

Hot Topic

Update on major accounting
and auditing activities

FASB issues Statement 167, amendments to FIN 46(R)

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Overview

On 12 June 2009, the FASB issued Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (Statement 167), which (1) addresses the effects of eliminating the qualifying special-purpose entity (QSPE) concept from FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), and (2) responds to concerns about the application of certain key provisions of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)), including concerns over the transparency of enterprises' involvement with variable interest entities (VIEs). Statement 167 is effective as of the beginning of an enterprise's first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. That is, Statement 167 is effective for calendar year-end companies beginning on 1 January 2010.

It is important to note that the amendments to FIN 46(R) are applicable to all enterprises and to all entities with which those enterprises are involved, regardless of when that involvement arose. Therefore, upon adoption of Statement 167, all enterprises must reconsider their consolidation conclusions for all entities with which they are involved.

Statement 167, among other things:

- ▶ Requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE
- ▶ Amends FIN 46(R)'s consideration of related party relationships in the determination of the primary beneficiary of a VIE by providing, among other things, an exception with respect to de facto agency relationships in certain circumstances
- ▶ Amends certain guidance in FIN 46(R) for determining whether an entity is a VIE, which may change an enterprise's assessment of which entities with which it is involved are VIEs
- ▶ Requires continuous assessments of whether an enterprise is the primary beneficiary of a VIE
- ▶ Requires enhanced disclosures about an enterprise's involvement with a VIE. In general, the disclosure requirements are consistent with the provisions of FASB Staff Position No. FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (FSP FAS 140-4 and FIN 46(R)-8)

These changes and others are discussed in further detail in the Amendments section below.

In conjunction with Statement 167, the FASB issued Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*. The Statement 140 amendments, among other things, eliminate the concept of QSPEs. Thus, Statement 167 eliminates the FIN 46(R) scope exception for QSPEs. This will result in more QSPEs being evaluated for consolidation. See our Hot Topic publication, *FASB issues Statement 166, an amendment to Statement 140* (HT No. 2009-21), for more information on the amendments to Statement 140.

Background

FIN 46(R) clarifies the application of ARB No. 51, *Consolidated Financial Statements* (ARB 51), to certain entities in which the equity investors do not have the characteristics of a controlling financial interest (i.e., they lack certain decision-making ability) or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. These entities are known as VIEs.

FIN 46(R) requires an enterprise holding a variable interest in an entity (i.e., an interest that absorbs the variability of changes in the fair value of the entity's net assets) to determine whether the entity is a VIE and, if so, to determine whether the enterprise is the primary beneficiary of the VIE. In general, a VIE's primary beneficiary absorbs the majority of the VIE's variability, as determined through quantitative analyses.

Some have expressed concerns that the determination of the primary beneficiary of a VIE is overly complex and, by emphasizing a quantitative analysis, requires a high degree of mathematical expertise to apply. Others have raised concerns that there is significant diversity in practice in the approaches and methodologies used to calculate a VIE's variability. Additionally, some believe that the use of quantitative analyses can at times require an enterprise to consolidate an entity over which it has little or no characteristics of substantive control.

In addition, users also have expressed concern over the lack of transparency (either through nonconsolidation or through lack of disclosure) of enterprises' involvement with off-balance-sheet structures. That lack of transparency limits their ability to understand the nature of an enterprise's involvement with a VIE and the related risks and benefits of that involvement. In an interim step to address users' concerns regarding the lack of sufficiency and timeliness of information regarding an enterprise's involvement with a VIE, the Board issued FSP FAS 140-4 and FIN 46(R)-8, which was effective for calendar year-end companies as of 31 December 2008.

Amendments

Primary beneficiary determination

Statement 167 revises paragraph 14 of FIN 46(R) to require that an enterprise perform a qualitative analysis to determine if it is the primary beneficiary of a VIE.

Power and rights to receive benefits/obligation to absorb losses

The qualitative analysis considers the purpose and design of the VIE as well as the risks that the VIE was designed to create and pass through to its variable interest holders. An enterprise is required to consolidate a VIE if it has both (a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance ("power") and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE ("benefits").

Therefore, an enterprise must identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. An enterprise's ability to direct the activities of a VIE when circumstances arise or events occur constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE.

To illustrate the concept of power, assume a VIE that is financed with debt and equity uses the proceeds from its financing to purchase commercial mortgage loans from a Transferor. The primary purposes for which the entity was created were to (1) provide liquidity to the Transferor and (2) provide investors with the ability to invest in a pool of commercial loans. The Transferor retains primary servicing responsibilities, which are administrative in nature and include remittance of payments on the loans, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by the borrower, the responsibility for administration of the loan transfers from the Transferor to the Special Servicer (the equity holder).

The Special Servicer, as the equity holder, also has the approval rights for budgets, leases, and property managers of foreclosed properties. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact the performance of the underlying assets. Therefore, the Special Servicer's ability to manage the entity's assets that are delinquent or in default provides the Special Servicer with power.

In evaluating whether an enterprise has satisfied the benefits criterion, the use of professional judgment may be required, to determine whether the benefits could potentially be significant to the VIE. Some respondents to the Exposure Draft asked the Board for additional guidance for completing this assessment. The Board considered the comments of constituents, but decided not to provide additional guidance. The Board noted that if an enterprise concludes that it does not have a variable interest in an entity, then it would not meet this criterion. We believe that if an interest meets the definition of a variable interest it would often represent an obligation or benefit that could potentially be significant to the VIE.

Kick-out rights and participating rights

In determining whether an enterprise has power, an enterprise should not consider kick-out rights or participating rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such rights. A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise such rights may be the enterprise with power.

The Board's conclusion regarding the consideration of kick-out rights in the determination of a primary beneficiary is consistent with the Exposure Draft. During the comment process, many constituents expressed concern regarding the inconsistency of how kick-out rights are considered in determining the primary beneficiary of a VIE and the parent of a voting interest entity.

The Board acknowledged these inconsistencies between Statement 167 and the conclusions reached in EITF Issue No. 96-16, *"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"* (EITF 96-16), and EITF Issue No. 04-5, *"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"* (EITF 04-5). In affirming its position during the redeliberations, the Board indicated that it may address these inconsistencies at a later date by reconsidering the conclusions reached in EITFs 96-16 and 04-5.

Protective rights

Protective rights held by other parties do not preclude an enterprise from having power. Statement 167's notion of protective rights is similar to that in EITFs 96-16 and 04-5.

Involvement with the design of the VIE

An enterprise's involvement with the design of a VIE does not, in and of itself, establish the enterprise as the party with power, even if that involvement was significant. However, that involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with power.

Shared power

If an enterprise determines that power is shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then no party is the primary beneficiary. Power is shared if each of the parties sharing power are required to consent to the decisions relating to the activities that most significantly impact the VIE's performance.

If an enterprise concludes that power is not shared but the activities that most significantly impact the VIE's economic performance are directed by multiple unrelated parties, and each party is directing the *same* activities, the party, if any, with the power over the majority of the activities is the primary beneficiary of the VIE (provided they have benefits). In addition, if power is not shared but the activities that most significantly impact the VIE's economic performance are directed by multiple unrelated parties, and each party is directing *different* activities, then an enterprise must identify which party has the power to direct the activities that most significantly impact the entity's economic performance. That is, one party has the power. In some circumstances, this determination of the primary beneficiary could prove to be challenging.

To illustrate, assume two unrelated parties form a venture (which is a VIE) to manufacture, distribute and sell beverages. Assume that each party manufactures, distributes and sells the beverages in

different locations, thereby receiving benefits. Power is not shared as each party is not required to consent to the other's decisions. As each party is directing the same activities, the party with the power over the majority of the activities is the primary beneficiary of the VIE.

Alternatively, assume in the above example that one party is the manufacturer and the other party is responsible for distribution and sales. In this instance, either the manufacturer or the party responsible for distribution and sales is the primary beneficiary. Determining which of these roles require decisions that most significantly impact the entity's performance could prove difficult, and will require a careful assessment of the facts and circumstances.

Quantitative analysis

Currently, FIN 46(R) requires an enterprise to determine if it has a controlling financial interest in a VIE through an analysis that generally is quantitative. Statement 167 eliminates the quantitative analysis from the primary beneficiary determination. While the Exposure Draft included the quantitative analysis as a "fall back test" if an enterprise was unable to determine whether it met the qualitative assessment criteria, several respondents noted in the comment process that the retention of the quantitative analysis may result in some defaulting to the quantitative model to obtain a desired accounting result. The Board shared these concerns and, therefore, eliminated the fall back test in the final standard.

It should be noted that Statement 167 does not necessarily eliminate the need to perform a quantitative analysis in other places within Statement 167. For example, a quantitative analysis is often necessary to determine whether the total investment at risk is sufficient to permit an entity to finance its activities without additional subordinated financial support and thus, whether or not an entity is a VIE.

Related party provisions

De facto agents

Currently under FIN 46(R), a party that has an agreement that it cannot sell, transfer, or encumber its interests in a VIE without the prior approval of an enterprise is a de facto agent of that enterprise if that right could constrain the party's ability to manage the economics of its interest in a VIE. Under FIN 46(R), de facto agents are considered along with related parties when evaluating FIN 46(R)'s related party provisions. Historically, many enterprises have found themselves evaluating the related party provisions of FIN 46(R) as sale, transfer, or encumbrance restrictions are present in many arrangements.

Statement 167's amendments provide for an exception to this de facto agency provision. Under Statement 167, a de facto agency relationship does not exist if both the enterprise and the other party have the right of prior approval and the rights are based on mutually agreed terms entered into by willing, independent parties. This change could result in the deconsolidation of VIEs.

Primary beneficiary determination

Currently under FIN 46(R), if two or more related parties (including de facto agents) hold variable interests in a VIE, and the aggregate variable interests held by the related party group would, if held by a single party, identify the group as the primary beneficiary, then the party within the related party group that is "most closely associated" with the VIE is the primary beneficiary. These related party provisions are currently considered prior to determining the primary beneficiary solely based upon the quantitative analysis.

Statement 167 amends FIN 46(R) so that the power and benefits provisions are considered prior to the related party provisions. Only if an enterprise concludes that neither it nor one of its related parties meet the power and benefits criteria (described above), but as a group, the

enterprise and its related parties have those characteristics, does an enterprise consider Statement 167's related party provisions.

Reconsideration events

Primary beneficiary

FIN 46(R) currently requires an enterprise to reconsider the primary beneficiary determination upon certain events. In particular, the primary beneficiary of a VIE might be required to be reevaluated in the event of a change in an entity's design or capital structure and for transactions that impact the entity's equity at risk. Statement 167 eliminates the primary beneficiary reconsideration concept, which would effectively require a VIE's primary beneficiary to be evaluated continuously, or every reporting period, as facts and circumstances change.

This amendment is more consistent with the application of ARB 51, which does not incorporate a reconsideration concept in its requirements, and implicitly requires continuous reconsideration of whether or not consolidation is required.

VIE

Currently, FIN 46(R) requires an enterprise to reevaluate the status of an entity as a VIE upon certain events similar to those described above for the reconsideration of the primary beneficiary. The Exposure Draft also proposed to eliminate this reconsideration concept. However, many respondents to the Exposure Draft expressed concerns that a requirement to continually reassess an entity's status as a VIE was not operational or practicable. Additionally, constituents were troubled by the potential that an entity could be classified as a VIE in one reporting period and a voting interest entity in the next reporting period (or vice versa) solely as a result of operating results changing the assessment of equity investment at risk.

The Board believed that these concerns were valid and decided that the reconsideration of an entity as a VIE should be based upon the occurrence of certain events. In addition to

the current requirements of FIN 46(R), Statement 167 also adds the following as a VIE reconsideration event: "changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance."

In addition, Statement 167 removes the current exemption for troubled debt restructurings, which could lead to more consolidation of borrowers by lenders in loan workouts that provide the lender with the power over the VIE's activities.

Fees paid to decision makers and service providers

Statement 167 amends the guidance an enterprise uses to determine whether fees paid to decision makers or service providers represent a variable interest. The most significant change is that there is no longer a requirement that a decision maker be subject to kick-out rights in order to conclude that it does not hold a variable interest. Under Statement 167, fees paid to decision makers represent a variable interest unless six specific conditions are met. These conditions focus on the nature of the services and the amount of the fees.

VIE determination

Statement 167 amends paragraph 5 to align the wording with other sections of FIN 46(R), as amended. Additionally, after the adoption of Statement 167, kick-out rights should not be considered in determining whether the equity investors lack characteristics of a controlling financial interest unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those rights. This is consistent with Statement 167's amendments to the primary beneficiary determination, but may result in entities becoming VIEs upon the adoption of Statement 167 in certain circumstances, such as when a non-equity holder (that has a variable interest) has power. For example, if decision making ability is held by a non-equity

holder, an enterprise may have previously concluded that the entity was not a VIE by giving consideration to kick-out rights held by the equity holders as a group (as opposed to a single equity holder).

Disclosures

In response to financial statement users' concerns over the transparency of entities' involvement with VIEs, Statement 167 adds disclosure requirements to FIN 46(R). Specifically, Statement 167 will require expanded disclosures in the following areas:

- ▶ The significant judgments and assumptions considered by the enterprise in determining whether it must consolidate a VIE or disclose information about its involvement with a VIE
- ▶ The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by the enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- ▶ The nature of, and changes in, the risks associated with an enterprise's involvement with a VIE
- ▶ How an enterprise's involvement with a VIE affects its financial position, financial performance and cash flows

Statement 167 retains the disclosure requirements applicable to FIN 46(R) within FSP FAS 140-4 and FIN 46(R)-8 with only minor editorial changes. Additionally, Statement 167 requires disclosures in situations in which an enterprise determines that it shares the power over a VIE.

Other

- ▶ Statement 167 amends FIN 46(R) to require that a reporting enterprise separately present on the face of the balance sheet (a) assets of a consolidated VIE that can be used only to settle specific obligations of the VIE and (b) liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the reporting enterprise

- ▶ Statement 167 clarifies that if an enterprise is required to deconsolidate a VIE, the enterprise should follow the deconsolidation provisions of ARB 51, as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (Statement 160)
- ▶ Statement 167 removes the significance exception from FIN 46(R) that provides that an enterprise is not required to determine whether an entity with which it is involved is a VIE if it is apparent that the enterprise's interest would not be a significant variable interest and if the enterprise, its related parties, and its de facto agents did not participate significantly in the design or redesign of the entity
- ▶ Statement 167 also contains language stating that only substantive terms, transactions and arrangements, whether contractual or noncontractual, should be considered in applying Statement 167

Effective date

Statement 167 is effective as of the beginning of an enterprise's first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter, with earlier application prohibited. That is, Statement 167 is effective for calendar year-end companies beginning on 1 January 2010.

Transition

Statement 167 applies to all entities in which an enterprise has a variable interest, unless there is a scope exception under FIN 46(R), as amended.

Consolidation

If an enterprise is required to consolidate a VIE upon the implementation of Statement 167, the enterprise initially will measure and recognize all assets, liabilities and noncontrolling interests of the VIE at their carrying amounts at the date of adoption. Carrying amounts are the amounts at which the assets, liabilities and noncontrolling interests would have been carried in the consolidated financial

statements if Statement 167 was effective when the enterprise would have first met the conditions to be the primary beneficiary under Statement 167. If determining the carrying amounts is not practicable, the assets, liabilities and noncontrolling interests of the VIE should be measured at fair value at the date of adoption.

However, Statement 167 provides a measurement alternative if the activities of the VIE are primarily related to securitizations or other forms of asset-backed financings and the assets of the VIE can be used only to settle obligations of the VIE. If determining carrying value is not practicable, the enterprise upon adoption may choose to measure the assets and liabilities of the VIE at their unpaid principal balance. The primary beneficiary must also consider the need to recognize accrued interest, allowances for credit losses, or other-than-temporary impairments, as appropriate under this measurement alternative. However, other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, should be measured at fair value.

Any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interest in the newly consolidated entity should be recognized as a cumulative effect adjustment to retained earnings.

Additionally, an enterprise that is required to consolidate a VIE as result of Statement 167 may elect the "fair value option" pursuant to FASB Statement No. 159, *The Fair Value Option of Financial Assets and Financial Liabilities*, for items of a VIE that are eligible for this option so long as the election is applied to all eligible items within the entity. Enterprises may elect the fair value option on an entity-by-entity basis. Also, an enterprise electing the fair value option should disclose its rationale for electing the option for certain entities and provide quantitative disclosure of the effect of this election on the cumulative effect adjustment.

Deconsolidation

If an enterprise is required to deconsolidate an entity upon the adoption of Statement 167, the deconsolidating enterprise should initially measure any retained interest in the deconsolidated entity at its carrying amount upon adoption. Carrying amount refers to the amount at which any retained interest would have been carried in the enterprise's financial statements if Statement 167 had been effective when the enterprise became involved with the entity or no longer met the conditions to be the primary beneficiary (as defined by Statement 167). Any difference between the net amount removed from the balance sheet of the deconsolidating enterprise and the amount of any retained interest in the deconsolidated entity should be recognized as a cumulative effect adjustment to retained earnings.

Retrospective application

Statement 167 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

Potential effects

Statement 167's requirement to qualitatively determine the primary beneficiary may affect structures on which a quantitative analysis provided the basis for the evaluation of whether the entity should be consolidated.

As an example, some sponsors do not consolidate their asset-backed commercial paper conduits because the conduit issued to

independent investors expected loss notes (ELNs) that absorb a majority of the conduit's expected losses. Because ELN holders typically have little decision making ability over the conduit's significant activities, their investors would not be the primary beneficiary. Instead, under Statement 167, the sponsor may be required to consolidate the conduit based on its decision making ability and economic interests in the conduit.

Certain partnerships and other entities previously considered voting interest entities may become VIEs under Statement 167 given the changes to the way in which kick-out rights are considered in the VIE analysis. Under Statement 167, a general partner will likely consolidate a traditional limited partnership that is deemed to be a VIE, as the general partner will typically have power.

The collective amendments to FIN 46(R) and Statement 140 are likely to result in more consolidation by sponsors of and transferees to entities that currently meet the definition of a QSPE. Consolidation of these structures may have significant effects on a reporting enterprise's financial statements, including debt-to-equity ratios. Regulatory capital requirements also may be affected.

Enterprises that have reached the following conclusions, among others, in their historical FIN 46(R) analyses will need to revisit their consolidation assessments:

- ▶ The enterprise concluded that they had a de facto agency relationship with another party as a result of sale, transfer, or encumbrance restrictions

- ▶ The enterprise concluded that it was the primary beneficiary of a VIE under FIN 46(R)'s related party provisions
- ▶ The enterprise is a decision maker or service provider as described in Appendix B of FIN 46(R) and concluded that it had a variable interest in a VIE
- ▶ The enterprise determined that an entity with which it had involvement was not a VIE as a result of considering kick-out rights in the VIE analysis, with respect to decision makers that do not hold an equity investment at risk

Next steps

Many enterprises will find that adopting Statement 167 will take significant time and effort. As an example, some entities that will be subject to consolidation under Statement 167 previously have not prepared financial statements, or did not have their financial statements audited. With the effective date of Statement 167 fast approaching, we encourage enterprises to develop an understanding of the new standard and inventory their involvement with on- and off-balance sheet entities to begin to evaluate the effect of the amendments on prior consolidation conclusions as soon as practicable. We will provide additional implementation guidance in the near future.

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