MARCH 2015
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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT FASB

SUBJECT:

FASB ISSUES ASU TO SIMPLIFY CONSOLIDATION ANALYSIS

Summary: The FASB recently changed its consolidation guidance, which may have a significant impact on certain entities. The new ASU simplifies U.S. GAAP by eliminating entity specific consolidation guidance for limited partnerships. It also revises other aspects of the consolidation analysis, including how kick-out rights, fee arrangements and related parties are assessed. The amendments rescind the indefinite deferral of FASB Statement 167 for certain investment funds and replace it with a permanent scope exception for money market funds. The new standard takes effect in 2016 for public companies and is available here. The changes affect all entities, particularly those in the financial service, real estate and energy sectors.

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MAIN PROVISIONS:

ASU 2015-02[1] changes the consolidation analysis for all reporting entities. The changes primarily affect the consolidation of limited partnerships and their equivalents (e.g., limited liability corporations), as well as structured vehicles such as collateralized debt obligations.

The existing consolidation guidance for corporations that are not variable interest entities (VIEs) is unchanged. The usual condition for a controlling financial interest in that situation is owning a majority of the voting shares.

Specifically, the amendments impact the following areas of consolidation analysis, most of which apply to the VIE assessment:

1. Limited partnerships and similar legal entities
2. Entities other than limited partnerships and their equivalents
3. Evaluating fees paid to a decision maker or a service provider as a variable interest
4. The effect of fee arrangements on the primary beneficiary determination
5. The effect of related parties on the primary beneficiary determination
6. Certain investment funds

[1] *Amendments to the Consolidation Analysis*

Limited partnerships and similar legal entities

The amendments eliminate the presumption in Subtopic 810-10 (formerly EITF 04-05) that a general partner should consolidate a limited partnership. As a result, fewer limited partnerships will be consolidated.

When evaluating whether a limited partnership or similar legal entity (collectively, an "LP") is a VIE, a new test that considers two factors must be addressed:[2]

- At a minimum, a simple majority (e.g., 51%) of the limited partners must hold substantive kick-out rights over the general partner. Kick-out rights may also be held by a lower threshold, for example a kick-out right exercisable by a single party.
- The limited partners must hold participating rights over the general partner.

If the limited partners lack both conditions, the LP is a VIE.[3] In that situation, the identification of a primary beneficiary is based on the "power and economics" principle in Topic 810.

If the LP is a voting entity (not a VIE), only a single limited partner with ownership of more than 50% of the LP's substantive kick-out rights, if any, will consolidate, unless other limited partners have substantive participating rights. The general partner typically will not consolidate the LP.

Entities other than limited partnerships and their equivalents

The new standard also changes how entities other than LPs, for instance corporations, are assessed to determine if they are VIEs by performing the following two-step analysis, assuming no other VIE characteristics are present:

- Do the equity holders as a group hold voting or similar rights to direct the activities of the entity that most significantly impact its economic performance? If so, the entity is not considered a VIE and the next step is not considered.
- If the equity holders lack such rights, is a single equity holder at risk able to exercise kickout or participating rights over the rights of the entity's decision maker, such as a fund manager? If so, the entity is not a VIE. Otherwise, it is.

This revision to the VIE model was primarily made to prevent certain mutual funds and other "externally managed" entities from being VIEs.

Evaluating fees paid to a decision maker or a service provider as a variable interest

The new ASU eliminates three of the six conditions that exist for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest, e.g., whether a fund manager's "2/20" fee arrangement is a variable interest. A decision maker or service provider would be precluded from consolidating a VIE solely on the basis of its fee interest if all three of the following conditions are satisfied:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision maker or service provider 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.[4]
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

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[2] See 810-10-25-14(b)(1)(ii) which amends one of the existing five characteristics of a VIE.

[3] The LP is not a VIE if one or both of the conditions exist, assuming no other VIE characteristics are present. For purposes of this assessment, the limited partners that hold these rights must be unrelated to the general partner.

[4] This factor also considers interests held by related parties. The assessment varies based on whether the related parties are under common control with the decision maker or not.

However, fee interests are not eligible for this exemption if the service provider is also exposed to a "principal" risk of loss in the entity. The ASU cites guarantees on the value of the VIE's assets or liabilities, an obligation to fund losses, or payments triggered by written put options to illustrate this point. In those situations, the service provider is exposed to more than the opportunity cost of earning its fees. Therefore, it would be exposed to a "principal" risk of loss, its fees would be a variable interest, and further analysis would be required to determine whether it is the primary beneficiary.

The effect of fee arrangements on the primary beneficiary determination

The amendments also state that, in certain circumstances, fees paid to a decision maker are excluded from the primary beneficiary analysis, which is distinct from the discussion above about whether the fees represent a variable interest in the VIE.

Specifically, if the fees are both customary and commensurate with the level of effort required for the services provided, the decision maker may exclude the fees from its determination of whether it has an 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 ("the economics test"). As a result, the decision maker would evaluate whether its other interests in the VIE (if any), such as debt or equity investments, meet the economics test.

The effect of related parties on the primary beneficiary determination

The amendments change the related party guidance such that a single[5] decision maker (e.g., a fund manager) with a direct interest in a VIE will also consider related party relationships indirectly on a proportionate basis. For example, assume a single decision maker owns a 20% interest in a related party and that related party owns a 40% interest in the VIE being evaluated. The decision maker's indirect interest would be considered equivalent to an 8% direct interest (40% x 20%) in the VIE for purposes of evaluating whether it holds significant economic exposure in the VIE.

If the single decision maker does not consolidate on the basis of its direct and indirect interests, its related party relationships should be considered in their entirety (e.g., 40% in the previous example) if the related parties are under common control and meet the economics test. Said differently, the single decision-maker and common control group have a controlling financial interest. In that situation, the current related party tie-breaker test should be performed to identify the primary beneficiary, which could be the decision maker or another member of the common control group. This is another significant change, since under current guidance, the related party tiebreaker test is applied regardless of whether the related parties and single decision maker are under common control.

Finally, if neither the decision maker nor a related party in the common control group consolidates under the two preceding paragraphs, but substantially all of the VIE's activities are conducted on behalf of a single variable interest holder that is related to the decision maker but is not part of the common control group, that variable interest holder (not the decision maker) is required to consolidate. This provision was included in the standard to address concerns about attempts to circumvent the VIE consolidation guidance. It is not expected to apply in most situations.

The changes above to the related party guidance do not apply to situations in which power is shared between two or more unrelated entities that hold variable interests in a VIE, for which existing guidance continues to apply.

Certain investment funds

The new standard eliminates the indefinite deferral of FASB Statement 167 for certain investment funds provided by ASU 2010-10.[6] Instead, it provides a scope exception for reporting entities with interests in entities subject to Rule 2a-7 of the

[5] If there is more than one decision maker within a related party group, the related party tiebreaker test must still be considered, consistent with current guidance.

[6] *Consolidation (Topic 810): Amendments for Certain Investment Funds*

Investment Company Act of 1940, and similar investments. Consequently, such money market funds will not be consolidated.

EFFECTIVE DATE AND TRANSITION:

The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

Transition methods include a modified retrospective approach wherein an entity records a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption, and a full retrospective approach.