

**Comment on Exposure Draft**  
**Proposed Accounting Standards Update: Consolidation (Topic 810)**  
**No. 2011-220**

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In this Comment, we suggest that FASB specifically address in connection with the principal-agent analysis of the Exposure Draft a contractual undertaking which will achieve harmony between FAS167 and FAS166, and facilitate securitizations—an irrevocable and unconditional disclaimer by the reporting entity of any assumption of liabilities of a VIE to other interest holders which is fully enforceable by regulators and corporate constituents of the reporting entity. Application of this contractual undertaking should result simultaneously in both a rejection of a reporting entity’s control of assets and responsibility for liabilities, on the one hand, and a reporting entity’s principalship with respect to a VIE, on the other. Accordingly, we suggest that consolidation not be required when the reporting entity has provided this contractual

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The predicate for consolidation in FAS 167 as well as the amendments contained in the Exposure Draft is spelled out in 810-10-25-1: "consolidation is appropriate if a reporting entity has a controlling financial interest in another entity . . ." The Exposure Draft amends the characteristics of a controlling financial interest in a VIE "to include that a reporting entity must evaluate whether it has the ability to use its decision-making authority in a principal capacity when assessing whether it has the power to direct the entity's activities that most significantly impact the entity's economic performance".

The notion underlying the criterion that power to direct an entity's activities that impact economic performance should be considered in determining the existence of a controlling financial interest is predicated on the entity theory of consolidation, namely: control over an entity implies the power to make decisions affecting economic performance so that the controlling and the controlled entity should be accounted for and presented as one economic unit in order to inform investors' decision-making.

For consolidated financial statements to properly serve this function, their constituent elements should ideally be defined in a manner consistent with the definitions of the Conceptual

Framework which share the objective of informing investors' decision-making. Concept 6, "Elements of Financial Statements" defines 10 interrelated elements that are directly related to measuring performance and status of an entity. The first two of these are Assets and Liabilities, upon which the definition of the other 7 elements depends, including specifically the major components of the income statement: revenues, expenses, gains, and losses. In other words, the economic performance of the entity is best reflected in its assets and liabilities and changes therein (constituting revenues, expenses, gains, and losses) as reflected in the financial statements. Hence, consolidation should result in assets and liabilities that are recognized in conformity with the definitions of the Conceptual Framework. These definitions are:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

It must then logically follow in order to be consistent with these definitions that an enterprise having a controlling financial interest in an entity—and hence, as required by the Exposure Draft, consolidating that entity—must be deemed as:

1. Obtaining or controlling probable future economic benefits of the assets included in its consolidated financial statements, and
2. Expecting probable future sacrifices of economic benefits arising from present obligations to transfer assets or provide services.

If this is not the case, the financial statements would include “non-assets” and “non-liabilities”, and correspondingly “non-revenues” and “non-expenses”, as elements, contrary to the definitions of elements in the Conceptual Framework and its stipulation that "the items in financial statements "represent in words and numbers certain entity resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims".

It is reasonable to assume, especially in the case of majority-owned entities in most circumstances, that the consolidating enterprise obtains or controls the economic benefits of its consolidated assets and is obligated, even if implicitly through the enterprise's control over decisions regarding those assets and liabilities, to acknowledge its consolidated liabilities. In other words, control over the assets and responsibility for the liabilities are subsumed in the control of the entity.

But this does not mean that evidence to the contrary could not show otherwise. Indeed, in the case of VIEs that are structured to facilitate securitization of financial assets such "evidence to the contrary" clearly exists. De-recognition of the securitized assets in the financial statements of the transferring enterprise under FAS 166 is manifest evidence that the enterprise has ceded control over the securitized assets; that is, the enterprise neither "obtains" nor "controls" the economic benefits associated with those assets. Hence, giving credence to FAS 166 alone, such transferred assets should not be an element of the enterprise's consolidated statements and thus should not be consolidated.

Likewise in the case of liabilities, the reporting entity, having ceded control over the assets as a result of satisfying the criteria of FAS 166, in most circumstances bears no responsibility for settling the liabilities arising from the assets' transfer, either in full or in part, and accordingly, such "non-liabilities" should not be shown as an element of the consolidated financial statements.

It is our understanding that the FASB in drafting FAS 167 or its proposed amendments was especially concerned that in certain circumstances, even if the reporting entity is not

*explicitly* liable for the debt of the VIE, the reporting entity may be *implicitly* liable since it may assume losses of the VIE's other interest holders to minimize the risk to its reputation.<sup>1</sup> As a result, the FASB, out of concern with excluding "in substance" liabilities from a reporting entity's balance sheet, has been willing to include "in substance" "non-liabilities" and "non-assets" in consolidated financial statements and risk inconsistency with the Conceptual Framework's definitions.<sup>2</sup>

We understand the Board's concern that an analysis which considers whether the decision maker has the right to use assets and whether it is obligated to fund liabilities "may result in inappropriate consolidation conclusions (BC13)." An irrevocable and unconditional undertaking disclaiming any obligation to assume liabilities of the VIE to other interest holders both avoids the risk of over-inclusiveness of consolidated assets and liabilities and eliminates any realistic likelihood of incorrect analysis of where control resides under a principal-agent analysis.

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<sup>1</sup> See 810-10-25-38A requiring an assessment of "implicit variable interests."

<sup>2</sup> The Board references implicit liabilities in 810-10-25-38 F: "Although a reporting entity may be significantly involved with the design of a VIE, that involvement does not, in isolation, establish that reporting entity as the entity with the power to direct the activities that most significantly impact the economic performance of the VIE. However, that involvement may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with that power. **For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the VIE operates as designed, the sponsor may have established arrangements that result in the sponsor being the entity with the power to direct the activities that most significantly impact the economic performance of the VIE.**" (emphasis added)

To be specific, the undertaking entails (a) the reporting entity unconditionally and irrevocably disclaiming any obligation to assume the losses of any other party involved in the VIE and (b) any regulator or corporate constituent of the reporting entity having the right to enforce the reporting entity's disclaimer. As a result, the reporting entity will have conclusively disclaimed any responsibility to absorb losses of other interest holders in the VIE.

The existence of an enforceable disclaimer demonstrates that the liabilities of the VIE to other interest holders are not and cannot be liabilities of the reporting entity, either explicitly or implicitly—they do not meet the Conceptual Framework's definition of liabilities. Since the reporting entity cannot incur a liability to other interest holders in the VIE, "...other interest holders are likely to introduce additional measures that are intended to ensure that the decision maker does not act against their interests, and accordingly, may limit the decision makers authority...(BC15)." Thus, as a matter of likelihood and logic, the reporting entity would not have control over the assets—a fact which will have been definitively established, in any case, as a result of de-recognition of the assets in the reporting entity's financial statements under FAS 166. As a result, the existence of a fully enforceable unconditional and irrevocable disclaimer

bolsters the necessary implications of FAS 166 and confirms the reporting entity's ceding of control of assets and negation of assumption of liabilities.

Under current FAS 167 criteria, the existence of a fully enforceable unconditional and irrevocable disclaimer of assumption of the losses of other interest holders in a VIE would preclude consolidation. If the reporting entity will not and cannot assume these losses by virtue of its disclaimer, it would likely not be invested with the power to direct activities that will significantly impact the VIE's economic performance (810-10-25-38A (a) and (b)).<sup>3</sup> In other words, the reporting entity should not then be deemed as having a controlling financial interest in the VIE and hence should not be considered as the VIE's primary beneficiary.

Likewise, the application of the new principal-agent criteria under the Exposure Draft to an unconditional and irrevocable disclaimer of assumption of liabilities shows that the reporting entity does not have a controlling financial interest in a VIE. The specific additional criteria for

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<sup>3</sup> In this regard, note the language of 810-10-25-38G which accords high significance to the obligation to absorb losses:

Consideration shall be given to situations in which a reporting entity's economic interest in a VIE, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of a reporting entity's economic interest may be indicative of the amount of power that reporting entity holds.

deciding on whether a reporting entity has a *controlling financial interest* in a VIE is the principal agent analysis.<sup>4</sup> This analysis entails the consideration of three factors (810-10-25-39C) to determine whether a party exercising decision making authority is not a principal but rather is an agent and "therefore, does not control the entity when it exercises its decision-making authority." (810-10-25-39B). The factors are:

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

810-10-25-39C goes on to state:

Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances considering the purpose and design of the entity, including the risks that the entity was designed to create and pass through to its interest holders.

The preclusive effect of the proposed unconditional and irrevocable disclaimer is best demonstrated by applying the third factor—the decision-maker's exposure to variability of

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<sup>4</sup> 810-10-25-38 A states:

In assessing whether a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, a reporting entity shall consider whether it has the ability to use its decision-making authority as a principal or an agent.

returns from other interests that it holds in the entity. The proposed disclaimer substantially limits the decision-maker's exposure to variability of returns. In evaluating the decision-maker's exposure to variable returns, 810-10-25-39L states that the decision-maker should consider, among other things:

c. Whether the decision maker's exposure to positive and negative returns (for example, an equity interest or a guarantee) makes it more likely to be a principal. In contrast, **an interest that exposes the decision maker to only positive returns, when considering the magnitude and variability of the interest, would be less indicative of a principal relationship.** (emphasis added)

d. **The decision maker's maximum exposure to losses of the entity.** Although the decision maker's exposure is evaluated primarily on the basis of returns expected from the activities of an entity, that evaluation also shall consider its maximum exposure to losses of the entity. (emphasis added)

Since the reporting entity will not have exposure to the losses of other interests holders, either explicitly or *implicitly*, as a result of the disclaimer, the reporting entity's exposure to losses of the VIE is limited and its relationship to the VIE is not indicative of a principal relationship. Indeed, since the negation of exposure to losses results from an unconditional and

irrevocable disclaimer which is legally enforceable by any regulator or constituent of the reporting entity, the negation of a principal relationship should be conclusive.

The Board has required consolidation out of an understandable concern with the implicit assumption of liabilities by a reporting entity. However, the consolidation of “non-assets” and “non-liabilities” has strained consistency with the Conceptual Framework. An unconditional and irrevocable undertaking disclaiming assumption of VIE liabilities to other interest holders which is enforceable by any regulator or constituent of the reporting entity eliminates the possibility of an *implicit* assumption of liabilities of the VIE to other interest holders. We submit that consolidation should not be required when this undertaking has been provided by the reporting entity.