Implementing IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities

Wednesday 27 June 2012—at the Frankfurt Marriott (Germany)

To assist you to prepare for the implementation of IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities, the IFRS Foundation will hold an intensive half-day session immediately before the IFRSs conference, on the morning of 27 June 2012.

Programme

09:00  Registration and refreshments

09:30  Introduction
Philippe Danjou
Member
IASB

09:35  IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities
Patrina Buchanan
Senior Technical Manager
IASB

10:15  Preparer’s perspective
Gavin Francis
Incoming Deputy Chief Accountant
HSBC

10:45  IFRS advisor’s perspective
Sandra Thompson
Partner
PricewaterhouseCoopers

11:15  Round-table Q&A
Chair: Philippe Danjou, Member, IASB

Panellists:
- Patrina Buchanan
- Philippe Danjou
- Gavin Francis
- Sandra Thompson

11:55  Concluding comments
Philippe Danjou
Member
IASB

12:00  Close session
Special Interest Session

Implementing IFRS 10
*Consolidated Financial Statements* and
IFRS 12 *Disclosure of Interests in Other Entities*

PATRINA BUCHANAN
*Technical Principal*
IASB

GAVIN FRANCIS
*Deputy Chief Accountant*
HSBC

SANDRA THOMPSON
*Partner*
PwC

Chair:
PHILIPPE DANJOU
*Member*
IASB
Overview

**IFRS 10 Consolidated Financial Statements**
- Refined definition of control

**IFRS 12 Disclosure of Interests in Other Entities**

Recent developments
International Financial Reporting Standards

IFRS 10

Why we undertook the project

**Issues – IAS 27 / SIC12**

- Inconsistencies in practice
  - Tension between IAS 27 (control) and SIC 12 (risk and rewards)
  - Inconsistent application

- Disclosures and financial crisis
  - Sufficient guidance for structured entities?
  - Reputational risk as a basis for consolidation?
  - Inadequate disclosures?

**Solution – IFRS 10, 12**

- A single control model for all entities
- Clear principle of control
- Additional application guidance

- SIC 12 performed well. Use of existing principles to create a sound foundation for SPEs
- Enhanced disclosures particularly for unconsolidated structured entities
Definition of control

An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

- Single consolidation model for all entities, including structured entities
- Consolidation based on control – ‘power so as to benefit’ model
  - Controller must have some exposure to risks and rewards.
  - Exposure is an indicator of control but is not control of itself
  - Power arises from rights—voting rights (either majority or less than a majority), potential voting rights, other contractual arrangements, or a combination thereof.

Assessing control

Assessing control of an investee:
- Consider the purpose and design
- Identify the activities of the investee that significantly affect the returns of the investee (ie the relevant activities)
- Identify how decisions about relevant activities are made
- Determine whether the rights of the investor give it the ability to direct the relevant activities
- Determine whether the investor is exposed, or has rights, to the variability associated with the returns of the investee
- Determine whether the investor has the ability to use its power over the investee to affect its own returns
De facto control

- Entity can control with less than 50% of voting rights.
- Factors to consider include:
  - Size of the holding relative to the size and dispersion of other vote holders
  - Potential voting rights
  - Other contractual rights
- If the above not conclusive consider additional facts and circumstances that provide evidence of power (e.g., voting patterns at previous board meetings, etc)

Potential Voting Rights

Substantive potential voting rights (PVR) can give the holder power

- Consider the terms and conditions, including:
  - Whether there are any barriers that prevent the holder from exercising
  - Whether exercise of the rights would be beneficial to the holder
  - Whether the rights are exercisable when decisions need to be made
Structured entities

General principles apply for assessing control for all types of entities (ie…)

- Consider the purpose and design
- Identify the activities of the investee that significantly affect the returns of the investee (ie the relevant activities)
- Identify how decisions about relevant activities are made
- Determine whether the rights of the investor give it the ability to direct the relevant activities
- Determine whether the investor is exposed, or has rights, to the variability associated with the returns of the investee
- Determine whether the investor has the ability to use its power over the investee to affect its own returns

Example Assessing Power

- Entity A and B each have 50% ownership interest in the trust.
- Entity A appointed as manager of trust.
- Manager: manages the assets of the trust, approves sellers permitted to sell to the trust, makes decisions about funding of the trust. Cannot be removed without cause.
- Relevant activities?
- Who directs?
Agency relationships

Consider all of the following factors:
- scope of the decision-making authority
- rights held by other parties (i.e., kick-out rights)
- remuneration of the decision-maker
- other interests that the decision maker holds in the investee

Example - Delegated rights

Responsible Entity:
- Broad decision making powers
- Removal by simple majority
- Remunerated via market-based fee - 1% of assets under management and 20% of profits over a hurdle
- Equity interest of 20%

Diagram:
- Responsible entity
- Other investors
- Investment trust
- Investment portfolio
Other features

Effective Date
- Aligned effective date for IFRS 10 and IFRS 12
  - Annual periods beginning on or after 1 January 2013
  - Earlier application permitted if applied as a package

Transition (Final amendments to IFRS 10 in June 2012)
- Clarifications:
  - Date of initial application is 1 January 2013 for a calendar-year entity, assuming no early adoption
  - No retrospective adjustment required for entities disposed of in the comparative period(s)
- Additional relief:
  - Requirement to present adjusted comparatives limited to immediately preceding period
  - Line-by-line information required by IAS 8 paragraph 28(f) limited to immediately preceding period

Other related projects

Investment entities project
Scope

Combined disclosure standard for:

- Subsidiaries
- Joint arrangements
- Associates
- Unconsolidated structured entities
Disclosure objective

To disclose information that helps users of financial statements evaluate:

(a) the nature of, and risks associated with, an entity’s interests in other entities, and
(b) the financial effects of those interests on the entity’s financial position, financial performance and cash flows

Requirements

Disclosures

• significant judgements and assumptions made
• information about interests in:
  – subsidiaries
  – joint arrangements and associates
  – unconsolidated structured entities
• any additional information that is necessary to meet the disclosure objective

Strike a balance between overburdening financial statements with excessive detail and obscuring information as a result of too much aggregation
Subsidiaries

- The composition of the group (including any changes)
- Involvement of NCI in the group’s activities (including profit and loss allocation and summarised financial information for subsidiaries with large NCI)
- The effect of significant or unusual restrictions on assets and liabilities
- The nature of, and changes in, the risks associated with structured entities

Unconsolidated structured entities

**Nature and extent of interests in unconsolidated structured entities**

- eg nature, purpose, size, activities and financing
- For sponsors not providing other risk disclosures
  - Type of income earned
  - The carrying amount of all assets transferred

**Nature of, and changes in, the risks associated with an entity’s interests**

- Carrying amount of the assets and liabilities recognised
- Maximum exposure to loss and comparison to carrying amounts
- Non-contractual support provided
Transition

Transition (Final amendments to IFRS 12 in June 2012)

- Additional relief:
  - Requirement to present comparatives limited to immediately preceding period
  - Disclosures relating to unconsolidated structured entities are not required for periods beginning before the first annual period for which IFRS 12 is applied
Implementing IFRS 10 and IFRS 12
A preparer’s perspective

Gavin Francis
HSBC Deputy Chief Accounting Officer

27 June 2012

What I am going to talk about…

• Backdrop at HSBC

• Our implementation plan

• Implementation issues
  – Developing IFRS 10 interpretations
  – Transition process
  – Disclosures

• On-going work

• Likely impact of IFRS 10 on HSBC

• Overall lessons learned
Backdrop at HSBC

- Limited use of special-purpose entities (SPEs) for structuring
- Approximately 3,000 SPEs used for conduits, securitisations, fund investments and others
- Many entities consolidated under IAS 27/ SIC 12
- Significant project effort
- Limited accounting impact from IFRS 10
- Disclosure impact from IFRS 12 still work in progress

Our Implementation plan
Project management

- **Central framework; regional execution**
  - Group Finance draft a project plan and agree the project plan with regions and global business functions;
  - Regional team assess the impact and implement new processes;
  - Group Finance monitor the project plan against milestones.

- **Technical resources**
  - Regional accounting policies; industry working group; central technical review committee to approve policies.

- **Financial reporting**
  - Design consolidation policies in accordance with IFRS 10 and implement approach to collect information for the new IFRS 12 disclosure requirements.

- **IT systems development**
  - Engage with IT department and consider the need to modify systems and process to de-consolidate any previously consolidated entities, and to consolidate any previously unconsolidated entities.

- **External resources**
  - Engage auditors as required.

Implementation issues

**Developing interpretations – process**

- **Technical resources**
  - Weekly issues calls with internal working groups (regional accounting policies, Global business functions, etc.);
  - Participate in industry working groups to discuss any interpretation issues;
  - Log and resolve issues;
  - Engage auditors as required;
  - Approval from central technical review committee on final interpretations.

- **Develop accounting guidance**
  - Develop accounting guidance based on the agreed accounting interpretations;
  - Circulate and publish the final accounting guidance.
Implementation issues

Developing interpretations – main areas of debate

- IFRS 10
  - **Predetermined activities** - which party has power when activities are predetermined
  - Funds - how to account for funds

- IFRS 12
  - Determine the scope of “non-consolidated structured entities”
  - Disclosures for entities which we have sponsored but have no further involvement
  - Determine the interpretation of “customer supplier relationship”

- Other considerations
  - Determine the transition requirements - IAS 8 restatement impact; determine for which periods comparative data is required.

Implementation issues

Transition process

- **Identifying population** – Each region reviews the existing population of investments in all entities to determine whether entities previously consolidated or unconsolidated in accordance with IAS 27 and SIC 12 changed their consolidation status as a result of applying IFRS 10.

- **Processes and systems** – Implement new processes and systems to monitor the consolidation conclusion under both IAS 27 and IFRS 10, both at the transition (from June 2011 till the effective date) and on ongoing basis for existing structures.

- **Approval process for new transactions resulting group structure change** – Redesign the review process to assess the impact under IAS 27/SIC 12 and IFRS 10 until the effective date.
Implementation issues

Disclosures

- **Determine scope of disclosures**
  - Determine the scope of disclosures; using the final interpretations of “structured entities”, “customer supplier relationship”, “variability of returns” and “sponsored entities”.

- **Source of information for the IFRS 12 disclosure**
  - Although IFRS 10 does not necessarily result a greater number of structured entities being consolidated, the new disclosure requirement mean that where we have an interest in an USE, detailed disclosure would be required under IFRS 12. This is a challenge if these unconsolidated entities are managed by third parties.
  - Identify any information gap as compared to the existing disclosure requirements. Some of the disclosure requirements may have been disclosed on a voluntary basis.

- **Consider training needs and guidance in data collecting template**

On-going work

Current challenges

- **Accounting treatment for insurance unit-linked funds**
  - Lack of industry consensus in this topic
  - Difficulties in determining whether an insurer is acting as an agent for the unit-linked policyholders, despite holding the majority of the units of a fund.

- **Continuous assessment**
  - Challenging to continually reassess whether there are changes to one or more of the three elements of control from time to time.

- **IFRS 12 data gathering issues**
  - Difficulties in obtaining information for the disclosure of those unconsolidated entities managed by third parties.
Impact assessment

Likely impact of IFRS 10 on HSBC

- The overall impact of IFRS 10 on HSBC does not appear to be significant based on our assessment to date.

- Only a relative small population of entities where there is expected to be a change in the basis of consolidation.

- The main reasons for deconsolidating entities under IFRS 10 were:
  - Inadequate link between power and returns;
  - Securitisations with no power.

- The main reasons for new consolidations required under IFRS 10 were:
  - Holdings of less than 50%;
  - Securitisations with power but no majority.
Overall lessons learned

- **Plan IFRS 10 and IFRS 12 together** – Concentrate on IFRS 10 first was inevitable but this would leave less time for IFRS 12 (we actually did both together).

- **Plan now for easier transition** - an early analysis of the impact of adopting these new standards will help avoid surprises and ease the transition process.

- **Communication** – Clearly communicate any significant changes to financial results and financial position to stakeholders as soon as possible. Give stakeholders enough time to consider potential impact.
To assist you to prepare for the implementation of IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities, the IFRS Foundation will hold an intensive half-day session immediately before the IFRSs conference, on the morning of 27 June 2012.

Programme

09:00  Registration and refreshments

09:30  Introduction
Philippe Danjou
Member
IASB

09:35  IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities
Patrina Buchanan
Senior Technical Manager
IASB

10:15  Preparer’s perspective
Gavin Francis
Incoming Deputy Chief Accountant
HSBC

10:45  IFRS advisor’s perspective
Sandra Thompson
Partner
PricewaterhouseCoopers

11:15  Round-table Q&A
Chair:
Philippe Danjou, Member, IASB

Panellists:
- Patrina Buchanan
- Philippe Danjou
- Gavin Francis
- Sandra Thompson

11:55  Concluding comments
Philippe Danjou
Member
IASB

12:00  Close session
Introduction

- IFRS 10 changes definition of control; core principle unchanged
- Significant changes not expected for most corporate entities
- Key areas of judgement:
  - Structured entities
  - Potential voting rights
  - Exposure to variability of investee
  - Principal-agent relationships
  - Disclosure: Interests in unconsolidated structured entities
**Structured entities**

“...voting or similar rights are not the dominant factor in deciding who controls the entity...”

1. Purpose and design
2. Involvement at inception
3. Contracts providing rights over closely-related activities
4. Rights over relevant activities upon contingent events
5. Commitment to ensure investee operates as designed

**Potential voting rights**

“...rights to obtain voting rights of an investee...”

- Practical ability to exercise
  - In/out of money options
- Non-currently exercisable rights
**Variable returns**

“...investor’s returns from its involvement have the potential to vary as a result of the investee’s performance...”

- Many possible forms, e.g.
  - Dividends
  - Servicing fees
  - Tax benefits
  - Economies of scale
- Must absorb variability (e.g. shares); exclude variability contributors (e.g. debtors)

---

**Variable returns**

“P+I” – Principal and interest cash flows

Do the following parties contribute or absorb variability:
- debtors?
- investors?
- swap counterparty?
**Principal-agent analysis**

“...An agent is a party primarily engaged to act on behalf and for the benefit of another party...”

**Agent does not control investee**

### Definitive considerations

- Removal without cause by single party
- Remuneration not commensurate with skill level
- Remuneration not at arm’s length

### Judgemental considerations

- Greater scope of authority over investee
- Less powerful rights by other parties
- Greater exposure to variability from other interests

- Discretion over activities
- Purpose and design of investee
- Involvement in design of investee
- Number of parties to remove decision maker
- Magnitude/variability of total interests
- Different exposure from other investors

- More likely to be principal

**Different weightings based on facts & circumstances**
IFRS 12 – Disclosure requirements

How much to disclose?

- Subsidiary
- Joint arrangements
- Associates
- Unconsolidated structured entities

Nature and extent of interest held
Assumptions and judgements
Risks associated with interest
Financial effects of interests

Materiality!

Questions?

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers International Limited, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2010 PricewaterhouseCoopers International Limited. All rights reserved. In this document, “PwC” refers to PricewaterhouseCoopers International Limited which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.