

NOVEMBER 23, 2011



# In Focus

## Essential Elements

- The proposed Update will affect all reporting entities that are required to evaluate whether they should consolidate another entity.
- The proposed Update would affect the evaluation of whether an entity is a VIE and, if so, whether the reporting entity is the primary beneficiary of the VIE.
- The proposed amendments would change the evaluation of kick-out and participating rights.
- The proposed Update would amend the consolidation assessment for partnerships and similar entities.
- The proposed amendments would more closely align U.S. GAAP consolidation guidance with IFRS.
- The proposed Update would rescind the indefinite Statement 167 deferral for particular investment funds.

## Next Steps

After the comment period closes, the FASB will analyze feedback received through comment letters, public roundtables, and information gathered through other outreach activities. The FASB will redeliberate the proposed requirements at public meetings before issuing a final Accounting Standards Update.

## Comment Deadline

January 17, 2012

## Effective Date

The proposed amendments would be effective for an entity's interim and annual reporting periods in fiscal years that begin after the effective date. The effective date and whether early application would be permitted will be determined after the Board considers the feedback on the amendments in this proposed Update.

## FASB Issues Proposed Improvements to Consolidation Accounting

The Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update intended to increase transparency and consistency of financial reporting about consolidations. The proposed amendments in this Update would affect all companies that are required to evaluate whether they should consolidate another entity. Specifically, the proposed Update would:

- Provide criteria for a reporting entity to evaluate whether a decision maker is using its power as a principal or an agent. These criteria would affect the evaluation of whether an entity is a variable interest entity and, if so, whether the reporting entity should consolidate the entity being evaluated.
- Amend the evaluation of kick-out and participating rights held by noncontrolling shareholders in a consolidation analysis.
- Change the requirements for determining whether a general partner controls a limited partnership and, therefore, could affect reporting entities that are involved with partnerships and similar entities.
- Rescind the indefinite deferral of the amended guidance about consolidation for reporting entities with interests in certain investment companies and other similar entities.

## Why Has the FASB Made These Changes?

In June 2009, the Board issued FASB Statement No. 167 (subsequently codified by Accounting Standards Update No. 2009-17, *Consolidation [Topic 810]: Improvements to Financial*

*Reporting by Enterprises Involved with Variable Interest Entities*). This guidance amended the evaluation for determining whether a reporting entity should consolidate a variable interest entity from a quantitative analysis to one that is primarily a qualitative evaluation of power and economics.

Some users and preparers of financial statements of investment managers were concerned that the qualitative evaluation in Statement 167 would result in investment managers consolidating certain funds that they manage. Additionally, the International Accounting Standards Board (IASB) was developing a consolidation standard that was expected to result in different conclusions for investment funds that are variable interest entities (VIEs). In response to these different conclusions and preparer and user concerns, the Board issued Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, which indefinitely deferred the effective date of the consolidation requirements in Statement 167 for certain entities. The deferral's purpose was to allow the FASB and the IASB to develop converged guidance for evaluating whether a decision maker (e.g., an asset manager, a general partner, a board of directors) is using its decision-making authority (power) as a principal or an agent and whether it should consolidate another entity.

The amendments in this proposed Update would rescind the indefinite Statement 167 deferral, require reporting entities to evaluate all VIEs for consolidation under the revised guidance, and clarify whether a decision maker is using its power as a principal or an agent. In addition, the amendments in this proposed Update

would reduce inconsistencies among U.S. generally accepted accounting principles (GAAP) related to kick-out and participating rights.

## Principal versus Agent Analysis

The proposed amendments will require an integrated, qualitative principal versus agent analysis, which the decision maker will apply throughout the overall consolidation assessment. To determine whether the decision maker is using its power as a principal or agent, it would consider three factors:

- *The rights held by other parties*—Substantive kick-out or participating rights held by multiple parties may indicate that the decision maker is an agent rather than a principal. As with the current VIE model, substantive kick-out or participating rights held by a single party (including related parties) would, in isolation, indicate that the decision maker is an agent. However, when multiple parties need to act together to exercise such rights, less weight would be placed on those rights. In this situation, those rights, in isolation, are not determinative of whether a decision maker is an agent or a principal. Rights exercisable by an entity's independent board of directors or similar governing body also may be considered in the analysis.
- *The decision maker's compensation*—A decision maker would consider the magnitude and variability of the compensation it receives relative to the entity's anticipated economic performance. A decision maker also would consider (1) whether its compensation is commensurate with the services it provides and (2) whether the compensation agreement includes only terms, conditions, or amounts that are customarily present in similar arrangements negotiated at arm's length. The absence of one or

both of these conditions would strongly indicate that the decision maker is a principal.

- *The decision maker's exposure to variability of returns from other interests that it holds in the entity*—A decision maker that holds other interests in an entity (such as investments or guarantees) would assess its exposure to variability of returns from those interests. When assessing this factor, a decision maker would consider (1) the magnitude of, and variability associated with, the decision maker's other interests, considering its compensation and other interests in the aggregate; (2) whether the decision maker's exposure to variability of returns is different from that of the other investors; (3) whether the decision maker is exposed to only negative returns, only positive returns, or both; and (4) its maximum exposure to losses in the entity.

Each factor would be weighed based on the facts and circumstances and by considering the purpose and design of the entity being evaluated for consolidation. To evaluate these factors, the decision maker would include both its direct interests in the entity and indirect interests held through related parties. For example, if a decision maker owns a 40 percent interest in a related party and that related party owns a 60 percent interest in the entity being evaluated, the decision maker's interest would be considered equivalent to a 24 percent interest in the entity for the purposes of evaluating whether it is a principal or an agent.

## Variable Interest Entities

The proposed amendments would affect the evaluation of whether an entity is a VIE and, if so, whether the reporting entity should consolidate the entity being evaluated. Under current U.S. GAAP, an entity is a VIE if (1) the entity lacks sufficient equity to finance its activities without additional subordinated financial support or (2) the equity holders, as a group, lack the

power to direct the activities of a legal entity that most significantly impact the entity's economic performance or the obligation and right as equity holders to absorb the entity's expected losses or to receive its expected residual returns. The evaluation of whether a decision maker is using its decision-making authority as a principal or an agent would affect the analysis of whether the equity investors, as a group, lack the power to direct the activities of the entity or have delegated it to an agent. If the decision maker is determined to be a principal and does not receive its decision-making authority (power) through an equity interest, the entity would be a VIE.

A reporting entity that concludes that it has a variable interest in a VIE would have to evaluate whether it is the entity's primary beneficiary and, thus, should consolidate the VIE. That determination is based on a qualitative assessment based on whether it has both (1) the power to direct the activities that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE.

Under the proposed amendments, a decision maker would apply the principal versus agent analysis to determine whether it uses its power as a principal or an agent. If the decision maker determines that it is a principal and the primary beneficiary of the VIE, it would consolidate the VIE.

## Voting Interest Entities

The proposed amendments would change how participating rights affect the consolidation analysis for voting interest entities and partnerships that are not VIEs to more closely align with the consolidation requirements for VIEs.

## Evaluating Noncontrolling Rights

For an entity not deemed to be a VIE (that is, a voting interest entity), ownership of a majority voting interest is the usual condition for a controlling financial interest. However, exceptions exist when noncontrolling shareholders have substantive participating

rights. Current U.S. GAAP states that rights are considered substantive if a noncontrolling shareholder can participate in the significant decisions made in the ordinary course of business. For example, noncontrolling shareholders' participation in some of the significant decisions made in the ordinary course of business (for example, approving the operating budget and setting the compensation of management responsible for implementing the investee's policies and procedures) may preclude a majority shareholder from consolidating an entity.

Under the proposed Update, a noncontrolling shareholder would have to participate in the activities that most significantly impact the

entity's economic performance for such rights to be substantive and preclude the majority shareholder from consolidating an entity. As a result, the analysis of whether rights are substantive would be more closely aligned with evaluation of participating rights for VIEs.

### **Evaluating Partnerships and Similar Entities**

Current U.S. GAAP presumes that a general partner in a limited partnership controls (and therefore consolidates) the limited partnership unless substantive kick-out or participating rights exist to overcome that presumption. The presumption that a general partner has

control is eliminated by the proposed Update. A general partner of a limited partnership or similar entity would determine whether it should consolidate the partnership by evaluating whether it has the ability to use its decision-making authority as a principal or an agent. As a result, rather than focusing on whether a simple majority of the limited partners hold substantive kick-out rights or participating rights, a general partner would consider its economic interests in the partnership and evaluate the ability, and the relative number, of limited partners required to act together to exercise kick-out rights or participating rights.

**For more information about the proposal please visit the FASB's website at [www.fasb.org](http://www.fasb.org).**

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