



**BDO Seidman, LLP**  
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# Financial Reporting

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## Consolidation of Variable Interest Entities

This *Financial Reporting* letter was prepared and distributed by BDO Seidman, LLP to help our clients anticipate and respond to questions that may arise with the implementation of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*.

### Executive Summary

In June, the FASB published its latest standard on consolidation policy.<sup>1</sup> The result? Many more entities will be consolidated than in the past and “off-balance sheet” accounting will be much less common.

This project comes on the heels of the credit crisis and is intended to respond to several perceived deficiencies in the current consolidation rules. For instance, Statement 167 mandates that substance, not form, govern whether variable interest entities<sup>2</sup> (VIEs) are consolidated or kept off the books. While this may seem obvious, the new standard was designed to more clearly portray business economics in financial reports, which some observers believed was lacking under prior GAAP.<sup>3</sup> Going forward, so-called “qualifying special purpose entities” will no longer be exempt from consolidation and must be evaluated like all other entities. Similarly, troubled debt restructurings in which creditors grant concessions to debtors must be analyzed, which wasn’t previously required. On the margin, these two scoping changes will result in more entities being consolidated compared to prior GAAP.

<sup>1</sup> FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*. This *Financial Reporting* letter has been drafted using legacy GAAP references since Statement 167 was issued in that format. The FASB’s Accounting Standards Codification is the single source of authoritative nongovernmental US GAAP for interim and annual periods ending after September 15, 2009. It supersedes all authoritative literature in Levels A-D of the GAAP hierarchy and new accounting guidance will be issued in the form of Accounting Standards Updates to the Codification.

<sup>2</sup> See section titled “Variable Interest Entities” below for a definition of this term.

<sup>3</sup> Generally Accepted Accounting Principles

In addition, Statement 167 eliminated one key reason that was commonly relied upon to avoid consolidation. In many structures, one party often managed daily operations but wasn't required to consolidate the entity because passive investors had the ability to remove the manager or block his or her actions in certain circumstances. Such rights were rarely exercised, but they frequently determined the accounting outcome. Under the new guidance, those situations should be much less common.

Most importantly, the fundamental criteria changed for deciding whether a VIE should be consolidated. Previously, companies measured who was exposed to a majority of a VIE's "risks and rewards" to decide which investor had to consolidate. That is, consolidation conclusions turned on complex modeling techniques that were used to estimate the entity's expected cash flows, taking into account uncertain market dynamics. The underlying accounting theory was that investors who agreed to take on such exposure only did so because it also conveyed control over the entity. However, that wasn't always borne out in practice. Now, companies are actually required to identify the business activities that significantly impact an entity's economic performance and decide who has the power to direct them, in addition to considering possible upside and downside investment risk. With this change, situations in which no one consolidates should be less frequent.

While these revisions will pull an incremental number of structures onto corporate balance sheets, the FASB preserved off-balance sheet treatment for situations in which none of an entity's investors are individually able to exert control. Said differently, if the power to direct key business activities is shared by two or more parties, consolidation isn't required. As a result, "true" joint ventures will continue to be presented in the financial statements as a single asset, as well as a single element of earnings.

The new standard should also improve transparency for users by segregating assets and liabilities on the balance sheet that are subject to certain settlement restrictions and enhancing footnote disclosures about the risks to which an investor is exposed.

As indicated above, it's helpful to understand that Statement 167 was developed squarely in the context of financial institutions and structured finance. Nevertheless, it applies to almost all industries. Therefore, companies should begin evaluating the new standard now to determine the impact it will have at adoption—the first fiscal year that begins after November 15, 2009, including interim periods within that year.

This *Financial Reporting* letter provides a short background on consolidation policy in general and then discusses the specific requirements of Statement 167. In addition, it outlines several important implications the new standard has for public companies that must comply with the SEC's rules, and includes practical suggestions at

the end to assist with implementation efforts for all companies. Two appendices are also provided to summarize the variable interest consolidation model and highlight the major changes that Statement 167 makes to FIN 46(R)<sup>4</sup>

## Background

The purpose of consolidated financial statements is to present the results of operations and the financial position of a parent and all its subsidiaries as if the consolidated group were a single economic entity. A parent consolidates entities in which it holds a controlling financial interest. The usual condition for a controlling financial interest is ownership of a majority voting interest. As a general rule, ownership by one company of more than 50% of the outstanding voting shares of another company results in consolidation (the "voting interest model").<sup>5</sup>

However, there are exceptions to the rule. The voting interest model may not identify the party with a controlling financial interest because control of some entities may be achieved through arrangements that do not involve voting interests. As indicated in Statement 167, the FASB believes a controlling financial interest in these types of entities should be identified on the basis of whether an interest gives its holder power over the entity's activities *and* rights to receive its benefits *or* obligations to absorb its losses. This is known as the "variable interest model." Entities subject to this approach are called "variable interest entities," or VIEs.

<sup>4</sup> FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* – an interpretation of ARB No. 51

<sup>5</sup> Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

► **BDO Insight:** To ensure the proper model is applied, it is critical to determine whether the entity being evaluated for consolidation is a VIE or not. The consolidation conclusion will often differ depending on which model is required—voting or variable. ◀

The rest of this letter describes the revised variable interest model in greater detail, including a review of its scope to help companies pick the right path when they come to this fork in the road.

## Statement 167

**Substance** – The FASB debated, and ultimately concluded, it was necessary to provide a reminder that only substantive terms, transactions and arrangements should be considered when applying Statement 167. That is, nonsubstantive items should be ignored—both contractual and noncontractual. On the surface, this seems straightforward. However, it's important to note that the FASB observed situations in practice where minor features have been added to or removed from arrangements solely to achieve a desired accounting outcome that frustrates the objective of the variable interest model. The intent of the substance principle is to prohibit similar structuring in the future, and does not imply that nonsubstantive items should be considered in other areas of GAAP. As a result, judgment will be required to determine whether certain terms, transactions and arrangements are substantive.

**Variable Interests** are contractual, ownership or other monetary inter-

ests in an entity that change with changes in the fair value of the entity's net assets, excluding variable interests themselves. That is, variable interests absorb changes in the fair value of an entity's net assets (i.e., variability), rather than create variability. Common examples of variable interests include subordinated debt and equity instruments issued by the entity, certain guarantees, puts, calls and forwards, marketing arrangements and leases, as well as other contracts such as management and service agreements. Importantly, if a reporting enterprise doesn't hold a variable interest in a VIE, it is precluded from applying the variable interest consolidation model.

The FASB provided a narrow exception in Statement 167 for management or service agreements of a strictly fiduciary nature. Fees paid to decision makers and service providers do not require evaluation as a variable interest if all of the following six conditions are satisfied:<sup>6</sup>

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
- The decision maker or service provider and its related parties, if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignifi-

cant amount of the entity'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 total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

Equity interests are generally inconsistent with the fiduciary concept because they represent an obligation to absorb losses and a right to receive benefits. In contrast, fixed fee arrangements, such as 1% of assets under management, may qualify for the exception depending on their terms. Moreover, determining whether a fee arrangement meets the scope exception described above will require an understanding of similar contracts used in the VIE's industry to help ascertain whether it represents a mere fiduciary relationship.

Some variable interests are easier to identify than others. The examples above are apparent because they exist in writing. Other variable interests are *implied* by the existence of relationships or transactions, historical patterns of acting in a certain capacity or the reputational risk of not providing financial support to an entity. These are known as implicit variable interests, which must be identified and considered when applying the variable interest model.

<sup>6</sup> Paragraph B22 of FIN 46(R), as amended

The FASB illustrated an implicit variable interest using the relationship between a manufacturing company and a leasing company. Assume a manufacturing company is owned by two individuals, one of which also owns a leasing company. The leasing company has no assets other than a manufacturing facility that it leases to the manufacturer. In this example, the lease does not contain a residual value guarantee related to the manufacturing facility or include an option for the lessee to buy the assets. Therefore the lease does not represent a variable interest. However, the manufacturing company would be deemed to hold an implicit variable interest in the leasing company if the manufacturer effectively guarantees the investment of the leasing company's owner. This would be true if an expectation exists (or history suggests) that the manufacturer would make funds available to the leasing company to avoid its debt being called or to prevent a creditor from invoking a guarantee that was issued by the leasing company's owner.

► **BDO Insight:** All of the relevant facts and circumstances must be considered when determining whether an implicit variable interest exists. In that regard, it is important to obtain a thorough understanding of the economic incentives or conflicts of interest that exist in a particular situation because they may influence behav-

ior and shed light on the presence of an implicit variable interest. ◀

**Variable Interest Entities** – An entity is a VIE if one or more of the following is true:

- The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties.
- Equity holders lack (i) the power to direct the activities that most significantly impact the entity's economic performance, (ii) the obligation to absorb expected losses or (iii) the right to receive expected residual returns.<sup>7</sup>
- Expected losses or returns are not proportionate to voting rights and substantially all of an entity's activities involve or are conducted on behalf of an investor with only a few voting rights.

While these are essentially the same three concepts that FIN 46(R) established, the second item – power over the entity – has changed significantly because of the role that kick-out rights<sup>8</sup> and participating rights<sup>9</sup> play under Statement 167.

To illustrate, many partnerships consist of a single general partner and many limited partners. These partnership agreements commonly assign responsibility for operations to the general partner, while the limited partners are passive. Often, the general partner's equity is not

considered “at risk” under FIN 46R because he “pays” for it by providing services. However, the limited partners who contributed the “at risk” equity were deemed to retain power of the partnership's operations by virtue of kick-out rights or participating rights. For example, if predefined circumstances occurred, such as a significant deterioration in financial condition, the limited partners acting as a group could kick the general partner out. While latent, this ability meant that the equity investment at risk (i.e., the limited partners' capital) represented power over the partnership. Therefore, it was not considered a VIE and the variable interest model didn't apply.

Under Statement 167, kick-out rights and participating rights are no longer relevant to the analysis, unless a single party has the unilateral ability to exercise them (including its related parties and de facto agents<sup>10</sup>). This is because the FASB was troubled that in practice, such rights have been considered substantive for accounting purposes but were rarely exercised. The FASB acknowledged that the new evaluation of kick-out rights and participating rights under Statement 167 is different than how they are currently treated in EITF Issues 96-16<sup>11</sup> and 04-5,<sup>12</sup> but decided that the inconsistency would be considered in a separate project to reconsider consolidation policy more broadly.

<sup>7</sup> Expected losses and expected residual returns refer to amounts derived from the entity's expected cash flows, discounted and otherwise adjusted for market factors and assumptions.

<sup>8</sup> For purposes of Statement 167, kick-out rights are the ability to remove the enterprise with the power to direct the activities of a VIE that most significantly impact the entity's economic performance.

<sup>9</sup> For purposes of Statement 167, participating rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a VIE that most significantly impact the entity's economic performance.

<sup>10</sup> The definitions of related parties and de facto agents are largely unchanged by Statement 167. These include the parties identified by Statement No. 57, *Related Party Disclosures*, and others specified in paragraph 16 of FIN 46(R), as amended.

<sup>11</sup> *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*

<sup>12</sup> *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*

► **BDO Insight:** In the partnership illustration above, the limited partners would now be deemed to lack power over the partnership's activities because no single limited partner could remove the general partner, meaning the partnership would be considered a VIE. Further, the general partner's unit would embody a controlling financial interest because it represents the ability to direct the partnership's most significant activities, as well as an obligation to absorb losses and a right to receive returns.<sup>13</sup> Consequently, the general partner would be the primary beneficiary and consolidate the partnership. This is a significant change from prior GAAP, in which the partnership was not considered a VIE, nor was it typically consolidated by the general partner under the voting interest model (generally, EITF 04-5) because the limited partners as a group could exercise kick-out rights.

Note that even if a single limited partner could exercise kick-out rights or participating rights, they must still be substantive to influence the consolidation analysis. In practice, companies should consider whether there are any significant barriers to the exercise of these rights, similar to the examples in EITF 04-5:

- Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
- Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant

disincentive for dissolution (liquidation) or removal

- The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
- The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
- The inability of the limited partners holding the rights to obtain the information necessary to exercise them. ◀

While there may be other factors relevant to a particular fact pattern, kick-out rights and participating rights should be currently exercisable, considering all of the potential barriers above, to be considered substantive under Statement 167. And, due to the inconsistent treatment of kick-out rights and participating rights between the voting interest model and the revised variable interest model, more entities will be considered VIEs under Statement 167 compared to prior GAAP.

Kick-out rights and participating rights differ from protective rights, which are designed to protect their interest holder without giving that party a controlling financial interest. Examples include approval or veto rights that do not affect a VIE's significant activities (e.g., a right that protects a lender by restricting an entity's ability to sell important assets), the ability to remove the enterprise that has a controlling financial interest in bankruptcy, or limitations on an entity's operat-

ing activities like provisions to protect a franchisor's brand. While protective rights do not influence the consolidation analysis, judgment may be required to differentiate protective rights from other types of rights, depending on the nature of the VIE and the terms of its governing documents.

In Statement 167, the FASB also affirmed that an entity's classification as a VIE can change over time. The FASB considered requiring an ongoing (i.e., daily) assessment of VIE status, but rejected that approach because it would have been too costly. Instead, all of the reconsideration events in FIN 46(R) were retained, and two more were added: i) changes that cause the equity holders to lose the power to direct an entity's significant activities, and ii) troubled debt restructurings under Statement 15.<sup>14</sup>

The FASB reasoned that an entity previously considered to be a voting interest entity could experience severe losses, causing shareholders to lose their voting power over the entity. This might enable a guarantor or lender to obtain control of the entity without triggering a reconsideration of its VIE status under prior GAAP. The FASB found such an outcome troubling, and as a result, added it to the list of reconsideration events to increase the scope of entities that may be subject to the variable interest consolidation model.

**Consolidation Based on Variable Interests** – This element of the variable interest model changed more than any other under Statement 167. Previously, companies were required to consolidate a VIE if they had a variable interest that would

<sup>13</sup> See "Consolidation Based on Variable Interests" below for further discussion of what constitutes a controlling financial interest under Statement 167.

<sup>14</sup> *Accounting by Debtors and Creditors for Troubled Debt Restructurings*

absorb the majority of the VIE's expected losses, receive a majority of its expected residual returns, or both. Expected losses and returns were calculated using sophisticated mathematical models that were often difficult to understand, apply and audit. In addition, the approaches and methods used by different companies to calculate variability were inconsistent, leading to different accounting conclusions for VIEs with similar characteristics. Lastly, quantitative and qualitative approaches often identified a different primary beneficiary for the same VIE.

To address these deficiencies, the FASB adopted a purely qualitative model for determining the primary beneficiary in Statement 167. That is, quantitative models are not permitted for this purpose, even as a fallback when the qualitative approach is considered highly judgmental in the circumstances. However, the standard did not change the approach for determining whether an entity has a sufficient amount of equity at risk, which is one of the criteria for determining whether it is a VIE in the first place. Therefore, a quantitative approach may still be necessary for that purpose.

Under Statement 167, a variable interest provides its holder with a controlling financial interest in a VIE if it represents both:

- The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance ("power"), and
- The obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from

the entity that could potentially be significant to the VIE ("economics").

The FASB articulated power in all-or-nothing terms, meaning a single party either does or does not have the ability to direct the activities that are most significant to the VIE. This encompasses situations in which a party does not currently exercise its power to direct the activities of an entity, but could choose to do so in the future—for example, directing the activities of a securitization vehicle if and when its assets become troubled. While it is possible different variable interest holders acting in good faith may place different weight on the relative importance of each activity, the FASB intended the revised primary beneficiary model to identify a single controlling financial interest holder, and therefore only one party should consolidate a VIE.

Statement 167 does not provide a list of factors or other criteria for determining which of a VIE's activities are significant. Instead, companies will have to use judgment to determine which activities most significantly impact an entity's performance. Because business activities will differ by the type of entity being analyzed, the FASB provided examples of applying the power and economics model in several different settings, including manufacturing and distribution, leasing arrangements and securitization vehicles.<sup>15</sup> This qualitative analysis includes a consideration of the purpose and design of the VIE as well as the risks and rewards that it was designed to create and pass through to its variable interest holders.

In addition, kick-out rights and participating rights do not affect a company's assessment of power, just as they are not relevant for determining whether an entity is a VIE, unless they can be exercised unilaterally by a single party (including its related parties and de facto agents).

With respect to economics, losses and benefits only need to be *potentially* significant to meet this characteristic of the primary beneficiary test. This differs from *expected* losses and residual returns that are used to define a VIE. Under this approach, companies may not look solely to what's probable for purposes of the economics test; they are required to make their determination on the basis of what is merely possible. Companies should also note that significance is measured with respect to the VIE, not with respect to the variable interest holder. As a result, Statement 167 establishes a very low threshold for determining whether a variable interest conveys a potentially significant level of losses or benefits.

The following example is reproduced from Statement 167 to illustrate the revised variable interest model for identifying a controlling financial interest:

<sup>15</sup> See Appendix C of Statement 167.

## Facts and Circumstances

An entity is created by a furniture manufacturer and a financial investor to manufacture and sell wood furniture to retail customers in a particular geographic region. The entity was created because the furniture manufacturer has no viable distribution channel in that particular geographic region. The entity is established with \$100 of equity, contributed by the furniture manufacturer, and \$3 million of 10-year fixed-rate debt, provided by a financial investor. The furniture manufacturer establishes the sales and marketing strategy of the entity, manages the day-to-day activities of the entity, and is responsible for preparing and implementing the annual budget for the entity. The entity has a distribution contract with a third party that does not represent a variable interest in the variable interest entity. Interest is paid to the fixed-rate debt holder (the financial investor) from operations before funds are available to the equity holder. The furniture manufacturer has guaranteed the fixed-rate debt to the financial investor. The debt agreement includes a clause such that if there is a materially adverse change that materially impairs the ability of the entity and the furniture manufacturer to pay the debt, then the financial investor can take possession of all the assets of the entity. An independent third party must objectively determine whether a materially adverse change has occurred on the basis of the terms of the debt agreement (an example of a materially adverse change under the debt agreement is the bankruptcy of the entity).

## Evaluation

### Purpose and Design of the Entity

An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- The primary purpose for which the entity was created was to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.
- The entity was marketed to the financial investor as a fixed-rate investment in a retail operating entity, supported by the furniture manufacturer's expertise and guarantee.
- The furniture manufacturer's guarantee of the debt effectively transfers all of the operating risk of the entity to the furniture manufacturer.

### Determination of the Primary Beneficiary

The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the variable interest entity.

An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the operations of the entity because the operating cash flows of the entity are used to repay the financial investor. Thus, the activities that most significantly impact the entity's economic performance are the operating activities of the entity. The furniture manufacturer has the ability to establish the sales and marketing strategy of the entity and manage the day-to-day activities of the entity.

The debt holder has the power to take possession of all of the assets of the entity if there is a materially adverse change under the debt agreement. However, the debt holder's rights under the materially adverse change clause represent protective rights. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. The debt holder's rights protect the interests of the debt holder; however, the entity's economic performance is most significantly impacted by the activities over which the furniture manufacturer has power. The debt holder's protective rights do not prevent the furniture manufacturer from having the power to direct the activities of the entity that most significantly impact the entity's economic performance.

If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits that could potentially be significant to the variable interest entity. The furniture manufacturer has the obligation to absorb losses that could potentially be significant through its equity interest and debt guarantee and the right to receive benefits that could potentially be significant through its equity interest.

On the basis of the specific facts and circumstances presented above and the analysis performed, the furniture manufacturer would be the primary beneficiary of the variable interest entity because:

- It is the variable interest holder with the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.
- Through its equity interest and debt guarantee, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Lastly, the FASB decided to require an ongoing assessment of primary beneficiary status. In the past, variable interest holders reconsidered whether they were the primary beneficiary only when certain triggering events occurred. Statement 167 eliminated this element of the variable interest model to align it with the voting interest approach. Now variable interest holders must monitor changing circumstances that influence whether the holder has either obtained or lost a controlling financial interest in the VIE, such as amendments to its governing documents or the issuance of new debt and equity securities. Decisions to consolidate or deconsolidate an entity should be reflected in the financial statements on the date circumstances change, and prior periods are not recast to conform to the current presentation.

**Shared Power** exists when a company determines that power is, in fact, shared among unrelated parties such that no individual has the power to direct the VIE's most significant activities. In that case, no one meets the definition of a primary beneficiary and the VIE isn't consolidated. Shared power is present when unrelated parties require mutual consent for decisions about the VIE's most significant activities. An entity's governing documents will usually indicate whether a mutual consent requirement exists.

► **BDO Insight:** Conclusions about shared power should also consider whether the written requirement has substance. For example, regardless of the agreement in place, does history indicate one party acts unilaterally? If not, what sort of consequences would stem from individual action in the future? This line of questioning may be particularly relevant to previously non-consolidated joint ventures that are VIEs during the implementation of Statement 167. ◀

If power over a VIE is not shared, consolidation is required by one party. When an entity's significant activities are directed by multiple unrelated parties and the nature of the activities that each party directs is not the same (for example, manufacturing, distribution and retailing), then the party who can direct the subset of activities that most significantly impact the entity's economic performance is deemed to have power.

If power is not shared but the entity's significant activities are directed by multiple unrelated parties and the nature of the activities that each party directs is the same, then the party with power over the majority of those activities is the primary beneficiary. This might be true for a securitization vehicle in which multiple parties service the loans that it holds, but one party services a majority of the loans.

If, after considering all available information, a variable interest

holder does not consolidate the VIE, other GAAP applies. For instance, an investor in a true joint venture would likely apply the equity method of accounting.<sup>16</sup> But in those circumstances, Statement 167 still requires certain disclosures about variable interests that are not held by the primary beneficiary.<sup>17</sup>

**Related Parties** – Statement 167 changed the role of related parties (including de facto agents<sup>18</sup>) in the consolidation analysis. Previously, a company was required to consider whether its variable interest, when combined with the variable interests of its related parties, would identify the company as the primary beneficiary. If so, the individual within the related party group that was judged to be the most closely associated with the VIE consolidated. This was known as the related party “tie-breaker” test and judgment was required to determine the “winner” based on any principal-agency relationships that exist between the parties, the relationship and significance of the VIE's activities to the various parties, exposure to variability and the entity's original design.

Under the revised approach, each individual within the related party group is now required to first apply the “power and economics” test described above. The related party tie-breaker test only applies if no individual has both power and economics, but the group as a

<sup>16</sup> Statement 167 provides an illustration in which a VIE does not have a primary beneficiary due to the presence of shared power. See example 8 in Appendix C.

<sup>17</sup> See paragraphs 22B – 22E of FIN 46(R), as amended.

<sup>18</sup> Paragraph 16 of FIN 46(R), as amended, defines de facto agents of an enterprise as: (a) A party that cannot finance its operations without subordinated financial support from the enterprise, for example, another variable interest entity of which the enterprise is the primary beneficiary (b) A party that received its interests as a contribution or a loan from the enterprise (c) An officer, employee, or member of the governing board of the enterprise (d) A party that has an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the enterprise. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the enterprise and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties. (e) A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

whole does. Because power and economics must be assessed before the related party tie-breaker can be applied, consolidation conclusions based on which related party is most closely associated with the VIE should be less frequent than prior to Statement 167.

### **Presentation and Disclosure** –

Generally, a primary beneficiary's consolidated financial statements are presented on the same basis as traditional voting entities. The assets, liabilities and noncontrolling interests of a VIE are treated the same as if they were consolidated based on holding a voting interest greater than 50%. Nevertheless, companies are required to present the assets and liabilities of consolidated VIEs separately if certain restrictions exist.<sup>19</sup> A VIE's assets must be separated if they can only be used to settle its own obligations, as opposed to obligations of the consolidated group. Similarly, liabilities have to be separated if the related creditors do not have recourse to the general credit of the primary beneficiary.

► **BDO Insight:** These circumstances are most prevalent in securitization vehicles, but the separate presentation requirements are not limited to entities in the financial services area. For example, in the manufacturing example above, assume the financial investor imposed a covenant restriction on the VIE's assets, such that assets cannot be distributed to any other lender, equity investor or affiliate until the 10-year fixed-rate debt is repaid. In that case, the VIE's assets would be separately presented in the manufacturer's consolidated

**financial statements until the restriction is satisfied.** ◀

In addition, if a company consolidates more than one VIE, the assets and liabilities of multiple VIEs can be aggregated on the balance sheet. In those circumstances, companies are encouraged to provide clear footnote disclosures explaining the criteria for aggregating entities with different risk exposures.

Statement 167 also requires additional disclosures that are designed to illustrate a company's involvement with VIEs and any significant changes in risk exposure due to that involvement. This includes describing any significant judgments and assumptions made in the consolidation analysis. The disclosures are mostly consistent with those required under FSP FAS 140-4 and FIN 46(R)-8, which was issued in December 2008 and is superseded by Statement 167.

**Transition** – Statement 167 is effective as of the beginning of the first fiscal year beginning after November 15, 2009 and for interim periods in those years. Voluntary adoption prior to that date is not allowed, although the new standard does provide a choice between prospective and retrospective adoption.

If a company consolidates an entity as a result of the initial application of the standard, it should measure and recognize the assets, liabilities, and noncontrolling interests of the newly-consolidated VIE at their carrying amounts as if Statement 167 had been applied from the time the enterprise first met the conditions to be a primary

beneficiary. While retrospective application isn't required upon adoption of Statement 167, companies who choose retrospective application and companies who don't will generally apply the same procedures with respect to prior periods to determine the proper carrying amounts to record.

Any difference between the net amounts recognized in the balance sheet and any previously recognized interest in the newly consolidated entity would be recognized as a cumulative effect adjustment to retained earnings. If it is not practicable to determine the carrying amounts of the assets, liabilities, and noncontrolling interests of newly-consolidated VIEs, companies are permitted to use fair value at date of adoption. Further, for VIEs that engage principally in securitizations or other forms of asset-backed financing, if certain conditions are met the standard permits a company to measure the assets and liabilities at their unpaid principal balances as an alternative to fair value.

► **BDO Insight:** Statement 167 does not define the term "practicable." As a result, companies will need to determine what level of effort is required to reach this threshold, and apply it consistently as an accounting policy election. Some companies may wish to consider the factors in Statement 154<sup>20</sup> for this purpose, but are not required to do so:

- After making every reasonable effort to do so, the entity is unable to apply the requirement.
- Retrospective application requires assumptions about management's

<sup>19</sup> While consolidated subsidiaries that are not VIEs may be subject to similar restrictions, the separate presentation requirement in Statement 167 is unique to VIEs.

<sup>20</sup> *Accounting Changes and Error Corrections* – a replacement of APB Opinion No. 20 and FASB Statement No. 3

intent in a prior period that cannot be independently substantiated.

- Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that:
  - Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and
  - Would have been available when the financial statements for that prior period were issued. ◀

If initial application results in deconsolidation of a VIE, a company should measure any retained interest in the deconsolidated subsidiary at its carrying value at the date of adoption. Any difference between the net amounts removed from the balance sheet and the amount of any retained interest in the newly deconsolidated entity should be recognized as a cumulative effect adjustment to retained earnings.

If a company consolidates an entity as a result of the initial application of the standard, it may choose to apply fair value under Statement 159.<sup>21</sup> This option must be elected on an entity by entity basis and must be applied to all eligible financial assets and financial liabilities of that entity. A company must disclose its rationale for electing the option and the impact it has on the cumulative effect adjustment.

Finally, Statement 167 permits, but does not require, a company to retrospectively apply the new guidance for one or more years with

a cumulative effect adjustment to retained earnings of the first year restated. In any event, companies should disclose their chosen transition method.

### SEC Reporting Implications

Statement 167 may require an SEC registrant to consolidate or deconsolidate an entity. It may require this either (a) as a result of the change in accounting that occurs when an entity adopts Statement 167 or (b) due to events or changes in circumstances that occur after an entity has adopted Statement 167. Some of the SEC reporting implications of these events are discussed below.

#### Internal Control Reporting

Entities consolidated under Statement 167 should be included in a company's assessment of its internal controls. Question 1 of the SEC staff's *Frequently Asked Questions related to Management's Report on Internal Control over Financial Reporting*<sup>22</sup> addressed the internal control reporting requirements when a registrant consolidated an entity as a result of adopting FIN 46. It states that the SEC staff "would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation."

*Upon Adoption* – In FAQ 1 referred to above, the SEC staff provided conditional relief from evaluating the internal controls of certain consolidated VIEs that existed prior to December 15, 2003. The relief was available for situations "where the

registrant does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment...." Since under Statement 167 VIEs will be consolidated by entities with the power to direct the activities of the VIE that most significantly affect its economic performance, it appears there will be few situations where the FAQ's conditions for relief will apply. Therefore in most cases, an evaluation of the consolidated VIE's internal controls will be required if the results of the VIE are significant to the company.

*After Adoption* – Question 3 of the FAQs noted above addresses a situation where a registrant acquires a business during a year but it is not possible to conduct an assessment of an acquired business' internal controls during the period between the consummation date and year end. The SEC staff allows a registrant to exclude a business from the scope of its internal control assessment in this situation. Accordingly, an SEC registrant may exclude a VIE that is newly consolidated due to events or changes in circumstances from the scope of its internal control assessment in the year consolidation occurs if an assessment is not possible.

#### Rule 3-05 and Article 11 of Regulation S-X and Form 8-K

*Upon Adoption* – In the past, the adoption of a new accounting standard (e.g., FIN 46 and FIN(R)) that resulted in a registrant consolidating an entity that is a business for the first time has not been considered the type of extraordinary cor-

<sup>21</sup> *The Fair Value Option for Financial Assets and Financial Liabilities*

<sup>22</sup> See [www.sec.gov/info/accountants/controlfaq.htm](http://www.sec.gov/info/accountants/controlfaq.htm)

porate event that triggers the need for acquired business financial statements under Rule 3-05 of Regulation S-X and Item 9.01(a) of Form 8-K. The adoption of Statement 167 also should not trigger the need for historical financial statements of newly-consolidated VIEs that are businesses. The SEC staff has not provided guidance on whether the consolidation or deconsolidation of a VIE resulting from adopting a new accounting standard is a reportable event under Item 2.01 of Form 8-K. The staff has, however, informally indicated that pro forma information may be appropriate. If adopting Statement 167 requires a registrant to consolidate or deconsolidate a VIE, the effect is material, and the registrant is not adopting Statement 167 retrospectively, it may wish to consider providing pro forma information.

*After Adoption* – In contrast, when events or changes in circumstances require a registrant to consolidate or deconsolidate a VIE, this is an event that may require reporting pursuant to Rule 3-05 and Article 11 of Regulation S-X and/or Items 2.01 and 9.01 of Form 8-K, even if a registrant did not issue or receive any consideration. Under these rules, the need to report and nature of the reporting required depend on whether the VIE is a business (under Rule 11-01(d) of Regulation S-X) or a collection of assets, whether it is consolidated or deconsolidated, and its signifi-

cance (under Rule 1-02(w) of Regulation S-X). These rules could require a description of the event, audited pre-consolidation financial statements of a newly consolidated VIE (if the VIE is a significant business), and/or pro forma information.

### **The Impact of Retrospective Adoption on Incorporating Financial Statements by Reference in Registration Statements**

As noted above, companies have the option to adopt Statement 167 retrospectively or prospectively. Companies will need to consider the consequences of the method they choose as they evaluate the financial statement requirements of registration statements that are filed or become effective (or are post-effectively amended) after their first Form 10-Q is filed that reflects the adoption of Statement 167.

This could be important because if the effect of adopting Statement 167 is material and a registrant has (a) retrospectively adopted Statement 167 and (b) filed interim financial statements for a period that includes the date of adoption, the SEC staff will expect the registrant to revise its prior period annual financial statements, selected financial data and management's discussion and analysis before incorporating them by reference or presenting them in a new registration statement (other than one filed on Form S-8).<sup>23,24</sup>

Conversely, if a registrant elects to adopt Statement 167 only on a prospective basis, or if the retrospective application of Statement 167 is not material, its registration statement may incorporate by reference its most recent Form 10-K (assuming the prior financial statements don't require revision for other purposes). This would include its historical annual financial statements for periods prior to the adoption of Statement 167.

### **Practical Steps**

The implementation of any new major accounting standard can require a significant amount of resources. With respect to Statement 167, affected companies should start their efforts soon if they haven't already done so to avoid a financial reporting crunch in 2010 (including the impact on loan covenants), particularly with first quarter 10-Qs. The following suggestions should help in that regard:

- Identify involvement with and investments in other entities – Companies should begin by taking an inventory of their investments in and arrangements with other entities. Remember, this list should include written and unwritten contracts, oral agreements and reputational considerations to capture explicit as well as implicit variable interests (recall the leasing example above).

<sup>23</sup> We understand that a registrant usually does not need to file revised annual financial statements in order to file a new registration statement on Form S-8. The instructions to Form S-8 require a registrant to disclose material changes in a filing that is incorporated by reference in the Form S-8. The manner in which material changes may be disclosed is a matter of judgment. In that regard, even though a change would require revising the annual financial statements if the offering was registered using a different registration statement form, it is usually possible to adequately disclose the change in a Form S-8 without revising the financial statements.

<sup>24</sup> We understand that a registrant usually does not need to file revised annual financial statements in order to conduct or continue an offering using an already effective registration statement. We understand that a registrant may continue to offer securities pursuant to an effective registration statement unless the revision to the financial statements would constitute a fundamental change. Determining whether a change is so significant that it constitutes a fundamental change is a legal question. In practice, fundamental changes are rare. However, an underwriter might request an issuer to voluntarily file revised financial statements or present them in a prospectus supplement.

- Determine whether such involvement and investments are variable interests – If these investments and arrangements do not meet the definition of a variable interest, no further consideration is required under Statement 167. For instance, an operating lease without purchase options and guarantees of an asset's residual value may not represent a variable interest in the lessor.
  - Determine whether entities are VIEs – If an entity has all of the required characteristics of a voting interest entity—for instance, a sufficient amount of equity exists, power and economics rest with the equity holders and so on—then other GAAP applies.
  - Start the analysis early – Because of the judgment required to apply the new standard, companies will need plenty of time to identify, document and consider all of the relevant facts and reach an appropriate conclusion, which may involve senior management, the audit committee and the independent auditor.
  - Don't forget disclosures for variable interests in VIEs that are not consolidated – This is a common oversight when another variable interest holder is the primary beneficiary. Given recent financial institution failures during the course of Statement 167's development, its disclosure requirements are designed to provide financial statement users with an insight into a company's risk exposures, even those that are considered remote.
  - Determine informational needs for VIEs to be consolidated – If a VIE is consolidated for the first time, the primary beneficiary will need access to the VIE's financial statements and supporting data. Practical challenges may exist in gaining access to the appropriate information and require time and effort to resolve.
  - Consider system updates and period-end close procedures – The primary beneficiary's information system may need to be modified to capture and interface with the VIE's accounting system.
  - Establish monitoring controls – Changing facts and circumstances may impact whether an entity is a VIE, and if so, who its primary beneficiary is. Therefore, companies will need to establish mechanisms alerting management to these events so they can be considered on a timely basis.
- ### On the Horizon
- The FASB developed Statement 167 as a response to the credit crisis. The IASB currently has a separate project to revise its consolidation model for all entities, both voting

and variable. Many observers believe the FASB will simply expose the IASB's final standard in the US at a later date, which if adopted would converge the two bodies of GAAP. Therefore, companies should expect more changes to consolidation policy in the not too distant future.

### For More Information

If you would like further information or to discuss the implications of the matters discussed in this *Financial Reporting* letter, please contact the BDO Seidman engagement partner serving you or one of the following partners:

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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

## Appendix A: Summary of FIN 46(R), as amended by Statement 167

### Step 1 – Does the variable interest model apply?

The variable interest model applies if the answer to all three questions is “yes.”

- Is the entity a legal entity? (par 3)
- Is the entity or reporting enterprise within the scope of FIN 46R? (par 4)
- Does the reporting enterprise have a variable interest in the entity? (par 2)

### Step 2 – Is the entity a VIE?

The entity is a VIE if the answer to any of the questions is “yes.”

- Is the total equity at risk insufficient to finance the entity’s activities without additional subordinated financial support? (par 5a)
- Do the equity holders, as a group, lack characteristics of a controlling financial interest? (par 5b)
- Do the equity holders have disproportionate voting rights when compared with their obligations to absorb expected losses? If so, do substantially all of the entity’s activities either involve or are conducted on behalf of the investor with disproportionately few voting rights? (par 5c)

### Step 3 – Who is the primary beneficiary?

- Identify all other parties that hold variable interests in the VIE. (par 14)
- Determine if any variable interest holder has a controlling financial interest based on both:
  - the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance (par 14A(a))
  - the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE (par 14A(b))
- Determine whether power is shared among the variable interest holders. (par 14D)
- If variable interest holders are related parties, does any individual in the related party group have the characteristics of a controlling financial interest? (par 17)
- If no individual related party has a controlling financial interest, but the group as a whole does, then determine which related party is most closely associated with the VIE. (par 17)

### Step 4 – Consolidation, Presentation and Disclosure

- Determine the initial measurement and accounting for consolidation of the VIE. (par 18-21)
- Ensure appropriate accounting after initial measurement. (par 22)
- Present restricted assets and liabilities separately on the balance sheet. (par 22A)
- Comply with disclosure requirements. (par 22B-26)

### Step 5 – Reassessments

- Evaluate whether specified events have occurred that could change the status of the VIE. (par 7)
- Evaluate whether changing circumstances affect the status of the VIE’s primary beneficiary. (par A25)

## Appendix B: Key Changes Statement 167 makes to FIN 46(R)

Topic	FIN 46(R)	Statement 167
<b>Substance vs. Form</b>	No explicit guidance.	Only substantive terms and arrangements are considered. This avoids form-driven conclusions that frustrate the objectives of the variable interest model.
<b>Primary Beneficiary</b>	Identified as the party that absorbs a majority of the VIE's expected losses and/or returns, often measured with mathematical models.	Identified as the party with power to direct a VIE's significant activities and an obligation to absorb losses or a right to receive benefits that could be significant. Mathematical models are not used.
<b>Kick-out Rights and Participating Rights</b>	Considered in the VIE determination as to whether the holders of equity at risk are able to direct an entity's activities.	Ignored unless they can be exercised by a single party, including its related parties and de facto agents.
<b>Reconsideration Events</b>	An entity's VIE status and the primary beneficiary were only reassessed based on certain triggering events.	An entity's VIE's status is reassessed based on revised triggering events. The primary beneficiary assessment is ongoing.
<b>Shared Power</b>	No explicit guidance. Variable interest holders did not consolidate VIEs if expected losses and returns were widely dispersed.	Variable interest holders do not consolidate a VIE when power is shared because no single party has the characteristics of a primary beneficiary.
<b>Related Parties</b>	If a variable interest holder and its related parties as a group had the characteristics of a primary beneficiary, then the individual in the group most closely associated with the VIE consolidated.	Variable interest holder and its related parties must individually determine whether they have the characteristics of a primary beneficiary. If none do, but the group does, then the party who is most closely associated with the VIE is the primary beneficiary.
<b>Scope exception for qualifying special purpose entities (QSPEs)</b>	No consolidation analysis was required.	The scope exception was removed and all QSPEs must be evaluated for consolidation.