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February 10, 2012

Via email to director@fasb.org

Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856

RE: Proposed Accounting Standards Update, Consolidation: Principal versus Agent Analysis (File Reference No. 2011-220)

Dear Ms. Cosper:

We are pleased to provide comments on the principal vs. agent exposure draft. As the ED's introduction alludes, we are aware that the Board initially intended to develop a single comprehensive consolidation model that would have converged with IFRS. We also note that some preparers and users in the financial services area expressed significant reservations about the outcome of Statement 167¹ that would have resulted in asset managers consolidating certain funds that they manage. These considerations led the FASB to issue the indefinite deferral in ASU 2010-10.² More recently, the Boards reached different conclusions related to consolidation policy for investment company and investment property entities, and the FASB adopted a narrower approach to address the concerns about asset managers consolidating their funds.

The proposed amendments would respond to those concerns, but they would also impact a much wider array of entities due to the pervasive effect they have on the variable interest entity consolidation model. While not every entity is a VIE, virtually every entity must be evaluated under the VIE criteria to determine whether the voting or variable interest consolidation model applies. We believe applying the principal vs. agent model to such a wide scope of entities is disproportionate compared to the asset management issues that were central to this project.

In addition, we are not certain that many financial service constituents would support managers consolidating funds, regardless of the accounting model that was applied. In other words, some constituents believe an asset manager's financial statements are most decision-useful when the fund is not consolidated. Therefore, we believe the Board should consider making the indefinite deferral permanent for such funds through a scope exception, without amending the rest of the consolidation guidance.

<sup>&</sup>lt;sup>1</sup> Amendments to FASB Interpretation No. 46(R)

<sup>&</sup>lt;sup>2</sup> Amendments for Certain Investment Funds



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Aside from that point, we have significant reservations about the principal vs. agent model itself. We are concerned it will introduce an unworkable amount of subjectivity into the consolidation analysis. Despite its qualitative aspects, the model has a substantial quantitative component due to its emphasis on variability. In particular, variability affects the weighting practitioners are supposed to attach to the rights held by other interest holders in an entity, and it influences how a decision maker evaluates the returns it absorbs through other interests in the entity, such as debt or equity. This will likely reintroduce some of the difficulties associated with FIN 46(R)<sup>3</sup> that the Board sought to address by moving to a more qualitative model in Statement 167.

The proposed amendments also lack clarity as to how the principal vs. agent model integrates with the existing primary beneficiary guidance. As we explain more fully in our responses to the questions posed in the exposure draft, the new analysis is supposed to be performed "in" the context of the larger primary beneficiary evaluation, but it isn't clear whether or how those concepts are intended to be distinct. In other words, if a principal determination always results in consolidation, what is the relevance of a primary beneficiary? We see no reason for having separate passages in the Codification devoted to each term if they are intended to result in the same consolidation conclusion.

Further, the principal vs. agent amendments include a consideration of the reporting entity's economic interests in the entity being evaluated as an element of the "power" analysis that currently exists in the VIE literature. Heretofore, the power analysis has focused on an entity's business activities, while "economics" were evaluated separately, i.e., the reporting entity's exposure to the losses or benefits flowing from the VIE. We do not understand why the Board would establish a seemingly redundant evaluation of economics within the power analysis. At a minimum, we believe the proposal could be improved by clarifying that economics should only be evaluated once.

For these and other reasons detailed below, we believe the Board could more efficiently address the indefinite deferral through a permanent scope exception, while leaving the rest of the consolidation guidance unchanged.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting at (312) 616-4667 or Adam Brown, Partner in the National Accounting Department at (214) 665-0673.

Very truly yours,

BDO USA, LLP

BDO USA, LLP

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<sup>&</sup>lt;sup>3</sup> Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51



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Question 1: When determining whether a decision maker is a principal or an agent, the proposed amendments require the analysis to consider the decision maker's overall relationship with the entity and the other parties involved with the entity. This analysis would be based on a qualitative assessment. Do you agree with this approach? If not, why?

We are unable to support the new approach, as explained in our cover letter. If the Board moves forward with its proposal, we offer the following comments.

Question 2: The evaluation of a decision maker's capacity would consider the following factors:

- a. The rights held by other parties
- b. The compensation to which the decision maker is entitled in accordance with its compensation agreement(s)
- c. The decision maker's exposure to variability of returns from other interests that it holds in the entity.

Are the proposed factors for assessing whether a decision maker is a principal or an agent appropriate and operational? If not, why? Are there any other factors that the Board should consider including in this analysis?

We generally agree that the nature of these factors are relevant to a consolidation analysis, that is, a consideration of the decision maker's power over an entity coupled with its financial interests in the entity. However, we have several concerns regarding how the Board intends for them to be evaluated.

## Rights held by other parties

The ED states that "the greater the number of unrelated parties required to act together to exercise rights to remove a decision maker, and the greater the magnitude of, and variability associated with, the decision maker's other economic interests (that is, compensation and other interests), the less weighting that shall be placed on [the rights held by other parties]." In practice, we believe this may invite the creation of rules of thumb related to the number of individuals required to exercise a kickout or participating right. We suggest the Board clarify its intent regarding the number of parties who hold kickout and similar rights by elevating language currently reflected in the basis for conclusions into the body of the standard, as discussed in our response to question four. We note the Board indicates that such rights should only impact the consolidation analysis when held by a "small number" of parties and believe that notion is more restrictive than the broader "sliding scale" language in the proposed amendments.

Separately, we believe the requirement to overlay a consideration of the decision maker's other economic interests—both in terms of magnitude and variability—will negatively impact the likelihood of comparable conclusions about kickout and similar rights, setting aside potential differences of opinion about the number of parties who hold them. While the relative magnitude of each interest holder's position should be something practitioners can



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reasonably assess, the requirement to analyze variability is likely to be more difficult and subjective, particularly in complex capital structures.

In addition, the proposed amendments include a consideration of whether substantive participating rights held by others allow them to block or participate "in the actions through which the decision maker exercises its power to direct the activities that most significantly impact the entity's economic performance." We believe the amendments should address whether participating rights must address all of an entity's significant activities, or if they could impact the consolidation conclusion by only addressing a subset of an entity's activities. We note the existing primary beneficiary guidance addresses situations in which an entity's performance is based upon activities directed by multiple unrelated parties, and the nature of the activities "that each party is directing is not the same. In that case, an evaluation of the activities "that most significantly impact" performance applies. The Board should clarify if the same thinking applies to kickout and similar rights in the principal vs. agent analysis.

## Compensation

A consideration of the decision maker's compensation is clearly relevant for asset managers. But as indicated in the revised examples, it doesn't apply to the property leasing entity or the furniture manufacturer because the interest holders in those situations are not being paid by the entity being evaluated for consolidation. The same will be true in many parent/subsidiary relationships where the consolidating entity doesn't provide a fee-based service to the subsidiary. But as described above, all reporting entities would be required to evaluate compensation or conclude it doesn't apply when determining whether an entity is a VIE or VOE. This suggests the principal vs. agent approach may not be appropriate in many commercial settings outside of the asset management industry, the backdrop for this project.

## Exposure to variability

Under this factor, a decision maker will need to decide whether its exposure to variability of returns is more than other investors (810-10-25-39L(b)). In some cases, one party's variability may be obviously different than another's, based on a qualitative assessment. However, in more complex situations that involve multiple parties, relative variability may not be as clear. This could result in quantitative modeling to estimate each party's variability, and then rank them. While the "risks and rewards" model in FIN 46(R) relied more heavily on a quantitative approach compared to the principal vs. agent model, the latter's emphasis on variability will likely include some of the difficulties that the Board was troubled by when it adopted the qualitative model in Statement 167.4

Question 3: The proposed Update would require judgment in determining how to weigh each factor in the overall principal versus agent analysis. Do you agree that the proposed amendments, including the related implementation guidance and illustrative examples, will result in consistent conclusions? If not, what changes do you recommend?

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<sup>&</sup>lt;sup>4</sup> See paragraphs A28-A34 of Statement 167.



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No, we do not agree. We note the proposed amendments and related implementation guidance require judgment, but do not clearly suggest a basis for how practitioners would weight the various factors. Specifically, the "principal versus agent analysis" portion of the examples often repeat facts established in the background without explaining a rationale for the conclusion. The language proposed in 810-10-55-3K is representative of this concern (numbered for readability):

- The level of economic variability that the fund manager is exposed to through its fees and its equity interests, relative to the returns expected from the activities of the entity, indicates that the fund manager is not using its decision-making authority to direct the relevant activities in a principal capacity.
- 2. In concluding that the fund manager is not using its decision-making authority in a principal capacity, the evaluation considered that the compensation arrangement provides the manager with an annual fee equal to 1 percent of the fund's net asset value, and the 10 percent equity interest exposes the fund manager to losses and the right to receive benefits from the fund.
- 3. The fee does not expose the decision maker to negative returns.
- 4. The 10 percent equity interest exposes the fund manager to both positive and negative returns that are not different from that of the third-party investors.
- 5. Because the fund manager's interest is pro rata, it is aligned with that of the third-party investors.
- 6. Considering the purpose and design of the fund, the magnitude and variability of the fund manager's 1 percent fee and 10 percent equity interest, relative to the fund's anticipated economic performance, are conclusive that the fund manager is not using its decision-making authority in a principal capacity.

The first sentence compares "the level of economic variability" to "the returns expected from the activities of the entity" as a basis for concluding the manager is not a principal. However, it is more of an assertion than an explanation because the example does not describe the amount of variability or returns that are anticipated over the life of the entity. If the Board intends for practitioners to estimate variability for multiple interest holders as part of this analysis, we do not agree that such an exercise will be operational because the estimates are so subjective.

Similarly, sentences two through five are mostly factual; they do not analyze or explain how the three principal vs. agent factors are weighted relative to each other. Even though the last sentence concludes the manager is an agent, we fail to see an analysis articulated that will assist practitioners apply the standard consistently, particularly when the model is applied outside of the financial services environment.

As suggested in our cover letter, we recommend a scope exception for asset managers, retaining the existing guidance for other entities.



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With respect to investment company entities (and investment property entities, if the Board adopts an IPE accounting model), we believe additional examples are needed. As we recommend in our investment company comment letter, illustrations of when an ICE should consolidate another ICE will be necessary to facilitate consistent application in practice, which has historically been diverse. We note the principal vs. agent ED addresses when a manager consolidates a fund, not when Fund A should consolidate Fund B. Assuming it is appropriate for a manager not to consolidate a fund, we believe questions will emerge as to what constitutes a controlling financial interest from the perspective of another fund (i.e., "the Parent") because many individual investors in the Parent will be widely dispersed and relatively passive as it relates to a potential subsidiary fund. As the Board is aware, diversity is evident in current practice, as some controlled ICEs are consolidated and others are not. In this context, we believe additional implementation guidance will be needed to drive practice in a manner consistent with the Board's intent.

Question 4: Should substantive kick-out and participating rights held by multiple unrelated parties be considered when evaluating whether a reporting entity should consolidate another entity? If so, do you agree that when those rights are held by multiple unrelated parties, they should not in and of themselves be determinative? If not, why? Are the guidance and implementation examples illustrating how a reporting entity should consider rights held by multiple unrelated parties in its analysis sufficiently clear and operational?

We agree that kickout and similar rights held by multiple unrelated parties should be evaluated. In our experience, they are not commonly held by a single party, and therefore, standards should exist for evaluating them when held by multiple parties. However, the exposure draft's guidance for evaluating kickout rights held by multiple parties is based in part on the relative variability that each interest holder has with respect to the entity. As noted previously, we're concerned that a return to this type of an approach will include much of the difficulty that the Board sought to correct when it issued Statement 167 to mitigate the focus on expected losses.

The exposure draft (particularly example E, the CDO) indicates that a simple majority voting requirement to exercise kickout and other rights will generally not be a significant consideration in the analysis, since holders of those rights often will be widely dispersed. In contrast, the proposed amendments indicate that rights held by an independent board will be a more important consideration, since board members are in close proximity to each other. Consequently, it appears that most kickout and similar rights will be ignored when they are not held by a single party, or they're held by parties (other than a board) that are not required to act together. We believe the Board's intent in BC19 should be elevated to the standard, including its emphasis on a "small number" of parties that would be necessary to overcome a decision-maker's rights.

<sup>5</sup> See paragraph 5 of FSP FIN46(R)-7, *Application of FASB Interpretation No. 46(R) to Investment Companies*.



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Question 5: The proposed Update would not include a criterion focusing on the level of seniority of a decision maker's fees when evaluating the decision maker's capacity. Do you agree that the seniority of the fee relative to the entity's other operating liabilities that arise in the normal course of the entity's activities should not be solely determinative of a decision maker's capacity? If not, why?

We agree. While we struggle with the notion of an agent whose compensation is subordinate to the interest of other debt and equity investors that are principals in the generic sense, we do not believe consolidation should turn solely on this point. The scope of a decision maker's rights and responsibilities would always be relevant.

Question 6: The evaluation of a decision maker's capacity places more emphasis on the decision maker's exposure to negative returns (for example, an equity interest or a guarantee) than interests that only expose the decision maker to positive returns. When performing the principal versus agent analysis, should the assessment differentiate between interests that expose a decision maker to negative returns (or both negative and positive returns) from interests that expose the decision maker only to positive returns? If not, why?

We agree the concept is an appropriate consideration. However, we believe the model should better distinguish "variability" from "negative returns," since the latter is new to the VIE literature. Consider a decision maker whose only interest in an entity is a fee-based service contract. If the decision maker fails to collect its fee, it would absorb negative variability, although failure to collect wouldn't constitute a "negative return" as described in the exposure draft. We believe this dynamic has the potential to confuse practitioners and that the Board might want to more explicitly contrast these concepts.

Question 7: A reporting entity would be required to evaluate whether there has been a change in the decision maker's capacity by considering whether there has been a change in the purpose and design of the entity. For example, the purpose and design of the entity may change if the entity issues additional equity investment that is at risk to the decision maker. Do you agree with this proposed requirement? If not, please specify when this relationship should be reassessed and why.

Yes we agree. We note the requirement to reassess an entity's VIE status has been operational in practice.

Question 8: The Board decided to include the principal versus agent assessment as a separate analysis within the overall consolidation assessment, rather than replacing the current guidance for evaluating whether a decision-making arrangement is a variable interest (and accordingly, a principal) with the revised principal versus agent analysis. The Board believes that if an entity's fee arrangement does not meet the definition of a variable interest (for example, a nominal performance-based fee), the decision maker



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should not be required to continue the consolidation assessment. Do you agree? If not, why?

We agree that consolidation should be precluded when an entity's fee arrangement is not considered a variable interest.

As it relates to the principal vs. agent assessment in the larger consolidation analysis, we find its placement in the decision tree confusing:

- The proposed amendments in 810-10-25-38A state that the principal vs. agent analysis should be performed "in" the assessment of whether the reporting entity has power over the entity. Further, the requirement to analyze power will continue to exist under 810-10-25-38B through 38G together with the new principal vs. agent amendments. Adding new language while retaining most of the existing text implies that i) power and ii) an interest holder's status as a principal or agent are distinct concepts. However, it appears the Board intends for a principal to always be the primary beneficiary. If so, we would recommend better integrating the new principal vs. agent amendments with the existing primary beneficiary guidance. Alternatively, if the Board intends to leave open the possibility that a principal may not be an entity's primary beneficiary, we believe this point needs substantial clarification. In a generic sense, we note many debt and equity investors would be more like a principal than an agent, and yet do not consolidate the entity to which they have provided funds.
- While the principal vs. agent amendments are related to whether a reporting entity has power, that analysis now includes a substantive focus on the returns that it expects to receive from the entity being evaluated for consolidation. Nonetheless, 810-10-25-38A(b) includes a separate, seemingly redundant, provision to evaluate whether the reporting entity has an obligation to absorb losses or a right to receive benefits. If an entity is a principal, it would seem to make this criterion moot. It appears the Board needs to reconcile these two overlapping elements, or indicate that the assessment in 38A(b) only applies in situations where there is no decision maker deemed to be a principal.
- The proposed amendments in 810-10-25-38A(b) also indicate that reporting entities are now required to evaluate the probability of absorbing losses or receiving benefits, which reverses the Board's conclusion in Statement 167:

In its deliberations leading up to the Exposure Draft, the Board decided that the obligation to absorb losses or the right to receive benefits would have to potentially be significant to the variable interest entity to have the characteristic in paragraph 14A(b) of Interpretation 46(R). The Board reasoned that although an enterprise might not have obligations or rights that currently are significant, its interest may provide it with obligations or rights that may be significant to the variable interest entity in the future. *The Board concluded that this guidance was imperative*, because obligations or



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rights that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of a variable interest entity (italics added).

While we note the Board's current belief in BC30 that most consolidation conclusions will not change as a result of considering probability, we are not similarly persuaded. There is a wide gap between what's possible, and what's expected, as several prominent business failures in recent years illustrate.

More specifically related to one of the implementation examples (Case G: Property Lease Entity), we think it is likely many practitioners will conclude that a lessor VIE should not be consolidated by the lessee. The Board's example includes facts making it obvious that the lessee has substantial economic exposure to the lessor. Situations encountered in practice are often less clear, for instance, a lessee whose only variable interest in the lessor VIE is a fixed price call option on the leased property. While the strike price may be substantive, it is often written at a premium to current market prices. As such, it will be much less clear under a probability assessment whether the lessee's exposure is sufficient to warrant consolidation.

Question 9: The Board expects the proposed principal versus agent guidance may affect the consolidation conclusions for entities that are consolidated as a result of the decision maker having a subordinated fee arrangement (for example, collateralized debt obligations). However, the Board does not otherwise expect the proposed amendments to significantly affect the consolidation conclusions for securitization entities, asset-backed financing entities, and entities formerly classified as qualifying special-purpose entities. Do you agree? If not, why?

We believe it's possible that practitioners may reach different conclusions for some of these of entities.

We note it is common for a securitization vehicle to be formed with a nominal amount of equity in order to give the entity legal standing at inception. The originator of the financial assets transferred to these entities may own the equity. When evaluating consolidation, the scope of the transferor's ongoing capacity would be key to the analysis, such as whether the transferor's responsibilities only include administrative duties and a "special servicer" or sponsor is responsible for addressing events of default and other activities. However, irrespective of that point, the Board's shift to a probability assessment of the decision-maker's exposure to an entity opens the door to assertions that the financial component of the decision-maker's relationship with the entity is not sufficient to result in consolidation, such as when the transferor's fee and equity holdings are not anticipated to result in significant returns. In other words, abandoning an analysis based on whether a reporting entity's economic exposure "could potentially be significant" necessarily diminishes the scope of when consolidation might result.



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Question 10: Update 2010-10 was issued to address concerns that some believe that the consolidation requirements resulting from Statement 167 would have required certain funds (for example, money market funds that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940) to be consolidated by their investment managers. The amendments in this proposed Update would rescind the indefinite deferral in Update 2010-10 and would require money market funds to be evaluated for consolidation under the revised guidance. The Board does not intend the application of the proposed Update to result in money market funds being consolidated. Do you agree that the application of the proposed Update will meet this objective? If not, why and what amendments would you recommend to address this issue?

We agree consolidation won't occur primarily because of the Board's clearly-expressed intent, rather than through an application of the principal vs. agent model. For situations like this, we believe many constituents would object to consolidation regardless of the accounting model that was applied. In other words, some constituents believe an asset manager's financial statements are most decision-useful when the fund is not consolidated. Therefore, we believe the Board should consider making the indefinite deferral permanent for such funds through a scope exception, without amending the rest of the consolidation guidance.

Question 11: For purposes of applying the proposed principal versus agent guidance, the proposed amendments would require a reporting entity to include the decision maker's direct and indirect interests held in an entity through its related parties. Do you agree with the requirement that a decision maker should include its proportionate indirect interest held through its related parties for purposes of applying the principal versus agent analysis? Why or why not?

We do not agree with limiting the assessment to proportionate indirect interests. A decision maker's related parties include its "affiliates," a term that encompasses entities under the decision maker's control. With respect to the example proposed in 810-10-25-42, a decision maker with a 40% interest in a related party that holds a 60% in the entity being evaluated results in a 24% indirect interest. If the decision maker instead held a 51% interest in the related party, its indirect interest would be 31%.

Assuming the 51% interest results in the decision maker controlling its related party/affiliate, it would also likely control the entity being evaluated through the 60% interest held by the affiliate, despite its indirect interest only changing by seven percentage points (31% - 24% = 7%). This illustrates the difficulty of finding clear distinctions in different indirect interest percentages compared to the current guidance of treating all related party interests as if they were held by the decision-maker. We believe such quantitative calculations may provide a false sense of precision because it is unclear how they would contemplate the contractual rights that the related parties hold through their direct interests.



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Further, an example based on equity instruments would leave many questions unanswered as to how a decision maker would evaluate other economic interests (a term which is undefined) on a quantitative basis, such non-voting preferred stock, debt instruments of various credit quality and subordination rights, guarantees, puts and calls, etc.

Separately, with respect to the proposed amendments in paragraph 810-10-25-42, we note current GAAP states that "For purposes of determining whether it is the primary beneficiary of a VIE, a reporting entity with a variable interest shall treat variable interests in that same VIE held by its related parties as its own interests (italics added)." This language indicates that consolidation is precluded when the reporting entity lacks a direct variable interest in an entity. In contrast, the amendments would require an analysis of a reporting entity's direct and indirect economic interests, which seems to contemplate a direct interest of zero. We believe the Board should clarify that interests held by related parties should only be considered if the reporting entity also holds a direct interest in the entity being evaluated, consistent with question 8.

Question 12: The amendments in this proposed Update would require a general partner to evaluate its relationship with a limited partnership (or similar entity) by applying the same principal versus agent analysis required for evaluating variable interest entities to determine whether it controls the limited partnership. Do you agree that the evaluation of whether a general partner should consolidate a partnership should be based on whether the general partner is using its decision-making authority as a principal or an agent?

We note the movement away from a simple-majority requirement related to kickout and similar rights might require many general partners to consolidate previously unconsolidated limited partnerships that are voting interest entities, particularly in the real estate and oil & gas industries. If the principal vs. agent model is adopted, we believe the final amendments should include language previously reflected in paragraph BC7 of ASU 2010-10 that a general partner's unlimited liability with respect a limited partnership would not necessarily be deemed to expose the GP to potentially significant losses. We also think it would be critically important to include examples illustrating how the principal vs. agent model is applied to voting interest entities, such as limited partnerships. Otherwise, we are concerned practitioners will reach inappropriate consolidation conclusions by focusing only on the change related to kickout rights. At a minimum, an example illustrating whether a 1% GP interest results in consolidation would be helpful in conveying the Board's intent.

Question 13: Do you agree with the proposed transition requirements in paragraph 810-10-65-4? If not, how would you propose to amend those requirements, and why? Please provide an estimate of how long it would reasonably take to implement the proposed requirements.

We agree with the transition requirements and believe preparers are best positioned to provide feedback regarding the amount of time necessary for implementation.



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At transition, carrying amounts may depend on whether they are calculated using US GAAP before or after the adoption of Statements  $141R^6$  and  $160^7$  (as well as other pronouncements). For investments made prior to their adoption, the Board should consider specifying whether the carrying amounts should be determined based on GAAP that was in effect at that time, or if practitioners should apply the standards that are in effect when the ASU is adopted.

Question 14: Should early adoption be permitted? If not, why?

We agree with precluding early adoption.

Question 15: Should the amendments in this proposed Update be different for nonpublic entities (private companies or not-for-profit organizations)? If the amendments in this proposed Update should be applied differently to nonpublic entities, please provide a rationale for why.

The Board may wish to consult with the Private Company Financial Reporting Committee or the FAF's proposed Private Company Standards Improvement Council to obtain input on this question. We note some private company constituents have suggested the VIE literature should be evaluated by the PCSIC for a potential private company GAAP difference.

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<sup>&</sup>lt;sup>6</sup> Business Combinations

<sup>&</sup>lt;sup>7</sup> Noncontrolling Interests in Consolidated Financial Statements