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FASB Statement 167: Consolidation of Variable Interest Entities

Best Practices for Consolidation Determinations and Disclosures Under the New Model

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Tuesday, January 12, 2010

The conference begins at:

1 pm Eastern

12 pm Central

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**FASB Statement 167: Consolidation of
Variable-Interest Entities Teleconference**

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Today's Program

- Changes From FAS 167 For Consolidation Rules For VIEs, slides 3 through 40 (*David Augustyn, David Allison*)
- Legal Analysis of Transaction Structures; FAS 166 Considerations, slides 41 through 49 (*Dave Ciancuillo, Brad Keck*)
- New Disclosures Required In Financial Statements, slides 50 through 59 (*David Allison, David Augustyn*)
- Implementation Considerations, slides 60 through 63 (*David Augustyn*)

Changes From FAS 167 For Consolidation Rules For VIEs

Overview Of FIN 46(R)

FIN46 was amended in 2003

- Identifies entities that are variable interest entities (VIEs)
- Provides a consolidation model for VIEs
- Requires disclosures

FAS 167 Deferral For Investment Companies

- The effective date of FAS 167 will be deferred for certain funds until the joint IASB/FASB consolidations project is completed in late 2010. The deferral applies to all reporting entities and potential VIEs that meet all of the following conditions:
 - The entity has all of the attributes specified in the scope of the AICPA Investment Companies Guide or, if one or more of the attributes specified are not present, it is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in the Investment Companies Guide
 - The reporting entity does not have an obligation to fund losses of the entity that could potentially be significant to the entity. This condition should be evaluated considering any implicit or explicit guarantees by the reporting entity
 - The reporting entity does not have an interest in the entity that absorbs a disproportionate share of the entity's actual losses to other investors

FAS 167 Deferral For Investment Companies (Cont.)

- Examples of entities that may meet the deferral criteria include, but are not limited to, mutual funds, hedge funds, private equity funds and venture capital funds
- Examples of entities that do not meet the deferral criteria include, but are not limited to, securitization entities, asset-backed financing entities, and entities formerly classified as qualifying special purpose entities
- The effective date of FAS 167 will also be deferred for money market mutual funds that are required to comply with or operate within the requirements of Rule 2a-7 of the 1940 Investment Company Act until the joint IASB/FASB consolidations project is completed (late 2010)

Statement 167, Amendment To FIN46(R)

- Effective for annual reporting periods beginning after Nov. 15, 2009, including interim periods (effective for calendar-year companies beginning in 2010)
- Applies to all new and existing entities
- Significantly changes prior guidance
 - Many entities consolidated for the first time
 - Some entities to be deconsolidated
- Can significantly affect:
 - Financial statements, footnotes, and MD&A
 - Financial ratios
 - Loan covenants
 - Regulatory capital
- May result in changes in financial statement processes and procedures

What Is A Variable Interest Entity, Per FIN46(R)?

- Entities with controlling financial interests that are not controllable through voting interests, or in which the equity investors do not bear the residual economic risks
 - Entities with one or more of the following characteristics:
 - Lack sufficient equity investment to operate without additional subordinated financial support
 - Equity holders lack characteristics of a controlling financial interest
 - Equity holders don't:
 - Have decision-making abilities
 - Absorb expected losses and receive residual returns
 - Derived from expected cash flows (Concepts Statement 7), discounted and adjusted for market factors and assumptions
 - Substantially all entity activities involve, or are conducted on behalf of, an investor with disproportionately fewer votes than economics (the “anti-abuse clause”)
- ⇒ Amendment results in changes to which entities are VIEs

Which Entities Are VIEs?

Scope Change Per Amendment

- The amendments to FIN46(R) changed the provisions regarding decision-making and whether the equity holders have the characteristics of a controlling financial interest
- Criteria amended
 - As a group, the holders of the equity investment at risk lack:
 - The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance. The investors do not have that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership)
 - Kick-out or participating rights are not considered unless a single enterprise has the unilateral ability to exercise them, and they are substantive

VIE Determination Example

- LP is funded with \$100 contribution by unrelated LPs. GP does not contribute any equity (i.e., non-equity holder decision-maker). GP receives a promote or incentive fee. LPs can kick out the GP by a majority vote
- Under FIN 46(R), the entity is a voting interest entity, since LPs have substantive kick-out rights (assuming all other criteria for kick-out rights to be substantive are met)
- Under Statement 167, the entity is a VIE, since kick-out rights are not substantive
 - Kick-out rights are not held by a single LP and are not unilaterally exercisable

Consolidation Model, Per FIN 46(R)

- Entity absorbing the majority of the VIE's variability consolidates
 - Arises from variable interests
 - Expected loss and residual returns, as defined
 - Quantitative analysis
- Amendment affects:
 - When a decision-maker/service provider has a variable interest
 - Variability analysis \Rightarrow power evaluation
 - Quantitative \Rightarrow qualitative analysis

What Is A Variable Interest (VI)?

- Contractual, ownership or other pecuniary interests that change with changes in VIE net assets
 - Interests that:
 - Absorb VIE variability are variable interests
 - Create VIE variability are not variable interests
 - Specific criteria related to decision-maker/service provider fees
- ⇒ If no VI, then no consolidation

Variable Interests – Decision-Maker/Service Provider Fees (Per Amendment)

- Fees paid to an entity's decision-maker(s) or service provider(s) are not variable interests if all of the following conditions are met:
 - 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 activities (e.g., trade payables)
 - The decision-maker or service provider and its related parties do not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses/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 entity's anticipated economic performance
 - The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's economic performance

Variable Interests – Decision-Maker/Service Provider Fees, Example

- Investment managers (e.g., mutual fund managers):
 - Have decision-making ability over the financial assets in the entities that they manage
 - Typically do not hold an ownership interest or other interests outside of their management contract
 - Receive a small fee that is calculated as a percentage of the fair value of the assets that they manage (e.g., 75 basis points)
- Investment managers likely will conclude that their management contract satisfies the fee criteria and does not constitute a variable interest in the entities that they manage
- Alternatively, GP in partnership arrangements may receive a “carried interest” that allow the GP to participate significantly in the profits of the partnership (e.g., 20%)
- In these situations, GPs likely will conclude that their management arrangement does provide them with a variable interest because of the fee structure

Determining The Primary Beneficiary

- Modifies approach to require qualitative, not quantitative, analysis
- Entities must determine which party has a controlling financial interest in a VIE
- An entity has a controlling financial interest in a VIE if it has both of the following:
 - The power to direct the activities of a VIE that most significantly affect the entity's economic performance; and
 - The right to receive benefits or obligation to absorb losses of the VIE that could potentially be significant to the VIE

Determining The Primary Beneficiary (Cont.)

- Consider VIE purpose and design
- An expected loss calculation is not the sole determinant as to whether an entity has benefits or obligations that can potentially be significant
- Consider changes to the concept of economic power

Determining The Primary Beneficiary (Cont.)

- Shared power
 - If it is determined that power is shared such that no one party has the power to direct the activities of a variable interest entity that most significantly affect the entity's economic performance, then no party is the primary beneficiary
- If power is not shared, but the activities that most significantly affect the VIE's economic performance are performed by multiple parties performing the same activities, the party (if any) with the power over the majority of the activities is considered to meet the first criteria in the controlling financial interest assessment

Economic Power

- VIE criteria – what the amendment has not changed
 - The obligation to absorb the expected losses of the entity, OR
 - The right to receive the expected residual returns of the entity

Economic Power (Cont.)

- VIE criteria – what the amendment has changed
 - The concept of economic power or a controlling financial interest model
 - Previously, the concept was based on the “ability to make decisions”

Economic Power (Cont.)

- Economic power, as defined
 - “The **power to direct** the activities of an entity that **most significantly** impact the entity’s economic performance”
- Qualitative assessment
 - Quantitative risks-and-rewards calculation in Paragraph 8 is not required (expected losses/expected residual returns)

Economic Power (Cont.)

- Determining economic power
 - Identify which activities most significantly affect the entity's economic performance
 - Determine who has power over those activities
 - An entity does not need to exercise its power in order to have the power to direct the activities
 - Power that can only be exercised upon the occurrence of contingent events may be relevant

Economic Power (Cont.)

- Kick-out and participating rights
 - Economic power is unaffected by these unless such rights are held by a single equity holder that has the unilateral ability to exercise such rights
 - The party holding such rights may be the party with economic power

Economic Power (Cont.)

- Protective rights
 - Such rights held by other parties do not preclude an entity from having economic power
 - Designed to protect the interests of the party holding such rights without giving that party economic power

Economic Power (Cont.)

- Decision-makers and service providers
 - Fees paid are not variable interests if the following conditions are met:
 - Fees are compensation for services provided and are commensurate with the level of effort required to provide those services
 - Fees are at the same level of seniority as other operating liabilities
 - The decision-maker or service provider and its related parties do not hold other interests in the VIE

Economic Power (Cont.)

- Fees paid are not variable interests if the following conditions are met:
 - Terms and conditions of the arrangement are customarily present in arrangements for similar services negotiated at arm's length
 - Total anticipated fees are insignificant relative to the anticipated economic performance of the VIE
 - Total anticipated fees are expected to absorb an insignificant amount of variability of the VIE

Economic Power (Cont.)

- Shared economic power
 - Multiple unrelated parties: Scenario #1
 - The power to direct the activities of an entity that most significantly affect the entity's economic performance **is shared** by multiple unrelated parties
 - **All** decisions about those activities **require the consent** of each of the parties sharing power

No primary beneficiary exists

Economic Power (Cont.)

- Shared economic power
 - Multiple unrelated parties: Scenario #2
 - **Power is not shared**, but activities that most significantly affect the entity's economic performance are directed by multiple unrelated parties
 - The nature of the activities that each party is directing **is the same**

Economic Power (Cont.)

- Shared economic power
 - Multiple unrelated parties: Scenario #2
 - Party A individually has the power over a majority of those activities

Party A is the primary beneficiary

Economic Power (Cont.)

- Shared economic power
 - Multiple unrelated parties: Scenario #3
 - Same facts as Scenario #2
 - No party individually has the power over a majority of those activities

No primary beneficiary exists

Economic Power (Cont.)

- Shared economic power
 - Multiple unrelated parties: Scenario #4
 - Activities affecting the entity's economic performance are directed by multiple unrelated parties, but the nature of the activities that each party is directing **is not the same**
 - Party A has the power to direct the activities that **most significantly** affect the entity's economic performance

Party A is the primary beneficiary

Economic Power (Cont.)

- Shared economic power
 - Related parties: Scenario #1
 - **One party** in a related party group (Related Party A) has the power to direct the activities of an entity that most significantly affect the entity's economic performance

Related Party A is the primary beneficiary

Economic Power (Cont.)

- Shared economic power
 - Related parties: Scenario #2
 - **No single party** in a related party group individually has economic power
 - **As a group**, the related parties collectively have economic power
 - Identify the enterprise (Related Party A) in the related party group that is most closely associated with the VIE

Related Party A is the primary beneficiary

Economic Power (Cont.)

- Design of an entity
 - Significant involvement does not, in isolation, establish economic power
 - However, may indicate the opportunity and incentive to establish arrangements that result in economic power

Economic Power (Cont.)

- Revisit the economic component
 - Obligation to absorb losses or the right to receive benefits is disproportionately greater than stated power to direct the activities
 - Not intended to be determinative, but may be indicative of the amount of power held
 - Quantitative analysis of risk/rewards is not required

Primary Beneficiary Determination – Kick-Out/Participating Rights

- Kick-out and participating rights are only considered if a single enterprise (including its related parties and *de facto* agents) has the unilateral ability to exercise such rights
- Participating rights are the ability to block the actions of the enterprise with the power to direct the activities of a VIE that most significantly affect the entity's economic performance
- Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a VIE that most significantly affect the entity's economic performance

Primary Beneficiary Determination – Kick-Out Rights Example

- LP is funded with \$100 contribution by unrelated LPs. GP does not contribute any equity (i.e., non-equity holder decision maker). GP receives a promote or incentive fee. LPs can kick out the GP by a majority vote
- Under Statement 167, the entity is a VIE, since decision-making does not reside with equity holders (kick-out right is not substantive)
- GP likely to have both power and benefits and hence consolidate
 - GP may have a variable interest (VI) due to fee structure
 - GP may have power; kick-out rights are not held by a single LP and are not unilaterally exercisable
 - GP may have benefit through VI

Reconsideration Events

- Reconsideration of the initial determination of whether an entity is a VIE
 - Based on the occurrence of a **triggering event**
 - Original events triggering reconsideration under FIN 46R are unchanged by the Amendment
 - Fifth reconsideration event added
 - Changes in facts and circumstances occur such that economic power over the VIE is lost

Reconsideration Events (Cont.)

- Reconsideration of the initial determination of whether an entity is a VIE
 - Exemption previously provided for troubled debt restructurings has been rescinded
 - Rescission of this provision may have a significant impact on banks and other lenders
 - May become the primary beneficiary
 - May become subject to the disclosure requirements

Reconsideration Events (Cont.)

- Primary beneficiary reconsideration assessment
 - Must be considered on a **continual basis**
 - An enterprise shall consolidate a VIE:
 - **When** an enterprise has a VIE that
 - Provides the enterprise with a controlling financial interest

Key change: ‘If’ to ‘when’ requires consolidation during a reporting period

Reconsideration Events (Cont.)

- Primary beneficiary reconsideration assessment
 - If required to deconsolidate a VIE, an enterprise shall follow the guidance in FASB Statement No. 160
 - Deconsolidate as of the date the primary beneficiary ceases to have economic power

Key change: Requires deconsolidation during a reporting period

Legal Analysis Of Transaction Structures; FAS 166 Considerations

Legal Analysis Of Transaction Structures; FAS 166 Considerations

- No more qualifying special purpose entities (QSPEs) under Statements 166 or 167
- Amendments to FAS 140 and FIN 46(R) are effective concurrently, in each case, for fiscal years beginning after Nov. 15, 2009
- Sales of undivided interests are no longer permitted under FAS 166 unless they are all pro rata, pari passu and receive collections at the same time as other parties

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- Legal structure for “off-balance sheet” transactions
 - Transfer that qualifies for sale treatment under paragraph 9 of 166 (three-part test)
 - Transfer to an entity that is not consolidated with the transferor (elimination of QSPEs)

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- Sale treatment – Must satisfy the three-part test of paragraph 9 of FAS 166 (isolation, free assignability and no “effective control”)

Three-part test - Transfer of entire financial assets, or a “participating interest” in entire financial assets in which control has been surrendered by the transferor, will be accounted for as a sale if all the following conditions are satisfied:

- a. Legal isolation analysis - The transferred assets have been isolated from the transferor and its creditors, i.e. put beyond the reach of the bankruptcy trustee for the transferor and its consolidated affiliates. Each entity involved is subject to consolidated analysis under FAS 167

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- For purposes of 9(a) isolation:
 - Must sell individual asset in its entirety (or group of individual assets) or “participating interest” in individual asset
 - “Participating interest” – Primarily designed to permit pari passu, pro rata pay participations that are like bank participations
 - No subordination of transferor interest or recourse to transferor or consolidated affiliates, other than for customary breaches
 - Customary sale of an undivided interest transaction will not achieve sale treatment

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- b. Each third-party transferor has the right to pledge or exchange the assets (or its beneficial interests), and no condition both constrains the transferee from taking advantage of such right to pledge or exchange and provides more than or trivial benefit to the transferor
 - If the transferee is an entity formed for the sole purpose of securitization, then this trust is applied to the beneficial interest holder and its interest
 - The ability of the buyer to pledge or exchange shows surrender of control by transferor under (9b)

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- c. The transferor does not maintain “effective control” over the transferred financial assets, for example (9c) the following are not permitted:
 - An agreement that both entitles and obligates transferor to repurchase assets
 - An agreement that entitles the transferor to return of a specific asset and provides some benefit for transferor (other than clean-up call)
 - An agreement that obligates the transferor to repurchase assets at option of transferee, at price so favorable that option exercise is probable

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- Transfer is to an entity that is not a consolidated an affiliate of the transferor
 - No more qualifying special purpose entities (QSPEs) under FAS 166 or 167
 - All former QSPEs are subject to consolidation

Legal Analysis Of Transaction Structures; FAS 166 Considerations (Cont.)

- Future of off-balance sheet treatment
 - Industry groups working together
 - Structures require review on a transaction-by-transaction basis
 - Accountants and law firms review VIE matters under a variety of possible legal structures

New Disclosures Required In Financial Statements

Disclosure Requirements

- FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*
 - Effective for the first reporting period ending after Dec. 15, 2008
 - Disclosure requirements retained by the amendment, with some changes
 - Qualified special purpose entities
 - Aggregation principle – materiality reference removed
 - Significant variable interest – concept removed
 - Scope of the disclosures has been expanded to include non-public enterprises

Disclosure Requirements (Cont.)

- Methodology for determining whether an entity is a VIE
 - Significant judgments and assumptions surrounding the following
 - Insufficient equity investment at risk
 - Equity holders lack economic power, obligation to absorb losses, or right to receive residual returns
 - Disproportionate voting rights
 - Occurrence of a reconsideration event

Disclosure Requirements (Cont.)

- Methodology for determining whether an enterprise must consolidate a VIE
 - Significant judgments and assumptions used to determine a controlling financial interest exists
 - Characteristics of the entity
 - Involvement of related parties and *de facto* agents
 - Purpose and design of the entity, including an assessment of the risk that the entity was designed as a pass-through to variable interest holders

Disclosure Requirements (Cont.)

- Methodology for determining whether an enterprise must consolidate a VIE
 - Significant judgments and assumptions used to determine a controlling financial interest exists
 - Nature of economic power over the entity
 - Kick-out and participating rights
 - Decision-makers and service providers
 - Shared economic power
 - » Multiple unrelated parties
 - » Related parties

Disclosure Requirements (Cont.)

- Methodology for determining whether an enterprise must consolidate a VIE
 - Significant judgments and assumptions used to determine a controlling financial interest exists
 - Obligation to absorb losses or the right to receive benefits that is disproportionately greater than stated power to direct the activities
 - Occurrence of a reconsideration event
 - Troubled debt restructurings

Disclosure Requirements (Cont.)

- Interest-holders other than primary beneficiaries
 - Carrying amounts and classification of assets and liabilities of the VIE
 - The enterprise's maximum exposure to loss
 - Tabular comparison of the above amounts, including terms of the arrangement

Disclosure Requirements (Cont.)

- Interest-holders other than primary beneficiaries
 - Liquidity arrangements, guarantees or other commitments by third parties that affect fair value or risk of the variable interest

Disclosure Requirements (Cont.)

- When power is shared and enterprise is not the primary beneficiary
 - Significant factors considered and judgments made in determining that economic power is shared

FAS 166 Disclosures

- Financial or other support provided to a VIE
 - The type and amount of support, including situations in which the enterprise assisted the VIE in obtaining another type of support
 - The primary reasons for providing the support

- Any arrangements that might require the entity to offer the VIE support in the future
 - The circumstances in which support would be provided
 - The maximum exposure to loss as a result of the future support

Implementation Considerations

Implementation Considerations

- Inventory potential VIEs
- Evaluate entities for consolidation or deconsolidation
- Obtain GAAP financials for newly consolidated VIEs
 - From third parties, or
 - By preparing from raw data
- Implement SOX compliant controls over auditable information
- Modify downstream processes such as:
 - Consolidation
 - Management reporting
 - Tax
 - Continuous reconsideration
- Have it done by 1/1/10

Possible Process And System Changes

- Accounting applications that may require change:
 - Consolidation decisions
 - Securities and loan accounting
 - Debt accounting
 - General ledger
 - Financial reporting (disclosures)
- Data feeds between systems

Implementation Approach

- Phase 1: Identify population of entities to consolidate under FAS 167
- Phase 2: Establish a project management team
 - Identify stakeholders to be represented
 - Develop project timeframes
 - Establish monitoring/tracking mechanisms
- Phase 3: Assess business impacts
 - Financial statement impact
 - Cross-functional impacts (IT, tax, regulatory, debt compliance, etc.)
- Phase 4: Implement and report

Background – Copy of FAS 167

<http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819183863&blobheader=application%2Fpdf>