January 2010

Changing the rules of the road: FAS 167 impacts to the automotive industry

At a glance

FAS 167 represents a dramatic shift in the consolidation model for variable interest entities and is expected to have broad implications.

With some strategic business relationships moving on balance sheet, companies may need to rethink transaction structuring and collaboration strategies.

The impact goes beyond financial reporting to include financial metrics, operations, stakeholder communications, internal controls and IT systems.

PricewaterhouseCoopers

A new standard has made the final turn and is heading towards the finish line. This new standard, FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), however, has not been declared a winner by all in the financial community. The new standard introduces more restrictive criteria that apply to new and existing arrangements. The impact on balance sheets, operations and business relationships may be considerable.

Ongoing concerns drive change

FIN 46(R) was issued in response to issues with the accounting for and disclosure of off-balance sheet entities. Since its release, there have been ongoing concerns that the application of FIN 46(R) has not provided financial statement users with timely and useful information about reporting entities' involvement with variable interest entities (VIEs). For example, because of its quantitative focus, application of FIN 46(R) sometimes resulted in accounting outcomes based on structure and form rather than the substance of the underlying transactions. These outcomes were highlighted by and became controversial during the recent financial crisis.

As a result, the FASB re-evaluated the accounting for VIEs and issued FAS 167 (the standard) in June 2009.[1] The standard introduces a consolidation model rooted in a qualitative determination that focuses on control of the most significant economic activities of the VIE. Based on our initial observations and analysis, we believe that application of this new model to the automotive industry will generally result in accounting conclusions that better reflect the substance of the relationships among the parties. Furthermore, accounting executives should be able to explain the resulting consolidation conclusions to boards and senior management without pages of complex analysis, diagrams and charts. However, despite these improvements, the new consolidation model remains complex and may require significant effort and analysis to reach the appropriate conclusions.

The standard is effective for annual reporting periods beginning after November 15, 2009. For calendar year-end companies, this date, January 1, 2010, has just passed. The standard does not include a grandfathering provision; therefore, all relationships must be evaluated under the new rules. This article focuses on the significant changes and impacts we believe will most broadly impact the automotive industry. It is not intended to and does not provide a comprehensive discussion of all aspects of accounting for VIEs. Therefore, this publication should be considered together with the related authoritative guidance and other PricewaterhouseCoopers (PwC) publications related to FIN 46(R) and FAS 167.

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[1] FAS 167, or Accounting Standards Update 2009-17, amends Topic 810, *Consolidations,* of the FASB Accounting Standards Codification (ASC).

Redesigning the model

More than just a refresh of old content, the changes in the new standard represent a redesign of the model. The key changes likely to affect the automotive industry include:

- A dramatic shift in the rules for determining the primary beneficiary—The old rule was focused on a quantitative assessment of who has the majority of the economic risks and rewards, and the new rule brings the consolidation analysis for VIEs closer to the traditional control-based approach.
- Introduction of shared power concept and changes in related parties and de facto agent guidance—The new rules introduce the concept of shared power and changes to the guidance for related parties and de facto agency relationships. These changes may cause certain entities that are currently consolidated to be de-consolidated.
- Elimination of the exception for qualified special purposes entities (QSPEs)—Previously, an exemption existed for QSPEs, therefore these entities were off-balance sheet structures. Under the new rules, these former QSPEs often will be consolidated.
- Reconsideration—The new rules eliminate the event-driven reconsideration of the primary beneficiary and instead require this assessment to be performed on an ongoing basis.

The standard will require management to make significant judgments and may require changes to existing systems, processes and internal controls.

The implications

The determination of whether entities should be consolidated or deconsolidated is only part of the story. The impact of the standard extends well beyond the accounting to potentially affect:

- Debt covenants—Additional debt from newly consolidated entities may trigger covenant violations or removal of debt from previously consolidated entities may improve these covenant calculations.
- Financial metrics—Changing which entities are consolidated will impact performance measures such as gross margins, return on assets, and return on equity. This may impact internal measures such as compensation plans, budgeting, and other externally communicated financial metrics of interest to investors.
- Controls and systems—The new requirements, such as the need to perform an ongoing reassessment of the primary beneficiary, will need to be embedded in systems and processes. Newly consolidated companies will be subject to internal control certifications of the parent, thus expanding the scope of internal control testing or reducing testing for newly deconsolidated VIEs.
- Business development—The new standard will need to be considered when structuring transactions and may require restructuring of past transactions to prevent changes to current consolidation conclusions.

The implications of applying the standard are expected to be broad, and will include not only accounting and reporting, but also operational and financial considerations.

Driving deeper

With these implications in mind, we take a more in-depth look at some of the key changes that likely will affect the automotive industry.

Determining the primary beneficiary

Under previous guidance, determining the primary beneficiary was based upon a quantitative expected loss model that considered risks and rewards. Under the new rules, the primary beneficiary is determined by a qualitative analysis that requires two criteria to be met:

1. Power to direct activities that most significantly impact the economic performance of the VIE, and the
2. Obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE

The power criterion requires an assessment of the activities that most significantly impact the economic success of the VIE. For example, a joint venture between two unrelated parties might require that one party be responsible for marketing and the second party be responsible for distribution. In this scenario, an assessment must be made to determine which activity, marketing or distribution, most significantly impacts the economic performance of the VIE. The party with the power over the activities that most significantly impacts the economic performance of the VIE is the primary beneficiary. If however, the facts change and the two parties to the joint venture share responsibility for the marketing and distribution, the parties to the joint venture may conclude they have shared power. If power is shared, neither party is deemed to be the primary beneficiary.

Determining which activities most significantly affect the entity's economic performance will require considerable judgment. As highlighted, while multiple parties may split power, the parties involved often do not direct the same activities that impact the entity's economic performance. If this is the case, it is necessary to first determine which activities most significantly affect the entity's economic performance and then identify the party with control over those activities.

Joint ventures are a common structure in the automotive industry. Many joint ventures are VIEs. Provided each of the venture's partners must consent to the activities that most significantly impact the entity's economic performance, the standard generally would not require either party to consolidate.

Consider the following example:

Scenario 1

An original equipment manufacturer (OEM) and a supplier enter into a joint venture entity to produce a specific part. For purposes of this discussion, let's assume the arrangement is a 50/50 relationship between the parties, and that the OEM takes production from the joint venture on a cost-plus basis.

Key considerations:

In this scenario, even though the arrangement is a 50/50 relationship between the parties, one party may have more power to direct the activities that most significantly impact the VIE's economic performance. The following considerations should be made:

- Are the parties involved in the joint venture related?
- Does the joint venture potentially create a de facto agency relationship?
- Who will manage the joint venture, and will one party have more power than the other? Items to consider include:
  - Does one party control the board of directors of the joint venture?
  - Does one party control executive management of the joint venture?
  - If party A controls the board, and party B controls executive management, does the board or executive management have more influence on the most significant activities that drive economic performance of the joint venture?
  - Which activities most significantly impact the entity's economic performance? Does one party have greater control over any of these activities?
  - Does the joint venture operate in multiple locations? If so, are the responsibilities of each party (i.e., power) the same in all locations? If not, is one location more significant than the others?
  - What happens in the event of an impasse? Does one party have a casting vote to break the tie or will the parties enter into binding arbitration with an independent arbitrator?

– Does one party have disproportionate economics in the entity compared with its voting rights? While in this scenario a joint venture with 50/50 economics is assumed, in a situation where voting and decisions are split 50/50 but the economics of the arrangement are split 90/10, the disproportionate economics may weight the consolidation guidance to the party with disproportionate economics.

In this scenario, the focus is on an arrangement between an OEM and a supplier. However, the considerations would be similar if the arrangement were between OEMs, who may enter into joint ventures together to develop specific technology.

Under the standard, a party only needs to have the ability to exercise power to meet the power criterion (i.e., a party may have power even if they have not exercised it). In an operating entity, key decisions will likely need to be made as operations occur potentially resulting in a conclusion that one party currently has the power. If one party currently has the power over the most significant activities, then a transfer of power on the occurrence of a future contingency would only be considered when that contingency is resolved.

In contrast, in a securitization structure, it may be that the key decisions that drive economic performance of the entity occur when a contingent event occurs; therefore, the party with those contingent powers will likely be the primary beneficiary.

Consider the following example:

Scenario 2

Automobile manufacturers and suppliers often share a level of dependence. A customer might be explicitly obligated to provide financial support to a supplier in financial distress, suggesting that the customer has some control over the supplier. Depending on the terms and conditions of the support arrangement, there may be specific provisions in a contract that explicitly create control by the customer over the supplier. This control may be current or contingent on the occurrence of specific events.

Key considerations:

In this scenario, the contract may give the party providing financial support control over the distressed party. If this control meets the power criterion of the new rules, and the other requirements are met, the result could be that the party with an obligation to provide financial support will need to consolidate the distressed party. The following considerations should be made:

- Does the distressed party have an obligation to pay the other party back for the support provided?
- Does the agreement convey a contingent right to control the assets of the distressed party?

- Does the agreement allow the party providing support to operate as management, in any way, of the distressed party?

- If the agreement allows the party providing support to operate in a management role, what steps have been taken to achieve that role?

- Whether the term of the contract is critical to the holder's power relative to the VIE. Specifically, does holding the contractual powers for a longer period impact the conclusion as to which party is the primary beneficiary? In general, we do not believe that contract length will be a defining factor in determining which variable interest holder controls activities that are most significant to the entity because the primary beneficiary analysis is performed based on who has the power to direct the most significant activities as of the reporting date. However, in some cases contract length may impact the determination of whether a contract is a variable interest.

If a company concludes it has met the power criterion, it will then need to determine whether it has the obligation to absorb losses or the right to receive benefits from the VIE that could be potentially significant to the VIE. This determination is not based on the quantitative expected loss/expected residual return calculation required under the previous accounting model. Rather, the assessment is intended to be a judgment-based analysis.

Consider the following example:

Scenario 3

In the automotive industry, it is not uncommon for buyers to purchase a significant amount (i.e., greater than 90 percent) of the output of a supplier. This may indicate that the customer has some control over the supplier. Assume the arrangement between customer and supplier includes variable pricing and that if the customer, in this case an OEM, reduces production, the supplier may be forced to reduce production as well.

Key considerations:

In this scenario, the implied ability of the OEM to control the supplier's production output may suggest the OEM meets the power criterion of the new rules if production is determined to be the most significant activity of the entity. Assuming the other requirements are met, the result could be that the OEM should consolidate the supplier. The following considerations should be made:

- If the OEM makes production cuts, what ability does the supplier have to find other customers for parts? For example, consider whether the parts are unique to the OEM, and, therefore, would have limited or no value to others (i.e., is there an external market for the parts, or is the only market with the OEM?).

- Does the supplier have responsibility or incentive to find other customers, or does the arrangement with the OEM specify minimum purchase requirements?

- Does the arrangement with the supplier create an exclusive agreement between the OEM and the supplier?

In addition, in this scenario, or even in a scenario where a customer does not take a significant amount of the supplier's output, the customer should consider the implications of the need to comply with quality control standards could have on the evaluation. Most automobile or automobile part manufacturers have implemented quality control programs throughout their organizations. In many cases, these programs also have been extended to their suppliers. The quality control programs may have participating rights. For example, when an OEM's quality control program has been implemented at a supplier, the program might require the involvement of an OEM representative in the procurement of raw materials, planning and scheduling of production, and in the production of goods. Although a quality control program would not have been considered in determining who should consolidate under the old rules, all rights and obligations under arrangements should be considered under the new rules; therefore, in this example, if the supplier was a VIE, these participating rights should be considered to determine if the OEM met the power criterion.

Related parties and de facto agents

In the automotive industry, joint venture relationships involving entities are common. Often, these relationships are between related parties. Under previous guidance, the related party tie-breaker provided that if more than one party in a related party group had a variable interest in the same entity, and collectively they were considered the primary beneficiary of that entity, the party within the related party group most closely associated with the

VIE was deemed to be the primary beneficiary. Under the new rules, the individual parties within a related party group are first required to separately consider whether they meet both the power and losses/benefits criteria on a standalone basis. If no party within the related party group meets both criteria on its own, but the group as a whole meets both criteria, the related party tie-breaker is applied.

It is also common for joint venture relationships to include mutual transfer restrictions, which may create a de facto agency. Mutual transfer restrictions exist when no one party can transfer their ownership interest and/or responsibilities without first obtaining approval from the other party(ies). Under the new rules, a de facto agency does not exist if there are mutual transfer restrictions based on mutually agreed upon terms by willing, independent parties. For example, if an OEM and an unrelated supplier enter into a joint venture agreement that contains mutual transfer restrictions that were agreed upon willingly by both parties, a de facto agency will not be deemed to exist.

As a result of these changes, we believe the related party tie-breaker will be applied to determine the primary beneficiary less frequently, and we anticipate that the changes may impact which party to the joint venture, if any, meets the criteria for consolidation of the joint venture.

Removal of QSPE scope exception

The new rules remove the QSPE scope exception from having to apply the consolidation guidance for VIEs. The concept of a QSPE was introduced to permit derecognition of transferred financial assets in securitization transactions. With the removal of the scope exception, all QSPEs that exist on the effective date will be subject to the new rules. We anticipate this change will have a less pervasive impact on the automotive industry than certain other industries, for example financial services related industries. However, this change may significantly impact enterprises that use QSPEs in securitization transactions, such as financing operations within the industry.

Reconsideration of the primary beneficiary

Previously, a company was required to reconsider whether it was the primary beneficiary of a VIE only when specific events arose. Under the new rules, an ongoing reconsideration of whether a company is the primary beneficiary due to changes in facts and circumstances is required. The need for an ongoing assessment is consistent with the consolidation model applicable to entities that are not VIEs.

In examining the power criterion, we discussed an example including a joint venture where one entity controlled marketing and the second controlled distribution. In some scenarios, marketing may be more significant to the economic performance of the VIE in the first years of the joint venture, but in later years distribution may more significantly impact the economic performance of the VIE. Under the new rules, this change in facts and circumstances may cause a change in the primary beneficiary.

When a company identifies a change in the primary beneficiary of a VIE, it will need to determine the date within the reporting period when the change occurred and recognize the effects as of that date.

Not the end of the road

As highlighted, the number of judgments required by the standard complicate the assessment of who should consolidate a VIE. However, the journey has only begun once the primary beneficiary is established. In particular, the following areas of accounting and disclosure will likely prove challenging as companies transition to the standard:

- The standard must be applied as of the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009 (i.e., effective January 1, 2010 for calendar year-end reporting entities). The provisions of the standard must be applied in interim and annual periods. Reporting entities may apply the impact of adoption retrospectively, requiring a cumulative-effect adjustment to retained earnings as of the beginning of the first year adjusted. Alternatively, entities may apply all changes as of the date of adoption of FAS 167, with a cumulative-effect adjustment to retained earnings as of that date.

  In considering whether to retroactively restate prior periods, reporting entities should evaluate their facts and circumstances including the extent of the reporting entity's involvement with VIEs and the availability of necessary information. Reporting entities with significant changes in the consolidated group as a result of adoption may lean toward retrospective application to improve comparability of financial results; however, applying the guidance as of the date of adoption may be less complex and time consuming.

- During transition, VIEs are to be consolidated or deconsolidated based on carrying amounts calculated as though the accounting had been applied since the first date the reporting entity became involved with the VIE. In accordance with this guidance, the reporting entity would go back in time to perform the initial consolidation or deconsolidation (at fair value) and to roll forward the carrying amounts through the date of adoption of the standard. The calculation of carrying amounts may be quite complex because of the passage of time (there may be multiple years of information to consider) and changes in reporting standards over the period (e.g., the release of FAS 141(R) [ASC 805]).

- A practical expedient using current fair value is available for consolidations if it is not practicable to determine carrying amounts. For example, this may apply if the reporting entity was not primarily responsible for maintaining the books and records of the reporting entity during the period, or if there is excessive cost to the reporting enterprise in determining the carrying amounts.

- Disclosures can be time consuming and may require extensive coordination with third parties. Reporting entities should build sufficient time into their reporting timelines to obtain all required information. Reporting entities are required to provide extensive disclosures about their involvement and relationships with VIEs. In particular, management teams are required to disclose key judgments and assumptions made in evaluating the nature of a reporting entity's involvement with VIEs. Furthermore, there is a focus on disclosure of potential risks and exposures associated with these relationships. Reporting entities should ensure that their FAS 167 implementation plan incorporates these requirements to facilitate the disclosure process.

Turning the corner

As the standard is now effective for calendar year-end companies, time is limited to react to and implement changes to address it. At this point, it is likely that calendar year-end companies have done the following:

- Developed an internal communication strategy and educated senior management and/or the audit committee about the potential broad-reaching effects of applying the new rules.

- Modified/developed accounting policies and processes for areas affected by the new rules (e.g., segment reporting, goodwill impairment testing).

- Identified and assessed the status of accounting records for VIEs.
- Assessed other impacts of the standard, including financial ratios, key performance indicators, management's discussion and analysis, and compensation policies and procedures.

In addition to these actions, companies may have also completed, or may be in the process of completing:

- Performing valuations to determine the necessary accounting entries on adoption
- Preparing draft financial statements and disclosures
- Changing and/or developing internal controls
- Changing and/or developing existing systems, processes, and resources for ongoing compliance

As companies complete, or consider these actions to implement FAS 167, it is important to keep in mind that the FASB recently agreed to develop a converged consolidation standard together with the IASB.

The boards currently plan to issue an exposure draft by the second quarter of 2010 and a new standard later in the year. The objective is to provide comprehensive guidance for consolidation of all entities, including variable interest entities and voting interest entities. This broader project may therefore not only lead to further consolidation changes for companies with VIEs, but also other entities not within the scope of FAS 167.

Additional Information [2]

- DataLine 2009-53, FASB Proposes Amendments to FAS 167, and a Deferral for Certain Investment Funds
- DataLine 2009-30, FAS 167—New Consolidation Guidance for Variable Interest Entities
- PwC Paper: FAS 167 Company Action Plan—Consolidation of Variable Interest Entities
- 10Minutes on Off-Balance Sheet Arrangements
- Archived Webcast—Consolidation of VIEs
- PwC's Guide to Accounting for Variable Interest Entities (2009 Edition)

[2] The information referenced can be found online at CFOdirect.com. For individuals without access to the CFOdirect.com network, please reach out to your local PwC contact or one of the individuals listed here for assistance in obtaining the referenced information.

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