

# *SPE financial reporting - avoiding the common pitfalls*

*How important is it to you to get the answers right? In this publication we discuss the common pitfalls in SPE financial reporting and how these can be avoided.*





# Special Purpose Entities financial reporting – avoiding the common pitfalls

In the UK the Special Purpose Entities (SPEs) through which asset backed securities (ABS) are issued are usually public limited companies required to file annual audited financial statements prepared under EU-adopted IFRS or UK GAAP. Audited financial statements are also required in locations such as Jersey, Holland, Ireland and Luxembourg.

Being a public document it is important for the SPE financial statements to be of good quality. But what are the most challenging areas of financial reporting for the typical SPE? What are the most common pitfalls? And what can be done to minimise the risk of errors?

SPE financial reporting often includes a number of complex issues such as the recognition and derecognition of financial instruments, offsetting of assets and liabilities and income and expenses, the impairment of financial assets, fair value measurements, the IFRS7 financial instruments disclosure requirements and wider issues such as the assessment of the SPE's going concern.

To avoid common pitfalls it is important to make sure the necessary lines of communication between the SPE directors, financial statements preparers and the Originator are established early and maintained throughout the life of the securitisation. All parties need to plan in advance regarding the information required to prepare the SPE financial statements.

With our experience in securitisations and the statutory audits of SPE financial statements, PwC can help Originators and SPE directors plan and manage the SPE accounts preparation process in a way that avoids these common pitfalls and ensures a smooth and efficient audit.

## **Setting the scene**

Let's first set the scene in the context of a typical securitisation transaction (see case study overleaf) and let's use the details to illustrate some of the potential issues in the SPEs' financial statements preparation process.

## **Should the SPE recognise the securitised assets on its balance sheet?**

The practical application of the IAS39 derecognition requirements can be complex and require a significant degree of professional judgement to be applied. Originators will invariably spend a significant amount of time and effort to make sure they get to the right answer for their own financial reporting. Based on our experience, it has not been uncommon for SPEs to prepare their accounts in a way that contradicts the judgement calls made by the Originator. For an SPE facing a similar set of facts to those in our case study that would be to prepare its financial statements showing the £1bn of residential mortgages on its balance sheet, contradicting the view taken by the Originator who also kept the same assets on its own balance sheet. International accounting standards make it clear that assets should only appear on one balance sheet. Based on the facts of our case study a deemed loan should be recognised between the

Originator and the SPE. This is a pitfall that can be easily avoided if the matter is discussed at an early stage between the SPE and the Originator.

## **When is offsetting the right answer?**

Offsetting is a consideration that is relevant to balances and transactions between the SPE and the Originator. Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Questions that may arise would include whether to account for separately or offset against other items the subordinated loan from the Originator, the interest rate swap between the SPE and the Originator and the relevant income and expense. In some cases it needs to be considered whether balances meet the definition of assets or liabilities. The answers to these questions may not be obvious simply by the SPE consulting with the Originator and the SPE directors may instead have to form a view with direct reference to the relevant accounting standards (IAS1, IAS32 and IAS39).

### **Case study - setting the scene**

A retail bank (the 'Originator' or 'Servicer' or 'Seller') wants to obtain funding through the securitisation of a pool of £1bn of UK residential mortgages it has on its balance sheet. For this, an SPE is incorporated in the UK with its entire share capital owned by a charitable trust that is independent from the Originator. Independent directors are appointed under a corporate services agreement between the SPE and an independent professional services firm. The SPE raises £1bn from the issue of a single class of ABS listed on the London Stock Exchange and uses the same amount to acquire the legal title to the pool of £1bn of UK residential mortgages from the Originator. The Originator also provides the SPE with a subordinated loan of £100m which the SPE keeps on its balance sheet as a cash reserve. The securitised assets comply with the minimum credit quality criteria set in the securitisation transaction documents and the income from them is expected to exceed the interest expense on the ABS. The SPE will retain this excess spread to build up its cash reserve from the initial £100m to a target £200m. After that any further excess spread will be returned to the Originator. Also, in order to make sure the interest income from the securitised assets and the interest expense on the ABS are matched the Originator and the SPE enter into an interest rate swap. All the necessary due diligence has been done and the ABS get a credit rating of AAA. The final legal maturity of the ABS is 2035.

The Originator continues to service the securitised assets (i.e. maintain the necessary bookkeeping records on its systems, manage collections, monitor the credit risk etc) and in accordance with the derecognition requirements in IAS 39 considers it appropriate to continue to recognise the securitised mortgages on its balance sheet. Also, in accordance with SIC 12 – Consolidation – Special purpose entities, the Originator considers it appropriate to consolidate the SPE.

### **How much are the securitised assets impaired by?**

The impairment of the securitised assets is a key area of focus for ABS investors and therefore the readers of the SPE financial statements. The practical application of the IAS39 requirements in relation to impairment and uncollectibility of financial assets can be complex and involve significant judgements and estimates. Indeed in the case of a deemed loan this may not be impaired despite the underlying loan portfolio being impaired. Although information on the credit quality of the securitised assets, such as defaults and arrears, will usually be supplied by the Servicer on a regular basis this may not give the IAS39 impairment loss provision amount. It is important to ensure at an early stage that the

necessary information for the SPE's statutory financial reporting is available from the systems of the Servicer.

### **What is the fair value?**

Usually the only financial instruments on the balance sheet of the SPE measured at fair value are derivatives such as the interest rate swaps. However, IFRS7 requires the disclosure of the fair value of financial instruments measured at amortised cost in a way that it can be compared with the relevant carrying amount. This requirement would apply to the ABS issued by the SPE, the securitised assets if recognised by the SPE (or alternatively the deemed loan to the Originator) and the subordinated loan from the Originator. Unless an active market price is readily available calculating the fair value of financial instruments can present a challenge given the assumptions and judgements

required. In principle the fair value information required for the SPE's financial statements should be available from the Originator. However, in practice this may not be the case if for example the amounts in question are not material in the context of the Originator's balance sheet.

### **Are all the IFRS7 financial instrument disclosures in place?**

In addition to fair value disclosures IFRS7 requires a number of other quantitative and qualitative disclosures to enable the understanding of the nature and extent of credit, liquidity and market risks arising from financial instruments. Again the challenge for the SPE is to identify those disclosure requirements and make sure a plan is in place regarding how the relevant information will be obtained.

## **How remote is bankruptcy?**

In most cases securitisations are designed so that the risk of the SPE having to declare bankruptcy is remote. The assets securitised are legally separated from the rest of the assets of the Seller, legal ownership is transferred to the SPE and the ABS investors have limited recourse which means that if the SPE does not have the funds to repay investors in full it does not technically become insolvent. However, in practice the protection from insolvency can become subject to challenge in court for example on the technical details of how the limited recourse is designed. Also, the SPE may not be able to continue to operate as expected for operational reasons such as for example where the Servicer is no longer in a position to continue to perform that role and a replacement servicer is not available. It is therefore important for the SPE directors to be clear on how sensitive their going concern assessment is to these factors.

## **Other issues**

Other areas that can present a challenge include the completeness of related party transactions, the correct application of effective interest rate calculations and the treatment of issue costs, planning to provide sufficient evidence to the auditors that the information on the securitised assets obtained from the Servicer and the waterfall calculations are free from material errors and drafting the front half of the SPE's financial statements to give a transparent view of the SPE's activities, business and risks – consistent with the relevant descriptions in the securitisation transaction documents.

The IAS39 replacement project is currently in progress with the issue of IFRS9. In addition, there is a number of other new and changes to existing



financial reporting standards including the recent issues of IFRS10 Consolidated Financial Instruments, IFRS12 Disclosure of Interests in Other Entities and IFRS13 Fair Value Measurement. All these need to be considered for their impact on SPE financial statements.

Also under the current ASB proposals to end the use of UK GAAP, SPEs currently reporting under UK GAAP will have to apply EU-adopted IFRS. Although the exact implementation timetable is not clear yet preparers of SPE financial statements should familiarise themselves with the current proposals and monitor the developments in this area.

## **Conclusion**

Spending the time early to make sure reporting and information requirements are understood and building relationships between the parties that need to work together is always an important ingredient for success. SPE financial reporting is no exception. The number of relevant financial reporting requirements is large and many of these requirements are complex. How important is it to you to get the answers right? Talk to us to find out more about how we can help.

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To discuss any of the issues raised in more detail, please speak to your usual PwC contact or one of our structured finance leadership team listed below:

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