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Audit considerations for SPV’s

30 September 2015

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Director
Financial Services Audit

CSP audit FAQ's – focus areas

- Levelling
- Valuations and pricing
- Risk disclosures and others

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Levelling

Fair value hierarchy

Level 1

Inputs are quoted prices in active markets

Level 2

Inputs other than quoted market places within level 1 that are observable

Level 3

Inputs are unobservable

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Levelling

What is an active market?

- "a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis"
- e.g. stock listed on FTSE 100 with intraday traded activity e.g. Vodafone, Apple Inc. etc.

Levelling

Indications of an inactive market

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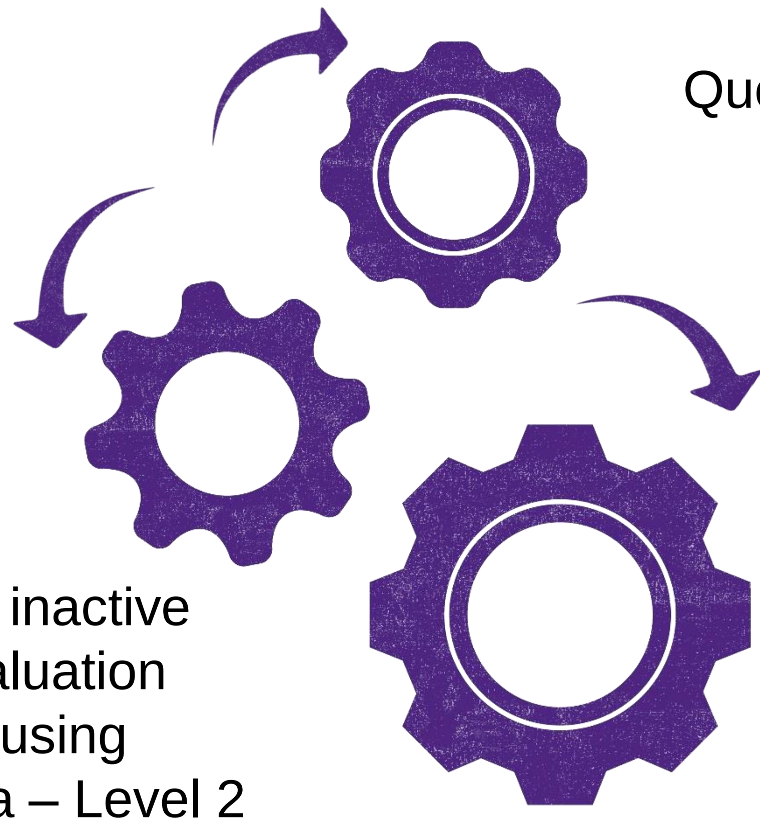
Levelling

Level 2 and Level 3 – what's the difference?



Quoted price active market – Level 1

Quoted price inactive market or valuation technique using observable data – Level 2

Valuation technique using unobservable inputs – Level 3

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Levelling

Level 2 and Level 3 – what's the difference?

Example	Level
Listed bond with infrequent trading activity	Level 2
Credit default swap based on a listed underlying bond and market observable volatility rates	Level 2
Investment in unlisted trading entity valued at the mid of three differing valuation models: 1. price of latest funding round to external investors; 2. Discounted Cash Flow (DCF) based on estimated production volumes; and 3. xEBITDA of similar type entities.	Level 3

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Levelling

Level 3 disclosure requirements

- quantitative information about significant unobservable inputs
- reconciliation of changes in fair value movements:
  - total gains/losses recognised in Profit and Loss (P&L)
  - purchases, sales, issues and settlements
  - transfers into or out of level 3
  - total gains recognised in P&L attributable to unrealised gains/losses.

Levelling

Level 3 disclosure requirements

- description of the valuation processes used for level 3 measurements
- narrative description of sensitivity analysis for level 3 measurements

Levelling

Level 3 example disclosure

Item	Fair Value at 12/31/XX	Valuation Technique	Unobservable input	Range (weighted average)
Residential mortgage-backed securities	$125	Discounted cash flow	❑Constant prepayment rate ❑Probability of default ❑Loss severity	❑3.5% to 5.5% (4.5%) ❑5% to 50% (10%) ❑40% to 100% (60%)
Direct venture capital investments: energy	$32	Market comparable companies	❑EBITDA multiple ❑Revenue multiple ❑Discount for lack of marketability ❑Control premium	❑6.5 to12 (9.5) ❑1.0 to 3.0 (2.0) ❑5% – 20% (10%) ❑10% to 20% (12%)

Levelling

FRS 102

IFRS 13	Valuation methodology	FRS 102
Level 1	Quoted price in active market	Classification A
Level 2	Price of recent transaction	Classification B
	Valuation techniques using observable data	Classification C
Level 3	Valuation techniques using unobservable data	

Levelling

FRS 102

Investment	Quote price	Recent price	Valuation technique	
			Observable inputs	Unobservable inputs
Credit default swap			$125	
Mortgage backed securities				$100

Reduced disclosures for level 3 investments

Valuations and pricing

What should an impairment memo include?

General discussion	Technical support	Impairment discussion	Conclusion
Scope	**According standards adopted**	**Indicators of impairment**	**Impairment assessment**
Background	**Supporting extracts from standards**	**Recoverability /impairment calculation**	**Impact on financial statements**

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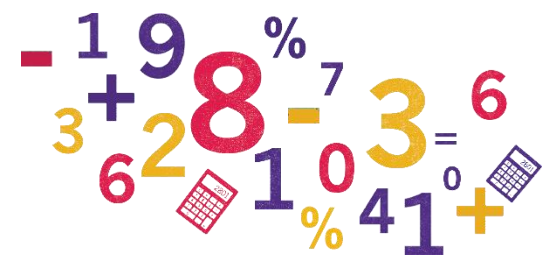
Valuations and pricing
Valuation models – what do we look for?

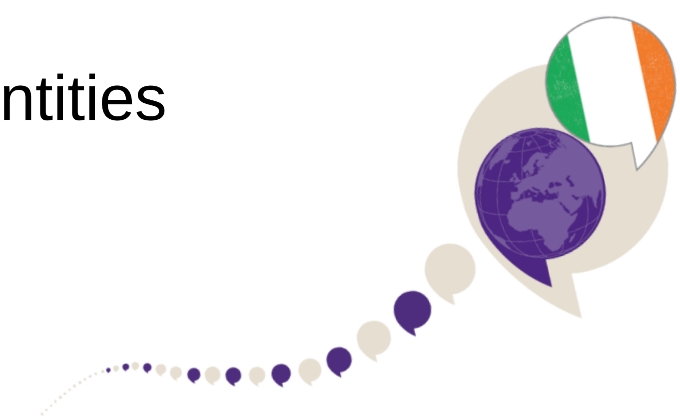
Income approach:

- discounted cash flow
- business plan support
- accuracy of cash flows
- discount rate applied.



Market approach:

- xEBITDA of disposal of similar type entities
- latest external funding rounds
- indices
- probabilities.



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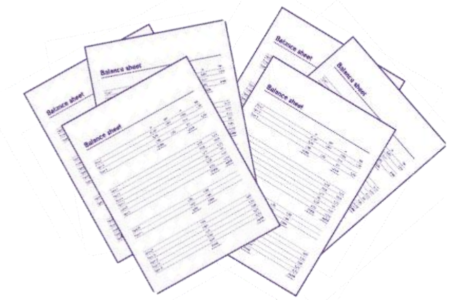
Valuations and pricing

Post balance sheet events



- **event after the reporting period:** an event, which could be favourable or unfavourable, that occurs between the end of the reporting period and the date that the financial statements are authorised for issue
- **adjusting event:** an event after the reporting period that provides further evidence of conditions that **existed** at the end of the reporting period
- **non-adjusting event:** an event after the reporting period that is indicative of a condition that arose after the end of the reporting period.

Valuations and pricing

Bid/ask pricing

- bid price – price that buyer is willing to pay
- ask price – price that seller is willing to sell at

IFRS 13

- bid
- ask
- mid
- bid/ask spread

FRS 102

- bid
- ask

Risk notes

General

- can risk disclosure notes be generic?
  - no.
- is a sensitivity analysis required for market risk?
  - yes with exceptions.
- are discloses required for credit and concentration risk?
  - credit risk specifically referred to.

Other

Related parties

Person

- has control or joint control of the reporting entity
- has significant influence over the reporting entity
- is a member of the Key Management Personnel (KMP) of the reporting entity or parent.

Other

Related parties

Entity

- part of the same group i.e. subsidiary undertakings
- associates/joint ventures
- post employment benefit plan
- entity controlled or jointly controlled by an identified related person
- identified related person whom has significant influence over the entity or is KMP of the entity
- entity provides KMP services to the reporting entity or its parent.

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Other

Related parties

Topic	Guidance	Effective
IAS 24 related party transactions: KMP services	Concerns about the identification of KMP costs arise when KMP services to the reporting entity are provided by entities that do not otherwise meet the definition of a related party provider. Amendment proposed that: • the management entity providing KMP services should be identified as a related party of the reporting entity; • an exemption should be granted from the detailed disclosure requirements in paragraph 17 of IAS 24 in respect of KMP services provided by a management entity; and • payments made to a management entity in respect of KMP services should be separately disclosed by extending the disclosure requirements in paragraph 18 of IAS 24.	1 July 14

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Other

Related parties

Disclosures:

- identified related parties
- relationship
- remuneration of directors
- fees paid to management service entity for provision of KMP
- related party transactions:
  - amounts, amounts outstanding
  - provision for doubtful debts
  - guarantee.

Financial reporting for SPVs

30 September 2015

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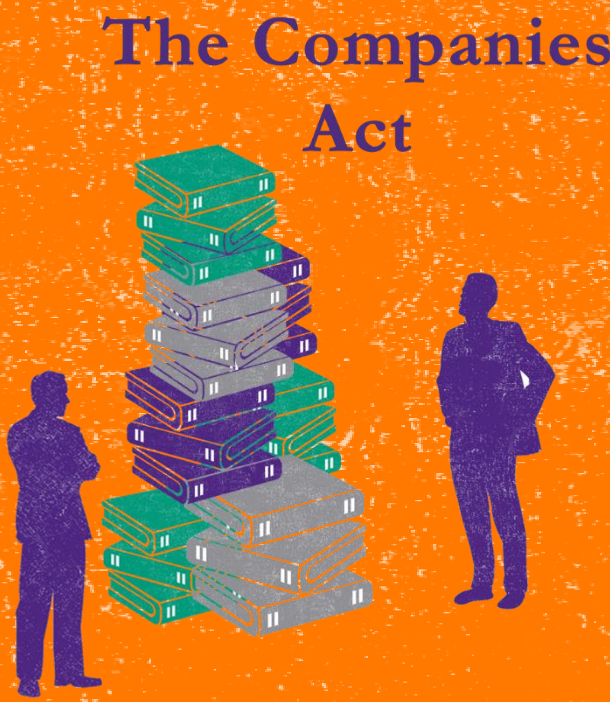
Technical Manager
Risk, Compliance and Professional Standards

Companies Act 2014



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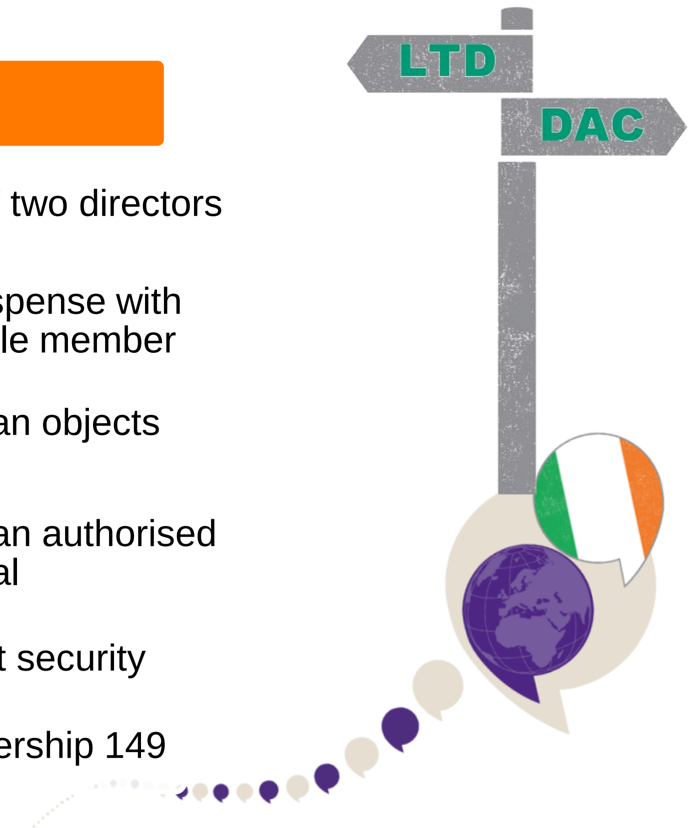
Introduction

- multiple Companies Acts (1963 to 2013), statutory instruments and other pieces of legislation
- need to reform, consolidate and modernise to prevent Irish law being less favourable to Irish business
- the Companies Act 2014 (the Act) consolidates all this into 25 parts and 1447 sections
- structured in two volumes:
  - parts 1-15 model private company limited by shares (primary focus)
  - parts 16-25 all other companies
- commenced 1 June 2015

What is a new model LTD and DAC?

Private CLS likely to be the most common form of private limited company

LTD	DAC
can have one director	minimum of two directors
can dispense with AGM even when multi-member	can only dispense with AGM if single member
will not require an objects clause	must have an objects clause
no need for an authorised share capital	must have an authorised share capital
cannot list debt security	can list debt security
max membership increased from 99 to 149	max membership 149



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Conversion of Irish companies – decisions for SPVs

- all Irish registered companies will have to consider their status:
  - convert to new model private limited company
  - convert to a DAC
  - remain as current type (PLC)
- some companies will have to change names
- 18 month **transition period** from the commencement date after which company will default to CLS if no election made

Conversion of Irish companies - decisions

- during transition company deemed DAC (i.e. company hasn't 'opted out') unless election specifically made (i.e. company 'opts in')
- if converting to DAC must make nomination three months before expiry of transition period i.e. by 1 September 2016

Accounting and audit matters

Audit exemptions

Small company exemption: where a company meets **two of three** of the requirements (for two consecutive financial years):

1. balance sheet total not exceeding €4.4m
2. turnover not exceeding €8.8m
3. average number of employees not exceeding 50

Small group exemption: entire group meets two of the three requirements

Dormant company exemption: where only has permitted assets and liabilities and no significant accounting transactions

Disclosure of information - directors

Directors report - general

	Existing	New
General matters [s325]	✓	
Business review [s325]	✓	
Information on acquisition and disposal of own shares [s325]	✓	
Information on interests in shares or debentures [s325]	✓	
Statement on relevant audit information [s325]		✓
Compliance Statement [s225]		✓
Audit committee statement [s167]		✓

Disclosure of information – directors (continued)

Statement on relevant audit information

The directors' report must include the above statement

- s330 outlines the relevant information:
  - so far as director is aware, there is no relevant audit information of which the statutory auditors are unaware
  - director has taken all steps they ought to have taken to ensure they are aware of any relevant audit information and to establish that the statutory auditors are aware of that information

Increased accountability – category 2 offence if statement is false

Disclosure of information – directors (continued)

Directors compliance statement – back on the agenda

- annual statement in the directors report acknowledging that they are responsible for securing company's compliance with its 'relevant obligations' [s225]

- **compliance statement** applies to all PLCs (except investment companies) and to all large limited companies

Compliance requirements only apply where company has turnover of greater than €25m and a balance sheet total of greater than €12.5m in any particular year

Audit committees

Establish or explain

A large company shall either:

- establish an audit committee and confirm in the directors' report or
- if not established, explain why not in the directors' report

A company whose	Large
Turnover*	>€50m
Balance sheet total*	>€25m
or	
A group together meeting the above criteria	

Disclosure of information – financial statements

- thresholds have changed for medium companies

	Small	Medium
Turnover	€8.8m	€20m (currently: €15.24m)
Balance sheet total	€4.4m	€10m (currently: €7.62m)
Employees	50	250

Company officers

Director:

- part 5 CA 2014
- move towards accountability and responsibility of directors
- fiduciary duties clarified
- directors' meeting location is location of majority or chairman

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Financial statements – other incidental changes

Companies Act 2014 section	Details
326	Interim dividends paid
326	List of directors at any time in the financial year (effective 1/6/15)
324	Balance sheet only financial statement required to be signed (note: directors' report must still be signed).
Sch 3, para 5	Corresponding amounts
322 (1)	Auditors remuneration definition expanded to include expenses reimbursed
Sch 3	'Accruals and deferred income' disclosed as separate financial statement line items
Part 5	Loans to/from directors' must be in writing
Sch 3, para 58	Terms of payment or repayment and the rate of any interest payable on any item shown under "creditors"
287/288	Financial period can only be changed once every 5 years
1111	Old section 40 has been eliminated – only applies to plc

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To summarise

- what type of entity?
- changes in audit exemption criteria
- more disclosures for directors
- more responsibilities for directors
- audit committees
- disclosure and terminology changes

FRS 102 and SPVs

The new accounting framework - options

Current framework	New framework	
IFRS	IFRS	FRS 101
Irish GAAP	FRS 102 FRS 102(1A)	Reduced disclosure
	FRS 105	

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The new accounting framework - timeline

Early adoption permitted

Transition date

We are here

1 Jan 2013

30 Jun 2013

Jan 2014

Dec 2014

Dec 2015

Opening balance sheet for 1 January 2014

Comparative year balance sheet for 31 December 2014

Financial statements for the year ended 31 December 2015

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FRS 102 – structural overview

- based largely on IFRS for SMEs but with numerous differences
- 35 sections grouped by topic
- glossary of defined terms
- not a **'one-stop shop'** – still need to meet statutory requirements too – **'Companies Act'** accounts
- **'PBE'** prefix for paragraphs specific to public benefit entities
- updated August 2014 for hedging and basic financial instruments
- updated July 2015 for small entities and other minor amendments

FRS 102 – overview of change

Main areas of change

- tangible fixed assets
- financial Instruments
- leases
- deferred tax
- employee benefits
- investment properties
- intangible assets

Minor/no change

- related party transactions
- foreign exchange
- revenue recognition
- government grants
- share based payments
- impairment
- provisions
- events after the BS date

FRS 102 – overview of change

Main areas of change	Minor/no change
• tangible fixed assets • **financial instruments** • leases • deferred tax • employee benefits • investment properties • intangible assets	• related party transactions • foreign exchange • revenue recognition • government grants • share based payments • impairment • provisions • events after the BS date

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FRS 102 – overview of change

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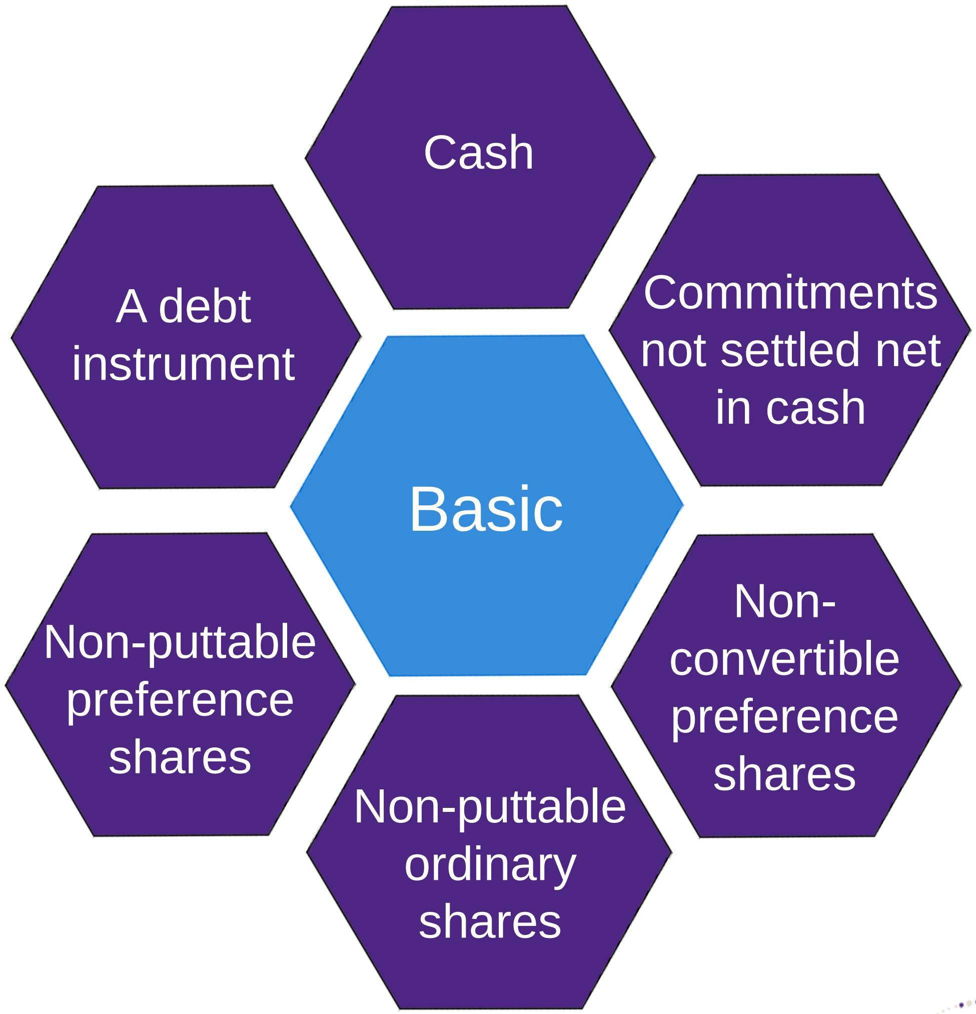
Financial instruments

Financial instruments – key differences

Current Irish GAAP	FRS 102
FRS 4: Capital instruments **FRS 25 FI's: "Disclosure and presentation"** **FRS 26 FI's: Recognition and measurement** **FRS 29 FI's: Disclosures**	**Section 11 Basic financial instruments** **Section 12 Non-basic financial instruments**
• mostly amortised cost	• two categories 'basic' and 'non-basic' • 'basic' = measured at amortised cost, except for • equity investments = measured at fair value through P&L [FVTPL] • 'non-basic' = measured at FVTPL

What are basic financial instruments?



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What are basic financial instruments?

A debt instrument is basic if it is not a derivative and…..

Fixed amount	**Combination of positive or negative fixed rate and positive variable rate**	**Determinable variation of return is permitted provided new rate meets all other criteria and…**	**Early settlement terms not contingent on future events other than … *protect against credit deterioration *changes in tax laws**
Positive fixed or variable rate	**Repayments linked to single observable index of general price inflation and return may not be leveraged**	**…variation is not contingent on future events other than protection against credit deterioration or new contractual rate**	**May be contractually extended provided return and other terms satisfy other conditions noted**

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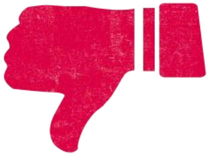
Example:

A combination of a positive or a negative fixed rate and a positive variable rates

- LIBOR plus 200 basis points 
- LIBOR less 50 basis points 
- 500 basis points less LIBOR 

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What are non-basic financial instruments?

- **asset backed securities**, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables
- **derivatives** (options, rights, warrants, futures contracts, forward contracts and interest rate swaps) that can be settled in cash or by exchanging other financial instrument
- financial instruments that qualify and are designated as **hedging instruments**
- commitments to make a loan to another entity and commitments to receive a loan, if the commitment can be settled net in cash.

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Question - basic or non-basic?

1. bond paying a variable rate of return based on issuing company's sales revenues **non-basic**
2. a loan where the lender has an option to convert the loan into a variable number ordinary shares **non-basic**
3. a loan which will become immediately repayable should the company default on interest or capital repayment, or if loan covenants are breached **basic**
4. a loan where the interest rate is linked to RPI **basic/non-basic?**
5. loan from bank where terms specify that the interest rate is calculated as 12-month LIBOR - 5% **basic**

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Recognition and measurement

Basic financial instruments – initial treatment

- initially recognise when becoming party to the contract
- initially measure at the **transaction price including transaction costs**
- however, if the arrangement is a **'financing transaction'**, initial measurement is at NPV of future payments, discounted at a market rate of interest for similar debt instruments
  - for short-term assets/liabilities, the discounting is assumed **immaterial**, therefore shall recognise at the undiscounted amount)

Recognition and measurement

Basic financial instruments – subsequent measurement

- short term: measured **at undiscounted amount i.e. cost** (less impairment for assets)

- long term: measured **at amortised cost using the effective interest rate method**, and (for assets) less any impairment
  - amortised cost = present value of future cash receipts/payments discounted at the effective interest rate
  - **effective interest rate method** = the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the carrying amount of the financial asset or financial liability

Amortised cost using the EIM

EIM equalises distortions of interest rate when:

- there are features that in substance are interest
- contractual interest cash flows are not aligned with actual cash flow due to for example:
  - premiums or discounts
  - fees or transaction costs

Challenges arise when:

- applying EIM to variable rate instruments
- revision of cash flows occur
- applying EIM to portfolios
- recognising interest revenue after impairments

Amortised cost using the EIM

Where valuation techniques are used to measure an instrument at FVTPL or where an instrument is measured at amortised cost, the following are the key considerations:

- **estimates** of future cash flows
- expectations around possible variations in amount and timing of cash flows
- time value of money based on risk-free rate
- risk premium due to uncertainty and illiquidity
- other market participant factors

Amortised cost using the EIM

- cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability
- cash flows and discount rates should take into account only the factors attributable to the asset or liability being measured
- discount rates should reflect assumptions that are consistent with those inherent in the cash flows

Recognition and measurement

Non-basic financial instruments – initial and subsequent measurement

- initially recognise when becoming a party to the contract
- initially measure at the **transaction price excluding transaction costs**
- subsequent measurement at FVTPL

Unless

- equity/linked instrument not traded and without reliable fair value => cost less impairment
- FV no longer available => deemed cost less impairment
- hedging instrument specifically required to be FV through OCI

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Accounting policy choices

- section 11.14b permits an entity to recognise a financial instrument to be **designated upon initial recognition** as a financial asset or financial liability at **fair value through profit or loss**.
- an entity shall choose (carefully) either the:
  - provisions of FRS 102 (both s11 & s12 in full)
  - recognition and measurement provisions of **IAS 39** and the disclosure requirements of FRS 102
  - recognition and measurement provisions of **IFRS 9** financial instruments and the disclosure requirements of FRS 102

Accounting policy choices – measurement impact

IAS 39

Four categories of financial assets:

- FVTPL – FV
- held to maturity - amortised cost
- loans & receivables – amortised cost
- available for sale – FV

Two categories of financial liabilities:

- FVTPL – FV
- all others - amortised cost

IFRS 9

Three primary categories

- fair value through profit or loss
- fair value through other comprehensive income
- amortised cost

FRS 102

Two categories

- basic- amortised cost
- non-basic – FV

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Accounting policy choices – presentation impact

Fair value hierarchy

IFRS 13	Valuation methodology	FRS 102
Level 1	Quoted prices for identical instruments in active market	Classification A
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	Valuation techniques using observable market data	Classification C
Level 3	Valuation techniques using unobservable market data	

Financial instruments – disclosure considerations

- sections 11, 12 and 34 of FRS 102 (regardless of recognition and measurement standard adopted)
- generally fewer disclosures under FRS 102
- be aware if the SPV meets the definition of a '**financial institution**'
- a 'financial institution is (among others):
  - an entity whose principal activity is to generate wealth or manage risk through financial instruments
- if SPV = financial institution => disclosures required will be similar to those under IFRS 7

In summary – considerations for SPVs

- consider whether financial instruments are basic or non-basic:
  - red flags:
    - contingent terms
    - early repayment options and penalties
    - conversion features
- if non-basic -> more fair valuing and increased volatility in P&L
- financing obtained and related financial assets purchased may not necessarily be classed the same
- accounting policy choice - IFRS 9 or IAS 39 but disclosure requirements of FRS 102

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Leases

Leases

Section 20

Current Irish GAAP	FRS 102
SSAP 21 – Accounting for leases & hire purchase contracts **UITF 28 – Operating lease incentives**	**Section 20 leases**

Current Irish GAAP

- finance lease vs operating lease distinction:
  - transfer substantially all risks and rewards
  - 90% test
- operating lease incentives spread over period until market rental applies

FRS 102

- finance lease vs operating lease distinction:
  - transfer substantially all risks and rewards
  - range of indicators
  - **no** 90% test
- operating lease incentives spread over **lease term**

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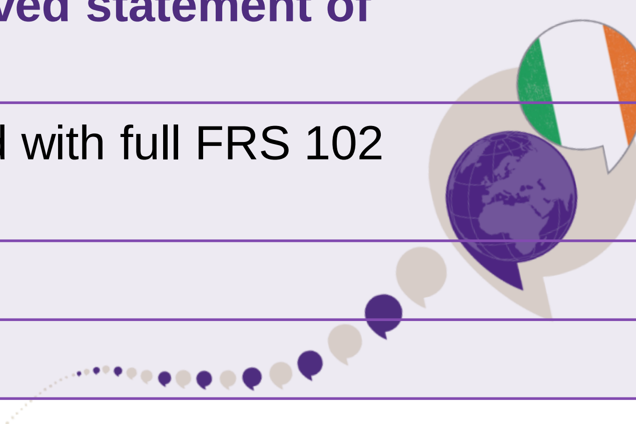
Making the transition

Basic principles

FRS 102 – new Irish and UK GAAP

- section 35 of FRS 102 – applies on transition regardless of previous GAAP
- basic principle – **retrospective application - restate** at date of transition as though FRS 102 had always applied
- some specific **rules**
- lots of transitional **reliefs** with no transitional reliefs in some areas
  - e.g. Section 19 for business combinations (optional)
  - e.g. Section 29 for deferred tax (no relief)
- **explain** transition and provide reconciliations
- first financial statements with **explicit and unreserved statement of compliance**
- transition date is start of earliest comparative period with full FRS 102 comparatives
- need to go through balance sheet **line by line**
- changes impact on **reserves** at transition date



Questions & feedback

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