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What's inside:

Background 1
Key provisions 2
Scope 3
Variable interest determination..................... 4
Determining whether an entity is a variable interest entity.................................. 9
Variable interest entity model 16
Voting interest entity model 22
Disclosures........................... 23
Effective date and transition 23

New consolidation standard

The new FASB guidance allows early adoption now

At a glance

On February 18, 2015, the FASB issued a final standard that amends the current consolidation guidance. The amendments affect both the variable interest entity (VIE) and voting interest entity (VOE) consolidation models. The changes are extensive and apply to all companies. The need to assess an entity under a different consolidation model may change previous consolidation conclusions.

The standard is effective for public reporting entities in fiscal periods beginning after December 15, 2015, and fiscal periods beginning after December 15, 2016 for non-public business entities. Early adoption is permitted.

Background

. 1 On February 18, 2015, the FASB issued Accounting Standard Update 2015-02, *Consolidation – Amendments to the Consolidation Analysis* (the "ASU"). Once effective, the ASU will apply to the consolidation assessment of all entities.

PwC observation:

The changes introduced by the ASU are not limited to any particular industry. All reporting entities that hold a variable interest in other legal entities will need to re-evaluate their consolidation conclusions and potentially revise their disclosures. This process may be time consuming, particularly for reporting entities with large numbers of VIEs and for those that need to apply an entirely new consolidation model to the assessment (for example, many limited partnerships and reporting entities that hold variable interests in investment companies previously subject to an indefinite deferral of certain provisions of the consolidation guidance). Changes may be required to systems, processes, and controls to analyze and continuously monitor applicable relationships for presentation and disclosure purposes.

. 2 The ASU concludes the FASB's project to rescind the indefinite deferral of the VIE guidance in ASU 2009-17[1] (FAS 167[2]) for reporting entities with variable interests in legal

[1] ASU 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
[2] FAS 167, *Amendments to FASB Interpretation No. 46(R),* codified in ASC 810, *Consolidation*

entities that have the attributes of an investment company that meet certain criteria (ASU 2010-10[3]). The ASU also makes changes to the VOE consolidation model.

. 3 Prior to the issuance of ASU 2009-17, the consolidation guidance for VIEs (FIN 46(R)[4]) 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 interests. ASU 2009-17 shifted the consolidation analysis from a risks and rewards-based approach to a model that defines control as a combination of having (i) the power to direct the most significant activities that impact an entity's economic performance, and (ii) potentially significant economic exposure. As an unintended outcome, ASU 2009-17 would have required many asset managers to consolidate the 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 required entities meeting the deferral criteria to continue to apply the risk and rewards approach.

. 4 The FASB undertook a project to consider changes to the consolidation model for the express purpose of rescinding the deferral and eliminating the risk and rewards approach. Their initial proposal was issued in late 2011. Under that proposal, a decision-maker with a variable interest in an entity would perform a separate analysis to determine whether it was using its decision-making authority in the capacity of a principal or an agent. A principal would consolidate the entity while an agent generally would not.

. 5 Numerous changes were made to the 2011 proposal in response to comment letter feedback received from constituents. Most notably, the FASB abandoned the requirement for a separate principal versus agent analysis, opting instead to embed the concepts underlying that analysis throughout the VIE model. The FASB also abandoned its proposal to align the definition of participating rights between the VIE and VOE models.

Key provisions

. 6 The ASU does not change the general order in which the consolidation models are applied. A reporting entity that holds an economic interest in, or is otherwise involved with, another legal entity (has a "variable interest") should first determine if the VIE model applies, and if so, whether it holds a controlling financial interest under that model. If the entity being evaluated for consolidation is not a VIE, then the VOE model should be applied to determine whether the entity should be consolidated by the reporting entity. Since consolidation is only assessed for legal entities, the determination of whether there is a legal entity is important. It is often clear when the entity is incorporated, but unincorporated structures can also be legal entities and judgment may be required to make that determination. The ASU contains a new example that highlights the judgmental nature of this legal entity determination (see paragraphs .48 –.51 for further information).

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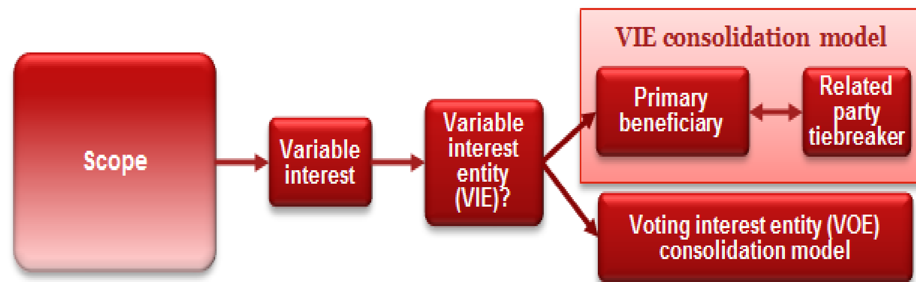
[3] ASU 2010-10, *Consolidation (Topic 810), Amendments for Certain Investment Funds*
[4] FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

Scope



Money market funds

. 7 The ASU does not remove or amend any of the existing scope exceptions. It does, however, provide a new scope exception pertaining to certain money market funds. The consolidation guidance will no longer apply to money market funds registered with the SEC pursuant to Rule 2a-7 of the *Investment Company Act of 1940* (registered money market funds) and "similar" unregistered money market funds. This scope exception is responsive to concerns of financial statement users and preparers that the consolidation of money market funds by the asset manager does not result in decision-useful financial information.

. 8 The scope exception applies to all reporting entities that hold interests in registered and similar unregistered money market funds, including investors, sponsors, asset managers, and any other interest holders. None of the interest holders will need to assess these funds for consolidation under any consolidation model (VIE or VOE). Reporting entities will be required to provide new disclosures about financial support (see paragraph .74 for further details).

PwC observation:

Once it has been determined that the scope exception applies, it will not be necessary to establish whether the investment advisor to the fund has a decision making fee that is a variable interest, since the VIE disclosure requirements would not apply. However, reporting entities involved with funds subject to this exception are required to provide certain disclosures irrespective of whether they have explicit variable interests. These disclosures are a subset of those required for reporting entities that have a variable interest in a VIE and are therefore considerably less onerous.

. 9 During redeliberations, the Board acknowledged the challenge of amending the VIE model to create an outcome where a sponsor would not consolidate a registered money market fund. Specifically, financial support provided by the sponsor to prevent the fund from "breaking the buck" through, for example, the waiver of management fees and purchases of securities at prices in excess of fair value created unique challenges that could not be solved by amending the model. The Board ultimately determined that the most effective way of addressing stakeholder concerns without creating unintended consequences for other entities was to provide a scope exception.

.10 Unregistered money market funds that operate in a manner similar to registered money market funds are also subject to the scope exception. Determining whether an unregistered money market fund is similar to a registered money market fund will require judgment. Registered money market funds are required to invest in securities issued by entities with minimal credit risk with a short duration (considering individual securities and the average maturity of the portfolio). In addition, they are subject to constraints related to credit risk and diversification.

.11 The unregistered money market fund's purpose and design, as well as the risks it was designed to create and pass along to its interest holders, should be considered in assessing whether the fund operates in a manner similar to a registered money market fund. Specifically, the fund's portfolio quality, maturity, and diversification should be considered when making this determination. The structure and intended outcome of the fund may also be relevant factors to consider.

Exhibit 1: Points of focus when assessing whether an unregistered fund is similar to a registered money market fund

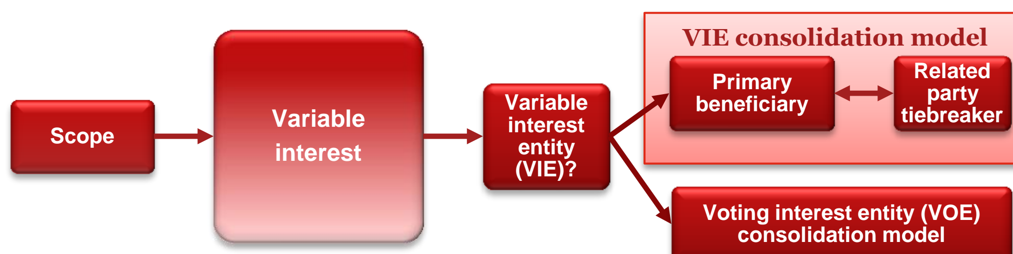
Characteristic	Description
Portfolio quality	Does the fund invest in high-quality, short-term securities with credit risk similar to those held by registered money market funds?
Portfolio maturity and diversification	Are the fund's objectives regarding (1) credit quality of its eligible investments, (2) the diversification of the portfolio, (3) maximum maturity of eligible investments, and (4) average maturity of the portfolio, consistent with the objectives of a registered money market fund?

PwC observation:

Unregistered money market funds that operate in a manner similar to registered money market funds are currently subject to the indefinite deferral. These unregistered money market funds may or may not be eligible for the scope exception. Sponsors of unregistered money market funds will need to evaluate and document their assessment of whether each of their unregistered funds is in fact similar to a registered money market fund based on the guidance contained in the ASU.

Variable interest determination

.12 The ASU also does not change the general approach for applying the VIE model. A reporting entity would first determine whether it holds a variable interest in the legal entity being evaluated for consolidation. If the reporting entity holds a variable interest, it must determine (a) whether the entity is a VIE, and (b) if the entity is a VIE, whether the reporting entity is the VIE's primary beneficiary. The reporting entity would perform the analysis of whether the entity is a VIE when it initially becomes involved with the entity and subsequently if one of the defined reconsideration events occurs. In contrast, the analysis of who is the primary beneficiary of the entity is an ongoing assessment.



.13 The ASU does not alter the definition of a variable interest. A variable interest continues to be defined as an economic arrangement that gives a reporting entity the right to the economic risks and/or rewards of another 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 an entity. In other cases, the nature of the interest (e.g., contracts) may

require judgment to determine if a variable interest exists. Only those interests that absorb changes in the fair value of an entity's net assets are considered variable interests.

.14 When a legal entity's shareholders or governing body outsources all or certain decision-making over the entity's activities through a contractual arrangement, the decision maker or service provider must assess its fee arrangement to determine whether it qualifies as a variable interest. Currently, a decision maker fee arrangement is not a variable interest if all six criteria in ASC 810-10-55-37 are met. This determination requires judgment and should consider all relevant facts and circumstances.

.15 The ASU removes three of the six criteria that must be considered when determining whether a decision maker fee arrangement is a variable interest. If all three of the retained criteria, presented in Exhibit 2a, are met, the fee arrangement will not be a variable interest.

Exhibit 2a: Retained criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

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

.16 The three criteria removed by the ASU are listed below.

Exhibit 2b: Removed criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

Ref.	Criterion
B	Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the VIE that arise in the normal course of the VIE's activities, such as trade payables
E	The total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance
F	The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE's anticipated economic performance

PwC observation:

It is expected that fewer fee arrangements will be considered variable interests under the ASU since the three criteria that have been removed have historically caused many decision maker fee arrangements to be variable interests. In particular, fee arrangements with a performance-based element that is *more than insignificant* (i.e., the fee's relative size and/or variability are *significant* to the entity) and/or where all or part of the fee is subordinated to other interests (i.e., paid after the entity's normal operating liabilities are settled) may no longer be variable interests under the ASU. If a reporting entity's decision maker fee arrangement no longer qualifies as a variable interest, and that reporting entity holds no other variable interests in the entity, it will not be required to further evaluate that entity for consolidation under the VIE model, or consider the applicability of the VIE disclosures. If a reporting entity's fee arrangement is not a variable interest, but it has other insignificant variable interest(s) in the entity, the reporting entity would still need to determine whether the entity is a VIE for disclosure purposes. Refer to PwC *Financial Statement Presentation Guide*, Chapter 18, for the disclosure requirements for reporting entities that have a variable interest in an unconsolidated VIE.

.17 As depicted in the Exhibit 2a above, the new analysis will continue to include the requirement that the decision maker fee arrangement is arms-length and contains customary terms and conditions ("at market" – see D in Exhibit 2a above) and represents compensation that is considered fair value for the services provided ("commensurate" – see A in Exhibit 2a above) to not be a variable interest. The ASU notes that the magnitude of the fee does not on its own mean that the fee arrangement is not at market or commensurate.

.18 To determine whether the fee arrangement is at market and commensurate, a reporting entity should consider external fee arrangements involving other third party decision makers for the same or similar services. However, the lack of any comparable arrangements does not necessarily mean that the fee arrangement is not at market or commensurate. For example, there may not be a comparable arrangement when the arrangement being assessed involves a new product or strategy, or a new service offering.

PwC observation:

The existence of comparable fee arrangements does not necessarily mean the fee arrangement is at market and commensurate. A fee arrangement that enables the decision maker to obtain substantially all of the residual returns of an entity is common in certain structures and likely would not be at market and commensurate. Examples of such arrangements include physician practice management entities, certain television/radio broadcasting structures, as well as entities in jurisdictions that restrict foreign equity ownership. The ASU includes a new example to illustrate this point.

.19 Other fee arrangements that expose the reporting entity to principal risk of loss are excluded from the at market and commensurate evaluation and would be considered variable interests. For example, fees for guarantees of an entity's outstanding debt or liquidity arrangements, for obligations to fund the entity's operating losses, or those relating to derivatives that absorb variability would still be considered variable interests. The FASB considered asset management fee arrangements to be different from other fee arrangements as the asset manager's downside exposure is limited to the risk that the fees collected will be less than expected (i.e., an opportunity cost). In contrast, a reporting entity is exposed to principal risk of loss when it could lose its existing investment or be required to fund losses of the entity or other investors.

.20 The ASU retains the criterion requiring consideration of the level of other economic interests held by the decision maker ("other economic interests" – see C in Exhibit 2a above). Holding other variable interest(s) in the entity that result in the decision maker absorbing more than an insignificant amount of variability would cause the decision maker fee arrangement to be a variable interest. In addition, certain related party interests will need to be considered in this assessment (see paragraph .23 below for further details). The assessment of whether the decision maker's collective other interests expose it to more than insignificant variability will continue to be both qualitative and quantitative, and require the exercise of judgment.

.21 If the decision maker does not hold other economic interests, directly or indirectly through its related parties, which absorb more than an *insignificant* amount of the entity's expected variability, and the fee arrangement is at market and commensurate, then the fee arrangement will not represent a variable interest.

PwC observation:

The reduction in the criteria reflects the FASB's belief that a decision maker with an at market and commensurate fee can still act in an agency capacity, notwithstanding the relative size or variability of its fee or the fact that its fee has subordination or residual-like characteristics.

By removing the three criteria that often caused a decision maker fee arrangement to be a variable interest (see Exhibit 2b), the ASU increases the focus on the determination of whether the fee is at market and commensurate. Historically, it was often clear that one of the other criteria was not met and, therefore, the arrangement was a variable interest.

Related party interests – the new "indirect" interest concept

.22 Today, for the purposes of assessing the "other economic interests" criterion, a decision maker includes all economic interests held by its related parties. Depending on whether the reporting entity is subject to the deferral, the interests of employees or employee benefit plans may be excluded. Including interests of employees and employee benefit plans, together with any other interests, often gives rise to these interests being more than insignificant.

.23 The ASU limits the extent to which related party interests are included in the other economic interest criterion to the decision maker's effective interest holding. A decision maker would need to have a direct economic interest in its related party, which in turn, has to have an economic interest in the entity being evaluated for consolidation. The decision maker would then include its effective share of that indirect economic interest as if it was held directly in the entity when applying this criterion. However, if the reporting entity and the related party are under common control, then the commonly controlled related party's entire economic interest should be attributed to the decision maker. In some cases, this may cause the decision maker's fee arrangement to be a variable interest.

PwC observation:

We believe the term "indirect interest" is intended to mean indirect *variable* interest. To have an indirect interest, a decision maker should have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation. For example, a reporting entity with a fee arrangement with a related party that is not a variable interest would not need to consider any interests held through that fee arrangement as an indirect interest (assuming it holds no other variable interests in the related party). Our rationale is based on the notion that it would be counterintuitive for a fee arrangement with a related party that is not a variable interest to carry greater weight in the analysis than if that fee arrangement existed directly with the entity being evaluated for consolidation.

.24 To illustrate the concept, consider a decision maker that owns a 30% equity interest in a related party that in turn, holds a 60% equity investment in an entity. Further assume that the decision maker's fee arrangement is at market and commensurate, and that the decision maker and its related party are not under common control. The decision maker would treat its effective 18% indirect equity interest in the entity (i.e., its 30% interest in the investee multiplied by the investee's 60% interest in the entity) as if it were a direct variable interest when assessing the significance of other economic interests held by the decision maker. However, if the decision maker and the related party were under common control, then the decision maker would include the related party's entire 60% interest in the analysis.

PwC observation:

Although this requirement may appear straightforward, this analysis will become more complex when the economic interests held deviate from "plain vanilla" common equity held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

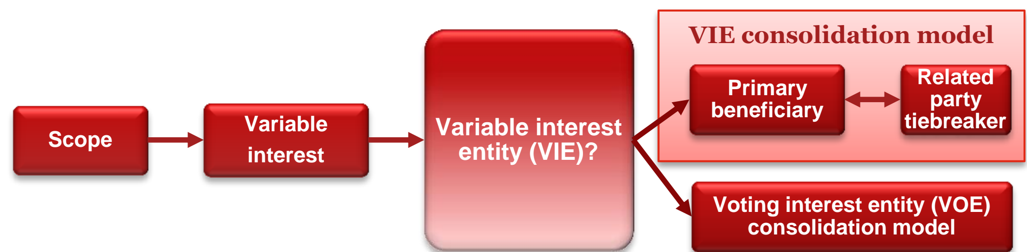
Companies will need to implement systems, processes, and controls to identify changes in the reporting entity's indirect interests in VIEs. Changes to indirect interest percentages may be frequent for entities that have ongoing changes in investors and investment amounts. For example, a related party investor's interest in a fund may change constantly as new investments are made or as interests are redeemed by third parties.

.25 A decision maker's employees or employee benefit plans may hold variable interests in the entity being evaluated for consolidation. However, those interests would only be included in the indirect interest assessment if they are being used to circumvent the VIE guidance.

PwC observation:

When evaluating whether a decision maker has an indirect interest through its employees and employee benefit plans, the guidance does not specifically state that the portion of any interest financed by the decision maker should be considered as an indirect interest. This differs from the guidance prescribed in the primary beneficiary analysis which specifically indicates that a decision maker should include the effective portion of any employee interests that it has financed as an indirect interest (see paragraph .60). Although not explicit, we would generally expect the guidance in the primary beneficiary analysis to also apply when assessing whether a decision maker fee is a variable interest. Note that in its basis for conclusions to the ASU, the FASB does not draw a distinction between these two analyses.

Determining whether an entity is a variable interest entity



.26 The ASU retains the five main characteristics of a VIE described in ASC 810-10-15-14. As is the case today, if a reporting entity holds a variable interest in an entity that fails to qualify for one of the VIE scope exceptions described in ASC 810-10-15, then the reporting entity should determine whether that entity is a VIE.

.27 The ASU introduces a separate and different analysis specific to limited partnerships and similar entities (e.g., a limited liability company governed by a managing member as opposed to a board of directors). In addition, the ASU changes the manner in which a reporting entity that is not a limited partnership assesses whether the equity holders at risk lack decision making rights under ASC 810-10-15-14(b)(1).

Separate requirement for limited partnerships and similar entities

.28 The ASU introduces a new requirement to be applied only to limited partnerships and similar entities. This requirement was added based on the unique purpose and design of a limited partnership as compared to a corporation. Entities that are determined to be "similar" to limited partnerships would also be subject to this new requirement. For example, as noted above, some limited liability companies may be more like limited partnerships than corporations.

PwC observation:

Consistent with today's practice, judgment should be applied to determine if an entity should be evaluated as a corporation or as a limited partnership subject to the new requirement. Some limited partnerships are currently evaluated as corporations on the basis that they have a governance structure more akin to a corporation, such as when the general partner interest is vested in a board of directors elected by the investors.

Under the ASU, the determination of whether entities such as limited liability companies are similar to, or the functional equivalent of, limited partnerships will continue to focus on the entity's governance structure. In practice, limited liability companies that have a managing member and separate partner capital accounts are typically evaluated as limited partnerships.

.29 The ASU requires limited partners of a limited partnership, or the members of a limited liability company that is similar to a limited partnership, to have, at minimum, kick-out or participating rights to demonstrate that the partnership is a voting entity. Any of these rights, if present, are considered analogous to voting rights held by corporate shareholders that provide those shareholders with power over the entity being evaluated for consolidation. A limited partnership may be a VIE under one of the other characteristics even if these rights are present.

.30 The definition of kick out rights is amended by the ASU to include both removal and liquidation rights. Liquidation rights are now broadly defined as the ability to dissolve the entity.

.31 The kick-out rights must be substantive to demonstrate the partnership (or similar entity) is not a VIE. Kick-out rights will only be considered substantive if they are exercisable by a simple majority vote of the entity's limited partners (exclusive of the general partner, parties under common control with the general partner, and other parties acting on behalf of the general partner) or a lower threshold (i.e., as low as a single limited partner). The substance of kick-out rights granted to an entity's limited partners may be called into question when there are economic or operational barriers such as:

- Conditions that make it unlikely that the rights will be exercised
- The kick-out rights are subject to financial penalties or operational barriers to exercise
- There is an inadequate number of qualified replacements, or the level of compensation paid to the decision maker is inadequate to attract a qualified replacement
- No explicit mechanism exists, by matter of contract or law, that would allow the holder to exercise the rights or obtain the information necessary to exercise the rights

PwC observation:

Many limited partnerships require the general partner to make a substantive investment of more than 1% of total partnership capital. Under today's guidance, when a general partner contributes substantive equity, that general partner is grouped with the other investors to determine whether the equity investors as a group have decision making over the most significant activities. As a result, in these situations the limited partnership is typically a voting interest entity (assuming no other characteristics of a VIE are met), and would be evaluated for consolidation under ASC 810-20 (formerly, EITF 04-5). In contrast, the ASU disregards the level of equity provided by the general partner and instead focuses on the voting rights of the limited partners.

We expect this change to cause more partnerships to be considered VIEs, as limited partners often do not hold kick-out or participating rights.

.32 Substantive participating rights held by one or more of the limited partners would also demonstrate that the partnership is a voting entity. For this purpose, the ASU defines participating rights as rights to block or participate in significant financial and operating decisions that are made in the ordinary course of business, consistent with the definition in the VOE model. Additional guidance already exists for assessing whether these rights are substantive.

.33 Redemption rights held by the limited partners are not considered equivalent to kick-out or participation rights under the ASU. The ability of an individual investor to require a limited partnership to redeem its interest is not considered by the ASU to provide the holder with the ability to remove the decision maker or liquidate the partnership. During redeliberations, the FASB acknowledged that a scenario could exist where the exercise of a redemption right could lead to liquidation (e.g., when an entity has a single investor that holds a redemption right) although that scenario was believed to be rare.

.34 If a limited partnership is determined to be a variable interest entity and the general partner meets both the "power" and "economics" tests (see paragraph .52), then a single party kick-out or participating right over all of the entity's most significant activities would be needed for the general partner to avoid consolidation. That is, the right must be unilaterally exercisable and not exercisable solely by a simple majority of limited partners.

Assessing if equity holders at risk lack decision making rights for entities that are not limited partnerships or similar entities

.35 The ASU changes the evaluation of whether the equity holders at risk lack decision making rights when decision making is outsourced. In particular, the changes apply if there is a single decision maker that is subject to a contractual fee arrangement separate from (not embedded in) a substantive equity investment in the entity, and that arrangement conveys power to the decision maker to direct the activities that most significantly impact the economic performance of the entity.

.36 The change in how outsourced activities are to be assessed resulted from the FASB's consideration of whether a registered mutual fund that outsources decision making to a third party manager should be considered a VIE in the absence of single party kick-out or participating rights. The rights of shareholders and boards of mutual funds registered in accordance with the *Investment Company Act of 1940* ("the 1940 Act") convinced the Board that these entities should generally be considered voting interest entities. The Board determined that rights exercisable by a registered mutual fund's shareholders, either directly or through the entity's independent board of directors, are not substantively different from rights held by shareholders of a public company (which would generally not be a VIE).

.37 The new guidance shifts the focus to a fund's shareholder rights and, if substantive, considers these rights to effectively constrain the manager's level of discretion and decision-making authority. Thus, the new guidance concludes that the shareholders, rather than the manager, have the power to direct the fund's most significant activities if these rights are substantive.

.38 Although this concept was discussed in the context of a registered mutual fund, it applies to all entities that outsource decision making power. Entities would apply this approach only if they are not subject to the separate requirement for limited partnerships and similar entities.

.39 The new approach can be summarized in the following three steps.

Step 1 – Determine if the decision-maker's fee arrangement is a variable interest

.40 If the decision maker fee arrangement is not a variable interest, then the equity investors as a group would not lack the power to direct the activities of the entity that most significantly impact its economic performance. The nature of that arrangement would suggest the decision maker is acting as an agent and is therefore presumed to lack power over the entity's most significant activities. As a result, the entity would not be a VIE under this characteristic and steps two and three would not apply. See paragraphs .15–.25 for a discussion of how to determine if a fee arrangement is a variable interest.

PwC observation:

As fewer fee arrangements will be variable interests under the ASU, certain entities may no longer be VIEs, since the equity investors would not lack decision making power.

Step 2 – Assess the rights of shareholders

.41 The need to assess the rights of shareholders is a new step required by the ASU if the decision maker's fee arrangement is a variable interest. Under current guidance applicable to companies not subject to the deferral, the equity investment at risk is not considered to have decision making rights over the outsourced activities unless there is a single party that is able to unilaterally exercise a substantive kick out or participating right.

.42 The ASU requires that the reporting entity first consider the rights of the equity investment at risk before determining whether substantive single party kick out or participating rights exist. If the shareholders have substantive rights, then the entity would not be a VIE and step three would not apply.

.43 The ASU contains an example to illustrate some of the rights that may suggest the equity investment at risk has decision making power. The example is written in the context of a series mutual fund, and points to various shareholder rights as being present, including the ability to remove and replace the board members and the decision maker, and to vote on the decision maker's compensation. However, the basis for conclusions to the ASU notes that this concept is intended to be applied broadly to all entities.

PwC observation:

The FASB introduced this concept to differentiate between typical voting corporations (where the shareholders have rights over the most significant activities of an entity) and entities where shareholders have limited or no rights.

The example does not point to any particular right as being determinative since it will depend on the specific facts and circumstances. It will generally be the *aggregate* rights that provide the shareholders with the ability to exercise power over the entity. However, the inability of shareholders or the entity's board of directors to remove and replace the decision maker and approve its compensation will likely be determinative that the equity holders lack decision making under this step.

The rights listed in the example are not intended to be all-inclusive. As such, other rights may exist that should be considered when determining whether the equity holders lack the power to direct the activities of the entity that most significantly impact its economic performance.

.44 The existence of these shareholder rights alone does not indicate that an entity's shareholders have power. The reporting entity would also need to consider if these rights are substantive when determining if the entity's shareholders have power.

.45 The following example illustrates the application of this concept in a non-fund scenario.

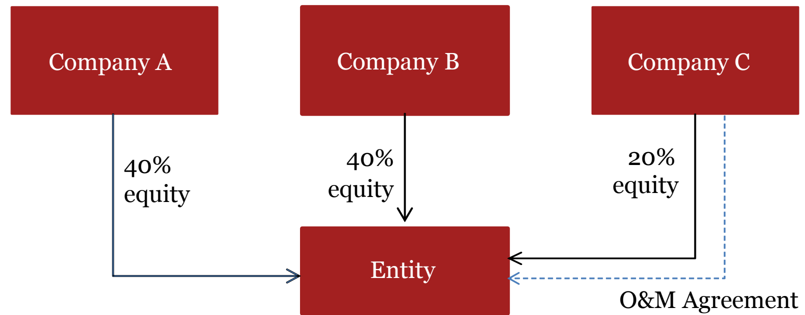
Example: Assessing shareholder rights

Three unrelated companies established an entity to invest in shipping vessels. Company A and B each provide 40 percent of the financing in exchange for equity interests and Company C provides the other 20 percent of equity financing. The entity operates subject to the supervision and authority of its board of directors. Each party has the ability to appoint members to the entity's board and shares in the entity's profits and losses in proportion to their respective ownership interests. The purpose, objective, and strategy of the entity is established at inception and agreed upon by the shareholders pursuant to the entity's formation agreements. The three companies identified and jointly agreed to the specified shipping vessels in which the entity would invest at formation.

A number of decisions require simple majority board approval. These include:

- The removal and replacement of the Operating and Maintenance (O&M) manager, without cause
- Changes in the O&M manager's compensation
- The acquisition of new ships
- The sale of existing ships
- A merger and/or reorganization of the entity
- The liquidation or dissolution of the entity
- Amendments to the entity's charter and by-laws
- Increasing the entity's authorized number of common shares
- Approval of the entity's periodic operating and capital budgets

Company C performs all of the daily operating and maintenance activities over the shipping vessels under an O&M agreement. The decisions relating to the operation and maintenance of the vessels are determined to be the activities that would most significantly impact the entity's economic performance. Company C receives a fixed annual fee for services provided to the entity that is at market and commensurate. However, the fee arrangement is determined to be a variable interest because Company C has another significant variable interest in the entity (equity financing).



Do the equity holders as a group lack decision making rights (is the entity a VIE)?

Analysis – current guidance

The entity would be a VIE as the equity holders would be deemed to lack decision making power to direct the entity's most significant activities. This is because the O&M agreement (the decision maker fee arrangement) is a variable interest, is not embedded in the equity of Company C, and no single equity holder is able to remove Company C as the O&M manager.

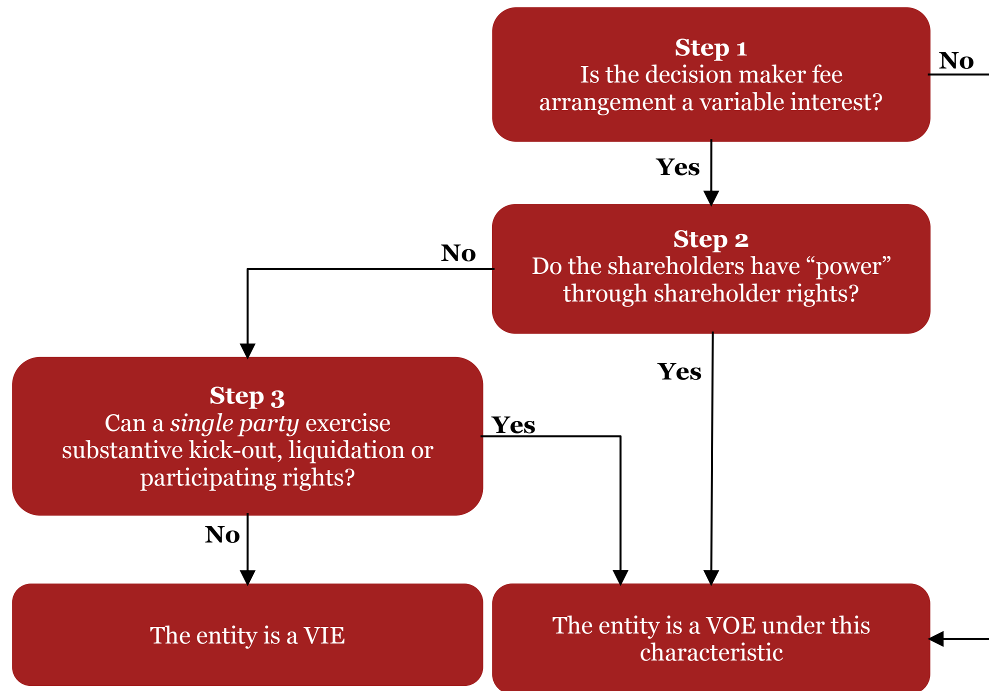
Analysis – amended guidance contained in the ASU

Under the ASU, the entity would not be a VIE despite the decision making fee arrangement being a variable interest. The board is actively involved in making decisions about the activities that most significantly impact the entity's economic performance. Among other rights, the board is able to remove the O&M manager without cause and approve its compensation. As the board is elected by the shareholders and is acting on their behalf, the shareholders in effect have power to direct the activities that most significantly impact the economic performance of the entity.

Step 3 – Determine if there is a unilateral kick out or participating right

.46 Finally, if the decision maker's fee arrangement is a variable interest under the first step, and the shareholders do not have certain rights as discussed in the second step (or such rights are not substantive), the reporting entity would need to determine if there is a single party that can exert substantive kick out or participating rights. Only if there is a single party with these rights would the entity not be a VIE under this characteristic. This step is consistent with current guidance applicable to companies not subject to the deferral.

.47 The decision tree for this characteristic applicable to entities that are not limited partnerships or similar entities can be illustrated as follows:



Series fund structures

.48 Series fund structures, which are common in the asset management industry, are structured with one umbrella legal entity that is typically a trust or corporation. Each series fund is represented by a separate share class of the trust/corporation and the proceeds from the issuance of the share class are invested in assets according to the strategy of the series fund. The trust/corporation is governed by a single board of directors that is responsible for overseeing the operations of each series fund. Many series funds are mutual funds registered in accordance with the 1940 Act.

.49 A question could be raised as to whether each individual series fund should be evaluated for consolidation as a separate legal entity, or instead, if the trust or corporation should first be evaluated. If the trust or corporation should be evaluated first, the determination of whether each series fund is a silo, subject to consolidation, would be required only if the trust/corporation is a VIE. The ASU includes an example that clarifies that each series fund that is a mutual fund subject to the 1940 Act should be treated as a separate legal entity. The rights of the entity's equity holders (series funds' shareholders), as opposed to the decision maker, are then considered to determine if the equity holders have the power to direct the entity's most significant activities (see the step discussed in paragraphs .41 – .45 for further information).

.50 The question of whether series funds are legal entities and VIEs is not new and there are differing views in practice today. However, because these series fund structures were subject to the indefinite deferral, the threshold for consolidation is generally the same (a majority) irrespective of whether they are viewed as VOEs or VIEs. By rescinding the deferral, these structures will potentially be subject to the "power" and "economics" consolidation model (see paragraph .52) for the first time. This model has a lower economic threshold for consolidation (potentially significant) and, therefore, this question becomes more important.

.51 The series fund example in the ASU includes specific factors that make 1940 Act series funds legal entities for purposes of the consolidation analysis. However, during Board redeliberations, the FASB staff noted that these factors are often not present in international series structures, and as a result, a different conclusion may be reached.

Exhibit 3: Factors noted as indicating that series mutual funds are legal entities

Exhibit 3: Factors noted as indicating that series mutual funds are legal entities
The fund has its own investment objectives and policies
The fund has its own custodial agreement
The fund has its own shareholders separate from other series funds
The fund has its own unique tax identification number
The fund files separate tax returns with the Internal Revenue Service
Separate audited financial statements are prepared for the fund
The fund is considered a separate investment company for investor protections in virtually all circumstances

PwC observation:

Asset managers expressed concern that by removing the deferral, the ASU would cause them to consolidate many series funds for a longer period than they do today after establishing a new fund and providing the initial seed capital. This is because the threshold for consolidating VIEs subject to the deferral (majority) will be lower upon adoption of the ASU (reduced to potentially significant). By concluding that each mutual series fund is a separate legal entity and focusing on each series' shareholder rights, the FASB expects that these funds will be considered VOEs. However, funds that continue to be VIEs on adoption of the ASU will be consolidated by asset managers for a longer period than today.

Variable interest entity model

Primary beneficiary determination

Scope → Variable interest → Variable interest entity (VIE)?

VIE consolidation model: Primary beneficiary ↔ Related party tiebreaker

Voting interest entity (VOE) consolidation model

.52 A reporting entity with a variable interest in a VIE consolidates that VIE if it has both the power to direct activities that most significantly impact the economic performance of the entity ("power") and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses ("economics").

.53 The ASU changes how the "economics" test is performed in two ways. First, the ASU reduces the circumstances when decision maker fees are included in the economics test. Second, the ASU changes the extent to which related party interests are considered in the test and also when related party relationships are considered in the VIE model.

Considering decision maker fee arrangements in the economics test

.54 The analysis to determine whether a reporting entity meets the economics test is not solely quantitative, but is also qualitative and should consider the VIE's purpose and design. Consequently, there is no bright line in today's guidance to indicate when a reporting entity's variable interests are potentially significant. In some cases, this analysis can be complex and highly judgmental.

PwC observation:

Upon adoption of the ASU, reporting entities will apply the "power" and "economics" VIE control model to entities that previously were subject to the deferral. Determining whether the economic interests are "potentially significant" is an area of significant judgment that is not probability-based; it considers all possible scenarios. During its redeliberations, the Board considered, but chose not to provide a new bright line that would indicate when economic interests are potentially significant.

.55 The ASU provides some relief to reporting entities applying the economics test. Under current GAAP, decision maker fees with a performance-based element would likely cause a decision maker with stated power to consolidate a VIE because the fee inuring to the decision maker could be potentially significant to the VIE. The ASU requires a decision maker to disregard the economics it absorbs through the fee arrangement when evaluating the economics test, provided the arrangement is at market and commensurate (see paragraph .15 for the definition of at market and commensurate).

PwC observation:

Under the ASU, the assessment of at market and commensurate is considered for the fee as a whole. Many fee arrangements include a fixed and a performance fee element. If the total fee is not at market and commensurate, then the entire fee should be included in the economics test. It would not be appropriate to only include that portion of the fee determined to be off-market or not commensurate.

.56 Although a decision maker's exposure to a VIE's economics through a fee arrangement will be disregarded if the arrangement is at market and commensurate, other variable interests held by the decision maker should be considered when applying the economics test. In addition, as discussed in paragraph .19, fees that expose a decision maker to a principal risk of loss would not be subject to the at market and commensurate assessment and would also be included in the economics test.

PwC observation:

The relief for at market and commensurate fees will not be helpful in the economics test if a decision maker's fee arrangement is considered a variable interest because this conclusion will likely stem from the fact that the decision maker holds other variable interest that are more than insignificant. The existence of a more than insignificant variable interest would generally be considered "potentially significant" under the economics test.

Certain funds that continue to be VIEs may now need to be consolidated by their asset manager due to the existence of other economic interests held by the manager. Entities subject to the deferral would have been consolidated by a party under the VIE model that either (1) absorbs a majority of the entity's expected losses or residual returns, or (2) was deemed the "most closely associated" under the related party tiebreaker test. Because the economic threshold (potentially significant) is lower in the "power" and "economics" VIE model, some funds that are determined to be VIEs may need to be consolidated despite the ability to exclude the asset manager's fee from the economics test.

.57 The ASU does not distinguish between the form of a decision maker's compensation (e.g., cash compensation or equity). A decision maker may receive an equity allocation based on performance of the entity, typically referred to as a "carried interest." Carried interests are commonly used in the alternative asset management industry, including for hedge funds and private equity funds.

PwC observation:

A question arises about whether a carried interest should be included in the economics test. Oftentimes that interest is subject to future reversal if performance of the entity declines. Until such time as that interest is no longer subject to reversal (i.e., the fee is crystallized), we believe that it should be excluded from the economics test. However, once the interest is no longer subject to reversal, it would be included in the economics test on the basis that it is no different from a direct equity investment made by the decision maker. The carried interest does not crystallize at the same times for all asset managers. Assuming it is determined to have power, an asset manager that continually reinvests its crystallized fee in a fund would need to consolidate that fund at the point when its cumulative interests meet the economics test threshold (i.e., becomes potentially significant).

Considering related party interests in the economics test – the new "indirect" interest concept

.58 Under current guidance, a reporting entity first performs the power and economics tests on a standalone basis. Only if the reporting entity does not meet both tests on a standalone basis does the reporting entity consider related parties in the analysis. At that time, the entire variable interest held by the reporting entity and its related parties are considered in determining if the related party group collectively meets the power and economics tests.

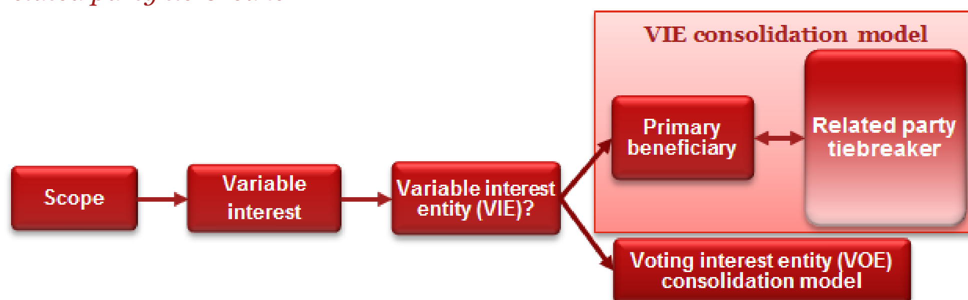
.59 The ASU changes the order in which related party interests are considered, and also the extent to which they are considered in many instances when the power test is met by a single party. The ASU brings forward the consideration of related party interests when analyzing whether the reporting entity with power meets the economics test on a stand-alone basis. Note, however, that the manner in which related parties are considered remains unchanged when the power test is not met by a single party (i.e., if power is shared).

.60 Under the ASU, the reporting entity that meets the power test will includes its indirect interests in the VIE together with its own direct interests when determining whether it meets the economics test on a standalone basis. An indirect interest exists when the reporting entity has a direct economic interest in a related party that in turn holds an economic interest in the VIE. Consistent with the analysis for whether a decision maker fee arrangement is a variable interest, the indirect interest represents the reporting entity's effective economic interest in the entity through its direct investment

in the related party (see paragraph .24 for an example of how to calculate the indirect interest). Consistent with that analysis, when the indirect interest is held by an affiliate under common control, the full economic interest of the affiliate should be included. In addition, if the decision maker financed any portion of an employee's interest, it would need to determine and include its effective economic interest in the entity through that financing.

.61 Related parties to be considered 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 (ASC 810-10-25-43).

Related party tie-breaker



.62 Under current guidance, if a reporting entity does not meet both the power and economics tests on a standalone basis, it would need to consider whether, together with its related parties, the group collectively meets both tests. If the related party group has both characteristics of a primary beneficiary, the "related party tiebreaker" test is performed to identify the variable interest holder within that related party group that is "most closely associated" with the entity. The party most closely associated with the VIE would be the one to consolidate it.

.63 As discussed in paragraph .60, the ASU introduces the indirect interest concept that effectively accelerates the consideration of related party interests by incorporating them into the reporting entity's assessment of whether it is the primary beneficiary on a standalone basis in situations where the power test is met by a single party. However, consistent with current practice, all variable interests must be considered when assessing whether the related party group has the characteristics of a primary beneficiary.

.64 The ASU limits application of the related party tiebreaker test to the following two circumstances:

(1) If no single party in the related party group has unilateral power (i.e., power is shared), then the related party tiebreaker should be applied to identify the related party that consolidates the entity.

(2) If a single party in the related party group has unilateral power, and the related party group is under common control, then the related party tiebreaker should be applied to identify the related party within the common control group that consolidates the entity.

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 requiring application of the related party tiebreaker. This is due to the discretionary or arbitrary manner in which an ultimate parent could shift interests within a related party group to avoid consolidation at the lower level. Under the voting model, consolidation is generally not required at an intermediate level if that reporting entity lacks a controlling financial interest in the investee on a standalone basis.

.65 The FASB made the changes discussed in paragraph .64 to reduce the application of the related party tiebreaker in response to constituent feedback that the tiebreaker test is applied in too many fact patterns and sometimes requires consolidation that results in less decision-useful financial reporting. In addition, requiring the application of the tiebreaker test after a reporting entity had already considered indirect interests held through related parties would in effect subject the reporting entity to two related party tests.

PwC observation:

Some may question when, if ever, the related party tiebreaker would apply in common control situations where a single party has power. The ASU requires a decision maker with unilateral power to consider its indirect interests held through related parties when applying the economics test. A decision maker must have a direct variable interest in a related party that has a variable interest in the VIE for that relationship to represent an indirect interest. Therefore, a decision maker would not consider a commonly controlled related party's variable interest(s) in the VIE absent a direct variable interest in the related party when determining if the decision maker is the VIE's standalone primary beneficiary.

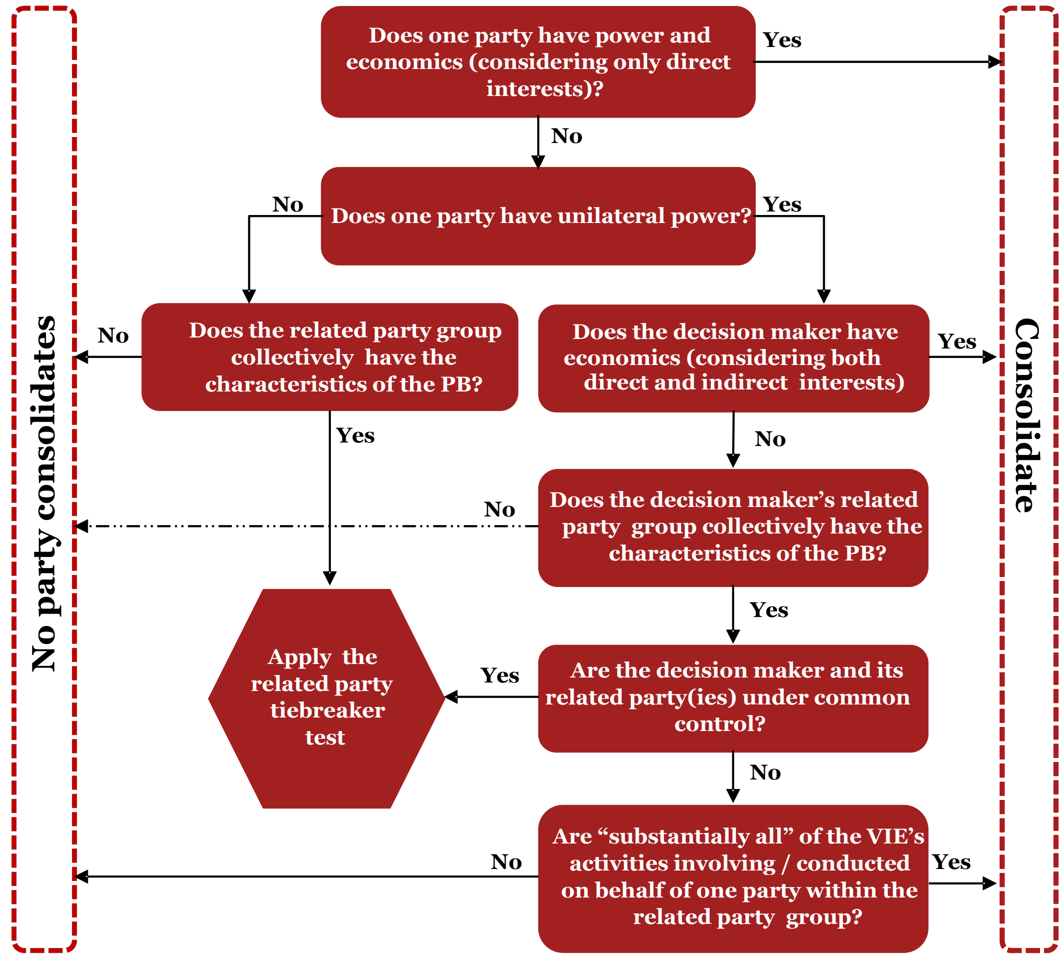
If the decision maker does not individually meet both characteristics of a primary beneficiary, the related party group must be evaluated to assess whether it meets the economics test. In that circumstance, all variable interests held by the related party group must be considered. If the related party group meets the primary beneficiary test, the related party tie breaker would be required to determine which party within the commonly controlled related party group must consolidate the VIE. The related party tiebreaker analysis requires judgment and a consideration of various factors, and therefore it is possible to conclude that the affiliate, and not the decision maker, would consolidate.

.66 If a single party within a related party group has unilateral power and the related party group is not under common control, the related party tiebreaker would not apply. However, the ASU requires that if "substantially all" of the VIE's activities involve or are conducted on behalf of any party within the related party group, then that party is required to consolidate the VIE. This requirement is intended to prevent abuse (i.e., "vote parking" arrangements) where the decision maker's level of economics is not consistent with its stated power. This assessment (which is intended to be consistent with the assessment of whether an entity is a VIE because the equity investment at risk has non-substantive voting) is qualitative and should consider all relevant facts and circumstances.

.67 The ASU specifically exempts investors in low income housing tax credit (LIHTC) partnerships from having to assess whether they benefit from "substantially all" of the entity's activities. The FASB was concerned that investors would be required to consolidate these partnerships despite not meeting the power test when they hold substantially all of the limited partner interests. This outcome would undermine the

recent ASU[5] enabling investors in qualified affordable housing projects to apply the proportionate amortization method (see Dataline 2014-02, *Accounting for investments in qualified affordable housing projects,* for further information).

.68 The analysis to be applied for related parties can be illustrated as follows:

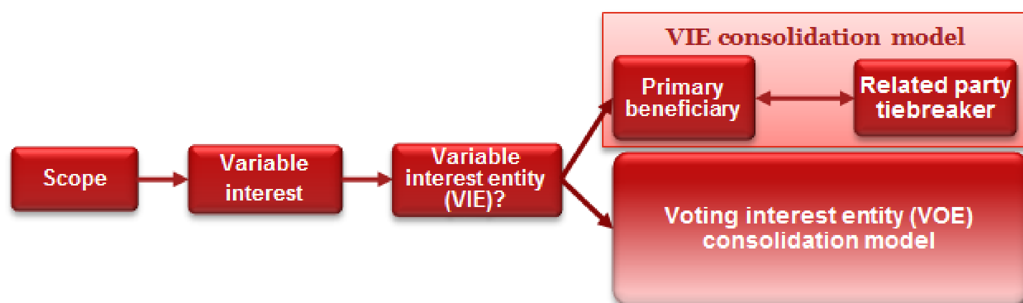


PwC observation:

Situations where the related party tiebreaker has been applied under current guidance should be evaluated carefully when there is a single party that meets the power test. It is possible that the new circumstances in which the tiebreaker is applied and the introduction of the new indirect interest concept could lead to different consolidation outcomes in certain fact patterns.

[5] ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*

Voting interest model



Creation of a single voting interest model for all entities

.69 The ASU creates a single model for all voting interest entities regardless of the entity's legal form of governance structure. This single VOE model will focus on relative voting rights and consider other rights that enable a noncontrolling equity investor to participate in an entity's ordinary course operating and/or financial decisions. Such voting rights may be in the form of kick-out or participating rights. In the absence of such rights, a majority investor would be expected to control an entity unilaterally and consolidate the entity under the voting model.

.70 In creating a single model, the ASU removes the voting model specific to limited partnerships and similar entities (ASC 810-20, formerly EITF 04-5). That guidance is effectively incorporated into the VIE determination in assessing whether the equity investment at risk has decision making rights (see paragraphs .28 – .33). In addition, the rebuttable presumption that a general partner unilaterally controls a limited partnership under the VOE model has been eliminated.

.71 The ASU also clarifies that a single investor's ability to exercise a kick-out right (for example, a limited partner that holds the majority of the kick out rights) may convey unilateral control to the holder in the voting model, assuming another limited partner does not hold a substantive participating right. Accordingly, the investor with the kick-out right may be required to consolidate the entity under the revised voting model. This represents a change in current practice as the holder of a single party kick-out right typically accounts for its interest in a partnership that is a VOE using the equity method of accounting, as opposed to consolidation.

PwC observation:

The changes will, in effect, mean that a general partner will not consolidate a limited partnership under the VOE model due to the existence of substantive kick out or participating rights.

In addition, unlike a single party kick out right, the ability to unilaterally exercise a participating right would not give a limited partner control, absent any other rights. Participating rights do not convey power, but only prevent the party with power from exercising that power (i.e., they provide the holder with the ability to veto decisions made in the ordinary course of business as oppose to directing such decisions).

Proportionate consolidation

.72 Only investors in unincorporated entities that are in the extractive industry (for example, oil and gas exploration and production) and the construction industry may apply proportionate consolidation instead of the equity method of accounting.

Proportionate consolidation requires the investor to reflect its pro rata share of assets, liabilities, revenues, and expenses of the investee on a gross basis. Although the separate consolidation model for limited partnerships and similar entities that are VOEs is being removed by the ASU, the previous exception in that model is being retained. Accordingly, a general partner may continue to apply the proportionate consolidation method rather than consolidating the entity and reflecting a noncontrolling interest.

Disclosures

.73 The ASU does not amend the existing disclosure requirements for VIEs or VOEs. During redeliberations, some Board members acknowledged the concerns of some stakeholders that the current disclosures pertaining to VIEs may at times be excessive and not helpful to financial statement users. However, the reconsideration of the current disclosures for VIEs was outside the scope of this project.

.74 The ASU does, however, require new disclosures for reporting entities that have explicit arrangements to provide financial support to money market funds. In addition, reporting entities would have to provide disclosures if they have provided any financial support during any of the income statement periods included in the financial statements. The following represent examples of sources of support noted in the ASU that would require disclosure in a reporting entity's footnotes:

- Capital contributions to the money market fund
- Standby letters of credit
- Guarantees of principal and interest
- Agreements to purchased troubled securities at amortized cost
- Waiver of fees, including management fees

PwC observation:

The sponsor of a money market fund may waive a portion of its management fee solely to enhance the fund's performance relative to its peer group. We believe the disclosure requirements for sponsors of money market funds apply when the sponsor has provided any form of support, including those described above, regardless of its purpose or intent. These disclosures should not be limited to situations where support provided by the sponsor was necessary to prevent the fund from "breaking the buck." Other requirements under the money market rules and investment company guidance may already result in similar disclosures.

Effective date and transition

.75 The ASU 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 need to apply the standard for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted.

.76 Reporting entities will be able to early adopt the changes in any interim reporting period and are required to apply the changes on a modified retrospective or on a full retrospective basis. If a reporting entity adopts the ASU during an interim period on a modified retrospective basis, it would be required to reflect any adjustments as of the beginning of the annual period of adoption. If a reporting entity adopts the ASU on a full

retrospective basis, it would be required to reflect any adjustments as of the beginning of the earliest comparative period presented.

PwC observation:

Companies seeking to early adopt the ASU should not underestimate the work needed to update their analyses, and the related changes that may be needed to systems and controls. In addition, associated internal controls may need to be evaluated and tested.

.77 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 ASU, assets and liabilities should be recognized as of the date of adoption based on what the carrying amounts would have been had this guidance always been applied. If it is not practical to determine the carrying amounts of individual assets and liabilities of the entity, then the fair value as of the date of adoption can be used. In addition, reporting entities can elect the fair value option on an entity by entity basis provided that the fair value option is applied to all eligible assets and liabilities of that entity.

- For entities that will be deconsolidated upon adoption of the ASU, the carrying amount of any retained interests should be determined based on what they would have been had this guidance always been applied. If it is not practical to determine the carrying amount of the retained interest in the entity, then the fair value of the retained interest as of the date of adoption can be used.

- 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 previously held or retained interest, should be recognized as a cumulative-effect adjustment to retained earnings.

PwC observation:

As reporting entities enter into new transactions prior to adoption of the ASU, they should consider the consolidation conclusions under the new guidance.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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