



MALAYSIAN INSTITUTE OF ACCOUNTANTS  
FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE  
("FRSIC")

**FRSIC Issue No. 5 [2007]**

**Accounting for Special Purpose Entities**

**How to Compute the Majority of the Benefits and Risks of Special Purpose Entity ("SPE") and what Constitutes the Residual Interest in the Case where there are Different Tranches of Risks?**

**The issue:**

There has been increasing number of transactions by Malaysian corporate entities involving Special Purpose Entities ("SPEs"), securitisation techniques and other sale of assets methods. This would also include Islamic transactions such as *Sukuks*.

Presently the applicable standards/interpretations are FRS 127 Consolidated and Separate Financial Statements and IC Interpretation 112, Consolidation - Special Purpose Entities and the impending FRS 139 Financial Instruments: Recognition and Measurement (on Derecognition).

Broadly, the key issues are in relation to consolidation of special purpose entities and derecognition of assets. Whilst the above standards/interpretations stipulates conditions and indicators to assess for the need to consolidate or ability to derecognise, there are several areas which requires interpretation and application of judgement which invariably result in diversity in practise by accounting practitioners and financial reporting entities.

**Current accounting practice as observed by the Submitter:**

Currently, the preparers of financials statements and practitioners consider these matters based on respective understanding of the standards/interpretations by applying judgement in each case under most circumstances.

There are already numerous interpretational and application issues, two of such examples are as follows:

**1) Transfers**

FRS 139 identifies two ways in which a transfer can be achieved. An entity 'transfers' a financial asset if, and only if, it either:

- transfers the contractual rights to receive the cash flows of the financial asset, or
- retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients, in what is often referred to as a 'pass through arrangement'. [FRS 139.18]

FRS 139 does not explain what is meant by the phrase 'transfers the contractual rights to receive the cash flows of the financial asset'. A literal reading of the words might suggest

that the phrase refers to a legal sale of the asset or a legal assignment of the rights to the cash flows from the asset. For example, an entity that has sold a financial asset (such as a legal sale of a security) has transferred its rights to receive the cash flows from the asset. In this situation, the transferee has unconditional, presently exercisable rights to all the future cash flows.

We understand that IFRIC is currently debating what is meant by a transfer of contractual rights. Specifically do transfers in the form of equitable assignments (where the debtor is not notified that their debt has been transferred), or where there are set off rights, etc. preclude a transfer from being in FRS 139.18(a) and therefore require those transactions to meet the pass through requirements?

## 2) Variability of Cash Flows

Paragraph 21 of FRS139 requires one to compare the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset.

The term "net" was unclear but one form of interpretation is as follows:

- Pre transfer - Cashflows from the asset (after taking into account any insurance policies that were being transferred with the asset – but ignoring funding costs).
- Post transfer – the seller's residual cashflows from the asset pool after taking into account the payments to eventual recipients (including the noteholders and swap counterparties).

Some example of the key clarification points are:

- (a) Does one take into account the funding of the asset pool and any hedges that the seller has in place when assessing pre transfer exposure?

One view is that the funding costs are ignored as it would be difficult in practice to identify how a seller funded an asset pre securitisation. For example, a seller with fixed rate assets which have no cashflow variability as regards to interest rates could create variability by changing its funding to floating rate immediately prior to transfer. Transfer of the asset to an SPE which issued fixed rate notes would automatically result in a reduction in variability.

- (b) Does the seller take into account cash flows post transfer such as fee arising from acting as servicing agent, swap counterparty, administrator etc.?

Logically, the seller should take into account all cash flows post transfer in order to properly assess the change in variability of cash flows post transfer as securitisation techniques can easily design indirect mechanisms for the seller to retain any potential upside for e.g. via significant servicing fee or non-arm's length swap transactions with the seller. However, there has already been observations of differing views whereby the only the direct cash flows

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arising from the assets are assessed post transfer e.g. subordinated debt participation.

In conclusion, there can be widely differing approaches that might be adopted to the application of the risks and rewards test.

**Reasons for the FRSIC to address the issue:**

In the International Financial Reporting Interpretations Committee ('IFRIC') update in November 2006, the IFRIC noted the factors set out in paragraph 10 of SIC-12 are indicators only and not necessarily conclusive. The IFRIC believed that this approach was deliberate, in acknowledgement of the fact that circumstances vary case by case. In the IFRIC's view, SIC-12 requires that the party having control over an SPE should be determined through the exercise of judgement and skill in each case, after taking into account all relevant factors. As a result, there will not be any further guidance internationally.

The active discussions on this area in the advanced markets indicate that these issues involve significantly divergent practices and there are already observations of similar emerging issues and divergence in Malaysia.

At present, other than the IIC 112 and FRS139, there are no other existing standards of MASB or projects that address these issues, hence, the need for guiding principles to be issued to help preparers and auditors deal with such issues locally.

**Submitter's proposal or recommendation to address the issue:**

- To recognise the need to address the issue by providing further guidance on interpretational and application issues
- To agree to include this matter in the FRSIC agenda and to develop a consensus on this issue incorporating practical issues and proposed solutions to be contributed by practitioners, regulators and corporate entities in view of developing guiding principles in this area.

**Submitted on:**

29 January 2007

**Corresponding FRSIC Consensus:**

*FRSIC Consensus 10 - How to Compute the Majority of the Benefits and Risks of Special Purpose Entity ("SPE") and what Constitutes the Residual Interest in the Case where there are Different Tranches of Risks?* [To view, click on the abovementioned Consensus title]