturer without penalty and actually exercises the right in practice	Dealer has no right to return stock or is commercially compelled not to exercise its right of return
Manufacturer bears obsolescence risk, eg: - obsolete stock is returned to the manufacturer without penalty, or - financial incentives given by manufacturers to prevent stock being returned to it (eg on a model change or if it become obsolete)	Dealer bears obsolescence risk, eg: - penalty charged if dealer returns stock to manufacturer, or - obsolete stock cannot be returned to the manufacturer and no compensation is paid by manufacturer for losses due to obsolescence
Stock transfer price charged by manufacturer is based on manufacturer's list price at date of transfer of legal title	Stock transfer price charged by manufacturer is based on manufacturer's list price at date of delivery
Manufacturer bears slow movement risk, eg: - transfer price set independently of time for which dealer holds stock, and - there is no deposit	Dealer bears slow movement risk, eg: - dealer is effectively charged interest as transfer price or other payments to manufacturer vary with time for which dealer holds stock, or

APPLICATION NOTE B – SALE AND REPURCHASE AGREEMENTS

NB: For ease of reading the parties to a sale and repurchase agreement are referred to below as 'seller' and 'buyer', notwithstanding that analysis of the transaction in accordance with this Application Note may result in the seller continuing to show an asset on its balance sheet.

Features

B1 Sale and repurchase agreements are arrangements under which assets are sold by one party to another on terms that provide for the seller to repurchase the asset in certain circumstances. A similar commercial effect may be achieved by arrangements under which one party holds an asset on behalf of another: although such arrangements are not sale and repurchase agreements, a similar analysis is appropriate and these are therefore covered by this Application Note.

B2 The main features of a sale and repurchase agreement will usually be:

(a) the sale price – this may be market value or another agreed price (analysed in paragraph B9);

(b) the nature of the repurchase provision – this may be: an unconditional commitment for both parties; an option for the seller to repurchase (a call option); an option for the buyer to resell to the seller (a put option); or a combination of put and call options; (analysed in paragraphs B10–B12);

(c) the repurchase price – this may: be fixed at the outset; vary with the period for which the asset is held by the buyer; or be the market price at the time of repurchase. It may also be designed to permit the buyer to recover incidental holding costs (eg insurance) if these do not in fact continue to be met by the seller; (analysed in paragraphs B13–B14); and

(d) other provisions, including where appropriate: for the seller to use the asset whilst it is owned by the buyer; for determining the time of repurchase; or for remarketing the asset if it is to be sold to a third party; (analysed in paragraphs B15–B18).

Analysis

Overview of basic principles

B3 The purpose of the analysis is to determine both whether the seller has an asset (and what is the nature of that asset), and whether the seller has a liability to repay the buyer some or all of the amounts received from the latter.

B4 In a straightforward case, the substance of a sale and repurchase agreement will be that of a secured loan – ie the seller will retain all significant rights to benefits relating to the original asset and all significant exposure to the risks inherent in those benefits and will have a liability to the buyer for the whole of the proceeds received. For example, this would be the case where the seller has in effect an unconditional commitment to repurchase the original asset from the buyer at the sale price plus interest. The seller should account for this type of arrangement by showing the original asset on its balance sheet together with a liability for the amounts received from the buyer.

B5 In certain more complex cases, it may be determined that a sale and repurchase agreement is not in substance a financing transaction and that the seller retains access to only some of the benefits of the original asset and retains only some of their inherent risks. Where this is so, in accordance with paragraph 23, the description or monetary amount of the original asset should be changed and a liability recognised for any obligation to transfer benefits that is assumed. It will also be necessary to give full disclosure of these more complex arrangements in the notes to the financial statements.

B6 The substance of the arrangement may be more readily apparent if the position of both buyer and seller are considered, together with their apparent expectations and motives for agreeing to its various terms. In particular, where the substance is that of a secured loan, the buyer will require that it is assured of a lender's return on its investment and the seller will require that the buyer earns no more than this return. Thus whether or not the buyer earns such a return is an important indicator of the substance of the transaction.

Benefits and risks

B7 The analysis that follows shows how the features set out in paragraph B2 may result in the seller having a liability to the buyer or in the seller retaining rights to some or all of the benefits of the original asset and exposure to some or all of the risks inherent in those benefits. These benefits and risks will usually include some or all of the following:

(c)

(d)

Benefits:
(i) the benefit of any expected increase in the value of the asset; and
(ii) benefits arising from use or development of the asset.

Risks:
(i) the risk of an unexpected variation (adverse or favourable) in the value of the asset;
(ii) the risk of obsolescence; and
(iii) where repurchase is not at a set date, the risk of a variation in the cost of financing the asset because of the variable period between sale and repurchase.

B8 In analysing any specific agreement in practice, it will be necessary to look at all the features of the agreement and give greater weight to those that are more likely to have a commercial effect in practice. In addition, it will be necessary to consider the interaction between the features in order to determine the substance of the arrangement as a whole.

Feature (a) – Sale price

B9 A sale price of other than the market value of the asset at the time of sale indicates that some benefit and risk have been retained by the seller, such that the seller has an asset (either the original asset or a new one) or a liability to the buyer. Even where the sale price is the asset's market value, the seller may nevertheless have an asset or a liability since the other terms of the arrangement may result in the seller retaining significant benefits and risks.

Feature (b) – Nature of repurchase provision

1. Commitment

B10 Any type of unconditional commitment for the seller to repurchase will give rise to both a liability and an asset for the seller: the liability being the seller's commitment to pay the repurchase price; and the asset being continued access to some or all of the benefits of the original asset that forms the subject of the sale and repurchase agreement. The price at which repurchase will occur and the other provisions of the arrangement will determine the exact nature of the seller's asset; these are dealt with in paragraphs B13–B18 below.

B11 There may in effect be a commitment to repurchase even without a strict legal obligation. In particular, this will be the case where there is an option (or a combination of options) on terms that leave no genuine commercial possibility that the option will fail to be exercised. For example, the exercise price of a call option may be set at a significant discount to expected market value, the seller may need the asset to use on an ongoing basis in its business, or the asset may provide in effect the

only source of the seller's future sales. Unwritten understandings between the parties may also result in a commercial commitment for the seller to repurchase even in the absence of a strict legal obligation. Such a commitment is more likely to exist where the buyer's business does not usually involve it in taking on risks of a kind associated with the asset.

2. Put and call options

B12 In some cases the seller may have a call option to repurchase the asset but have no commitment to do so, or the buyer may have a put option to transfer the asset back to the seller without the seller having an equivalent right to insist on repurchase. It will be important to determine why the parties have agreed to such a one-sided option and to assess the commercial effect of the option with regard to all aspects of the arrangement, including whether the seller has a commercial need to repurchase the asset. This analysis may reveal that, in substance, there is a commitment to repurchase as discussed above. Conversely, such an analysis may reveal that the buyer assumes significant benefits and risks relating to the original asset, indicating that the seller has neither the original asset, nor a liability for the option's exercise price. In such a case, where the seller holds a call option it will have a new asset in the form of the option itself; where the buyer has a put option, the seller will have a contingent liability to the buyer for the exercise price of the option (contingent on the buyer exercising its option). In both cases, the seller's new asset or liability should be recognised or disclosed, on a prudent basis, following the principles set out in SSAP 18 'Accounting for contingencies'.*

Feature (c) – Repurchase price and provision for a lender's return

B13 In the most straightforward case, the repurchase price will be the sum of the original sale price, plus any major costs incurred by the buyer and a lender's return (comprising interest on the sale price and costs incurred by the buyer, perhaps with a relatively small fee), but no more. In this case, even if the repurchase provision takes the form of an option, the repurchase price indicates that the substance of the transaction is that of a secured loan, with the benefits and risks of the asset remaining with the seller. This is because the buyer is not compensated for assuming any significant exposure to loss, nor is the seller compensated for giving up any significant potential for gain, thus indicating that the transaction is, in substance, a financing. It will be necessary to look at the arrangement as a whole to establish whether the buyer receives a lender's return since the means of providing it will vary. For example, it may be achieved by lease or other regular payments, licence fees, adjustment to the original sales price or the calculation of the repurchase price.

B14 Conversely, if the buyer is not assured of a lender's return, this indicates that some benefit and risk have been passed to the buyer such that the seller has not retained

**Editor's note: SSAP 18 has been superseded by FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.*

the original asset. The seller may, nevertheless, have a different asset (and a corresponding liability). For example, if a manufacturer sells equipment but agrees to repurchase it in a substantially different form towards the end of its economic life, the manufacturer has both a liability (to pay the repurchase price) and an asset (the equipment as at the repurchase date).

Feature (d) – Other provisions

1. Ability to use the asset

B15 Whilst the ability of the seller to determine the use of the original asset does not, of itself, result in the substance of the transaction being that of a secured loan, it will usually indicate this is so. Continued use of the asset by the seller may indicate that it has a commercial obligation to repurchase even if it has no legal obligation to do so, for instance if there is a commercial need for the seller to repurchase or an expectation that it will do so.

B16 Where the seller continues to use the asset in its business by entering into a sale and leaseback transaction, the provisions of both SSAP 21 'Accounting for leases and hire purchase contracts' and this Application Note will be relevant. Where, in the terms of this Application Note, the substance of the transaction is that of a secured loan, it will be structured so that no significant benefits or risks are passed to the buyer, with the rentals and other lease payments providing the buyer with a lender's return. Thus, in the terms of SSAP 21, 'substantially all the risks and rewards of ownership' of the asset will remain with the seller, the leaseback will be classified as a finance lease, and the transaction will be accounted for as the raising of finance secured on the asset. If, on the other hand, the leaseback is in substance an operating lease, the transaction will be accounted for as a sale of the original asset.

2. Profits or losses on a sale of the asset to a third party

B17 In some cases, the seller may retain access to any increase in the value of the asset via provisions that pass to it substantially all of any profit arising on a sale by the first buyer to a third party (subject to the buyer receiving a lender's return). In addition the buyer may be protected from risk of loss, for instance by the seller being obliged to reimburse the whole or part of any loss on a sale to a third party, or the original sale price being such that losses are unlikely to occur in practice. The substance of such an arrangement is that of a secured loan.

3. Use of special entities ('vehicles')

B18 Some cases may involve a sale to a special entity (a 'vehicle') that is partly or wholly financed by a party other than the seller (eg a financial institution). In such a case, the seller will usually retain access to any increase in the value of the asset and, where

relevant, the benefits from its use, via a right either to repurchase the asset or, in the event that the seller does not repurchase, to receive the majority of any profits from a future sale to a third party. In addition, the seller may provide protection against loss to the other investors in the vehicle, eg by providing a subordinated loan to the vehicle that acts as a cushion to absorb any losses or by guaranteeing the value of the asset in the event that it is sold on to a third party. Such provisions are clear indications that the substance of the transaction is that of a secured loan. Where the terms of the arrangement taken as a whole mean that the investors in the vehicle are reasonably assured of recovering their original investment and earning a lender's return (but no more) thereon, the substance of the transaction will be that of a secured loan.

Required accounting

Substance of the transaction is that of a secured loan

B19 Where the substance of the transaction is that of a secured loan, the seller should continue to recognise the original asset and record the proceeds received from the buyer as a liability. Interest – however designated – should be accrued. The carrying amount of the asset should be reviewed and provided against if necessary. The notes to the financial statements should describe the principal features of the arrangement, including the status of the asset and the relationship between the asset and liability.

B20 Where the transaction is a sale and leaseback, no profit should be recognised on entering into the arrangement and no adjustment made to the carrying value of the asset. As stated in the guidance notes to SSAP 21, this represents the substance of the transaction, "namely the raising of finance secured on an asset that continues to be held and that is not disposed of".

Substance of the transaction is that the seller has a different asset

B21 Where the seller has a new asset or liability (for example, merely a call option to repurchase the original asset), it should recognise or disclose that new asset or liability on a prudent basis in accordance with the provisions of SSAP 18.* In particular, the seller should recognise (and not merely disclose) a liability for any kind of unconditional obligation it has entered into. Where doubts exist regarding the amount of any gain or loss arising, full provision should be made for any expected loss but recognition of any gain, to the extent that it is in doubt, should be deferred until it is realised. The notes to the financial statements should describe the main features of the arrangement, including: the status of the asset; the relationship

**Editor's note: SSAP 18 has been superseded by FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.*

between the asset and the liability; and the terms of any provision for repurchase (including any options) and of any guarantees.

Table

Indications of sale of original asset to buyer (nevertheless, the seller may retain a different asset)	Indications of no sale of original asset to buyer (secured loan)
	Sale price does not equal market value at date of sale.
No commitment for seller to repurchase asset, eg: - call option where there is a real possibility the option will fail to be exercised.	Commitment for seller to repurchase asset, eg: - put and call option with the same exercise price, - either a put or a call option with no genuine commercial possibility that the option will fail to be exercised, or - seller requires asset back to use in its business, or asset is in effect the only source of seller's future sales.
Risk of changes in asset value borne by buyer such that buyer does not receive solely a lender's return, eg: - both sale and repurchase price equal market value at date of sale/purchase.	Risk of changes in asset value borne by seller such that buyer receives solely a lender's return, eg: - repurchase price equals sale price plus costs plus interest, - original purchase price adjusted retrospectively to pass variations in the value of the asset to the seller, - seller provides residual value guarantee to buyer or subordinated debt to protect buyer from falls in the value of the asset.
Nature of the asset is such that it will be used over the life of the agreement, and the seller has no rights to determine its use. Seller has no rights to determine asset's development or future sale.	Seller retains right to determine asset's use, development or sale, or rights to profits therefrom.

Illustrations

Illustration 1

A, a house-builder, agrees with B, a bank, to sell to B some of the land within its land bank. The arrangements surrounding the sale are as follows:

(a) the sales price will be open market value as determined by an independent surveyor;

(b) B grants A the right to develop the land at any time during B's ownership, subject to B's approval of the development plans (which approval shall not be unreasonably withheld); for this right, A pays all the outgoings on the land plus an annual fee of [illegible] per cent of the purchase price;

(c) B will maintain a memorandum account in respect of the land for the purpose of determining the price to be paid by A should A ever re-acquire the land or any adjustments necessary to the original purchase price. In this account will be entered the purchase price, any expenses incurred by B in relation to the transaction, a sum added quarterly (or on the sale by B of the land) calculated by reference to B's base lending rate plus 2 per cent applied to the daily balance on the account, and from the account will be deducted any amounts paid by A to B;

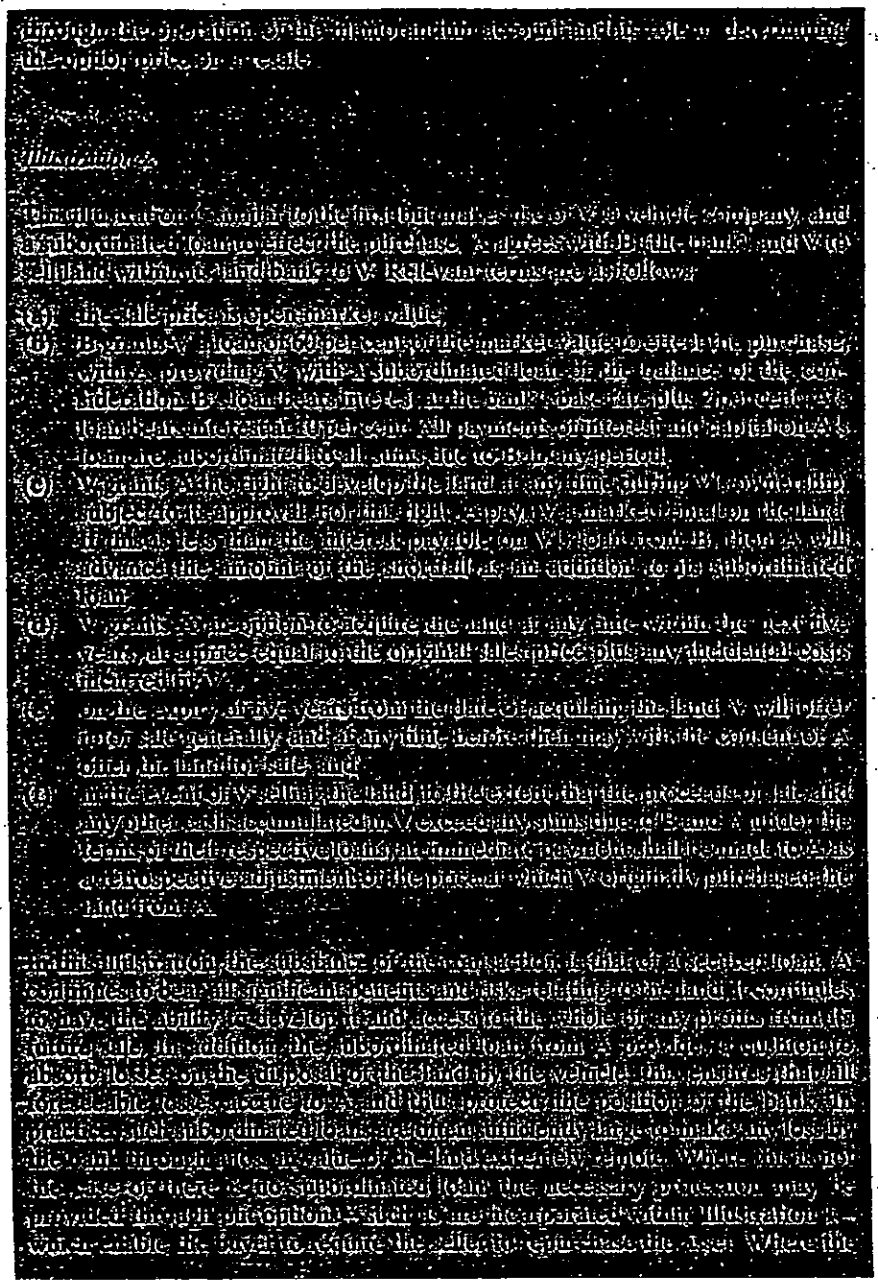
(d) B grants A an option to acquire the land at any time within the next five years, the acquisition price is to be the balance on the memorandum account at the time of exercising the option;

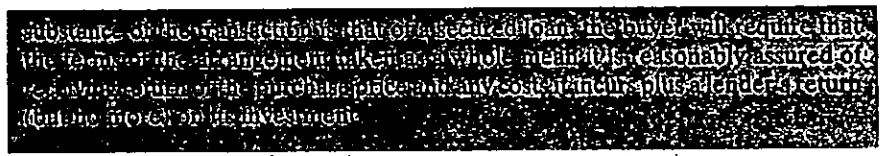
(e) A grants B an option to require it to repurchase the land at any time within the next five years, the price to be the balance on the memorandum account at that time;

(f) on the expiry of five years from the date of acquiring the land, B will offer it for sale generally, and at any time prior to that it may with the consent of A offer the land for sale; and

(g) in the event of B selling the land to a third party, the proceeds of sale shall be deducted from the memorandum account maintained by B and the balance on the account shall be settled between A and B in cash, as a retrospective adjustment of the price at which B originally purchased the land from A.

The commercial effect of the above arrangement is that of a secured loan. A continues to bear all significant benefits and risks relating to the land, retains control of its development and bears all resulting gains and losses. A will either [illegible] call option, or adjust the purchase price on sale of the land to a third party. This latter would also give rise to a liability for A to repay the whole of the sale proceeds received from B. In addition B is assured of a lender's return (and no more): whilst the regular payments by A to B to secure the right to develop the land are not sufficient to provide this, B's return is guaranteed





APPLICATION NOTE C – FACTORING OF DEBTS

NB: For ease of reading the parties to a factoring agreement are referred to in this Application Note as 'seller' and 'factor', notwithstanding that analysis of the transaction in accordance with this Application Note may result in the seller continuing to show the factored debts as an asset on its balance sheet.

Features

Factoring of debts is a well established method of obtaining finance, sales ledger administration services, or protection from bad debts. The principal features of a factoring arrangement are as follows: C1

(a) Specified debts are transferred to the factor (usually by assignment). The transfer may be of complete debtor balances or of all invoices relating to named debtors (perhaps subject to restrictions on the amount that will be accepted from any one debtor).

(b) The factor offers a credit facility that permits the seller to draw up to a fixed percentage of the face value of the debts transferred. Normally these advances are repaid as and when the underlying debts are collected, often by paying the money that is collected into a specially nominated bank account for the benefit of the factor.

(c) The factor may also offer a credit protection facility (or insurance cover). This will limit or eliminate the extent to which the factor has recourse to the seller for debts that are in default.

(d) The factor may administer the sales ledger of the seller. Where such a service is provided, the factor becomes responsible for collecting money from debtors and pursuing those that are slow in paying. In such cases the fact that debts have been factored is likely to be disclosed to the seller's customers; this may not be necessary in other circumstances.

On the transfer of debts, the factoring charges levied on the seller will be set by the factor with reference to expected collections from the debtors and any credit protection services provided (sales ledger administration services are usually invoiced separately). These charges may be fixed at the outset or subject to adjustment at a later date to reflect actual collections; they may be payable immediately or on some future date. C2

Analysis

Overview of basic principles

C3 The purpose of the analysis below is to determine the appropriate accounting treatment in the seller's financial statements. There are three possible treatments:

(a) to remove the factored debts from the balance sheet and show no liability in respect of any proceeds received from the factor ('derecognition');
(b) to show the proceeds received from the factor deducted from the factored debts on the face of the balance sheet within a single asset caption (a 'linked presentation'); or
(c) to continue to show the factored debts as an asset, and show a corresponding liability within creditors in respect of the proceeds received from the factor (a 'separate presentation').

C4 In order to determine the appropriate accounting treatment, it is necessary to answer two questions:

(a) whether the seller has access to the benefits of the factored debts and exposure to the risks inherent in those benefits (referred to below as 'benefits and risks'); and
(b) whether the seller has a liability to repay amounts received from the factor.

Where the seller has transferred all significant benefits and all significant risks relating to the debts, and has no obligation to repay the factor, derecognition is appropriate; where the seller has retained significant benefits and risks relating to the debts but there is absolutely no doubt that its downside exposure to loss is limited, a linked presentation should be used; and in all other cases a separate presentation should be adopted.

Benefits and risks

C5 The main benefits and risks relating to debts are as follows:

Benefits:
(i) the future cash flows from payment by the debtors.

Risks:
(i) slow payment risk; and
(ii) credit risk (the risk of bad debts).

Analysis of benefits

C6 At first glance it may appear that the factor has access to the cash flows from payments by debtors. This may be particularly so if the money that is collected is

be paid direct to the factor (or into a specially nominated bank account for its benefit). However, it may actually be the seller that benefits from payments by debtors, these payments merely representing the primary source from which the factor will be repaid. In particular, where the seller has an obligation to repay any sums received from the factor on or before a set date regardless of the level of collections from the underlying debts, it is clear that the seller has the benefit of payments by debtors, exposure to their inherent risks and a liability to the factor. Such an arrangement should be accounted for by using a separate presentation. Conversely, where the seller receives a single non-returnable cash payment from the factor and the only future payments to be made are by the seller passing to the factor all and any payments from debtors as and when paid, the seller will both have transferred the benefits and risks of the factored debts and have no obligation to repay amounts received from the factor.

This latter arrangement would qualify for derecognition.

C7 Considering the benefits in isolation will not normally enable a clear decision to be made on the appropriate accounting treatment for a factoring. The cash flows may appear similar in both of the above arrangements – an initial cash inflow for the seller followed by a later cash outflow (or a sacrifice of a cash inflow that would otherwise occur). For this reason, the risks (both upside potential for gain and downside exposure to loss) are more significant than the benefits.

Slow payment risk: credit facility

C8 The first main risk associated with non-interest bearing debts is slow payment risk (including the upside potential from prompt payment by debtors). Where the finance cost charged by the factor is essentially a fixed sum determined at the time the transfer is made, the factor will bear the risk of slow payment; where it varies to reflect the speed of collection of the debts subsequently, the seller will bear that risk. Close attention to the arrangements and to their commercial effect in practice may be necessary to determine whether a variable finance cost falls upon the seller since it may take various forms, including a bonus for early settlement, or a retrospective adjustment to the purchase price.

Credit risk: credit protection facility

C9 Credit risk is the other main risk associated with trade debts. If there is no recourse to the seller for bad debts, the factor will bear this risk; if there is full recourse, the seller will bear it. Furthermore, as non-payment is merely the ultimate form of slow payment, where credit risk is retained by the seller, the latter will normally also bear at least some risk of slow payment. For example, where the arrangement takes the form of the seller repurchasing debts that remain outstanding after a given time, the seller bears the slow payment risk beyond this time as well as bearing the credit risk.

Administration arrangements and service-only factoring

C10 For the purpose of deciding upon the appropriate accounting treatment, the administration arrangements will not be directly significant (provided they are on an arm's length basis, and for a fee that is commensurate with the service provided). In a service-only factoring arrangement, where the factor administers the sales ledger but cash is received no earlier than if the debts had not been factored, the seller retains access to the benefits of the debts and exposure to their inherent risks. Thus such an arrangement should be accounted for by using a separate presentation.

Derecognition

C11 Derecognition (ie ceasing to recognise the factored debts in their entirety) is appropriate only where the seller retains no significant benefits and no significant risks relating to the factored debts.

C12 Whilst the commercial effect of any particular transaction should be assessed taking into account all its aspects and implications, the presence of all of the following indicates that the seller has not retained significant benefits and risks, and derecognition is appropriate:

(a) the transaction takes place at an arm's length price for an outright sale;
(b) the transaction is for a fixed amount of consideration and there is no recourse whatsoever, either implicit or explicit, to the seller for losses from either slow payment or non-payment. Normal warranties given in respect of the condition of the debts at the time of the transfer (eg a warranty that goods have been delivered or that the borrower's credit limit had not been breached at the time of granting him credit) would not breach this condition. However, warranties relating to the condition of the debts in the future or to their future performance (eg that debtors will not move into arrears in the future) would breach the condition. Other possible forms of recourse are set out in paragraph 83; and
(c) the seller will not benefit or suffer in any way if the debts perform better or worse than expected. This will not be the case where the seller has a right to further sums from the factor which vary according to the future performance of the debts (ie according to whether or when the debtors pay). Such sums might take the form of deferred consideration, a retrospective adjustment to the purchase price, or rebates of certain charges; they include all forms of variable finance cost.

C13 Where any of the above three features is not present, this indicates that the seller has retained benefits and risks relating to the factored debts and, unless these are insignificant, either a separate presentation or a linked presentation should be adopted.

C14 Whether any benefit and risk retained are 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to

the total possible benefits and risks. For example, if for a portfolio of factored debts of 100, expected bad debts are 5 and there is recourse to the seller for credit losses of up to 10, significant risk will have been retained (as the seller would bear losses of up to twice those expected to occur). Accordingly, in this example, derecognition would not be appropriate and either a linked presentation or a separate presentation should be used. The terms of any roll-over provisions and their effect in practice require careful consideration since these may result in the seller continuing to bear significant risk where, at first sight, it appears that the arrangements do not have this effect. For example, the pricing of future transfers may be adjusted to reflect recent slow payment or bad debt experience and there may be a significant disincentive (eg a penalty) for the seller to cancel the arrangement. This may result in the seller continuing to bear significant risk, albeit disguised as revised charges for debts factored subsequently.

Linked presentation

C15 A linked presentation will be appropriate where, although the seller has retained significant benefits and risks relating to the factored debts, there is absolutely no doubt that its downside exposure to loss is limited to a fixed monetary amount. A linked presentation should be used only to the extent that there is both absolutely no doubt that the factor's claim extends solely to collections from the factored debts, and no provision for the seller to re-acquire the debts in the future. The conditions that need to be met in order for this to be the case are set out in paragraph 27 and explained in paragraphs 81–86. When interpreting these conditions in the context of a factoring arrangement the following points apply:

condition (a) (specified assets) –
a linked presentation should not be used where the debts that have been factored cannot be separately identified.

condition (d) (that the factor agrees in writing there is no recourse, and such agreement is noted in the financial statements) –
the inclusion of an appropriate statement in the factoring agreement will meet the first part of this condition.

C16 Where debts are factored on an ongoing basis, the arrangements for terminating the agreement must be carefully analysed in order to ensure that the conditions for a linked presentation are met. It will be necessary that, although the factor does not take on any new debts, it continues to bear losses on debts already factored and is not able to transfer them back to the seller. Where this is not the case, there remains the possibility that the factor will return debts that it suspects to be bad by terminating the arrangement. In such a case the seller's exposure to loss is not limited, and a separate presentation should be adopted.

Separate presentation

C17 Where the seller has retained significant benefits and risks relating to the debts and the conditions for a linked presentation are not met, a separate presentation should be adopted.

Required accounting

Derecognition

C18 Where the seller has retained no significant benefits and risks relating to the debts and has no obligation to repay amounts received from the factor, the debts should be removed from its balance sheet and no liability shown in respect of the proceeds received from the factor. A profit or loss should be recognised, calculated as the difference between the carrying amount of the debts and the proceeds received.

Linked presentation

C19 Where the conditions for a linked presentation are met, the proceeds received, to the extent they are non-returnable, should be shown deducted from the gross amount of the factored debts (after providing for bad debts, credit protection charges and any accrued interest) on the face of the balance sheet. An example is given in illustration 2 below. The interest element of the factor's charges should be recognised as it accrues and included in the profit and loss account with other interest charges. The notes to the financial statements should disclose: the main terms of the arrangement; the gross amount of factored debts outstanding at the balance sheet date; the factoring charges recognised in the period, analysed as appropriate (eg between interest and other charges); and the disclosures required by conditions (c) and (d) in paragraph 27.

Separate presentation

Where neither derecognition nor a linked presentation is appropriate, a separate presentation should be adopted, ie a gross asset (equivalent in amount to the gross amount of the debts) should be shown on the balance sheet of the seller within assets, and a corresponding liability in respect of the proceeds received from the factor should be shown within liabilities. The interest element of the factor's charges should be recognised as it accrues and included in the profit and loss account with other interest charges. Other factoring costs should be similarly accrued and included in the profit and loss account within the appropriate caption. The notes to the financial statements should disclose the amount of factored debts outstanding at the balance sheet date.

Table

Indications that derecognition is appropriate (debts are not an asset of the seller)	Indications that a linked presentation is appropriate	Indications that a separate presentation is appropriate (debts are an asset of the seller)
Transfer is for a single non-returnable fixed sum.	Some non-returnable proceeds received, but seller has rights to further sums from the factor (or vice versa) whose amount depends on whether or when debtors pay.	Finance cost varies with speed of collection of debts, eg - by adjustment to consideration for original transfer, or - subsequent transfers priced to recover costs of earlier transfers
There is no recourse to the seller for losses.	There is either no recourse for losses, or such recourse has a fixed monetary ceiling.	There is full recourse to the seller for losses.
Factor is paid all amounts received from the factored debts (and no more). Seller has no rights to further sums from the factor.	Factor is paid only out of the amounts collected from the factored debts, and seller has no right or obligation to repurchase debts.	Seller is required to repay amounts received from the factor on or before a set date, regardless of timing or amounts of collections from debtors.

Illustrations

Illustration 1 – Factoring with derecognition (separate presentation)

Company A enters into a factoring arrangement with B with the following principal terms:

(a) A sells (transfers by assignment) all its trade debts to B, subject only to credit approval by B and a limit placed on the proportion of the total that may be due from any one debtor.

(b) B administers the sales ledger and handles all aspects of collection of the debts, including any administration charges, at an annual rate of 1 per cent payable monthly in arrears on the total debts factored during the month and

(c) S may draw up to 70 per cent of the gross amount of debts factored and outstanding at any time, such drawings being debited in the books of F to a factoring account operated by F for S;

(d) weekly, S assigns and sends copy invoices to F as they are raised. F sends statements to debtors, following up all overdue invoices by telephone or letter;

(e) F credits collections from debtors to the factoring account and debits the account monthly with interest calculated on the basis of the daily balances on the account using a rate of base rate plus 2 per cent. Thus this interest charge varies with the amount of finance drawn by S under the finance facility from F, the speed of payment of the debtors and the base rate;

(f) any debts not recovered after 90 days are re-assigned to S for an immediate cash payment, which is credited to the factoring account;

(g) F pays for all other debts, less any advances and interest charges made, 90 days after the date of their assignment to F, and debits the payment to the factoring account; and

(h) on termination of the agreement the balance on the factoring account is settled in cash.

The commercial effect of the above arrangement is that, although the debts have been legally transferred to F, the benefits and risks are retained by S. S continues to bear the slow payment risk as the interest charged by F varies with the speed of payment by the debtors. S continues to bear all of the credit risk as S must pay for any debt not recovered after 90 days, and is therefore exposed to unlimited exposure to loss. In addition, S in effect has an obligation to repay amounts received from F on or before a set date regardless of the level of collections from the factored debts — either out of collections from debtors on the day they pay, or from its general resources after 90 days, whichever is the earlier. Thus a separate presentation should be adopted.

Illustration 2 – Factoring without recourse (linked presentation)

S enters into an agreement with F with the following principal terms:

(a) S will transfer (by assignment) to F such trade debts as S shall determine, subject only to credit approval by F and a limit placed on the proportion of the total that may be due from any one debtor. F levies a charge of 0.5 per cent of turnover, payable monthly, for this facility;

(b) S continues to administer the sales ledger and handle all aspects of collection of the debts;

(c) S may draw up to 80 per cent of the gross amount of debts assigned at any time, such drawings being debited in the books of F to a factoring account operated by F for S;

(d) weekly, S assigns and sends copy invoices to F as they are raised;

(e) S is required to bank the gross amounts of all payments received from debts assigned to F direct into an account in the name of F. Credit transfers made by debtors direct into S's own bank account must immediately be paid to F;

(f) F credits such collections from debtors to the factoring account and debits the account monthly with interest calculated on the basis of the daily balances on the account using a rate of base rate plus 2.5 per cent. Thus this interest charge varies with the amount of finance drawn by S under the finance facility from F, the speed of payment of the debtors and base rate;

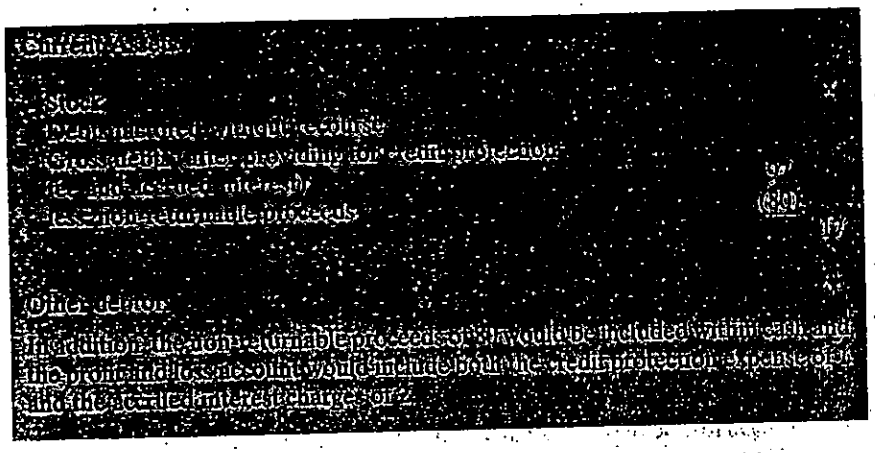
(g) F provides protection from bad debts. Any debts not recovered after 90 days are credited to the factoring account, and responsibility for their collection is passed to F. A charge of 1 per cent of the gross value of all debts factored is levied by F for this service and debited to the factoring account;

(h) F pays for the debts, less any advances, interest charges and credit protection charges, 90 days after the date of purchase, and debits the payment to the factoring account; and

(i) on either party giving 90 days' notice to the other, the arrangement will be terminated. In such an event, S will transfer no further debts to F, and the balance remaining on the factoring account at the end of the notice period will be settled in cash in the normal way.

The commercial effect of this arrangement is that, although the debts have been legally transferred to F, S continues to bear significant benefits and risks relating to them. S continues to bear slow payment risk as the interest charged by F varies with the speed of collection of the debts. Hence, the gross amount of the debts should continue to be shown on its balance sheet until the earlier of collection and transfer of all risks to F (i.e. 90 days). However, S's maximum downside loss is limited since any debts not recovered after 90 days are in effect paid for by F, which then assumes all slow payment and credit risk beyond this time. Thus even for debts that prove to be bad, S receives some proceeds.* Hence, assuming the conditions given in paragraphs 26 and 27 are met, a linked presentation should be adopted. The amount deducted on the face of the balance sheet should be the lower of the proceeds received and the gross amount of the debts less all charges to the factor in respect of them. In the above example, for a debt of 100 this latter amount would be calculated at 100 less the credit protection fee of 1 and the maximum finance charge (calculated for 90 days at base rate plus 2.5 per cent). Assuming the proceeds received of 80 are lower than this, and accrued interest charges at the year end are 2, the arrangement would be shown as follows:

*For a debt of 100 that subsequently proves to be bad, the proceeds received would be 100, less the credit protection fee of 1, less an interest charge calculated for 90 days at base rate plus 2.5%.



APPLICATION NOTE D – SECURITISED ASSETS

Features

D1 Securitisation is a means by which providers of finance fund a specific block of assets rather than the general business of a company. The assets that have been most commonly securitised in the UK are household mortgages. Other receivables such as credit card balances, hire purchase loans and trade debts are sometimes securitised, as are non-monetary assets such as property and stocks. This Application Note applies to all kinds of assets.

D2 The main features are generally as follows:

(a) The assets to be securitised are transferred by a company (the 'originator') to a special purpose vehicle (the 'issuer') in return for an immediate cash payment. Additional deferred consideration may also be payable.

(b) The issuer finances the transfer by the issue of debt, usually tradeable loan notes or commercial paper (referred to below as 'loan notes'). The issuer is usually thinly capitalised and its shares placed with a party other than the originator – charitable trusts have often been used for this purpose – with the result that the issuer is not classified as a subsidiary of the originator under companies legislation. In addition, the major financial and operating policies of the issuer are usually predetermined by the agreements that constitute the securitisation, such that neither the owner of its share capital nor the originator has any significant continuing discretion over how it is run.

(c) Arrangements are made to protect the loan noteholders from losses occurring on the assets by a process termed 'credit enhancement'. This may take the form of third party insurance, a third party guarantee of the issuer's obligations or an issue of subordinated debt (perhaps to the originator); all provide a cushion against losses up to a fixed amount.

(d) The originator is granted rights to surplus income (and, where relevant, capital profits) from the assets – ie to cash remaining after payment of amounts due on the loan notes and other expenses of the issuer. The mechanisms used to achieve this include: servicing or other fees; deferred sale consideration; 'super interest' on amounts owed to the originator (eg subordinated debt); dividend payments; and swap payments.

(e) In the case of securitised debts, the originator may continue to service the debts (ie to collect amounts due from borrowers, set interest rates etc). In this capacity it is referred to as the 'servicer' and receives a servicing fee.

(f) Cash accumulations from the assets (eg from mortgage redemptions) are reinvested by the issuer until loan notes are repaid. Any difference between the interest rate obtained on reinvestments and that payable on the loan notes will normally affect the originator's surplus under (d) above. The terms of the loan notes may provide for them to be redeemed as assets are realised, thus minimising this reinvestment period. Alternatively, cash accumulations may be invested in a 'guaranteed investment contract' that pays a guaranteed rate of interest (which may be determined by reference to a variable benchmark rate such as LIBOR) sufficient to meet interest payments on the loan notes. Another alternative, used particularly for short-term debts arising under a facility (eg credit card balances), is a provision for cash receipts (here from card repayments) to be reinvested in similar assets (eg new balances on the same credit card accounts). This reinvestment in similar assets will occur for a specified period only, after which time cash accumulations will either be used to redeem loan notes or be reinvested in other more liquid assets until loan notes are repaid.

(g) In certain circumstances, for example if tax changes affect the payment of interest to the noteholders or if the principal amount of loan notes outstanding declines to a specified level, the issuer may have an option to buy back the notes. Such repurchase may be funded by the originator, in which case the originator will re-acquire the securitised assets.

D3 From the originator's standpoint, the effect of the arrangement is usually that it continues to obtain the benefit of surplus income (and, where relevant, capital profits) from the securitised assets and bears losses up to a set amount. Usually, however, the originator is protected from losses beyond a limited amount and has transferred catastrophe risk to the issuer.

Analysis

D4 The purpose of the analysis is to determine the following:

(a) the appropriate accounting treatment in the originator's individual company financial statements. There are three possible treatments:

(i) to remove the securitised assets from the balance sheet and show no liability in respect of the note issue, merely retaining the net amount (if

any) of the securitised assets less the loan notes as a single item ('derecognition');

(ii) to show the proceeds of the note issue deducted from the securitised assets on the face of the balance sheet within a single asset caption (a 'linked presentation'); or

(iii) to show an asset equivalent in amount to the gross securitised assets within assets, and a corresponding liability in respect of the proceeds of the note issue within creditors (a 'separate presentation');

(b) the appropriate accounting treatment in the issuer's financial statements. Again there are three possible treatments: derecognition, a linked presentation or a separate presentation; and

(c) the appropriate accounting treatment in the originator's group accounts. This involves issues of:

(i) whether the issuer is a subsidiary or (more usually) a quasi-subsidiary of the originator such that it should be included in the originator's group accounts; and

(ii) where the issuer is a quasi-subsidiary, whether a linked presentation should be adopted in the originator's consolidated accounts.

Each of these is considered in more detail below.

(a) Originator's individual accounts

Overview of basic principles

D5 The principles for determining the appropriate accounting treatment in the originator's individual company financial statements are similar to those applied in both Application Note C – 'Factoring of debts' and in Application Note E – 'Loan transfers'. It is necessary to establish what asset and liability (if any) the originator now has, by answering two questions:

(a) whether the originator has access to the benefits of the securitised assets and exposure to the risks inherent in those benefits (referred to below as 'benefits and risks') and

(b) whether the originator has a liability to repay the proceeds of the note issue.

Where the originator has transferred all significant benefits and risks relating to the securitised assets and has no obligation to repay the proceeds of the note issue, derecognition is appropriate; where the originator has retained significant benefits and risks relating to the securitised assets but there is absolutely no doubt that its downside exposure to loss is limited, a linked presentation should be used; and in all other cases a separate presentation should be adopted.

D6 The benefits and risks relating to securitised assets will depend on the nature of the particular assets involved. In the case of interest bearing loans, the benefits and risks are described in paragraph E6 of Application Note E – 'Loan transfers'.

Derecognition

Derecognition (ie ceasing to recognise the securitised assets in their entirety) is appropriate only where the originator retains no significant benefits and no significant risks relating to the securitised assets. D7

Whilst the commercial effect of any particular transaction should be assessed taking into account all its aspects and implications, the presence of all of the following indicates that the originator has not retained significant benefits and risks, and derecognition is appropriate: D8

(a) the transaction takes place at an arm's length price for an outright sale;

(b) the transaction is for a fixed amount of consideration and there is no recourse whatsoever, either implicit or explicit, to the originator for losses from whatever cause. Normal warranties given in respect of the condition of the assets at the time of the transfer (eg in a mortgage securitisation, a warranty that no mortgages are in arrears at the time of transfer, or that the income of the borrower at the time of granting the mortgage was above a specified amount) would not breach this condition. However, warranties relating to the condition of the assets in the future or to their future performance (eg that mortgages will not move into arrears in the future) would breach the condition. Other possible forms of recourse are set out in paragraph 83; and

(c) the originator will not benefit or suffer if the securitised assets perform better or worse than expected. This will not be the case where the originator has a right to further sums from the vehicle that vary according to the eventual value realised for the securitised assets. Such sums could take a number of forms, for instance deferred consideration, a performance-related servicing fee, payments under a swap, dividends from the vehicle, or payments from a reserve fund.

Where any of these three features is not present, this indicates that the originator has retained benefits and risks relating to the securitised assets and, unless these are insignificant, either a separate presentation or a linked presentation should be adopted.

Whether any benefit and risk retained are 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks. Where the profits or losses accruing to the originator are material in relation to those likely to occur in practice, significant benefit and risk will be retained. For example, if for a portfolio of securitised assets of 100, expected losses are 0.5 and there is recourse to the originator for losses of up to 5, the originator will have retained all but an insignificant part of the downside risk relating to the assets (as the originator bears losses of up to ten times those expected D9

to occur). Accordingly, in this example, derecognition will not be appropriate and either a linked presentation or a separate presentation should be used.

Linked presentation

D10 A linked presentation will be appropriate where, although the originator has retained significant benefits and risks relating to the securitised assets, there is absolutely no doubt that its downside exposure to loss is limited to a fixed monetary amount. A linked presentation should be used only to the extent that there is both absolutely no doubt that the noteholders' claim extends solely to the proceeds generated by the securitised assets, and there is no provision for the originator to re-acquire the securitised assets in the future. The conditions that need to be met in order for this to be the case are set out in paragraph 27 and explained in paragraphs 81–86. When interpreting these conditions in the context of a securitisation the following points apply:

condition (a) (specified assets) –

a linked presentation should not be used where the assets that have been securitised cannot be separately identified. Nor should a linked presentation be used for assets that generate the funds required to repay the finance only by being used in conjunction with other assets of the originator;

condition (d) (agreement in writing that there is no recourse; such agreement noted in the financial statements) –

where the noteholders have subscribed to a prospectus or offering circular that clearly states that the originator will not support any losses of either the issuer or the noteholders, the first part of this condition will be met. Provisions that give the noteholders recourse to funds generated by both the securitised assets themselves and third party credit enhancement of those assets would also not breach this condition;

condition (f) (no provision for the originator to repurchase assets) –

where there is provision for the originator to repurchase only part of the securitised assets (or otherwise to fund the redemption of loan notes by the issuer), the maximum payment that could result should be excluded from the amount deducted on the face of the balance sheet. Where there is provision for the issuer (but not the originator) to redeem loan notes before an equivalent amount has been realised in cash from the securitised assets, a linked presentation may still be appropriate provided there is no obligation (legal, commercial or other) for the originator to fund the redemption (eg by repurchasing the securitised assets).

D11 These conditions should be regarded as met notwithstanding the existence of an interest rate swap agreement between the originator and the issuer, provided all the following conditions are met:

(a) the swap is on arm's length market-related terms and the obligations of the issuer under the swap are not subordinated to any of its obligations under the loan notes;

(b) the variable interest rate(s) that are swapped are determined by reference to publicly quoted rates that are not under the control of the originator;

(c) at the time of transfer of the assets to the issuer, the originator had hedged exposures relating to these assets (either individually or as part of a larger portfolio) and entering into the swap effectively restores the hedge position left open by their transfer. Thereafter, where the hedging of the originator's exposure under the swap requires continuing management, any necessary adjustments to the hedging position are made on an ongoing basis. This latter requirement will be particularly relevant where any prepayment risk involved cannot be hedged exactly.

The conditions for a linked presentation should also be regarded as met notwithstanding the existence of an interest rate cap agreement between the originator and the issuer provided that, in addition to all the above conditions being met, the securitisation was entered into before 22 September 1994.

D12 In the case of securitisations of revolving assets that arise under a facility (eg credit card balances), a careful analysis of the mechanism for repaying the loan notes is required in order to establish whether or not conditions (b) and (f) in paragraph 27 are met. For such assets, the loan notes are usually repaid from proceeds received during a period of time (referred to as the 'repayment period'). The proceeds received in the repayment period will typically comprise both repayments of securitised balances existing at the start of the repayment period and repayments of balances arising subsequently (for example arising from new borrowings in the repayment period on the credit card accounts securitised). In order that the conditions for a linked presentation are met, it is necessary that loan notes are repaid only to the extent that there have been, in total, cash collections from securitised balances existing at the start of the repayment period equal to the amount repaid on the loan notes. This is necessary in order to ensure that the issuer is allocated its proper share of any losses.

D13 It will also be necessary to analyse carefully any provisions that enable the originator to transfer additional assets to the issuer in order to establish whether or not conditions (b) and (f) in paragraph 27 are met. To the extent that the originator is obliged to replace poorly performing assets with good ones, there is recourse to the originator and a linked presentation should not be used. However, where there is merely provision for the originator to add new assets to replace those that have been repaid earlier than expected (and thus to 'top up' the pool in order to extend the life of the securitisation), the conditions for a linked presentation may still be met. For a linked presentation to be used, it is necessary that the addition of new assets does not result in either the originator being exposed to losses on the new or the old assets, or in the originator re-acquiring assets. Provided these features are present, the effect is the same as if the noteholders were repaid in cash and they immediately invested that cash in new assets, and a linked presentation may be appropriate.

Separate presentation

D14 Where the originator has retained significant benefits and risks relating to the securitised assets and the conditions for a linked presentation are not met, the originator should adopt a separate presentation.

Multi-originator programmes

D15 There are some arrangements where one issuer serves several originators. The arrangement may be structured such that each originator receives future benefits based on the performance of a defined portfolio of assets (typically those it has transferred to the issuer and continues to service or use). For instance, in a mortgage securitisation, the benefits accruing to any particular originator may be calculated as the interest payments received from a defined portfolio of mortgages, less costs specific to that portfolio (eg insurance premiums, payments for credit facilities), less an appropriate share of the funding costs of the issuer. The effect is that each originator bears significant benefits and risks of a defined pool of mortgages, whilst being insulated from the benefits and risks of other mortgages held by the issuer. Thus each originator should show that pool of mortgages for which it has significant benefits and risks on the face of its balance sheet, using either a linked presentation (if the conditions for its use are met) or a separate presentation.

(b) Issuer's accounts

D16 The principles set out in paragraphs D5–D15 for the originator's individual financial statements also apply to the issuer's financial statements. In a securitisation, the issuer usually has access to all future benefits from the securitised assets (in the case of mortgages, to all cash collected from mortgagors) and is exposed to all their inherent risks. Hence, derecognition will not be appropriate. In addition, the noteholders usually have recourse to all the assets of the issuer (these may include the securitised assets themselves, the benefit of any related insurance policies or credit enhancement, and a small amount of cash). In this situation, the issuer's exposure to loss is not limited, and use of a linked presentation will not be appropriate. Thus the issuer should usually adopt a separate presentation.

(c) Originator's group financial statements

D17 Assuming a separate presentation is used in the issuer's financial statements but not in those of the originator, the question arises whether the relationship between the issuer and the originator is such that the issuer should be included in the originator's group financial statements. The following considerations are relevant:

(a) Where the issuer meets the definition of a subsidiary, it should be consolidated in the normal way by applying the relevant provisions of companies legislation and FRS 2. Where the issuer is not a subsidiary, the provisions of this FRS regarding quasi-subsidiaries are relevant.

(b) In order to meet the definition of a quasi- subsidiary, the issuer must give rise to benefits for the originator that are in substance no different from those that would arise were the entity a subsidiary. This will be the case where the originator receives the future benefits arising from the net assets of the issuer (principally the securitised assets less the loan notes). It is not necessary that the originator could face a possible benefit outflow equal in amount to the issuer's gross liabilities. Strong evidence of whether this part of the definition is met is whether the originator stands to suffer or gain from the financial performance of the issuer.

(c) The definition of a quasi-subsidiary also requires that the issuer is directly or indirectly controlled by the originator. Usually securitisations exemplify the situation described in paragraphs 34 and 98, in that the issuer's financial and operating policies are in substance predetermined (in this case under the various agreements that constitute the securitisation). Where this is so, the party possessing control will be the one that has the future benefits arising from the issuer's net assets.

D18 It follows that it should be presumed that the issuer is a quasi-subsidiary where either of the following is present:

(a) the originator has rights to the benefits arising from the issuer's net assets, ie to those benefits generated by the securitised assets that remain after meeting the claims of noteholders and other expenses of the issuer. These benefits may be transferred to the originator in a number of forms, as described in paragraph D2(d); or

(b) the originator has the risks inherent in these benefits. This will be the case where, if the benefits are greater or less than expected (eg because of the securitised assets realising more or less than expected), the originator gains or suffers.

D19 In general, where an issuer's activities comprise holding securitised assets and the benefits of its net assets accrue to the originator, the issuer will be a quasi-subsidiary of the originator. Conversely, the issuer will not be a quasi-subsidiary of the originator where the owner of the issuer is an independent third party that has made a substantial capital investment in the issuer, has control of the issuer, and has the benefits and risks of its net assets.

D20 Where the issuer is a quasi-subsidiary of the originator, the question arises whether a linked presentation should be adopted in the originator's group financial statements. It follows from paragraph 37 that where the issuer holds a single portfolio of similar assets, and the effect of the arrangement is to ring-fence the assets and their related finance in such a way that the provisions of paragraphs 26 and 27 are met from the point of view of the group, a linked presentation should be used.

Required accounting

Originator's individual financial statements

Derecognition

D21 Where the originator has retained no significant benefits and risks relating to the securitised assets and has no obligation to repay the proceeds of the note issue, the assets should be removed from its balance sheet, and no liability shown in respect of the proceeds of the note issue. A profit or loss should be recognised, calculated as the difference between the carrying amount of the assets and the proceeds received.

Linked presentation

D22 Where the conditions for a linked presentation are met, the proceeds of the note issue (to the extent they are non-returnable) should be shown deducted from the securitised assets on the face of the balance sheet within a single asset caption. Profit should be recognised and presented in the manner set out in paragraphs 28 and 87–88. The following disclosures should be given:

(a) a description of the assets securitised;
(b) the amount of any income or expense recognised in the period, analysed as appropriate;
(c) the terms of any options for the originator to repurchase assets or to transfer additional assets to the issuer;
(d) the terms of any interest rate swap or interest rate cap agreements between the issuer and the originator that meet the conditions set out in paragraph D11;
(e) a description of the priority and amount of claims on the proceeds generated by the assets, including any rights of the originator to proceeds from the assets in addition to the non-recourse amounts already received;
(f) the ownership of the issuer; and
(g) the disclosures required by conditions (c) and (d) in paragraph 27.

D23 Where an originator uses a linked presentation for several different securitisations that all relate to a single type of asset (ie all the assets, if not securitised, would be shown within the same balance sheet caption), these may be aggregated on the face of the balance sheet. However, securitisations of different types of asset should be shown separately. In addition, details of each material arrangement should be provided in the notes to the financial statements, unless they are on similar terms and relate to a single type of asset, in which case they may be disclosed in aggregate.

Separate presentation

D24 Where neither derecognition nor a linked presentation is appropriate, a separate presentation should be adopted, ie a gross asset (equal in amount to the gross amount of the securitised assets) should be shown on the balance sheet of the originator within assets, and a corresponding liability in respect of the proceeds of the note issue shown within liabilities. No gain or loss should be recognised at the time the securitisation is entered into (unless adjustment to the carrying value of the assets independent of the securitisation is required). Disclosure should be given in the notes to the financial statements of the gross amount of assets securitised at the balance sheet date.

Issuer's financial statements

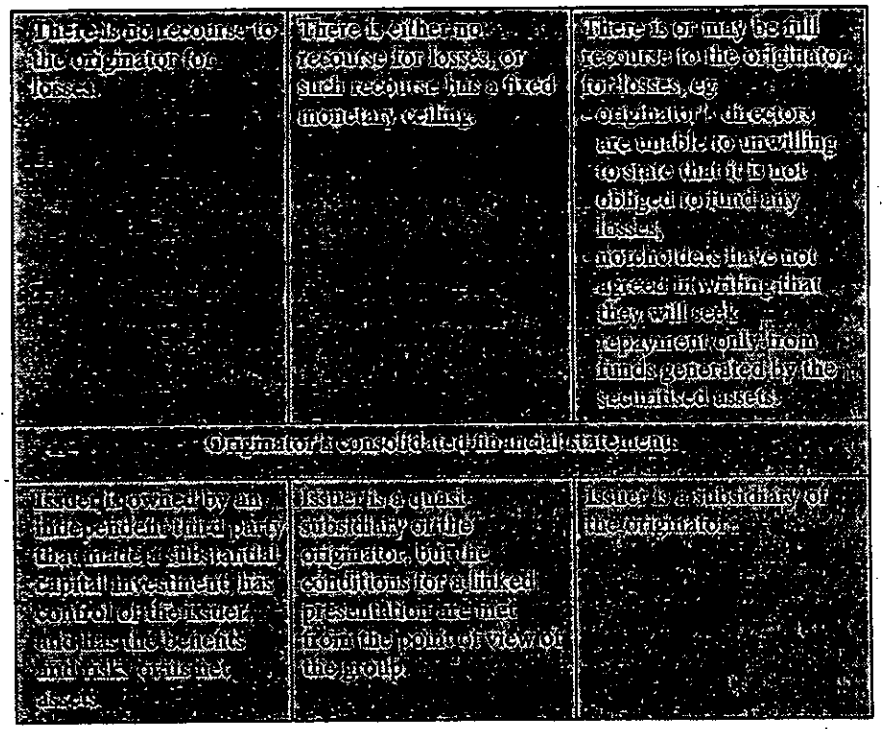
D25 The requirements set out in paragraphs D21–D24 for the originator's individual financial statements also apply to the issuer's financial statements. For the reasons set out in paragraph D16, in most cases the issuer will be required to adopt a separate presentation, in which case the provisions of paragraph D24 will apply.

Originator's consolidated financial statements

D26 Where the issuer is a quasi-subsidiary of the originator, its assets, liabilities, profits, losses and cash flows should be included in the originating group's consolidated financial statements. Where the provisions of paragraph D20 are met, a linked presentation should be applied in the consolidated financial statements and the disclosures required by paragraphs D22 and D23 should be given; in all other cases a separate presentation should be used and the disclosure required by paragraph D24 should be given.

Table

Indications that derecognition is appropriate (securitised assets are not assets of the originator)	Indications that a linked presentation is appropriate	Indications that a separate presentation is appropriate (securitised assets are assets of the originator)
Originator's individual financial statements		
Transaction price is best's length price for an outright sale.	Transaction price is not arm's length price for an outright sale.	Transaction price is not arm's length for an outright sale.
Transfer is for a single, non-returnable fixed sum.	Some non-returnable proceeds received, but originator has rights to further sums from the issuer, the amount of which depends on the performance of the securitised assets.	Proceeds received are returnable, or there is a provision whereby the originator may keep the securitised assets on repayment of the loan notes or re-acquire them.



APPLICATION NOTE E – LOAN TRANSFERS

NB: In this Application Note, the following terminology is used:

(a) the 'lender' is the party that has rights to principal and interest under the original loan agreement, and is purporting to transfer them;
(b) the 'transferee' is the party purporting to acquire the loan, and includes a new lender (in a novation), an assignee and a sub-participant;
(c) the 'borrower' is the party that has obligations to make payments of principal and interest under the original loan agreement; and
(d) references to the transfer of a 'loan' or 'loans' apply equally to the transfer of both a single loan and a portfolio of loans.

Features

E1 This Application Note deals with the transfer of interest-bearing loans to an entity other than a special purpose vehicle. The main features of a loan transfer are as follows:

(a) Specified loans are transferred from a lender to a transferee by one of the methods set out in paragraph E2 below, in return for an immediate cash payment. The transfer may be of the whole of a single loan, part of a loan, or of all or part of a portfolio of similar loans.
(b) Payments of principal and interest collected from borrowers are passed to the transferee (either direct or via the lender). In some cases, there may be a difference between amounts received from borrowers and those passed to the transferee (the lender retaining or making up the difference), or if a borrower fails to make payments when due, the lender may nevertheless make payments to the transferee.

E2 Loans cannot be 'sold' in the same way as tangible assets. However, there are three methods by which the benefits and risks of a loan can be transferred:

Novation: The rights and obligations under the loan agreement are cancelled and replaced by new ones whose main effect is to change the identity of the lender. Although rights can be transferred by other means, novation is the only method of transferring obligations (eg to supply funds under an undrawn loan facility) with the consequent release of the lender.

Assignment: Rights (to principal and interest), but not obligations, are transferred to a third party (the 'assignee'). There are two types of assignment: statutory assignment, which must relate to the whole of the loan and where notice in writing must be given to the borrower and other obligors (eg a guarantor); and equitable assignment, which may relate to only part of a loan and which does not require notice to the borrower. Both types are subject to equitable rights arising before notice is received. For example, a right of set-off held by the borrower against the lender will be good against the assignee for any transactions undertaken before the borrower receives notice of the assignment.

Sub-participation: Rights and obligations are not formally transferred but the lender enters into a non-recourse back-to-back agreement with a third party, the 'sub participant', under which the latter deposits with the lender an amount equal to the whole or part of the loan and in return receives from the lender a share of the cash flows arising on the loan.

E3 The terms of a loan transfer will usually not be identical to those of the original loan, and a gain or loss will arise for the lender. This gain or loss may occur in one of two ways: first, if all future payments made by the borrower (and only such payments) are to be passed to the transferee, the consideration for the transfer will differ from the carrying amount of the loan and the lender's gain or loss will be realised in cash immediately. Alternatively, the consideration for the transfer may be set equal to the carrying amount of the loan, and the amounts to be paid by the borrower and those to be passed on to the transferee will differ. In this case, the lender's gain or loss will be the net present value of this difference and will be realised in cash over the term of the loan.

Analysis

Overview of basic principles

E4 The purpose of the analysis is to determine the appropriate accounting treatment in the financial statements of the lender. There are three possible treatments:

(a) to remove the loan (or a part of it) from the balance sheet and show no liability in respect of the amounts received from the transferee ('derecognition');
(b) to show the amounts received from the transferee deducted from the loan on the face of the balance sheet within a single asset caption (a 'linked presentation'); or
(c) to continue to show the loan as an asset, and show a corresponding liability within creditors in respect of the amounts received from the transferee (a 'separate presentation').

E5 The principles to be applied to determine the appropriate accounting treatment are similar to those applied in both Application Note D – 'Securitised assets' relating to individual (rather than consolidated) financial statements and in Application Note C – 'Factoring of debts'. It is necessary to answer two questions:

(a) whether the lender has access to the benefits of the loans and exposure to the risks inherent in those benefits (referred to below as 'benefits and risks'); and
(b) whether the lender has a liability to repay the transferee.

Where the lender has transferred all significant benefits and risks relating to the loans and has no obligation to repay the transferee, derecognition is appropriate (this would be the case where all future cash flows from borrowers – but only those cash flows – are passed to the transferee as and when received). Where the lender has retained significant benefits and risks relating to the loans but there is absolutely no doubt that its downside exposure to loss is limited, a linked presentation should be used (this is likely to be rare for a loan transfer). In all other cases a separate presentation should be adopted.

Benefits and risks

E6 The main benefits and risks relating to loans are as follows:

Benefits:
(i) the future cash flows from payments of principal and interest.
Risks:
(i) credit risk (the risk of bad debts);
(ii) slow payment risk;
(iii) interest rate risk (the risk of a change in the interest rate paid by the borrower. Included in this risk is a form of basis risk, ie the risk of a change in the interest rate paid by the borrower not being matched by a change in the interest rate paid to the transferee);
(iv) reinvestment/early redemption risk (the risk that, where payments from the loans are reinvested by the lender before being paid to the transferee, the rate of interest obtained on the reinvested amounts is above or below that payable to the transferee); and
(v) moral risk (the risk that the lender will feel obliged, because of its continued association with the loans, to fund any losses arising on them).

Analysis of benefits

E7 At first sight it may appear that the transferee has access to the cash collected from borrowers. However, as set out in more detail in paragraphs C6 and C7, the cash flows may appear similar even where different accounting treatments are appropriate and considering the benefits in isolation will not normally enable a clear decision to be made. Rather, it is necessary to determine which party is exposed to the risks relating to the loans (both upside potential for gain and downside exposure to loss).

Analysis of risks

E8 The benefit of cash payments of principal and interest are subject to the five risks outlined in paragraph E6. The first of these, credit risk, will be borne by the lender to the extent there is recourse to it for bad debts; if there is no such recourse, the transferee will bear the credit risk.

E9 The second risk, slow payment, will be borne by the party that suffers (or benefits) if borrowers pay later (or earlier) than expected. If amounts are passed to the transferee only when received from the borrower, the transferee will bear this risk; if the lender pays amounts to the transferee regardless of whether it has received an equivalent payment from the borrower, the lender will bear it.

E10 Interest rate risk will be borne by the lender where the interest it receives from the borrower and payments it makes to the transferee are not directly related*. Where any changes in the interest rate charged to the borrower are passed on to the transferee after a short administrative delay, the lender may not bear significant interest rate risk; however, where any delays are significant the lender will bear significant risk.

E11 The lender will bear reinvestment risk where payments received from the borrower are not immediately passed on to the transferee but are reinvested by the lender for

*'Directly related' in this context means that either the interest rates paid and received are both fixed, or the two rates are tied to the same external rate eg LIBOR.

a period. An exception would be where the transferee is entitled to all of any interest actually earned (but no more) on the amounts reinvested by the lender.

E12 The final risk is moral risk. For either derecognition or a linked presentation to be appropriate, the lender must have taken all reasonable precautions to eliminate this risk such that it will not feel obliged to fund any losses. This will include ensuring that the arrangements for servicing the loans reflect the standards of commercial behaviour expected of the lender.

Derecognition

E13 Derecognition (ie ceasing to recognise the loans in their entirety) is appropriate only where the lender retains no significant benefits and no significant risks relating to the loans. In determining whether any benefit and risk retained are 'significant', greater weight should be given to what is more likely to have a commercial effect in practice.

E14 The three possible methods of transferring the benefits and risks relating to a loan are described in paragraph E2; each may result in derecognition in appropriate cases:

(a) A novation (ie the replacement of the original loan by a new one with the consequent release of the lender) will usually transfer all significant benefits and risks, provided that there are no side agreements that leave benefits and risks with the lender.

(b) An assignment (ie the transfer of the rights to principal and interest that constitute the original loan, whilst not transferring any obligations) may also transfer all significant benefits and risks, provided that, in addition to there being no side agreements that leave benefits and risks with the lender, there are no unfulfilled obligations (eg to supply additional funds in the event of a restructuring of the loan) and any doubts regarding intervening equitable rights are satisfied.

(c) A sub-participation (ie the entering into an additional non-recourse back-to-back agreement with the sub-participant rather than the transfer of any of the rights or obligations that constitute the original loan itself) may also transfer all significant benefits and risks, provided that the lender's obligation to pay amounts to the transferee eliminates its access to benefits from the loans but extends only to those benefits. Thus the sub-participant must have a claim on all specified payments from the loans but on only those payments, and there must be no possibility that the lender could be required to pay amounts to the sub-participant where it has not received equivalent payments from the borrower.* Where this is the case, the loans no longer constitute an asset of the lender, nor does the deposit placed by the sub-participant represent a liability;

**Where only part of the payments due under the original loan are eliminated in this way, it may be appropriate to derecognise only part of the original loan. This is addressed in paragraphs E19 and E20 below.*

it will therefore be appropriate to derecognise the loans. Particular attention should be paid to the effect of the borrower asking for a rescheduling. The lender may, for commercial reasons, wish to agree to a rescheduling plan, whereas the sub participant may simply look to the lender for compensation if it is not repaid. Where the lender has an obligation (legal, commercial or other) to provide such compensation, derecognition will not be appropriate.

E15 Whilst the commercial effect of any particular transaction should be assessed taking into account all its aspects and implications, the presence of all of the following indicates that the lender has not retained significant benefits and risks, and derecognition is appropriate:

(a) the transaction takes place at an arm's length price for an outright sale;

(b) the transaction is for a fixed amount of consideration and there is no recourse whatsoever, either implicit or explicit, to the lender for losses from whatever cause. Normal warranties given in respect of the condition of the loans at the time of the transfer (eg a warranty that no loan was in arrears at the time of transfer) would not breach this condition. However, warranties relating to the condition of the loans in the future or to their future performance (eg that loans will not move into arrears in the future) would breach the condition. Other possible forms of recourse are set out in paragraph 83; and

(c) the lender will not benefit or suffer in any way if the loans perform better or worse than expected. This will not be the case where the lender has a right to further sums that vary according to the future performance of the loans (ie according to whether or when borrowers pay, or according to the amounts borrowers pay). Such sums might take the form of an interest differential, deferred consideration, a performance-related servicing fee or payments under a swap.

Where any of these three features is not present, this indicates that the lender has retained benefits and risks relating to the loan and, unless these are insignificant, either a separate presentation or a linked presentation should be adopted.

E16 Whether any benefit and risk retained are 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks. Where the profits or losses accruing to the lender are material in relation to those likely to occur in practice, significant benefit and risk will be retained, such that derecognition will not be appropriate and either a linked presentation or a separate presentation should be used.

Linked presentation

E17 A linked presentation will be appropriate where, although the lender has retained significant benefits and risks relating to the loans, there is absolutely no doubt that its downside exposure to loss is limited to a fixed monetary amount. A linked presentation should be used only to the extent that there is both absolutely no doubt that the

transferee's claim extends solely to cash collected from the loans, and no provision for the lender to keep or re-acquire the loans by repaying the transferee. The conditions that need to be met in order for this to be the case are set out in paragraph 27 and explained in paragraphs 81–86.

Separate presentation

E18 Where the lender retains significant benefits and risks relating to the loans and the conditions for a linked presentation are not met, a separate presentation should be adopted.

Transfers of part of a loan

E19 In some cases the amount received by the lender from the transferee represents only part of the original loan. As explained in paragraph 71, where the effect of the arrangement is that a part of the loan is transferred, derecognition of that part will be appropriate. This will be the case where each party has a proportionate share of all future cash collected from the loan (and of related profits and losses). For example, were the transferee to be entitled to 40 per cent of any cash flows from payments of both principal and interest as and when paid by the borrower (ie it does not receive cash if such payments are not made), the lender should cease to recognise 40 per cent of the loan. Conversely, if the lender bears losses in preference to the transferee and thus retains significant risk relating to the loans, derecognition of any part of them is not appropriate. For example, were the transferee to have first claim on any cash flows arising from a portfolio of loans with the lender's share acting as a cushion to absorb any losses, the lender should continue to show the gross amount of the whole portfolio on the face of its balance sheet (although if the conditions for a linked presentation are met, it should be used).

E20 In other cases, the entire principal amount of a loan may be funded by the transferee, but there may be a difference between the interest payments due from the borrower and those the lender has agreed to pass on to the transferee. In such cases derecognition of a part of the original loan may still be appropriate provided that the lender's interest differential does not result in it bearing significant risks relating to the loan. For instance, if the lender's interest differential is fixed and is in substance no more than a fee for originating or administering the loan, derecognition will be appropriate. Conversely, if the lender's interest differential varies depending on the performance of the loan (as where it acts as a cushion to absorb losses or the lender bears interest rate risk), either a separate presentation or a linked presentation should be used. A linked presentation should be used only where the lender's maximum loss is capped, as might be the case where a variable rate loan is funded by a fixed rate one (if the lender's maximum loss is capped at the fixed interest payments due to the transferee). However, a linked presentation should not be used where the lender's maximum loss is not capped, as will be the case where a fixed rate loan is funded by a variable rate one, or where a loan in one currency is funded by a

loan in another. The principles in this paragraph apply equally where the transferee funds only part of the principal amount of the original loan.

Administration arrangements

Whether or not the lender continues to administer the loans is not, of itself, relevant to deciding upon the appropriate accounting treatment. However, the administration arrangements may affect where certain benefits and risks lie. For instance, where the lender's servicing fee is not an arm's length fee for the services provided, this indicates it has retained significant benefits and risks relating to the loans. E21

Required accounting

Derecognition

Where the lender has retained no significant benefits and risks relating to the loans and has no obligation to repay the transferee, the loans should be removed from its balance sheet and no liability shown in respect of the amounts received from the transferee. A profit or loss may arise for the lender in the two ways set out in paragraph E3. Where the profit or loss is realised in cash it should be recognised, calculated as the difference between the carrying amount of the loans and the cash proceeds received. Where, however, the lender's profit or loss is not realised in cash and there are doubts as to its amount, full provision should be made for any expected loss but recognition of any gain, to the extent it is in doubt, should be deferred until cash has been received. E22

Linked presentation

Where the conditions for a linked presentation are met, the proceeds received, to the extent they are non-returnable, should be shown deducted from the gross amount of the loans on the face of the balance sheet. Profit should be recognised and presented as set out in paragraphs 28 and 87–88. The notes to the financial statements should disclose: the main terms of the arrangement; the gross amount of loans transferred and outstanding at the balance sheet date; the profit or loss recognised in the period, analysed as appropriate; and the disclosures required by conditions (c) and (d) in paragraph 27. E23

Separate presentation

Where neither derecognition nor a linked presentation is appropriate, a separate presentation should be adopted, ie a gross asset (equivalent in amount to the gross amount of the loans) should be shown on the balance sheet of the lender within E24

assets, and a corresponding liability in respect of the amounts received from the transferee should be shown within creditors. No gain or loss should be recognised at the time of the transfer (unless adjustment to the carrying value of the loan independent of the transfer is required). The notes to the financial statements should disclose the amount of loans subject to loan transfer arrangements that are outstanding at the balance sheet date.

Table

Indications that derecognition is appropriate (off lender's balance sheet)	Indications that a linked presentation is appropriate	Indications that a separate presentation is appropriate (on lender's balance sheet)
Transferee is for a single, non-returnable fixed sum	Some non-returnable proceeds received, but lender has rights to further sums whose amount depends on whether or when the borrowers pay	The proceeds received are returnable in the event of losses occurring on the loans
There is no recourse to the lender for losses from any cause	There is either no recourse for losses or such recourse has a fixed monetary ceiling	There is full recourse to the lender for losses
Transferee is paid all amounts received from the loans (and no more), as and when received; lender has no rights to further sums from the loans or the transferee	Transferee is paid only out of amounts received from the loans, and lender has no right or obligation to repurchase them	Lender is required to repay amounts received from the transferee on or before a set date, regardless of the timing of amounts or payments by the borrowers

APPLICATION NOTE F – PRIVATE FINANCE INITIATIVE AND SIMILAR CONTRACTS

NB In this Application Note the following terminology is used:

(a) the entity (usually a public sector body) that acquires services under a Private Finance Initiative (PFI) contract is referred to as the 'purchaser';

(b) the entity (usually a private sector body) that provides services under the PFI contract in return for payments from the purchaser is referred to as the 'operator'.

(c) the road, hospital, prison etc that is the subject of the PFI contract is referred to as the 'property'. The word 'asset' is reserved for items that are recognised in the balance sheet.

FEATURES

Under a PFI contract, the private sector is responsible for supplying services that traditionally have been provided by the public sector. It is integral to most PFI contracts that the operator designs, builds, finances and operates a property in order to provide the contracted service. Examples of such properties are roads, bridges, hospitals, prisons, offices, information technology systems and educational establishments. F1

The main features of a PFI contract are as follows: F2

(a) A contract to provide services is awarded by the purchaser (a public sector entity) to the operator (a private sector entity). The contract will specify the level of service required over the period of the contract. Usually, the contract also provides for a single ('unitary') payment to be made in each period, linked to factors such as availability, performance and levels of usage.

(b) A property, which is legally owned by or leased to the operator, will usually be necessary to perform the contracted service. Such properties include buildings (eg a prison or hospital), roads, railways, bridges, vehicles, and computer systems. Under the PFI contract, the operator will typically design, build, finance and operate the property. The contract may specify features or standards required of the property, for example, in order to satisfy statutory obligations of the purchaser. The property may or may not have potential for third-party use during the term of the PFI contract.

(c) The PFI contract will specify arrangements for the property at the end of the contract term (which may include various options available to one or both parties). Legal title to the property may pass to the purchaser for a fixed, perhaps nominal, price. Alternatively, or in addition, there may be provision to re-tender the PFI contract for a further term and for the property to pass to the successful new operator. In either of these cases the PFI contract may require the property to be maintained to a minimum standard or to have a stated remaining useful economic life at the end of the contract term. Further possibilities are that the operator retains legal title to the asset at the end of the PFI contract or that the purchaser acquires legal title to the property for its market value at the time.

(d) As a public sector body, the purchaser is required to demonstrate that the involvement of the private sector offers value for money when compared with alternative ways of providing the services. This is generally achieved by a transfer of risk from the public to the private sector.

F3 Contracts of a similar nature to PFI contracts exist between entities in the private sector, for example some contracts for warehousing and distribution services, where a property is necessary to perform the contracted service. This Application Note is relevant to such contracts.

ANALYSIS

Overview of basic principles

F4 Present practice is not to capitalise contracts for services. However, where a property is needed to fulfil a contract for services, present practice may require the property to be recognised as the purchaser's asset. (For example, this is the case for some take-or-pay contracts where the operator builds a specialist property with little alternative use.) The purpose of the analysis below is to determine:

(a) whether the purchaser in a PFI contract has an asset of the property used to provide the contracted services together with a corresponding liability to pay the operator for it or, alternatively, has a contract only for services; and
(b) whether the operator has an asset of the property used to provide the contracted services or, alternatively, a financial asset being a debt due from the purchaser.

F5 Under the general principles of the FRS, a party will have an asset of the property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits. If that party is the purchaser, it will have a corresponding liability to pay the operator for the property where the commercial effect of the PFI contract is to require the purchaser to pay amounts to the operator that cover the cost of the property.

F6 In some cases the contract may be separable, ie the commercial effect will be that elements of the PFI payments operate independently of each other. 'Operate independently' means that the elements behave differently and can therefore be separately identified. Where this is the case, and where some elements relate only to services (such as cleaning, laundry, catering etc) rather than to the property, any such service elements are not relevant to determining whether each party has an asset of the property and should be ignored. A contract may be separable in various circumstances (see paragraph F10).

F7 Once any separable service elements have been excluded, PFI contracts can be classed into:

(a) those where the only remaining elements are payments for the property. These will be akin to a lease and SSAP 21 'Accounting for leases and hire purchase contracts' (interpreted in the light of the FRS) should be applied.
(b) other contracts (ie where the remaining elements include some services). These contracts will fall directly within the FRS rather than SSAP 21.

F8 For those contracts that fall directly within the FRS, the question of whether a party has an asset of the property should be determined by looking at the extent to which each party would bear any variations in property profits (or losses). There are three important principles to be considered when undertaking such an analysis:

(a) A range of factors will be relevant in determining the extent to which each party would bear any variations in property profits (or losses) and it will be necessary to look at the overall effect of these factors when taken together.
(b) However, any potential variations in profits (or losses) that relate purely to a service should be excluded since it is only the property that may be included on the balance sheet of one of the parties, not the capitalised value of the whole service contract. Consequently, potential variations relating to the provision of services are not relevant to determining whether each party has an asset of the property.
(c) Paragraph 14 requires that, in determining the appropriate accounting treatment, greater weight should be given to those features that are more likely to have a commercial effect in practice. Where there is no genuine commercial possibility of a particular scenario or cash flow occurring, this scenario/cash flow should be ignored.

F9 The principles outlined above are considered in more detail below, under the following headings:

- Separation of the contract
- Should SSAP 21 or the FRS be applied?
- How to apply SSAP 21
- How to apply the FRS

Subsequently, the required accounting is explained.

Separation of the contract

F10 In some cases the contract may be separable, ie the commercial effect will be that elements of the PFI payments operate independently of each other. 'Operate independently' means that the elements behave differently and can therefore be separately identified. Any such separable elements that relate solely to services

should be excluded when determining whether each party has an asset of the property. In establishing whether the contract is separable, regard should be had to the terms of the contract and how the payments vary under different scenarios: it will not be relevant that the contract designates the payments as 'unitary' or, indeed, what labels they are given. In particular, where the PFI contract includes ancillary services, such as catering and cleaning, the payments for these services may be separable. A contract may be separable in a variety of circumstances, including but not limited to the following.

(a) The contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services.
(b) Different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract.
(c) Different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the purchaser in such a way that the part of the payment by the purchaser that relates specifically to that service can be identified.

Should SSAP 21 or the FRS be applied?

F11 Paragraph 13 requires that where a transaction falls within the scope of both this FRS and another FRS or a SSAP, the standard that contains the more specific provision(s) should be applied. As explained in paragraph 45, for transactions that contain a stand-alone lease, SSAP 21 will be the relevant standard. Other transactions, in particular those containing a lease as an element of a larger arrangement, will fall within the FRS.

F12 A PFI contract will contain a stand-alone lease (so that SSAP 21, interpreted in the light of the FRS, should be applied) where the only elements remaining after excluding any separable service elements are payments for the property.

F13 Other PFI contracts, ie those where there are some non-separable service elements, will fall directly within the FRS.

How to apply SSAP 21

F14 In applying SSAP 21, the key question is whether the lease is a finance lease, ie one that "transfers substantially all the risks and rewards of ownership of an asset to the

lessee".* One indication of this is given by comparing the present value of the minimum lease payments with the fair value of the asset (often referred to as the '90 per cent test'). However, in many cases such a numerical test will not be required. The principal risks and rewards of ownership in a leasing context are usually demand and residual value. Where substantially all of the risks and rewards associated with these lie with the purchaser, it will be clear, without performing any calculations, that the lease is a finance lease (ie that the property is an asset of the purchaser). Only where there is a sharing of risk will a 90 per cent test be required.

F15 Even where a 90 per cent test is used, it is important neither to apply this as the only test nor to apply a 90 per cent cut-off in a mechanistic way. The overriding principle is to establish whether the purchaser has substantially all of the risks and rewards of ownership.

F16 Where a 90 per cent test is used, the question arises what rate should be used to discount the minimum lease payments. The principles underlying SSAP 21 require a discount rate that relates only to the property. A rate based in some way on the return from the entire PFI contract may **not** be a suitable rate to use since it will include an allowance for the risk relating to the service element of the contract. Where the service element is perceived as being riskier, relative to the property, this will give rise to a rate that is too high. Since a prerequisite for using SSAP 21 is that the payments for the property have been separated from those for services, it will usually be possible to derive such a property-specific rate from the PFI contract. Where sufficient information is not available, the rate should be estimated by reference to the rate that would be expected on a similar lease (ie a lease of a similar property in a similar location and for a similar term). The estimate of the rate should be reviewed together with (i) the present value of the lease payments, (ii) the assumed fair value of the property, and (iii) the assumed residual value, to ensure that all figures are reasonable and mutually consistent.

F17 In determining what are the minimum lease payments, regard should be had to what is likely to have a commercial effect in practice. It follows that the minimum lease payments will comprise the expected PFI payments for the property, less any amount for which there is genuine possibility of non-payment.

F18 A further factor to be taken into account is residual value risk. Where this risk both is significant and lies with the purchaser, it is normally evidence that the PFI contract in substance contains a finance lease and the property is an asset of the purchaser. An example is where the property has a material remaining useful economic life at the end of the PFI contract and is passed to the purchaser for a nominal or substantially fixed amount.

** SSAP 21, paragraph 15.*

How to apply the FRS

What variations are relevant?

F19 For those contracts that fall directly within the FRS, whether a party has an asset of the property will depend on whether it has access to the benefits of the property and exposure to the associated risks. This will be reflected in the extent to which each party bears the potential variations in property profits (or losses). The principle here is to distinguish potential variations in costs and revenues that flow from features of the property—which are relevant to determining who has an asset of the property (see paragraphs F22-F50) – from those that do not—and which are therefore not relevant to determining who has an asset of the property (see paragraph F20).

F20 There may be features that could lead directly to profit variations for reasons that relate purely to a service. Such variations may take the form of potential penalties for underperformance, or potential variations in revenues or in operating costs. These should be ignored when assessing who has an asset of the property, irrespective of their size. For example, a penalty may arise in a PFI contract for a prison because the security staff have not been trained satisfactorily, or in a PFI contract involving a catering facility because the food purchased is not up to standard. Similarly, potential variations in operating costs may relate purely to a service, for example the cost of raw materials and consumables in a catering facility. Such potential variations are irrelevant to determining which party has an asset of the property.

F21 There may be a significant number of property factors (for example, those listed in paragraph F22). It will be important to assess the effect of all relevant factors and the interaction between them, giving greater weight to those that are more likely to have a commercial effect in practice. It will not be appropriate to focus on one feature in isolation. It will be necessary to consider both the probability of any future profit variation arising from a property factor and its likely financial effect. Additional costs may be incurred to correct a problem rather than risking the imposition of a much greater penalty, in which case the relevant variation to consider is the likely increase in costs rather than the possible penalty. Similarly, a possible increase in future costs may be avoided by altering some feature of the property at a lower net cost, in which case the variation to consider is the cost of altering the property.

Factors relevant to the property

F22 As noted in paragraph F19, in applying the FRS the key test is to establish who will bear any variations in property profits (or losses). Depending on the particular

circumstances, a range of factors may be relevant to this assessment of profit variation. The principal factors that, depending on the particular circumstances, may be relevant are:

- demand risk (see paragraphs F24–F31)
- the presence, if any, of third-party revenues (see paragraphs F32–F34)
- who determines the nature of the property (see paragraphs F35–F37)
- penalties for underperformance or non-availability (see paragraphs F38 and F39)
- potential changes in relevant costs (see paragraphs F40 and F41)
- obsolescence, including the effects of changes in technology (see paragraphs F42 and F43)
- the arrangements at the end of the contract and residual value risk (see paragraphs F44–F48).

F23 The above list of the factors to be considered should be applied only with reference to the analysis given in paragraphs F24-F50. The key features of the analysis are summarised and illustrated in the table at the end of this Application Note.

Demand risk

F24 Demand risk is the risk that demand for the property will be greater or less than predicted or expected. Where demand risk is significant, it will normally give the clearest evidence of who should record an asset of the property. Demand risk is imposed by the economic conditions of the market in which the PFI contract is written. Its existence and significance cannot be altered by the terms of the contract; the contract can only allocate demand risk between the parties to the contract, for example by allowing renegotiation of the contract at certain demand levels.

F25 The first step is to identify whether demand is a significant risk. There may be instances where there is little genuine uncertainty about the level of future demand for the services provided by the property. For example, in a short-term IT contract there may be very little likelihood of demand varying greatly from the levels predicted under the contract. In such a case, demand risk is not significant and little weight should be given to this test. In other cases there may be much genuine uncertainty over the extent to which a property will be used – for example, a new road to be built in a newly developed area. In these cases demand risk will be significant and who bears it will be highly relevant to determining the appropriate accounting treatment.

F26 The length of the contract may influence the significance of demand risk. In general, demand risk will be greater the longer the term of the contract, since it is usually more difficult to forecast for later periods.

F27 It is also important to distinguish where demand risk is insignificant from where the terms of the contract are such that it is passed to one or other party. For example, there may be much uncertainty over the demand for a certain type of property in the long term. However, the terms of a long-term PFI contract for such a property may be such that the purchaser would fill the PFI property in preference to properties not subject to PFI, with the effect that it is very unlikely that the PFI property will not be full. In such a case, the purchaser has retained demand risk.

F28 Where it is established that demand risk is significant, it is necessary to determine who will bear it, ie who will bear the effects of reasonably likely changes in demand. This will depend on the answers to two interrelated questions:

(a) Will the payments between the operator and the purchaser reflect the usage of the property or does the purchaser have to pay the operator regardless of the level of usage (paragraphs F29 and F30)?
(b) Who will gain if demand is greater than expected (paragraph F31)?

F29 Where the PFI payments do not vary substantially with demand or usage of the property (although they may vary with other factors), the purchaser will be obliged to pay for the output or capacity of the property (eg prison places, hospital beds) whether or not it is needed (ie whether or not there are sufficient prisoners or patients). This is evidence that the property is the purchaser's asset and the purchaser has a liability to pay for it. In particular, if the purchaser, in substance, is obliged to pay a minimum amount (ie there is no genuine commercial possibility of non-payment) whether or not it will need the property, and the minimum amount more than covers the cost of the property, this is evidence that the property is an asset of the purchaser. In making this assessment of demand risk, any penalties or reductions in payments for non-availability of the property should be ignored: these relate to whether the property is in a state fit for use and do not affect the incidence of demand risk.

F30 Conversely, where the PFI payments will vary proportionately over all reasonably likely levels of demand, the purchaser will not be obliged to pay for the property to the extent it is not needed, which is evidence that the property is the operator's asset.

F31 In addition, the party that bears demand risk will gain if demand is greater than expected. If the purchaser bears demand risk, it will benefit from additional usage of the property at little or no extra property cost (for example, if payment for a hospital outpatients facility is largely independent of its usage, the purchaser will benefit from additional patients being treated when usage is high at little or no extra cost). This is evidence that the property is an asset of the purchaser. Conversely, if the

operator bears demand risk, it will benefit from the increased payments that result from any additional usage of the property (for example, if payment for a hospital outpatients facility is based on throughput, the operator will benefit from additional usage payments when usage is high, although it may bear little or no extra cost). This is evidence that the property is an asset of the operator.

The presence, if any, of third-party revenues

F32 A feature of some PFI contracts is that the property is expected to be used by third parties. Where the operator relies on revenues from third parties to cover its property costs, this is evidence that the property is an asset of the operator.

F33 Conversely, where third-party usage is minimal or merely a future possibility, it is more likely that the property is an asset of the purchaser. This would particularly be the case where the purchaser in some way guarantees the operator's income from the property or where there is genuine scope for significant third-party use of the property but the purchaser significantly restricts such use.

F34 The existence of third-party revenues may be linked to the incidence of demand risk. For example, the purchaser may have the option to reduce its usage of the property, in which case the operator will attempt to find third parties to use the resulting spare capacity. If the purchaser's option is a genuine one with a real possibility of exercise, and if the operator bears a significant risk of a large fall in property income as a result, this is evidence that the property is an asset of the operator.

Who determines the nature of the property

F35 This factor relates to who determines how the PFI contract is to be fulfilled and, in particular, what kind of property (road, hospital etc) is to be built. Where in essence the purchaser determines the key features of the property and how it is to be operated, bearing the cost implications of any changes to the method of operation, this is evidence that the property is its asset. The purchaser may determine the key features of the property explicitly by agreeing them as terms of the PFI contract or, for example, through a contractual acceptance provision at the end of the construction phase. Alternatively, the purchaser may implicitly determine the key features of the property. For example, a contract for a road may specify that the road will revert to the purchaser in a predefined state after a relatively short period: this may have the effect that the operator has little discretion over the standard of road to build in the first instance or how it is maintained subsequently.

F36 Conversely, where the operator has significant and ongoing discretion over how to fulfil the PFI contract and makes the key decisions on what property is built and how

it is operated, bearing the consequent costs and risks, this is an indication that the property is the operator's asset. For example, this would be the case if the operator is free to redesign the property extensively during the term of the contract (perhaps even to scrap the original property and build a replacement), in the hope of reducing its costs. Similarly, in a PFI contract to design, build and operate a road, the operator may have complete discretion over the balance between the quality of the original road built and the consequent level of maintenance costs.

F37 Design risk is the risk that the design of the property is such that, even if it is constructed satisfactorily, it will not fully meet the requirements of the contract. This is part of the question of who determines the nature of the property, discussed above. In contrast, construction risk refers to who bears the financial implications of cost and time overruns during the construction period (and related warranty repairs caused by poor building work after the asset has been completed). Construction risk is not generally relevant to determining which party has an asset of the property once construction is completed, because such risk normally has no impact during the property's operational life. However, construction risk may be relevant where it calls into question the other evidence. In particular, if the purchaser is bearing construction risk in a project in which the property is claimed to be that of the operator, it will be necessary to look closely at the other terms of the transaction to determine whether the property really is the operator's asset and is not actually an asset of the purchaser.

Penalties for underperformance or non-availability

F38 Many PFI contracts provide for penalties if the property is below a specified standard or is unavailable because of operator fault. (Penalties relating purely to services, however, are not relevant and should not be brought into the assessment.) These penalties may take the form of either cash payments or reductions in revenue. It will be important to assess both the likelihood of the penalty occurring in practice and whether the likely payments are significant. For example, a penalty may have little impact in practice because the contract gives the operator ample time to rectify the fault or the penalty is invoked only if the property is completely unavailable. Where, as in this example, potential penalties are either not significant or are unlikely to occur, this is evidence that the property is an asset of the purchaser.

F39 Conversely, the penalty mechanism may have the effect that the operator's profits associated with the property are genuinely subject to significant potential variation. For example, a PFI contract for a road may contain penalty clauses if lanes are closed for more than a minimal period for maintenance, with the penalty being significant and having a reasonable possibility of occurring. This would be evidence that the property is an asset of the operator.

Potential changes in relevant costs

F40 Potential changes in relevant costs may be dealt with in different ways under a PFI contract. (Only changes in property costs are relevant; changes in service costs are not relevant and should not be brought into the assessment.) The contract may have the effect that any significant future cost increases can be passed on to the purchaser, which would be evidence that the property is an asset of the purchaser. For example, this would be the case where the PFI payments will vary with specific indices so as to reflect the operator's costs.

F41 Conversely, where the operator's costs are both significant and highly uncertain, and there is no provision for cost variations to be passed on to the purchaser, this is evidence that the property is an asset of the operator. For example, this would be the case where the payments are fixed or vary in relation to a general inflation index such as the Retail Prices Index. Similar considerations apply to any cost savings and how they are shared between the parties.

Obsolescence, including the effects of changes in technology

F42 Whether obsolescence or changes in technology are relevant will depend on the nature of the contract. In contracts for the introduction of information technology systems, it will be of great significance who bears the future costs and any benefits associated with obsolescence or changes in technology: in other cases (eg a roads contract) it is likely to be of much less significance.

F43 Where the potential for obsolescence or changes in technology are significant, the party that bears the costs and any associated benefits will be the one for whom there is evidence that the property is its asset.

The arrangements at the end of the contract and residual value risk

F44 Residual value risk is the risk that the actual residual value of the property at the end of the contract will be different from that expected. This risk is more significant the shorter the PFI contract is in relation to the useful economic life of the property. Where it is significant, residual value risk will normally give clear evidence of who should record an asset of the property. In part, residual value risk stems directly from the economic conditions of the market for the property, ie the rise or fall of prices relevant to the property. The price aspects of residual value risk cannot be reduced or increased by the contract. The contract can only influence those aspects of

residual value risk relating to the condition of the property at the end of the contract.

F45 Where this risk is significant, who bears it will depend on the arrangements at the end of the contract. For example, the purchaser will bear residual value risk (providing evidence that the property is its asset) where:

(a) it will purchase the property for a substantially fixed or nominal amount at the end of the contract;
(b) the property will be transferred to a new operator, selected by the purchaser, for a substantially fixed or nominal amount; or
(c) payments over the term of the PFI contract are sufficiently large for the operator not to rely on an uncertain residual value for its return.

F46 Where the purchaser has an option to purchase the property or, alternatively, an option to 'walk' and leave the property with the operator, the practical effect of the option should be carefully analysed. In particular, where there is no genuine possibility that a purchase option will not be exercised (or, alternatively, that a 'walk' option will be exercised), the option will not transfer residual value risk to the operator.

F47 The significance of a minimal payment for the residual interest at the end of the contract depends on other features of the contract. If the property has a significant remaining useful economic life, such minimal payment will be evidence, in the absence of evidence to the contrary, that the purchaser paid for the property over the term of the PFI contract. This in turn is evidence that the property was an asset of the purchaser throughout.

F48 Conversely, the operator will bear residual value risk (providing evidence that the property is its asset) where:

(a) it will retain the property at the end of the PFI contract; or
(b) the property will be transferred to the purchaser or another operator at the prevailing market price.

Assessment of relevant factors

F49 In determining whether each party has an asset of the property, it will not be appropriate to focus on one feature in isolation. Rather, the combined effect of all relevant factors should be considered for a range of reasonably possible scenarios,

with greater weight being given to those outcomes that are more likely to occur in practice.

F50 In addition, it will often be useful in weighing all the evidence to consider the position of the various parties to the transaction, including their apparent expectations and motives for agreeing to its various terms. For example, an assessment of the operator's financing* may indicate a level of debt funding that could be credible only if another party stood behind the operator. In such circumstances the PFI contract would be deemed a financing arrangement and thus indicate that the property is an asset of the purchaser. Similarly, a financing arrangement would be indicated where, in the event that the contract is terminated early, the bank financing will be fully paid out by the purchaser under all events of default, including operator default.

REQUIRED ACCOUNTING

Purchaser has an asset of the property

F51 Where it is concluded that the purchaser has an asset of the property and a liability to pay for it, these should be recorded in its balance sheet. The initial amount recorded for each should be the fair value of the property.† Subsequently, the asset should be depreciated over its useful economic life and the liability should be reduced as payments for the property are made. In addition, an imputed finance charge on the liability should be recorded in subsequent years using a property-specific rate (paragraph F16 discusses how to determine such a rate). The remainder of the PFI payments (ie the full payments, less the capital repayment and the imputed financing charge) should be recorded as an operating cost. If the purchaser has any other obligations in relation to the PFI contract, these should be accounted for in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.‡

F52 Generally, the purchaser should recognise each property when it comes into use. An exception is where the purchaser bears significant construction risk, in which case it should recognise the property as it is constructed.

** All aspects of the financing arrangements should be taken into account, eg the use of senior or subordinated debt and the presence of any guarantees.*

† For a lease the sum to be recorded both as an asset and as a liability is the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease.

‡ FRS 12 will be issued in September 1998 and it will be effective for accounting periods ending on or after 23 March 1999.

Purchaser does not have an asset of the property

F53 Where it is concluded that the purchaser does not have an asset of the property, there may nevertheless be other assets or liabilities that require recognition. These can arise in respect of contributions, acquisition of the residual and other obligations of the purchaser.

Contributions

F54 Contributions to a PFI contract by the purchaser may take a number of forms, including an up-front cash payment or the contribution of existing assets for development by the operator. The accounting treatment of such contributions depends on whether they give rise to future benefits for the purchaser. For example:

- If the contribution of an existing property results in lower service payments, the carrying amount of the property should be reclassified as a prepayment (current asset) and subsequently charged as an operating cost over the period of reduced PFI payments. If there is in effect a sale of part of the contributed asset (for example, a parcel of surplus land that is not used in the PFI contract), any profit should be recognised in accordance with paragraphs 23 and 24 (as explained in paragraphs 70–74).
- If the contribution does not give rise to a future benefit for the purchaser, it should be charged as an expense when the contribution is made. For example, a capital grant might be given for which the operator would have qualified even if the transaction had not been part of the PFI, or short-life assets might be donated to the contract for no value.

Acquisition of the residual

F55 In some PFI transactions, all or part of the property (eg the land element) will pass to the purchaser at the end of the contract. Where the contract specifies that this transaction should take place at market value at the date of transfer, no accounting is required until the date of transfer, as this represents future capital expenditure for the purchaser.

F56 Where the contract specifies the amount (including zero) at which the property will be transferred to the purchaser at the end of the contract, the specified amount will not necessarily correspond with the expected fair value of the residual estimated at the start of the contract. Any difference must be built up over the life of the contract

in order to ensure a proper allocation of payments made between the cost of services under the contract and the acquisition of the residual. At the end of the contract the accumulated balance (whether positive or negative), together with any final payment, should exactly match the originally estimated fair value of the residual. For example, if the expected residual value at the end of a 30-year contact is £20 million, but the contract specifies that £30 million should be paid by the purchaser for that residual at that date, then a credit balance of £10 million should be accrued over the life of the contract, with the corresponding charge each year being included in the service expense. The payment of £30 million at the end of the contract will extinguish the balance of £10 million and establish an asset of £20 million, representing the value of the residual.

F57 If, during the life of the contract, expectations change so that the expected value of the residual falls (but there are no changes to the payments scheduled under the contract), then consideration should be given to whether there has been an impairment. Ultimately, a positive difference may become negative, in which case a provision is required. Using the example in paragraph F56, if the expected residual value fell to zero after five years, then an expense and a liability of £20 million would be recorded immediately. The remaining £10 million is still accrued over the life of the contract, giving a final liability of £30 million which is paid at the end of the contract.

Other obligations of the purchaser

F58 If the purchaser has any other obligations in relation to the PFI contract, these should be accounted for in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.*

Operator has an asset of the property

F59 Where it is concluded that the operator has an asset of the property, it should record this asset in its balance sheet. The asset should initially be recorded at its cost and then depreciated to its expected residual value over its useful economic life (which, unless the property is to be retained by the operator on the expiry of the PFI contract, will be constrained by the term of the PFI contract). Where the contract specifies a sum for which the residual value will be transferred to the purchaser, the difference between the amount payable and the expected residual value should be accounted for in a similar way to the accounting treatment adopted by the purchaser

** FRS 12 will be issued in September 1998 and it will be effective for accounting periods ending on or after 23 March 1999.*

(see paragraph F56), on the assumption that the difference is accounted for by higher or lower PFI payments during the life of the contract. If the operator is obliged to meet any liabilities as a result of the contract (eg environmental clean-up costs), these should be recorded separately, within liabilities.

Operator does not have an asset of the property

F60 Where it is concluded that the operator does not have an asset of the physical property, it will, instead, have a financial asset, being a debt due from the purchaser for the fair value of the property. This asset should be recorded at the outset and reduced in subsequent years as payments are received from the purchaser. In addition, finance income on this financial asset should be recorded in subsequent years using a property-specific rate (paragraph F16 discusses how to determine such a rate). The remainder of the PFI payments (ie the full payments, less the capital repayment and the imputed financing charge) should be recorded within operating profit.

TABLE

Variation in profits/losses for the property in transactions falling directly within the rule rather than under it Three principles govern the assessment of the indications set out below: ○ only variations in property profits/losses are relevant ○ the overall effect of all of the factors taken together must be considered ○ greater weight should be given to those factors that are more likely to have a commercial effect in practice	
Indications that the property is an asset of the purchaser	**Indications that the property is an asset of the operator**
Demand risk is significant and borne by the purchaser, eg (a) the payments between the operator and the purchaser will not reflect usage of the property so that the purchaser will have to pay the operator for the property whether or not it is used (b) the purchaser gains where future demand is greater than expected	Demand risk is significant and borne out by the operator, eg (a) the payments between the operator and the purchaser will vary proportionately to reflect usage of the property over all reasonably likely levels of demand so that the purchaser will not have to pay the operator for the property to the extent it is not used (b) the operator gains where future demand is greater than expected
There is genuine scope for significant third-party use of the property by the purchaser, significantly restricts such use The purchaser in some way guarantees the operator's property income	The property can be used, and paid for, to a significant extent by third parties and such revenues are necessary for the operator to cover its costs The purchaser does not guaranteed the operator's property income
The purchaser determines the key features of the property and how it will be operated	The operator has significant ongoing discretion over what property is to be built and how it will be operated
Potential penalties for under-performance or non-availability of the property are either not significant or are unlikely to occur	Potential penalties for under-performance or non-availability of the property are significant and have a reasonable possibility of occurring

Indications that the property is an asset of the purchaser	Indications that the property is an asset of the operator
Relevant costs are both significant and highly uncertain, and all potential material cost variations will be passed on to the purchaser	Relevant costs are both significant and highly uncertain, and all potential material cost variations will be borne by the operator
Obsolescence or changes in technology are significant, and the purchaser will bear the costs and any associated benefits	Obsolescence or changes in technology are significant, and the operator will bear the costs and any associated benefits
Residual value risk is significant (the term of the PFI contract is materially less than the useful economic life of the property) and borne by the purchaser	Residual value risk is significant (the term of the PFI contract is materially less than the useful economic life of the property) and borne by the operator
The position of the parties to the transaction is consistent with the property being an asset of the purchaser, eg (a) the operator's debt funding is such that it implies the contract is in effect a financing arrangement (b) the bank financing would be fully paid out by the purchaser if the contract is terminated under all events of default including operator default	The position of the parties to the transaction is consistent with the property being an asset of the operator, eg (a) the operator's funding includes a significant amount of equity (b) the bank financing would be fully paid out by the purchaser only in the event of purchaser default or limited force majeure circumstances

Adoption of FRS 5 by the Board

Financial Reporting Standard 5 – 'Reporting the Substance of Transactions' was approved for issue by the nine members of the Accounting Standards Board.

David Tweedie	(Chairman)
Allan Cook	(Technical Director)
Robert Bradfield	
Ian Brindle	
Sir Bryan Carsberg	
Michael Garner	
Raymond Hinton	
Donald Main	
Graham Stacy	

'Amendment to FRS 5 "Reporting the Substance of Transactions": Private Finance Initiative and Similar Contracts – September 1998' (Application Note F) was approved for issue by the ten members of the Accounting Standards Board.

Sir David Tweedie	Chairman
Allan Cook	Technical Director
David Allvey	
Ian Brindle	
Dr John Buchanan	
John Coombe	
Raymond Hinton	
Huw Jones	
Professor Geoffrey Whittington	
Ken Wild	

Appendix I
Note on legal requirements

GREAT BRITAIN

References are to the Companies Act 1985

Group accounts

Definitions of 'parent undertaking' and 'subsidiary undertaking' are set out and explained in section 258 and Schedule 10A. 1

Other provisions of the Companies Act relevant to the preparation of consolidated accounts are given in paragraphs 95 and 96 of FRS 2 'Accounting for Subsidiary Undertakings'. 2

The requirement to show a true and fair view 3

Section 227 provides the following:

"(1) If at the end of a financial year a company is a parent company the directors shall, as well as preparing individual accounts for the year, prepare group accounts.

(2) Group accounts shall be consolidated accounts comprising –

(a) a consolidated balance sheet dealing with the state of affairs of the parent company and its subsidiary undertakings, and

(b) a consolidated profit and loss account dealing with the profit or loss of the parent undertaking and its subsidiary undertakings.

(3) The accounts shall give a true and fair view of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

(4) A company's group accounts shall comply with the provisions of Schedule 4A as to the form and content of the consolidated balance sheet and consolidated profit and loss account and additional information to be provided by way of notes to the accounts.

(5) Where compliance with the provisions of that Schedule, and the other provisions of this Act, as to the matters to be included in a company's group accounts or in the notes to those accounts, would not be sufficient to give a true and fair view, the necessary additional information shall be given in the accounts or in a note to them.

(6) If in special circumstances compliance with any of those provisions is inconsistent with the requirement to give a true and fair view, the directors

shall depart from that provision to the extent necessary to give a true and fair view.

Particulars of any such departure, the reasons for it and its effect shall be given in a note to the accounts."

Section 255A(5) states that, in the case of a banking or insurance company, the references to the provisions of Schedule 4A in section 227(5) and (6) shall be read as references to those provisions as modified by Part II of Schedule 9.

Offset

4 The Companies Act contains the following provisions relating to offset:

Schedule 4 paragraph 5 (an identical requirement for banking companies and groups is contained in Schedule 9 paragraph 5)

'Amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure (as the case may be), or vice versa.'

Schedule 4 paragraph 14 (an identical requirement for banking companies and groups is contained in Schedule 9 paragraph 21)

'In determining the aggregate amount of any item the amount of each individual asset or liability that falls to be taken into account shall be determined separately.'*

NORTHERN IRELAND

5 The legal requirements in Northern Ireland are identical to those in Great Britain. In particular:

Article 266 of and Schedule 10A to the Companies (Northern Ireland) Order 1986 are identical to section 258 of and Schedule 10A to the Companies Act 1985 as referred to in paragraph 1 above.

Other provisions of companies legislation relevant to the preparation of consolidated accounts, as referred to in paragraph 2 above, are given in paragraph 97 of FRS 2 'Accounting for Subsidiary Undertakings'.

Articles 235 and 263A(5) of the Companies (Northern Ireland) Order 1986 are identical to sections 227 and 255A(5) respectively of the Companies Act 1985 as referred to in paragraph 3 above.

**Editor's note: A similar requirement for insurance companies and groups is contained in Schedule 9A paragraph 3(4) 'subject to the provisions of this Schedule'.*

Paragraphs 5 and 14 of Schedule 4 to the Companies (Northern Ireland) Order 1986 are identical to paragraphs 5 and 14 of Schedule 4 to the Companies Act 1985 as referred to in paragraph 4 above.

REPUBLIC OF IRELAND

The legal requirements in the Republic of Ireland are similar to those in Great Britain. In particular: 6

Regulation 4 of the European Communities (Companies: Group Accounts) Regulations 1992 is similar to section 258 of and Schedule 10A to the Companies Act 1985 as referred to in paragraph 1 above.

Other provisions of companies legislation relevant to the preparation of consolidated accounts, as referred to in paragraph 2 above, are given in the insert replacing paragraph 98 of FRS 2 'Accounting for Subsidiary Undertakings'.

Regulations 5, 13 and 14 of the European Communities (Companies: Group Accounts) Regulations 1992 are similar to section 227 of the Companies Act 1985 as referred to in paragraph 3 above. As regards banks, section 5(1) of the European Communities (Credit Institutions: Accounts) Regulations 1992 is similar to section 255A(5) of the Companies Act 1985 as referred to in paragraph 3 above. Pending implementation of the EC Insurance Accounts Directive (91/674 EC) there is no legislation similar to section 255A(5) for insurance companies.

Sections 4(11) and 5(e) of the Companies (Amendment) Act 1986 are similar to paragraphs 5 and 14 of Schedule 4 to the Companies Act 1985 as referred to in paragraph 4 above.

Appendix II
Compliance with International Accounting Standards

There is no International Accounting Standard on this subject. The International Accounting Standards Committee (IASC) has issued a 'Framework for the Preparation and Presentation of Financial Statements'. The definitions of assets and liabilities set out in the FRS and the principles underlying it are similar in all material respects to those set out in the IASC's Framework. However, neither International Accounting Standards nor the Framework currently envisage use of a linked presentation for certain non-recourse finance as required by paragraphs 26–28 of the FRS.

Appendix III
The development of the FRS

GENERAL

The problems of what is commonly referred to as 'off balance sheet financing' became evident during the 1980s. In that period, a number of complex arrangements were developed that, if accounted for in accordance with their legal form, resulted in accounts that did not report the commercial effect of the arrangement. In particular, concern grew over arrangements for financing a company's operations in such a way that, if the arrangement were accounted for merely by recording its legal form, the finance would not be shown as a liability on the balance sheet. 1

At the same time, there was rapid innovation in financial markets. New arrangements for financing assets were developed, the accounting for which was not immediately obvious. An example of one such arrangement is securitisation, whereby an asset and its non-recourse finance are tightly ring-fenced using a separate vehicle company. 2

These developments raised fundamental questions about the nature of assets and liabilities and when they should be included in the balance sheet. Questions were also raised about the accounting for some transactions that had been used by businesses for many years. For example, some queried whether factoring should be accounted for as a secured loan rather than as a sale of debts. 3

The FRS has been developed to address these issues and to deal with the problems caused by the misleading effects that 'off balance sheet financing' can have on the accounts. As that term indicates, the most widely recognised effect is the omission of liabilities from the balance sheet. However, the assets being financed, as well as the finance itself, are excluded, with the result that both the resources of the entity and its financing are understated. There may also be important effects on the profit and loss account. For instance, a profit may be reported on a 'sale' that is, in substance, a secured loan. As another example, what is in substance a finance charge may be either omitted from the profit and loss account altogether or described as some other kind of expense. All of these effects make it harder for the reader of the accounts to assess the true economic position of the reporting entity because they obscure the true extent and nature of its borrowings, its assets and the results of its activities. 4

The Board believes that financial statements should represent faithfully the commercial effects of the transactions and other events they purport to represent. This requires transactions to be accounted for in accordance with their substance and not merely their legal form, since the latter may not fully indicate the commercial effect of the arrangements entered into. 5

HISTORY OF DOCUMENTS ISSUED

TR 603

6 The first authoritative document to address this issue was Technical Release 603 (TR 603) – 'Off Balance Sheet Financing and Window Dressing', issued in December 1985 by the Institute of Chartered Accountants in England and Wales. The main provision of this short, preliminary document was that, in determining the accounting treatment of transactions, their economic substance rather than their mere legal form should be considered.

ED 42

7 TR 603 was followed by ED 42 'Accounting for special purpose transactions', which was issued in March 1988 by the Accounting Standards Committee (ASC). ED 42 took a general approach, providing guidance that could be applied to a variety of situations, rather than specifying detailed rules for specific transactions. It proposed that assets and liabilities arising from off balance sheet transactions be included in the balance sheet rather than merely disclosed in the notes. For this purpose, ED 42 described the essential characteristics of assets and liabilities. It also proposed that 'controlled non-subsidiaries' should be consolidated as if they were subsidiaries as legally defined. The definition of a controlled non-subsidiary was substantially the same as that of a quasi-subsidiary given in FRS 5.

ED 49

8 ED 49 'Reflecting the substance of transactions in assets and liabilities' was issued by the ASC in May 1990. ED 49 responded to the comments received on ED 42 as well as certain changes in the law. The ED continued to take a general approach, proposing analysis of the substance of transactions by reference to the essential characteristics of assets and liabilities. It also continued to propose that controlled non-subsidiaries should be consolidated in group accounts, although these vehicle entities were renamed 'quasi subsidiaries'. The main changes from ED 42 were: the inclusion, for the first time, of general recognition tests; the inclusion of Application Notes specifying how the draft standard was to be applied to five specific transaction types (including securitisation and factoring) – these were included at the specific request of commentators to ED 42 and their inclusion was later supported by the majority of commentators to ED 49; and the addition of guidance on identifying control.

Bulletin 15

9 Respondents to ED 49 raised, inter alia, the concern that the treatment it proposed for factoring was inconsistent with that proposed for securitisation. This led the

Accounting Standards Board to review the accounting for securitisation and, in October 1991, to issue proposals (in Bulletin 15) under which most securitised assets would be shown on the balance sheet, the arrangement being accounted for as a secured loan. This was on the grounds that, in most securitisations, the originating entity retains significantly all of the profits from the securitised assets. Although the entity has strictly limited its exposure to losses on those assets, the same is true for other non-recourse finance arrangements and for limited liability subsidiaries, where it is accepted that assets and liabilities should be reported gross.

10 The respondents to Bulletin 15 were divided on whether securitisations should be accounted for on balance sheet as a secured loan, or off balance sheet as a sale. Views on both sides of the argument were strongly held, reflecting different beliefs about the primary purpose of the balance sheet. Those who favoured securitisations being accounted for on balance sheet believed that the primary use of the balance sheet is in assessing the amounts, timing and certainty of future cash flows. In their view, the total resources that underlie these future cash flows (and on which income will be earned in the future) should be shown on one side of the balance sheet, and the means by which they are financed should be shown on the other. They also pointed out that typically, the originating entity continues to gain significantly all the profits from the securitised assets and to be exposed to all those losses likely to occur in practice.

11 Those respondents who favoured securitisations being accounted for as a sale and therefore off balance sheet believed that the primary use of the balance sheet is in assessing the maximum possible loss to which the entity is exposed. They thought that the accounting treatment of securitisations (and perhaps other forms of non-recourse finance) should concentrate on showing that the originating entity has a limited downside exposure to loss, and that only a net asset of the amount to which the entity is exposed should be presented.

12 The Board debated in detail the issues raised by the respondents and also consulted numerous interested parties. It concluded that users of accounts need to know both the entity's gross resources and finance (as these determine the size of its future income) and the net amount of these (as this is the maximum loss the entity can suffer). Hence the Board developed a new kind of presentation – a 'linked presentation' – under which the finance is deducted from the gross securitised assets on the face of the balance sheet. This presentation shows the gross resources that underlie the business (and on which income will be earned in the future), yet highlights that the entity has a strictly limited exposure to loss.

FRED 4

13 Finally, in February 1993, the Board issued FRED 4 'Reporting the Substance of Transactions'. This carried through the general principles set out in ED 49 with only two major changes. The first was the introduction of proposals for a linked presentation for certain forms of non-recourse finance (including securitisations), as

described above. These proposals attracted general support and are retained in the FRS with only one minor change which is described in paragraphs 29–32 below.

14 The only other major change from ED 49 was the inclusion of detailed criteria for when items may be offset in accounts. These prohibited offset of amounts denominated in different currencies or bearing interest on different bases, on the grounds that, for two items to be offset, they must exactly eliminate one another. Such elimination would not be present where the items were in different currencies or bore interest on different bases, because of the currency or interest rate risk that was present. It was therefore proposed that the two items should not be offset but should be reported as separate assets and liabilities. This proposal has been modified in the FRS, in the light of comments received, as described below.

15 Other, less significant changes from ED 49 were: the inclusion of definitions of assets and liabilities as opposed to a description of their 'essential characteristics' (these definitions are drawn from the Board's draft Statement of Principles); the provision of more guidance on accounting for transactions with options; the inclusion, for the first time, of criteria for when assets should cease to be recognised; the introduction of a distinction between control of an asset and control of another entity; and changes to some of ED 49's recognition tests, including removing the proposal that recognition be based on a 'reasonable accounting analogy'.

Matters considered in the light of responses to FRED 4

Most of the respondents to FRED 4 agreed with its principal proposals and these have been largely retained in the FRS. The following paragraphs describe those points on which respondents expressed concern and, where appropriate, explain, with reasons, the changes the Board has made to the proposals of FRED 4 or the Board's reasons for not adopting a change.

Complexity of the FRS

Several respondents expressed concern that FRED 4 was complex and difficult to understand. In part, this complexity stemmed from the inclusion of proposals for a linked presentation as set out above. Another reason for the FRED being difficult to understand was its general approach of specifying principles applicable to all transactions rather than detailed rules for specific situations. Whilst this general approach was supported, there was concern that the resulting principles appeared somewhat abstract and difficult to comprehend on a first reading.

To meet these concerns, the structure and drafting of the FRED have been reviewed and, where possible, simplified. In addition, the Explanation section to the FRS gives examples where appropriate. However, the Board believes this is a complex area that cannot be reduced to a few simple rules without the danger of over-simplification. Indeed, simple rules, mechanically applied, would result in accounts that do not report substance.

Offset

As noted above, FRED 4 proposed prohibiting offset of amounts denominated in different currencies or bearing interest on different bases but asked for comments on this prohibition. The majority of those who commented favoured either allowing or requiring offset of such items. Their reasons included: that the balance sheet does not, in general, show currency or interest rate exposures, hence grossing up the items does not necessarily allow a better assessment of these risks; that the currency or interest rate risk may be hedged such that the risk portrayed by grossing up may, in fact, no longer exist; that given freely accessible and liquid foreign exchange markets, monetary items in different currencies can be regarded as being freely convertible, and essentially a single item; and that the balance sheet should focus on portraying credit risk since users expect to get information about credit risk from the balance sheet, but not about currency or interest rate risks. A majority of the Board is persuaded by these arguments and, accordingly, the FRS requires offset of amounts denominated in different currencies or bearing interest on different bases provided that certain criteria are met. 19

The Board also considered whether it should require disclosure of amounts in different currencies or bearing interest on different bases that have been offset. Such disclosure would allow the user to draw up a balance sheet incorporating all items that do not exactly eliminate one another. However, such a balance sheet would give only part of the information needed to assess the entity's exposure to currency and interest rate risk. For a full assessment, it would be necessary to disclose the currency and interest rate profile of all recognised assets and liabilities as well as the effects of 'off balance sheet' instruments such as swaps and options. The Board decided that it was not yet in a position to specify comprehensive disclosure of such risks and that to require disclosures that gave only partial information on currency and interest rate risk would be potentially misleading. Accordingly, the FRS does not require disclosure of amounts that have been offset. 20

FRED 4 also proposed prohibiting offset where the right to settle net was contingent (for example on the counterparty going into liquidation). This was on the basis that as such contingent rights could not have been exercised at the balance sheet date, they should not be reflected in the assets and liabilities reported at that date. After reviewing the comments on this issue, the Board decided that provided: (a) the right to settle net can be invoked in all situations of default; and (b) the entity's debit balance matures no later than its credit balance, the amounts should be offset. This is because in such a situation there is no possibility that the entity could be required to pay out its credit balance without first having recovered its debit balance. 21

Finally, FRED 4 did not propose the approach taken in US and certain other overseas accounting standards that require for offset that the reporting entity intends to settle net; FRED 4 required merely that the reporting entity has the ability to do so. The reason FRED 4 did not propose this approach is that the intended manner of settlement is essentially a matter of administrative convenience and does not affect the economic position of the parties. This reasoning was supported by commentators 22

and, accordingly, the conditions given in the FRS for offset are not based on the intent of the reporting entity.

Ceasing to recognise assets

23 FRED 4 contained criteria for when assets should cease to be recognised. These required both that no significant access to benefits was retained and that any risk retained was immaterial. Commentators were particularly concerned over the second of these conditions: for instance that it might require continued recognition of an asset sold with a residual value guarantee or of a subsidiary sold with deferred performance-related consideration.

24 As a result, the FRS distinguishes three types of transactions. The first is transactions that transfer all significant rights to benefits relating to an asset and all significant exposures to the risks inherent in those benefits. For such transactions, the asset should cease to be recognised in its entirety. Conversely, where a transaction transfers no significant rights to benefits relating to an asset or no significant exposures to their inherent risks, the asset should continue to be recognised in its entirety. The third type of transaction comprises those special cases where not all significant benefits and risks have been transferred, but it is necessary to amend the description or monetary amount of the original asset or to recognise a new liability for any obligations assumed. Examples of this third type of transaction are given in paragraphs 71–73.

Contracts for future performance

25 For the avoidance of doubt, the Board decided that contracts for future performance, such as swaps, forward contracts and purchase commitments, should be removed from the scope of the FRS, except where they are merely a part of a transaction (or of a connected series of transactions) that falls within the FRS. The accounting for such contracts is a complex area that requires further research and consultation before an FRS dealing with their accounting could be issued.

Options

26 FRED 4's approach to options and the new guidance it contained were generally supported. However, the comments revealed some uncertainty over the approach to be taken to options for which there is a genuine commercial possibility both that the option will be exercised and that it will not be exercised, but the transaction is structured such that one or other outcome is significantly more likely. The FRS provides that the commercial effect of an option should be assessed in the context of all the aspects and implications of the transaction. It also explains that it may be necessary to consider the true commercial objectives of the parties and the commercial rationale for the inclusion of the option in the transaction in order to establish whether the parties' rights and obligations are, in substance, optional or conditional or, alternatively, outright.

27 Finally, for the avoidance of doubt, the FRS emphasises that, in assessing the commercial effect of an option, all the terms of the transaction and the circumstances

of the parties that are likely to be relevant during the exercise period of the option should be taken into account – and not just conditions existing at the balance sheet date.

Linked presentation for subsidiaries

28 The FRS carries through the proposal in FRED 4 that where an item and its non-recourse finance are 'ring-fenced' in a quasi-subsidiary in such a way that the conditions for a linked presentation are met from the point of view of the group, the quasi-subsidiary should be included in consolidated financial statements using a linked presentation. However, if in a similar arrangement the item and its finance are held by a subsidiary, a linked presentation may not be used. In this case, the subsidiary is part of the group as legally defined: hence the item and its finance, being an asset and liability of the subsidiary, are respectively an asset and a liability of the group and companies legislation requires them to be shown in consolidated accounts in the normal way. Some respondents argued that the commercial effect is the same regardless of whether the vehicle is a subsidiary or a quasi-subsidiary, and hence the same accounting treatment should be adopted. However, companies legislation does not permit this. In legal terms, the inclusion of a quasi-subsidiary constitutes the provision of *additional* information about the group as legally defined and thus a quasi-subsidiary may be included in any way necessary to give a true and fair view of that group. However, a subsidiary is *part of* the group as legally defined and companies legislation requires the subsidiary to be consolidated in the normal way.

The use of swaps in securitisations

29 The Board was asked to clarify whether, in a securitisation, an interest rate swap or an interest rate cap between an originator and an issuer would restrict use of a linked presentation. FRED 4 required, as does the FRS, that, for a linked presentation, there must be 'no recourse whatsoever' to the originator and 'no possibility whatsoever of a claim being established on the entity [ie the originator] other than against funds generated by that item [ie the securitised assets]'. These provisions would prohibit use of a linked presentation where there is an interest rate swap or an interest rate cap between the originator and the issuer.

30 However, the argument was put to the Board that an exception to this principle was appropriate because the risks are often hedged by the originator as part of its normal hedging activities and thus payments to the issuer under the swap or cap would not represent a net loss to the originator. In many cases, the originator will have hedged any interest rate (and related) risks relating to the securitised assets prior to the securitisation, with the result that the securitisation opens up a gap in the originator's hedging portfolio by removing a hedged asset without removing its hedge. The most natural way to close this gap is for the issuer and the originator to enter into an interest rate swap or cap. Such a swap or cap will also be advantageous to the issuer by providing it with a hedge of the difference in the interest rate received on its newly acquired assets and that paid on its loan notes. It was also stated that, in the

case of an interest rate swap (although not in the case of an interest rate cap), the issuer is currently unable to enter into a suitable swap with a third party as there is currently no market for such swaps in the UK (principally because the swap would require an amortising amount of principal to reflect actual repayments of the securitised assets).

31 The Board believes, as a matter of principle, that a linked presentation should be permitted only where there is no recourse whatsoever to the originator and accordingly should not be permitted where there is an interest rate swap or cap between the originator and the issuer. However, it decided with reluctance and as a pragmatic and provisional response to the issue, to permit use of a linked presentation in the originator's accounts notwithstanding the presence of an interest rate swap between the originator and the issuer in a securitisation provided certain strict criteria are met. (These are set out in paragraph D11.) In reaching this decision, the Board took into account the interaction of its decision with the present framework for regulating banks. The Board was also swayed by the fact that there is currently no market for such swaps in the UK and hence the issuer is unable to enter into a suitable swap with anyone other than the originator. For interest rate caps, the Board decided to give a similar concession but to resctrict it to those securitisations in existence prior to 22 September 1994 since the availability of a suitable market for interest rate caps means there is no need for future transactions of this kind to be undertaken with the originator and the issuer where a linked presentation is used.

32 The Board's decision with respect to interest rate swaps represents an interim measure and will be reviewed in the light of developments in securitisations and of progress made in the Board's forthcoming project on derivatives.

Disclosures of derecognised assets

33 Three of the Application Notes to FRED 4 contained specific disclosure requirements in respect of fderecognised assets. Commentators generally thought these requirements were excessive, they have not been retained in the FRS.

AMENDMENT TO FRS 5 – INSERTION OF APPLICATION NOTE F 'PRIVATE FINANCE INITIATIVE AND SIMILAR CONTRACTS'

The Preface to this amendment issued September 1998 stated the following:

The Application Note has been prepared in response to the need for clarification of how the principles and requirements of FRS 5 should apply to transactions conducted under the UK Government's Private Finance Initiative (PFI). The Note will also be appropriate for other contracts of a similar nature.

The amendment was published as an Exposure Draft in December 1997 for public comment. In finalising this document the Accounting Standards Board has taken into consideration the comments received in response to the E sure Draft and has

consulted interested parties. In particular, in the final version of the Note the Board has clarified the question of separability and which variations in profits (or losses) should be taken into account when determining who has an asset of the property in a PFI contract.

Annex 2

Board Members of the 13 TSI Banks decide on TSI Securitisation Infrastructure

30.04.2004 - 12:08 Uhr

Frankfurt/Main (ots) -

- Cross reference: Picture is available at
http://www.presseportal.de/galerie.htx?type=ogs -

Today members of the Managing Boards of the thirteen TSI banks (Bayerische Landesbank, Citigroup Deutschland, Commerzbank, DekaBank, Deutsche Bank, Dresdner Bank, DZ Bank, Eurohypo, HSH Nordbank, Helaba, HVB Group, KfW Bankengruppe and WestLB) signed the founding documents for True Sale International GmbH at a special ceremony and decided on the TSI securitisation infrastructure.

In the run-up to signing the contract documents they had been discussed with all competent supervisory authorities. The cooperation was very result-oriented and proceeded swiftly. Now all authorities involved have given the expected positive feed-back. In particular the Bundeskartellamt, the German Competition Authority, has no reservations in terms of merger control legislation with regard to True Sale International GmbH. The formal notarial foundation of the GmbH will take place next week.

The TSI securitisation infrastructure was developed jointly by KfW Bankengruppe, cooperative banks, commercial banks and the Sparkassen-Finanzgruppe. It can be used by all interested banks and will contribute to substantially increasing the number of securitisations transacted from Germany. From the viewpoint of investors a new investment segment will be created. The ABS securities issued in this German true sale segment are intended to be standardised and marked by liquid trading.

The securitisation platform will be composed of three charitable trusts (domiciled in Frankfurt am Main) and special purpose vehicles (SPV), which will be set up individually for each transaction. The charitable trusts assume the role of the shareholders of the securitisation SPVs issuing the ABS securities under such true sale transactions. This model, which was chosen in analogy with the structures practiced internationally, enables the establishment of insolvency-remote German SPVs, which is a central requirement from the viewpoint of the rating agencies and investors.

The neutral securitisation platform will on principal be available to all market participants and for the first time allows the establishment of SPVs exclusively under German law. As a result, credit institutions will no longer have to make a detour via foreign SPVs. Under this structure true sale securitisation functions as follows:

- In each true sale transaction the respective originator founds its own insolvency-remote SPV with a limited task profile which meets the standard requirements of the rating agencies.

- These SPVs are assigned the legal form of a GmbH (limited liability company) and are donated to the three trusts, i.e. the trusts hold equal shares of these companies and thereby help make the SPV insolvency remote.

- The SPV buys the loan portfolio to be securitised from a bank, converts it into tradeable securities collateralised by loan receivables (asset-backed securities, or ABS) and then sells them to investors on the capital market.

- The securitisation platform created under the charitable trust model can be used by all portfolio providers, regardless of whether they participate in the True Sale Initiative.

The trusts pursue the common goal of supporting research on the financial and capital market for Germany as a financial center. The Department of Finance of the European Business School International University in Oestrich-Winkel/Germany has already been selected as one of the beneficiaries of the charitable trusts.

True Sale International GmbH (TSI GmbH) is a collective institution and the second most important element of the securitisation infrastructure that was decided on today.

Above all, TSI GmbH will be a driving force behind the standardisation of the ABS market in Germany. In this respect TSI GmbH will in particular determine the quality attributes that ABS transactions must have in order to be able to use the label "TSI" on the market. Acquiring the seal of quality requires, among other things, standardised reporting by the originator. For investors, this is a key prerequisite that will give them a real-time insight about the transaction and its performance. Additionally, specifications as to the minimum issuing amount, the market making and the eligibility of the ABS securities to be used as collateral for the ECB will lead to an improvement in the development of liquidity in the secondary market and therefore also to greater acceptance of the ABS papers. This then will make it possible to progressively build up a broad true sale market.

Ultimately, TSI GmbH is also planned to serve as a forum where key market participants pool their expertise and analyse the overall conditions for ABS in Germany, comment on them and devise recommendations for their further development.

TSI GmbH is open to other shareholders. Apart from a company general meeting it will also have a shareholders' council to assist with the performance of its tasks. Each of the thirteen founding shareholders will send one member of its Management Board or of its management to the council. High-ranking policymakers will also be approached to join the council, ensuring that the dialogue on market development will be as broad as possible.

Apart from its management the GmbH will initially employ three additional employees and have a capital basis of EUR 1,950,000.00. Its seat will be in Frankfurt am Main.

The securitisation platform is scheduled to be completed in June. From then on it will be possible to issue securities via the platform and the German capital market will have a new, important instrument at its disposal. The "Global Financial Stability Report" recently published by the IMF also underlines the tremendous importance of the True Sale Initiative for the capital market in Germany.

ANNEX to the press release on TSI dated April 30, 2004 On April

30, 2004 the Board members of the TSI banks decided as follows:

Managing Directors of True Sale International GmbH Dr. Hartmut Bechtold and Dr. Dieter Glüder

Designated Foundation Chairmen of the "Charitable Trust Corporate Finance and Capital Markets in the Financial Center Germany"

Professor Ulrich Hommel Ph. D. and Professor Dr. Lutz Johanning from the European Business School, International University, Oestrich-Winkel/Germany.

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Annex 3

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CAPITAL MARKETS & COMMODITIES: Sale initiative yet to make impact in Germany
By Charles Batchelor
Financial Times; Jan 20, 2005

Germany's "true sale initiative", which allows banks to remove securitised assets from their balance sheet, has yet to make an impact in terms of deals done.

But bankers believe that it will increase activity in a sector that has been shrinking as banks move away from using securitisations as a way of reducing their requirement to maintain reserves for regulatory purposes.

Deal volume fell from €41.6bn in 2002 to €19.6bn in 2004, although the number of deals done shrank only slightly, according to Commerzbank.

Securitisations involve banks assembling packages of assets, usually residential mortgages, that are used to provide collateral and generate cashflows for the issue of bonds that allow the banks to make more mortgage loans.

The 13 banks involved in the TSI have lobbied for changes to tax and insolvency legislation to make it easier for them to securitise their debts.

Innovative securitisation deals are now being arranged that do not make use of the formal TSI platform but which are benefitting from the changes that have been ushered in, bankers said.

Recent deals that have been completed include a pool of homes in multi-family ownership, several consumer loan transactions and the first securitisation of mezzanine debt issued to Mittelstand companies, Nicolaus Trautwein, co-head of German asset securitisation told a London conference.

Further deals of this sort are expected, particularly after proposed changes to Germany's insolvency lows expected by the middle of this year, he added. These changes would reduce the administrative burden of assembling a portfolio of mortgages. Under current legislation, every mortgage has to be reregistered if it is securitised. The TSI platform allows the special purpose vehicle set up to transfer the assets off the bank's balance sheet to be based in Germany rather than in offshore jurisdictions such as Jersey or the Cayman Islands. Deals can be standardised and costs cut.

Only one securitisation has been completed so far using the special framework created by the TSI. Volkswagen Bank, part of the automobile manufacturer, issued €1.1bn worth of bonds backed by car purchase loans in November.

KfW, the business development bank that has co-ordinated the initiative, expects only just over €5bn worth of TSI deals to be completed this year. But issuers believe TSI will increase the appeal of German securitisations to international investors. Previously, low levels of issuance meant there was little liquidity in the secondary market, so spreads - the premium over a risk-free investment - were wider than in the rest of Europe.

The initiative was launched in early 2003 at a time when the credit ratings of German banks were under pressure and the banks lacked alternative means of refinancing themselves in the capital markets.

TABLE ASSESSING THE CHARACTERISTICS OF A TYPICAL SECURITISATION TRANSACTION WITH THE "CONTROL" TESTS UNDER HKAS-INT 12

Typical characteristics of securitisation structure/transaction	**HKAS tests of "control" which catch the characteristics**
Transferor creates an SPE on autopilot mechanism.	**Activities test**: Control is presumed where the activities of the SPE are being conducted on behalf of the reporting entity which created the SPE according to its business needs. **Decision-making test**: Control is presumed to exist over an SPE on autopilot.
Transferor may retain residual interests e.g. excess spread (i.e., the difference between interest rate paid to noteholders and interest received from mortgagors).	**Benefits test**: Control is presumed to exist where Transferor has rights to majority of residual interests.
Credit enhancement if provided by Transferor or third party service provider: • Transferor or highly-rated third party may provide guarantee to noteholders • Over-collateralisation (i.e., the collateral securing the repayment obligations to the noteholders is greater than the repayment obligations) • Transferor agrees to absorb initial credit losses by retaining the first-loss layer • Transferor establishes Reserve Fund arrangements to absorb initial credit losses.	**Risks test**: Control is presumed where Transferor retains residual or ownership risks.
Noteholders/Transferee may have right to early redemption of the notes (i.e., to put the notes back to the Transferee issuer who will then call on the Transferor to repurchase the mortgage portfolio).	**Risks test**: Control is presumed where Transferor retains residual or ownership risks.