Regulatory consolidation under the influence of international accounting standards

Abstract

The observance of international accounting standards is playing an increasingly significant role in dynamic regulatory developments and presents several challenges, which may necessitate a variety of procedural and technical data processing changes.

The observance of international accounting standards is playing an increasingly significant role in dynamic regulatory developments. On the one hand, publicly listed parent institutions must conform to the new requirement for a financial data report based on an IFRS balance sheet (Financial Reporting, FINREP). This financial data report should be implemented by 1 January 2013 in accordance with the provisions of the new EU CRR Regulation. On the other hand, as part of the implementation of the Banking and Credit Adequacy Directives[1], § 10a (7) of the German Banking Act (KWG) obliges all parent institutions to use consolidated accounts as the basis for determining their own funds and risk exposure for the purpose of solvency reporting (Common Reporting Framework, COREP)[2]. Current legislation requires groups of institutions to create both the FINREP and COREP reports with the regulatory consolidation group set out as per §10a of the KWG. As well as the problem of differing consolidation groups between the IFRS and the KWG, consideration should also be given to the different consolidation techniques used in the conversion of group institution reports based on IFRS-consolidated accounts.

What follows is an overview of the differences between groups of consolidated companies under regulatory provisions and commercial law. As the consolidation group outlined in the German Commercial Code (HGB) largely matches that outlined by the IFRS in the wake of the changes made to the HGB in the German Accounting Law Modernisation Act (BilMoG), the provisions below will only be considered in further detail in accordance with the IFRS. This will illustrate deviations from provisions set out in the KWG. Consolidation methods will then be briefly presented. Finally there will be a short summary of the article.

Differences in the definition of the consolidated group

The authority of the regulatory consolidation group to determine own funds and risk exposure (and also for the creation of FINREP reports) is enshrined in §10a (1-5) of the KWG. In reconciling the IFRS consolidation group to the regulatory consolidation group, particular consideration must be given to the differences that exist between the

[1] Law for the Implementation of the Revised Banking and Capital Adequacy Directives of 17 November 2006, Federal Law Gazette (BGBL) I 2006.

[2] The current draft version of the KWG provides transitional provisions that necessitate the use of IFRS accounting standards as a consolidated reporting basis before the end of 2013. See Articles: 'Erhöhte Anforderungen an die Systeme und Datenhaltung durch IFRS Bewertung im Meldewesen' and 'Basel III und die europäische Umsetzung - Schaffung eines Single-Rule-Book'.

consolidated companies as well as the consolidation methods that are necessitated by these regulatory requirements. Non-compliant IFRS consolidation groups must adapt the following points to comply with regulatory reporting provisions:

- Deconsolidation of companies that belong to the IFRS consolidation group but that are not part of the regulatory consolidation group as per the KWG. At present, this primarily includes all companies that do not belong to the banking and investment services sectors[3].
- Add companies that are not consolidated under the IFRS but that represent subordinate companies as per the KWG[4] (including companies that have voluntarily become proportionately consolidated as per §10a (5) of the KWG).

As per §10a (1) of the KWG, a group of institutions consists of a single superordinate and multiple subordinate companies. The superordinate company (parent institution) is an institution (a bank or financial services institution) that is not subordinated to either another institution or a financial holding company based in Germany or another EEA state. The KWG defines subordinated companies as subsidiaries, qualified minority interests and voluntarily consolidated companies.

Subsidiary companies as per the IFRS and the KWG

On the issue of subsidiary inclusion, the KWG refers to the commercial law definition as per §290 of the HGB. According to this definition, a subsidiary is qualified for inclusion if the possibility exists of exerting a controlling influence over this company (Control Concept). The following facts make a parent-subsidiary relationship irrefutable:

- Majority voting rights
- Executive control right
- Contractual or statutory control rights
- Bearing the majority of risks and rewards in an economic sense

The inclusion of subsidiary companies under the IFRS is set out in IAS 27 and SIC 12. In content terms, the requirements for subsidiary inclusion as per the IFRS are essentially in agreement with the requirements as per §290 of the HGB, in which the regulatory requirements explicitly refer to consolidation group composition as per the KWG. In principle, the four above-stated criteria are also subsumed under the controlling influence under the IFRS. However, a subtle difference arises if, for example, an enforceable executive control right exists as per §290 (2)(2) of the HGB. To fulfil this criterion for the subsidiary's consolidation obligation as per the HGB, the possibility of executive formation is sufficient. In comparison, the consolidation of subsidiaries as per the IFRS is based on the definition of the control concept by which the controlling parent company holds more than 50 per cent of the voting rights (IAS 27.13). Support for the consolidation of special purpose entities (SPEs) is found in SIC 12, where the inclusion of an SPE in the consolidation group originates from economically justified control.

[3] Subordinate firms as per §10a (1)(2) of the KWG are to be consolidated for regulatory purposes. This includes: institutions, investment companies, financial companies and companies with banking-related auxiliary services.

[4] Horizontal corporate connections represent a special case. As per §10a (2) of the KWG, such equal subsidiaries should be consolidated for regulatory purposes.

Joint ventures as per the IFRS and minority interests as per the KWG

As per §10a (4) of the KWG, companies that are jointly managed with third parties should be included in the regulatory consolidation group if the superordinate company holds at least 20 per cent of the joint venture (qualified minority interests), with its responsibility for the joint venture's liabilities also being limited to this share.

The joint venture represents the counterpart to this qualified minority interest as per the IFRS. For qualified minority interests, the range of direct and indirect shareholdings typically lies between 20 and 50 per cent. As such, a shareholding of less than 20 per cent of the consolidated joint venture should be deconsolidated for regulatory purposes. However, as per §10a (5) of the KWG, the possibility exists to voluntarily consolidate such joint ventures for the purposes of regulation - in case these have not been taken account of in the preparation of consolidated financial statements as per the IFRS.

Voluntarily consolidated companies as per the KWG and associated companies as per the IFRS

As per IAS 28.2, an associated company exists if the superordinate company can exert significant influence and the associated company is also neither a subsidiary nor a joint venture. In addition, as with the joint venture, a minimum shareholding of 20 per cent is required for classification as an associated company. As such, qualification as an associated company does not require joint management to be contractually defined - as is involved for the classification of a joint venture.

Associated companies can be compared with voluntarily included subordinate companies on a regulatory basis, as is set out in §10 (6)(4) and §10a (5) of the KWG. If shareholding is below 20 per cent, it is not possible to derive a refutable assumption of significant influence. As per IAS 28.6, such shareholdings can be reported as financial instruments as per IAS 39. A difference exists here between the IFRS and the KWG in the demarcation criteria of subordinate companies. Like associate companies, portfolio companies with a shareholding of less than 20 per cent can be proportionally consolidated on a voluntary basis as per §10 (6)(4) of the KWG - despite them not belonging to the consolidation group as per the IFRS. This means that the regulatory capital deduction can be avoided for investments in banks, financial institutions and payment institutions.

Comparison of KWG and IFRS consolidation methods full consolidation of the subsidiary company

In principle, the methods of full and proportionate consolidation as per the IFRS and KWG are conceptually similar. In the case of subsidiaries, both regulatory law and IFRS accounting rules state that the subsidiaries' balance sheet items are to be fully included in the consolidation group. To create the IFRS-consolidated balance sheet, the individual items on the balance sheet and invoice statement will be summarised as individual financial statements. Capital consolidation will then be carried out to eliminate internal cross-ownership, and debt consolidation will be performed to offset internal claims and debts. Based on the produced consolidated accounts, the combined own funds and risk positions will be determined for the purpose of institutional group reporting as per §10a (6) of the KWG.

The minority interests of third parties can be considered as core capital within the capital consolidation framework. This framework is required to determine own funds at the group level as per §10 (6) (1) in conjunction with §10 (2) of the KWG. As per IAS 27.33, minority interests should be disclosed in the consolidated balance sheet within the own funds - and separated from the own funds of the parent company.

The treatment of goodwill arising from capital consolidation presents a particular problem. The goodwill that appears from regulatory consolidation arises from the difference between the higher shareholding book value and the share of own funds held by the subordinate company on the relevant reporting date. This amount may currently be deducted within the framework of the aggregation method, taking half from both the core and supplementary capital on a proportional basis across ten years. In contrast, the demonstrated goodwill arising from the IFRS-consolidated accounts should be completely deducted from the core capital as per §10 (2a) of the KWG. In line with the discussion draft of a CRD IV implementation law, an existing goodwill sum should be fully deducted from core capital as of 2013, and then deducted in instalments from common equity as of 2014.

Proportionate consolidation of joint ventures

For jointly managed companies, the IFRS provides a choice between proportionate consolidation and use of the equity method (IAS 27.38). With proportionate consolidation as per the IFRS, assets, liabilities and income statement items are proportionately consolidated in accordance with the equity shares in the consolidated accounts. The elimination of intra-group transactions also takes place on a proportionate basis.

For joint ventures that are proportionately consolidated under the IFRS, §10a (11) of the KWG makes proportionate consolidation mandatory. This approach corresponds to the rule for the treatment of qualified minority interests as per §10a (4) of the KWG. IFRS item values can be used when carrying out the consolidation.

This procedure is also applicable for regulatory consolidation group companies that have opted for proportionate consolidation - e.g. associate companies assessed with the equity method under the IFRS.

Consolidation of companies assessed with the equity method

Under IAS 28.13, shareholdings in joint ventures can be included in IFRS-consolidated accounts using the equity method[5]. This method is mandatory for the consolidation of associate companies. In regulatory consolidation, proportionate consolidation is mandatory for both of these subordinated company forms. Otherwise, as per §10a (5) of the KWG, the reporting parent institution may voluntarily use proportionate consolidation on its subordinate companies. Regulatory proportionate consolidation must therefore be implemented for subordinated companies that use the equity method for IFRS-consolidated accounts. §7 of the German Consolidated Financial Statements Reconciliation Regulation (KonÜV) deals with correcting the effects of equity method application when the method is used simultaneously with proportionate inclusion of the shareholding company's own funds.

According to §7 (1)(1) of the KonÜV, shareholdings in institutions, financial companies and ancillary service providers that have been assessed using the equity method can be included in the regulatory consolidation group. The own fund elements should be differentiated with this inclusion. In addition, as per §§2-6 of the KonÜV, the IFRS' accounting effects must be filtered out for the purposes of regulatory consolidation. As per §7 (1)(2) of the KonÜV, the continued shareholding value of companies assessed with the equity method should be equally deducted from both the core and supplementary capital. In contrast, the goodwill contained therein must be deducted entirely and directly from the core capital.

Associated companies that do not belong to the banking and financial services sector and therefore do not fall under the regulations outlined in §10 (6) of the KWG should be neutralised in the regulatory consolidation as per §7 (2) of the KonÜV. As such, the continued shareholding book value should be calculated from the group's own funds and regarded as a risk position as per SolvV.

Under IFRS 11, which will replace IAS 31, joint ventures will be included in the consolidated accounts via the equity method (IFRS 11.24). The right to choose between proportionate consolidation and the equity method is eliminated.

[5] In accordance with IAS 31.38, joint ventures are permitted under commercial law to be consolidated with the equity method.und die europäische Umsetzung - Schaffung eines Single-Rule-Book'.

The consolidation groups and procedures as per the KWG and IFRS are compared in the diagram below.

DIAGRAM:

IFRS Consolidation Group
Subsidiary Companies (IAS 27 and IFRS 10) – Full Consolidation
Joint Ventures (IAS 31 and IFRS 11*) – Proportionate Consolidation, Equity Method
Associated Companies (IAS 28) – Equity Method

KWG Consolidation Group
Subsidiary Companies (§1 (7) KWG) – Full Consolidation
Qualified Minority Interests (§10a (4) KWG) – Compulsory Proportionate Consolidation §10 a (11))
Voluntary Consolidation (§10a (5) KWG)
Adaptation to §7 KonÜv

* as per IFRS 11, joint ventures will in future lose the right to choose between consolidation methods, instead only being able to use the equity method

New IFRS consolidation standards

In May 2011, the International Accounting Standards Board (ISAB) for the IFRS published new standards for consolidated accounts, IFRS 10, as well as for the accounting of joint activities, IFRS 11. These come into force as of 1 January 2013 and thereby replace the previously applicable rules, IAS 27[6] and SIC 12. According to the new IFRS 10 standard, the assessment of parent-subsidiary relationships will be carried out with a new 'Control Term'. The option of exercising decision-making power and claiming variable profit-sharing thereby brings an obligation to carry out a full consolidation on the affected subsidiary - even with a shareholding of under 50 per cent. The amended control concept may lead to newly subordinated companies having to be added to the IFRS consolidation group. The result will be an immediate requirement for full consolidation under the IFRS. As the regulatory consolidation group remains relevant to the establishment of group reporting, the regulatory group and the classification of companies will remain unchanged even when the new accounting standards have come into force. In consequence, an analysis should be carried out on the changes to the IFRS consolidation group. The process of determining the consolidation group should also be adapted to the KWG. Both of these measures will ensure that group reporting based on IFRS-consolidated accounts accommodates the new IFRS 10.

[6] For individual financial statements, IAS 27 regulations will remain in force in the future.

Summary

As the consolidation group defined by the KWG is essential to the preparation of institutional group reporting, the transfer of regulatory group reporting to the IFRS balance sheet and the implementation of new accounting standards bring no changes with regard to regulatory law.

The differences between IFRS accounting-related consolidation requirements and the regulatory requirements set out in the KWG, including the different consolidation techniques, nevertheless present challenges with regard to the conversion of consolidation accounting processes. These challenges may necessitate a variety of procedural and technical data processing changes.