

To the Point

FASB – final guidance

New consolidation guidance will affect entities in all industries

Reporting entities will need to change how they evaluate limited partnerships or similar entities for consolidation.

What you need to know

- ▶ The FASB issued final guidance that eliminates the deferral of FAS 167 and makes changes to both the variable interest model and the voting model.
- ▶ While the new guidance is aimed at asset managers, all reporting entities involved with limited partnerships or similar entities will have to re-evaluate these entities for consolidation and revise their documentation.
- ▶ In some cases, consolidation conclusions will change. In other cases, a reporting entity will need to provide additional disclosures if an entity that currently isn't considered a variable interest entity (VIE) is considered a VIE under the new guidance.
- ▶ Under the new guidance, a general partner will not consolidate a partnership or similar entity under the voting model.
- ▶ For public business entities, the guidance is effective for annual and interim periods beginning after 15 December 2015. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standard Update (ASU)¹ that eliminates the deferral of FAS 167,² which has allowed reporting entities with interests in certain investment funds to follow the previous consolidation guidance in FIN 46(R),³ and makes other changes to both the variable interest model and the voting model.



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While the ASU is aimed at asset managers, it will affect all reporting entities involved with limited partnerships or similar entities. In some cases, consolidation conclusions will change. In other cases, reporting entities will need to provide additional disclosures about entities that currently aren't considered VIEs but will be considered VIEs under the new guidance when they have a variable interest in those VIEs. Regardless of whether conclusions change or additional disclosure requirements are triggered, reporting entities will need to re-evaluate limited partnerships or similar entities for consolidation and revise their documentation. This publication highlights the effects on reporting entities transitioning from FAS 167.

Key considerations

Deferral of FAS 167

The new guidance eliminates the deferral of FAS 167 but permanently exempts reporting entities from consolidating money market funds that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940. A reporting entity that has an interest in a fund that qualifies for the exception is required to disclose any financial support it provided to the fund during the periods presented and any explicit arrangements to provide financial support in the future.

Variable interest model

The ASU changes (1) the identification of variable interests (fees paid to a decision maker or service provider), (2) the VIE characteristics for a limited partnership or similar entity and (3) the primary beneficiary determination.

Variable interests

In the first step in the variable interest model, a reporting entity determines whether it has a variable interest in the entity being evaluated for consolidation. Fees received by decision makers or service providers may represent variable interests depending on the facts and circumstances. Decision makers and service providers include asset managers, real estate property managers, oil and gas operators, and providers of outsourced research and development.

The variable interest model in FAS 167 lists six criteria that fees received by an entity's decision makers or service providers must meet for them to conclude that the fees do not represent a variable interest in that entity. The FASB decided to eliminate three of those six criteria, including the requirement that substantially all of the fees be at or above the same level of seniority as the entity's other operating liabilities for the decision maker or service provider to conclude that the fees do not represent a variable interest.

The ASU retained the following three criteria:

- ▶ The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- ▶ The decision maker or service provider (and its related parties or de facto agents) does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
- ▶ The service arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The ASU requires that, when evaluating whether its fee is a variable interest, a decision maker or service provider consider only its direct interests plus its proportionate share of the related parties' or de facto agents' interests. However, if the decision maker and a related party are under common control, the decision maker will consider the related party's entire interest.

For purposes of this analysis, the term related parties excludes employees or employee benefit plans of the decision maker or service provider (and their related parties), unless they are used to circumvent the provisions of the variable interest model.

How we see it

We believe a decision maker or service provider will have to exercise significant judgment to determine whether its fee is at market, particularly for new service offerings.

VIE characteristics

The ASU changes how reporting entities determine whether limited partnerships or similar entities are VIEs. Specifically, the ASU changes the evaluation of power when determining whether, as a group, the holders of the equity investment at risk lack the characteristics of a controlling financial interest. Under the ASU, partners lack power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact its economic performance if they do not hold kick-out or participating rights over the general partner(s).

Said differently, assuming the other characteristics of a VIE are not met, a limited partnership or similar entity is not a VIE and should be evaluated for consolidation under the voting model if (1) a single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are able to exercise substantive kick-out rights or (2) limited partners with equity at risk are able to exercise substantive participating rights. When evaluating whether the threshold for kick-out (or liquidation) rights has been met, a reporting entity will not consider voting interests held by the general partner, entities under common control with the general partner or other parties acting on behalf of the general partner.

The ASU generally does not change how a reporting entity evaluates corporations and similar entities as VIEs but does illustrate how to evaluate series funds for consolidation under the variable interest model.

Primary beneficiary determination

Consistent with FAS 167, a reporting entity will still have a controlling financial interest in a VIE and must consolidate if it has both (1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance (power) and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (collectively, benefits). However, under the ASU, a reporting entity that is determining whether it satisfies the benefits criterion will now exclude most fees that meet both of the following conditions:

- The fees are compensation for service provided and are commensurate with the level of effort required to provide those services.
- The compensation arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The ASU changes how related parties and de facto agents are considered in the primary beneficiary determination. Under the ASU, a reporting entity that does not individually have power and benefits must consider whether the arrangement involves a single decision-maker or multiple decision makers. In other words, a reporting entity must consider whether a single variable interest holder has the power to direct the activities of a VIE that most significantly impact its economic performance or whether two or more parties together have that power.

If a single decision maker has power but no benefits (i.e., the decision maker does not individually satisfy the characteristics of a primary beneficiary), the decision maker must consider whether it and one or more variable interest holders are under common control and, as a group, whether they have benefits. If they do, the party in the common control group that is most closely associated with the VIE is the primary beneficiary.

The ASU changes the criteria for determining whether limited partnerships or similar entities are VIEs.

If a single decision maker concludes that it (1) individually does not satisfy the characteristics of a primary beneficiary and (2) is not under common control with one or more entities that, as a group, have the characteristics of a primary beneficiary, it will still need to determine whether both of the following new criteria are met:

- The single decision maker and one or more variable interest holders are related parties or de facto agents and, as a group, they have the characteristics of a primary beneficiary.
- Substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder that is a related party or de facto agent of the decision maker.

If both criteria are met, the variable interest holder on whose behalf substantially all of the activities of the VIE are conducted would consolidate the VIE.⁴

The ASU does not change the primary beneficiary determination when there are multiple decision makers.

Voting model

The ASU eliminates the presumption in today's voting model that a general partner controls a limited partnership or similar entity unless that presumption can be overcome. Under the new guidance, a general partner will not consolidate a partnership or similar entity under the voting model. Generally, only a single limited partner that is able to exercise substantive kick-out rights will consolidate. The ASU does not change the voting model for consolidation of corporations and similar entities.

Effective date and transition

For public business entities, the ASU is effective for annual and interim periods beginning after 15 December 2015. For nonpublic business entities, it is effective for annual periods beginning after 15 December 2016, and interim periods beginning after 15 December 2017. Early adoption is permitted, including adoption in an interim period. Therefore, a company that has not issued its year-end financial statements can early adopt the guidance for its 2014 financial statements.

A reporting entity must apply the amendments using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the period of adoption or apply the amendments retrospectively.

Endnotes:

- ¹ ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*.
- ² FAS 167, *Amendments to FASB Interpretation No. 46(R)* now codified in ASC 810, *Consolidation*.
- ³ FIN 46(R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51*.
- ⁴ Reporting entities that apply ASU 2014-01, *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*, to account for their investments in qualified affordable housing projects are exempt from applying this provision.

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