FSR Insights

Financial Instruments, Structured Products & Real Estate Insights

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Impacts of the proposed consolidation standard will be felt by collateral managers and many investors in partnerships

Introduction

The FASB is nearing the completion of its deliberations on its consolidation project and expects to issue a final standard in late 2014 with an effective date in 2016. Financial reporters should begin to assess the potential impact of the proposed changes.

Until the final standard is issued, all FASB decisions are tentative and subject to change. Although the guidance is not yet final, our views herein are based on our understanding of the FASB's deliberations.

We believe the most significant impacts will be:

Variable interest entities

- More LPs will be considered VIEs
- VIE disclosures may apply to more entities
- The consolidation model for LPs that are non-VIEs is changing

Related party tiebreaker

- New standard may limit the application of the related party test
- A "substantially all" test has been added that triggers consolidation

Primary beneficiary

- Market based fees are EXCLUDED from the economics assessment
- Both direct and indirect interests (interests held by affiliates) are INCLUDED in the assessment
- "Potentially be significant": no incremental threshold guidance

Scope exceptions

- Certain money market funds are excluded
- All other existing scope exceptions remain

Variable interests

- Relaxed criteria for evaluating fees
- Fewer fee arrangements may be considered VIs

Effective date

- Final standard expected late 2014, and effective in 2016
- Early adoption will be allowed which could affect FYE 2014 reporting

Executive summary

The anticipated changes to the consolidation guidance may have broad sweeping impacts across all industries, and certain amendments are expected to have a particularly significant impact on the accounting and disclosure requirements for financial services companies such as banks, insurance companies, and asset managers that manage and/or hold interests in partnerships and investment companies.

The changes amend the criteria for how decision maker and service provider fee arrangements are analyzed, and are expected to have a meaningful impact on CLO and collateral managers.

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The following components of the new standard may be of particular interest for companies involved with partnerships, investment companies and asset collateral managers:

- The criteria for evaluating whether partnerships and investment companies are considered variable interest entities ("VIEs"); and
- The factors for considering whether decision maker and service provider fees are considered variable interests ("VIs").

Impact for partnerships and investment companies

One of the new provisions is intended to limit the circumstances where asset managers involved with partnerships and investment companies will consolidate the funds they manage.

The new guidance is expected to end the current deferral from FAS 167 for certain investment companies, and to result in more partnership type entities being considered VIEs.

If more partnerships and investment companies are considered VIEs under the new guidance, the managers and investors that hold VIs in these structures would be subject to the VIE disclosure requirements as it relates to these entities.

Impact for CLO collateral managers

The new guidance is expected to relax the criteria used to evaluate whether fees earned by certain decision makers and service providers (for example, CLO collateral managers) are considered VIs.

Under the new standard, fewer fee arrangements may be considered VIs and as a result, companies may need to revisit their consolidation analyses.

A CLO collateral manager may conclude that it does not have a variable interest under the new guidance if the fee is "market–based" and the CLO collateral manager (and its related parties) does not hold other significant VIs, including equity, in the CLO.

Impact for related party tie breaker test

The new standard should limit situations where the "related party tie breaker" test is performed to identify the variable interest holder ("VIH") within the related party group that is considered "most closely associated" with the VIE – and thus must consolidate it.

FSR Insight*: We expect that many companies will be interested in early adopting the new standard since the guidance may result in potential de-consolidations for certain asset managers and collateral managers.*

Upon adoption, companies will need to re-evaluate:

- *The impact of the removal of the deferral granted to investment companies;*
- *The VIE status of entities in which they hold a VI; and*
- *The terms of any service provider fees and other interests with these entities.*

This analysis can be a time consuming process. An effective process will require planning, a detailed review of the entities, the preparation of accounting and disclosure adjustments, and detailed documentation to support changes in VIE status and consolidation conclusions.

Reporting companies should consider potential changes that may be required for systems, processes, and controls to analyze and continuously monitor and report these relationships for presentation and disclosure purposes.

Project history

The primary purpose of the consolidation project is to rescind the deferral (ASU 2010-10[1]) of the VIE guidance in ASU 2009-17 (FAS 167[2]) for entities with the attributes of an investment company that meet certain criteria.

Prior to the issuance of ASU 2009-17, the consolidation guidance for VIEs (FIN 46(R)[3]) required a reporting entity to consolidate a VIE if it was exposed to a majority of the VIE's expected losses, expected residual returns, or both, through its VIs. This approach was commonly labeled the risks and rewards approach.

ASU 2009-17 shifted the consolidation analysis from a risks and rewards approach to a model that considers both:

- Control (i.e., the power to direct the most significant activities that impact the VIE's economic performance); and
- Exposure to potentially significant economics (from the VIE's perspective).

As a result of these requirements, the current model could lead to a conclusion that certain asset managers would be considered the primary beneficiary ("PB") of the investment funds they manage and, therefore, would be required to consolidate them.

Many preparers and users believed this conclusion would not provide useful financial information. In response, the FASB issued ASU 2010-10 to defer the new criteria for certain investment companies.

ASU 2010-10 allowed entities that met the requirements for deferral to continue to apply the risks and rewards approach while the FASB reconsidered the issues in the pending guidance. The FASB's approach was intended to align the US model with the IFRS model.

***FSR Insight**: The targeted changes in the new guidance have been primarily designed to address the concerns of the asset management industry; however, entities across all sectors will be affected.*

For example, the real estate sector may be impacted due to its use of limited partnership structures.

In addition, companies that have applied the "related party tie breaker" test may have a change in their consolidation conclusion.

What are the details?

The new standard is expected to impact several areas within the consolidation assessment. It could impact:

- Whether or not a reporting entity has a VI;
- If an entity is a VIE or a voting interest entity; and/or
- Which party consolidates the entity.

Specific provisions

Variable interests and decision maker fees

The definition of a VI remains unchanged; however, the standard would change the analysis of whether a decision maker fee is a VI.

Currently, a decision maker fee is considered a VI unless certain criteria (outlined in ASC 810-10-55-37) are met. The standard is expected to relax those criteria and may result in fewer fee arrangements being considered VIs.

The new analysis will focus on whether the fees are "market-based" (i.e., commensurate with the level of effort and customary for the services provided). If the fee is market-based, the arrangement will not be a VI unless the decision-maker (and its related parties) hold equity or other VIs in the VIE that absorb

[1] ASU 2010 – 10, *Consolidation (Topic 810), Amendments for Certain Investment Funds*

[2] FAS 167, *Amendments to FASB Interpretation No. 46(R), codified in ASC 810, Consolidation*

[3] FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

more than an insignificant amount of the entity's variability.

The new standard would eliminate the criterion that "substantially all" of the fees are at or above the same level of seniority as other operating liabilities of the entity. Today, a decision maker's fee that is subordinate to other liabilities of the entity is generally a VI even if it is market based.

> ***FSR Insight****: Today, the manager of a collateralized loan obligation (CLO) entity that receives a three-tier fee (i.e., a senior (base), subordinate, and incentive fee) that is "market-based" generally is considered to have a VI in the CLO due to subordination of some portion of the fee.*
>
> *Under the new standard, the manager will not have a VI in the CLO assuming it (and its related parties) hold no other significant interests in the entity and can demonstrate that the fee arrangement is "market-based."*

Variable interest entity evaluation and limited partnerships

If a reporting entity has a VI in an entity and the entity does not qualify for a scope exception in ASC 810-10-15, the reporting entity needs to evaluate whether that entity is a VIE.

The general characteristics of a VIE (described in ASC 810-10-15-14) are expected to remain intact when the guidance is issued. However, an additional analysis will be required for limited partnerships and similar entities, including limited liability companies, having the characteristics of limited partnerships.

Limited partnerships are generally not considered VIEs under the current VIE rules if:

- The general partner has power over the most significant activities; and
- The GP has a substantive investment in the entity.

Limited partnerships will be VIEs under the revised standard, unless there are substantive kick-out, liquidation, or participating rights that are exercisable by:

- A single limited partner; or
- A simple majority vote of all of the partners (inclusive of the general partner and its related parties).

The level of the general partner's equity investment will no longer be relevant to the analysis.

> ***FSR Insight****: We expect that more limited partnerships could be considered VIEs upon adoption of the new standard.*
>
> *Many LPs do not empower a single partner or a simple majority of all partners with the ability to exercise substantive kick-out, liquidation, or participating rights.*
>
> *Limited partnerships are utilized in many different industries and are particularly prevalent in asset management, structured investments, and real estate.*
>
> *Even if the ultimate consolidation conclusions do not change as a result of applying the VIE model, additional analyses and, importantly, additional disclosures relevant for VIEs are expected to be required.*

The standards specific to assessing consolidation of partnerships under the voting model (ASC 810-20) will be eliminated, including the presumption of control by the general partner.

All limited partnerships that are not VIEs will need to be assessed for consolidation under the same voting model applicable to corporations. Under that model, the holder of a majority of the voting rights is deemed to control the entity unless the minority shareholder holds substantive participating rights enabling them to participate in certain financial and operating decisions that are made in the ordinary course of business.

***FSR Insight**: The details of how to apply these concepts are not yet clear. The FASB's discussions on this topic suggest that a GP that holds a majority of the kick-out or liquidation rights likely will be deemed to control the entity absent substantive participating rights held solely by one or more of the minority limited partners.*

Participating rights provide a veto right or permit participation in the ordinary course of business decisions. Participating rights may not enable the holder to initiate decisions and may not, on their own, provide control over an entity.

Primary beneficiary

Currently, as noted above, a reporting entity with a VI in a VIE consolidates the VIE if it has both the power to direct the most significant activities that impact economic performance of the entity ("power") and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses ("economics"). The new standard will introduce changes that will impact the "economics" analysis.

First, a reporting entity will need to include its indirect interests held in the VIE together with its own direct interests when determining whether it has potentially significant economics.

An indirect interest exists when a VIH has an economic interest in a related party that holds a VI in the VIE.

***FSR Insight**: Companies will need processes to identify, assess and determine changes in direct and indirect interests in VIEs, including any changes to indirect interest percentages.*

For example, interests in a fund may change as new investments are made or interests are redeemed by third parties.

Judgment will be required to determine the percentage of indirect interests that should be included in the PB analysis.

For example, the amount of the indirect interest may not be clear and judgment will be needed to determine the appropriate interest to include (e.g., if the reporting entity owns preferred stock in the equity method investee or when the holding structure is complex).

The FASB is expected to provide guidance in the standard on qualitative factors to consider in determining whether the indirect interest should be considered in the VI analysis.

Second, variability absorbed by the decision maker through a "market-based" fee generally will not be considered in the PB analysis. However, any other VIs held by the decision maker (or its related parties) will need to be considered in the analysis.

The "market-based" decision maker fee arrangement is not excluded from the "power analysis." The fee is only excluded from the "potentially significant economic analysis."

***FSR Insight**: Upon adoption of the standard, entities with interests in investment companies that previously qualified for the investment company deferral will be* *applying the "power" and "economics" VIE control model for the first time.*

Determining whether the decision marker's level of economic interests is "potentially significant" is an area of significant judgment that is not probability-based; it must consider all possible scenarios.

The exclusion of the "market-based" fee may provide some relief for asset managers in their assessment of economic interests; however, the overall level of economics (ex-fees) held by the related party group as a whole will be a key determining factor.

Related party tie breaker

The evaluation of related parties can significantly impact conclusions reached when analyzing whether VIEs require consolidation.

Related parties include those defined in ASC 850, *Related Party Disclosures*, and "de facto agents" under the VIE guidance.

A single reporting entity may not individually have the characteristics of a PB, but when considered together with its related parties, the related party group as a whole may have the characteristics of a PB. In that case, a "related party tiebreaker" test is performed to identify the VIH within that related party group that is "most closely associated" with the VIE. The party that is most closely associated with the VIE "wins" the tiebreaker and consolidates the VIE.

The new standard is expected to limit situations where the related party tiebreaker test is performed. If any of the following three circumstances are present, VIHs within a related party group are to consider the related party tie breaker provisions:

- If no single party in the related party group has unilateral "power" (power is shared), then the related party tiebreaker should be applied to identify the party that consolidates the VIE.
- When a single party in the related party group has unilateral "power" together with its related party(ies) that are under common control, then the related party tiebreaker should be applied to identify the party that consolidates the VIE.
- If "substantially all" of the VIE's activities involve or are conducted on behalf of one of the VIHs in the related party group, then that VIH is required to consolidate the VIE. This is intended to capture voting arrangements where an entity is designed to benefit a single investor who does not have "power."

***FSR Insight**: Entities that previously applied the "related party tie breaker" would continue to do so when:*

- *The collateral management of the VIE was performed by one related party with unilateral power (e.g., the collateral manager); and*
- *The other related party VIHs under common control with the collateral manager purchase debt, equity, or issue guarantees to the VIE (i.e., passive investors, guarantors).*

The FASB retained the notion that a VIE should be consolidated in common control situations by applying the related party tiebreaker to consider the discretionary manner in which interests could be shifted around within a related party group.

Under the voting model, consolidation is generally not required at an intermediate level if that specific reporting entity does not have a controlling financial interest on a standalone basis even if, overall, the ultimate parent has a controlling financial interest.

***FSR Insight**: Application of the related party tie breaker test may result in different consolidation conclusions than a consolidation analysis that does not consider related parties.*

Scope exceptions

The standard is not expected to change the existing scope exceptions to the VIE model (ASC 810-10-15).

A new scope exception will be provided for investors in certain money market funds.

Money market funds ("MMFs") registered with the SEC pursuant to Rule 2a-7 of the Investment Company Act of 1940 and "similar" unregistered MMFs will be subject to the scope exception. Qualifying companies will be exempted from assessing these funds for consolidation under any model.

To be considered "similar," an unregistered money market fund's structure and targeted outcome must be consistent with those of a registered money market fund. The targeted outcome is "similar" if an unregistered fund's exposure to credit risk, maturity, and diversification are substantially the same relative to a typical registered money market fund.

Managers of MMFs qualifying for the scope exception will be required to provide additional disclosures, including information about past financial support provided to the funds for all periods presented and any explicit commitments to provide future financial support.

***FSR Insight**: The new scope exception addresses concerns of users and preparers that consolidation of MMFs by their managers does not result in decision-useful information.*

Given the prevalence and size of money market funds, the FASB decided that a scope exception was the most effective means to address these concerns while mitigating the risk of unintended consequences for other entities.

Effective date

We expect the FASB to issue the new standard late in 2014.

The standard is expected to be effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2015.

Nonpublic business entities are expected to apply the standard for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. Early adoption will be allowed.

The final standard allows a reporting entity to adopt the changes on a modified retrospective or full retrospective basis.

The transition guidance is intended to be broadly consistent with that in ASU 2009-17, namely:

- For entities that will be consolidated for the first time due to the application of the changes, assets and liabilities will be recognized as of the date of adoption based on what the carrying amounts would have been had the new guidance always been applied.
- If it is not practicable to determine the carrying amounts of the individual assets and liabilities of the entity, then fair value at the date of adoption will be used.

- For entities that will be deconsolidated due to the application of this proposal, the carrying amount of any retained interests will need to be determined based on what it would have been if the new guidance had always applied.
- Any difference between the net amount of:
  - The assets and liabilities of the entities that are added to or subtracted from the reporting entity's balance sheet; and
  - The carrying amount of the reporting entity's interests in any newly-consolidated VIEs and those now-deconsolidated VIEs will be recognized as a cumulative-effect adjustment to retained earnings.

Conclusion

The new standard is expected to make targeted changes to the current consolidation guidance, and will end the deferral currently granted to certain investment companies.

The new standard is expected to limit the circumstances where asset managers consolidate funds they manage, change the consolidation analyses, and impact the disclosure requirements.

Companies involved with asset and collateral management activities, MMFs, partnerships and partnership-like entities, and investment companies, likely will be affected by the new standard.

Additional information

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