Consolidation—a new standard is imminent

Highlights of the expected changes

At a glance

The FASB completed deliberations on its consolidation project in July 2014 and expects to issue a final standard in the coming months. The new standard will make targeted changes to the current consolidation guidance and end the deferral granted to investment companies from applying the VIE guidance. It is primarily intended to limit the circumstances where asset managers will consolidate funds they manage, but consolidation conclusions, as well as applicable disclosure requirements, could change for entities in all industries. Companies involved with partnerships and investment companies may be the most affected. The new standard will be effective in 2016 for calendar year-end public companies, and early adoption will be permitted.

Background

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

.2 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 variable interest(s). ASU 2009-17 shifted the consolidation analysis from a risks and rewards approach to a model that considers both (a) control (i.e., the power to direct the most significant activities that impact economic performance) and (b) exposure to economics. As an unintended outcome, many asset managers would have been required to consolidate investment funds they manage, which most practitioners (preparers and users alike) believed would not provide useful financial information. As a result, the FASB issued ASU 2010-10, which allowed entities meeting the deferral criteria to continue to apply the risk and rewards approach.

.3 In late 2011, the FASB issued a proposal to further amend the consolidation model and rescind the deferral. Under that proposal, the FASB would have required a decision maker with a variable interest in an entity to perform a separate analysis to determine whether its decision-making authority is used in the capacity of a principal or an agent. A principal would generally consolidate the entity, while an agent would not. That proposal would also have amended which rights would be considered substantive “participating rights” in the assessment of control of a voting interest entity.

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\(^1\) 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
The FASB made a number of changes during its redeliberations of the proposal in response to comment letter feedback. Most notably, the FASB abandoned the requirement for a separate principal versus agent analysis, opting instead to embed those concepts throughout the various steps in the consolidation analysis. For example, the FASB concluded that the existence of kick-out, liquidation, or participating rights held by the investors in a limited partnership should be a determining factor of whether the entity is a VIE, effectively causing more limited partnerships to be considered VIEs. In addition, the FASB ultimately decided not to change the definition of participating rights in the voting interest model due to cost-benefit concerns.

PwC observation:
The targeted changes have been designed to address the concerns of the asset management industry; however, entities across all industries will be affected. The oil & gas, transportation, and real estate sectors may be more impacted (as described later in this In depth) due to their use of limited partnerships. In addition, companies in any industry that have applied the related party tiebreaker may have a change in their consolidation conclusion.

The FASB completed its redeliberations in July 2014 and is currently drafting the final standard. Until the final standard is issued, all decisions are tentative and subject to change. To the extent that the final provisions of the standard are materially different, we will update this In depth.

Key provisions

The final standard is expected to impact several areas within the variable interest entity assessment. It could impact (a) whether or not a reporting entity has a variable interest, (b) if an entity is a VIE or a voting interest entity, and/or (c) which party consolidates the entity. We have summarized the changes into five key areas as shown below.

PwC observation:
Because these changes are not limited to any particular industry, all reporting entities will need to re-evaluate entities in which they hold a variable interest. This process may be time consuming for certain reporting entities, particularly for those that have large numbers of VIEs or involvement with limited partnerships that previously were not VIEs, and entities that were previously subject to the deferral. Changes may be required to systems, processes, and controls to analyze and continuously monitor these relationships for presentation and disclosure purposes. In addition, as companies enter into new transactions, they should consider the consolidation conclusions under the new guidance.
The concept of a variable interest remains unchanged. It is an economic arrangement that gives the reporting entity the right to the economic risks and/or rewards of another entity. A reporting entity needs to determine whether an entity is a VIE only when it holds a variable interest in that entity. Sometimes it may be obvious that the reporting entity has a variable interest, such as when it holds a debt or equity interest in the entity. For other interests (e.g., contracts), judgment is required to determine if a variable interest exists.

Although the definition of a variable interest remains unchanged, the new standard changes the analysis of whether a decision maker fee is a variable interest. Currently, a decision maker fee is considered a variable interest unless certain criteria (outlined in ASC 810-10-55-37) are met. The new standard will relax those criteria and, as a result, fewer fee arrangements will be considered variable interests.

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 variable interest unless the company also holds equity or other variable interests that absorb more than insignificant amount of the entity’s variability.

One of the most significant changes to the decision maker fee criteria is the elimination of considering subordination. Today, a decision maker’s fee that is subordinate to other liabilities of the entity is generally a variable interest. The new standard will eliminate the criterion that “substantially all” of the fees be at or above the same level of seniority as other operating liabilities of the entity.

PwC observation:

Today, the manager of a collateralized loan obligation (CLO) entity that receives a three-tier fee (i.e., a senior, junior, and subordinate incentive fee) that is “market-based” generally has a variable interest in the CLO due to subordination of some of that fee. Under the new standard, the manager will not have a variable interest in the CLO assuming it holds no other interests in the entity and can demonstrate that the fee arrangement is “market-based.”
.11 The standard will not change the existing scope exceptions to the VIE model (ASC 810-10-15). It will, however, provide a new scope exception for interest holders in certain money market funds. Reporting entities will be exempted from assessing these funds for consolidation under any model.

.12 Money market funds registered with the SEC pursuant to Rule 2a-7 of the Investment Company Act of 1940 as well as “similar” unregistered money market funds will be subject to the scope exception. An unregistered money market fund’s structure and targeted outcome must be consistent with that of a registered money market fund in order to be considered “similar.” The structure is “similar” if its purpose and design is consistent with a registered fund. The targeted outcome is “similar” if its exposure to credit risk, maturity, and diversification are insignificantly different relative to a registered money market fund.

.13 Managers of money market funds 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 financial support in the future.

PwC observation:
The new scope exception is responsive to concerns of users and preparers that consolidation of money market funds by their managers does not result in decision-useful financial information. Given the prevalence and size of money market funds, the FASB decided that a scope exception is the most effective means to address these concerns without creating unintended consequences for all other entities.

Variable interest entity
.14 If a reporting entity has a variable interest in an entity, and the entity does not qualify for one of the scope exceptions in ASC 810-10-15, the reporting entity needs to evaluate whether that entity is a VIE. The characteristics of a VIE (described in ASC 810-10-15-14) remain intact. However, an additional analysis will be required for limited partnerships and similar entities.

.15 Under the current VIE rules, limited partnerships are generally considered VIEs only if the general partner has power over the most significant activities, but has not made a substantive investment in the entity. Under the new standard, however, limited partnerships will be VIEs unless substantive kick-out, liquidation, or participating rights are exercisable by either a single limited partner or a simple majority vote of all of the partners (inclusive of the general partner and its related parties), regardless of the level of the general partner’s equity investment.

**PwC observation:**

Many limited partnership arrangements require the general partner to make a substantive investment of more than 1% of the total partnership capital. As a result, these limited partnerships are generally voting interest entities under current guidance and are evaluated for consolidation under ASC 810-20 (formerly, EITF 04-5). We expect many more partnerships to be considered VIEs upon adoption of the new standard given the new requirement that a single partner or a simple majority of all partners must have the ability to exercise substantive kick-out, liquidation, or participating rights in order for a partnership to be considered a voting interest entity.

Limited partnerships are utilized in many different industries and are particularly prevalent in asset management, oil & gas, transportation, 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 will be required.

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

**PwC observation:**

It remains to be seen how the FASB’s decision related to assessing partnerships under the voting model will be reflected in the amendments to existing voting model. The FASB’s discussions on this topic suggest that a general partner that also holds a majority of the kick-out or liquidation rights will likely be deemed to control the entity absent substantive participating rights held solely by one or more of the minority limited partners. Since participating rights only enable the holder of those rights to veto or otherwise participate in the ordinary course of business decisions and not to initiate decisions, they do not, on their own, give the holder control over an entity.
Primary beneficiary

.17 A reporting entity with a variable interest 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 two changes that impact the “economics” analysis.

.18 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 variable interest holder has an economic interest in another reporting entity that also holds a variable interest in the VIE. For example, a reporting entity may own a 40% equity interest in an entity that holds a 20% equity investment in the VIE. In that case, there will be a rebuttable presumption that the reporting entity will include its effective indirect 8% equity interest in the VIE (i.e., its 40% interest in the investee multiplied by the investee’s 20% interest in the VIE) in evaluating whether its economics are potentially significant.

PwC observation:
Companies will need to implement systems and processes to identify and determine changes in the reporting entity’s indirect interests in VIEs. Changes to indirect interest percentages may be frequent for entities that have ongoing changes in investors and investment amounts. For example, an equity method investee’s interest in a fund may change constantly as new investments are made or interests are redeemed by third parties.

Judgment will be required to determine if the full indirect interest percentage should be included in the primary beneficiary analysis, or instead, if no portion or another amount should be included. In some situations, the amount of the indirect interest to be included 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). Further guidance is expected to be provided in the standard on qualitative factors to consider in determining whether the rebuttable presumption can be overcome.

.19 Second, variability absorbed by the decision maker through a “market-based” fee will not be considered in the primary beneficiary analysis. Only economics absorbed through other variable interests will be considered.

.20 The “market-based” decision maker fee arrangement is not excluded from the power analysis. It is only excluded from the potentially significant economic analysis. Accordingly, a decision maker with a “market-based” fee that still has the “power” will consolidate the VIE if it holds other potentially significant variable interests.
PwC observation:
Upon adoption of the new standard, entities that previously qualified for the deferral will be applying the “power” and “economics” VIE control model for the first time. Determining whether the decision maker’s level of economic interests is “potentially significant” is an area of significant judgment that is not probability-based; it considers all possible scenarios.

The exclusion of the “market-based” fee will provide some relief for asset managers in their assessment of economic interests; however, certain funds will still need to be consolidated due to the level of economics. The FASB considered whether to explicitly define or raise the threshold of potentially significant economics during its redeliberations, but chose not to do so. A change in the existing threshold would have had a broader impact on the reporting entities that already apply the VIE model today.

Related party tiebreaker

.21 The existence of related parties can significantly impact conclusions reached when analyzing whether VIEs require consolidation. Related parties in this context include those defined in ASC 850, Related Party Disclosures, as well as parties deemed to be “de facto agents” under the VIE guidance. Sometimes a reporting entity does not individually have the characteristics of a primary beneficiary, but when considered together with its related parties, the related party group has characteristics of a primary beneficiary. In that case a “related party tiebreaker” test is performed to identify the variable interest holder within that related party group that is “most closely associated” to the VIE. The party that is most closely associated to the VIE “wins” the tiebreaker and consolidates the VIE.

.22 The new standard will limit situations where the related party tiebreaker test is performed. There are three circumstances where a variable interest holder within a related party group deemed to be the primary beneficiary will be required to consolidate a VIE.

(1) 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.

(2) If a single party in the related party group has unilateral “power,” and

(a) together with its related party(ies) are under common control, then the related party tiebreaker should be applied to identify the party that consolidates the VIE, or
(b) if “substantially all” of the VIE’s activities involve or are conducted on behalf of one of the variable interest holders in the related party group, then that variable interest holder is required to consolidate the VIE. This is intended to capture abusive “vote parking” arrangements where an entity is clearly designed to benefit a single investor who does not have “power.”

**PwC observation**

The FASB retained the notion that a VIE should be consolidated at an intermediate level (i.e., sister company level) in common control situations by applying the related party tiebreaker, because of the discretionary or arbitrary manner in which interests could be shifted around within a group. Under the voting model, however, 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.

.23 The thought process to be applied for related parties can be illustrated as follows:
PwC observation:
Reporting entities that have VIEs where the related party tiebreaker is applied today should evaluate this change closely. It is possible that this change will result in the reporting entity or its related party deconsolidating the VIE upon adoption of the new standard.

What’s next

.24 We expect the FASB to issue a final standard late in the fourth quarter of 2014.

.25 The new standard will be effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2015. Nonpublic business entities will 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.

.26 The final standard allows a reporting entity to either adopt the changes on a modified retrospective or full retrospective basis. The transition guidance is intended to be broadly consistent with those contained in ASU 2009-17, summarized as follows:

- 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 if this guidance had always 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 this 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 retained interest will be recognized as a cumulative-effect adjustment to retained earnings.