



FASB Issues New Consolidation Guidance

On February 18, 2015, the FASB issued a new consolidation standard to improve targeted areas of the consolidation guidance and reduce the number of consolidation models. The new consolidation standard changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity (VIE), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE.¹ It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities.²

The FASB decided to exclude from the U.S. GAAP consolidation requirements money market funds that are required to comply with Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act) or that operate in accordance with requirements similar to those in Rule 2a-7 of the 1940 Act.³ The Board also changed the way the voting rights characteristic in the VIE scope determination is evaluated for corporations, which may significantly impact entities for which decision making rights are conveyed through a contractual arrangement.

Key Facts

- More limited partnerships and similar entities will be evaluated for consolidation under the revised consolidation requirements that apply to VIEs.
- Fees paid to a decision maker or service provider are less likely to be considered a variable interest in a VIE.
- Variable interests in a VIE held by related parties of a reporting enterprise are less likely to require the reporting enterprise to consolidate the VIE.

¹ FASB Accounting Standards Update No. 2015-02, Amendments to the Consolidation Analysis, available at www.fasb.org.

² FASB Accounting Standards Update No. 2010-10, Amendments for Certain Investment Funds, and FASB ASU No. 2009-17, Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, both available at www.fasb.org.

³ FASB ASC Topic 810, Consolidation, available at www.fasb.org.

Contents

Background.....	2
Changes to VIE Consolidation Requirements.....	3
Changes to Consolidation Requirements for Entities That Are Not VIEs.....	15
Interests in Investment Entities ..	16
Effective Date and Transition	18

- There is a new approach for determining whether equity at-risk holders of entities that are not similar to limited partnerships have power to direct the entity's key activities when the entity has an outsourced manager whose fee is a variable interest.
- The deferral of consolidation requirements for certain investment companies and similar entities of the VIE in ASU 2009-17 is eliminated.⁴
- The guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. The effective date is one year later for all other entities. Early adoption is allowed, including early adoption in an interim period. A reporting enterprise is permitted to apply either a modified retrospective approach or full retrospective application.

Key Impacts

- A new consolidation analysis is required for VIEs, including many limited partnerships and similar entities that previously were not considered VIEs.
- It is less likely that the general partner or managing member of limited partnerships and similar entities will be required to consolidate the entity when the other investors in the entity lack both participating rights and kick-out rights.
- Limited partnerships and similar entities that are not VIEs will not be consolidated by the general partner.
- It is less likely that decision makers or service providers involved with a VIE will be required to consolidate the VIE.
- Entities for which decision making rights are conveyed through a contractual arrangement are less likely to be considered VIEs.
- Reporting enterprises with interests in certain investment companies and similar entities that are considered VIEs will no longer evaluate those entities for consolidation based on majority exposure to variability.⁵

Background

The FASB issued its proposed consolidation guidance in 2011 and began redeliberating the proposals in 2012. The primary objective of the proposals was to address concerns expressed by financial statement users about the possibility that the guidance in ASU 2009-17 could require investment managers and similar entities to consolidate certain investment funds that they manage. Another objective of the proposals was to eliminate the inconsistency between how participating rights and kick-out rights are evaluated for VIEs versus other entities. To achieve these objectives, the Board initially proposed a judgmental framework in which the following qualitative factors would be evaluated to determine whether a decision maker or service provider is exercising its decision-making rights in the capacity of a principal or an agent:

⁴ FASB Accounting Standards Update No. 2010-10, Amendments for Certain Investment Funds, and FASB ASU No. 2009-17, Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, both available at www.fasb.org.

⁵ FASB ASC paragraph 810-10-25-38A, available at www.fasb.org.

- Rights held by other parties;
- Decision maker's compensation; and
- Decision maker's other economic interests.

Constituents expressed a number of concerns about the complexity of the FASB's proposals and the lack of clarity about how to weigh the factors in the qualitative analysis. During its redeliberations, the Board decided it could achieve its primary objective through fairly limited changes to the existing consolidation literature. The Board decided, based on feedback from constituents, that aligning the evaluation of participating rights and kick-out rights for VIEs and other entities is not necessary. The Board concluded that it could accomplish its primary objective mainly by making changes to the criteria that define a VIE and the guidance for evaluating whether a service provider or decision maker's fee is considered a variable interest that would require the reporting enterprise to consolidate the VIE, including the manner in which interests of related parties affect those evaluations.

The FASB ultimately decided not to develop a separate set of criteria to determine whether a decision maker is functioning in the capacity of a principal or an agent, but rather to integrate that evaluation into the criteria for identifying a controlling financial interest in a VIE. Instead of issuing a revised exposure draft of the 2011 proposed standard, the FASB staff conducted an extended fatal-flaw review process involving a broad range of stakeholders. In response to comments received from the fatal-flaw review process, the Board decided to make further revisions to the VIE criteria, mainly to address concerns about how those criteria would affect certain mutual fund investment structures. Given the Board's decision not to establish separate principal versus agent criteria, the final standard's title does not refer to principal versus agent guidance.

Changes to VIE Consolidation Requirements

To limit the circumstances in which investment managers and similar entities are required to consolidate the entities that they manage, the FASB decided to eliminate some of the criteria under which their fees are considered a variable interest and limit the circumstances in which variable interests in a VIE held by related parties of a reporting enterprise require the reporting enterprise to consolidate the VIE. The Board also decided that the general partner or managing member of limited partnerships and similar entities should be subject to the new VIE consolidation requirements when the limited partners do not hold substantive kick-out rights or participating rights. Consequently, the Board expanded the VIE criteria to specifically include limited partnerships and similar entities in some circumstances in which they are not considered VIEs under current U.S. GAAP.

In addition, the FASB revised the requirements used to determine whether the equity-at-risk investors in corporations and other entities that are not similar to limited partnerships have the power through voting rights or similar rights to make decisions about the activities that most significantly impact the entities' economic performance. Those changes essentially obviate the need for a single party to hold a substantive kick-out right or participating right over a decision maker whose fee represents a variable interest for an entity not to be a VIE. Although the Board made this change in response to constituent concerns about

the results of applying the previous VIE criteria to certain mutual fund structures, the changes are not restricted to mutual fund entities and may significantly affect previous consolidation conclusions in some cases.

Fees Paid to a Decision Maker or Service Provider

Variable Interest Determination

The ASU defines a decision maker as “An entity or entities with the power to direct the activities...that most significantly impact [a] legal entity’s economic performance...” Under the ASU’s provisions, fees paid to a decision maker or service provider do not represent a variable interest in a VIE if all of the following conditions are met:

- The decision maker’s compensation is commensurate with the services provided;
- The arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated on an arm’s-length basis; and
- The decision maker does not hold other interests in the VIE (including interests held through related parties) that individually or in the aggregate, 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.

A reporting enterprise may need to analyze similar arrangements among parties outside the fee arrangement being evaluated to determine whether the fee meets the first two conditions above. A fee would not presumptively be considered a variable interest when similar fee arrangements do not exist if the fee arrangement relates to a unique or new service or if it reflects a change in what is considered customary for the services. In addition, the magnitude of a fee would not be determinative in evaluating the criteria.

The criteria do not apply to fees or payments in connection with agreements that expose the decision maker or service provider to risk of loss in the VIE, such as fees related to guarantees of the value of the assets or liabilities of a VIE, fees in relation to obligations to fund operating losses, etc. Those fees are automatically considered variable interests under the guidance in the ASU.

Under current U.S. GAAP, fees paid to a decision maker or service provider are considered a variable interest unless they meet all of the following conditions in addition to the three conditions above:⁶

- Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the VIE that arise in the normal course of the VIE’s activities (e.g., trade payables);
- The anticipated fees are insignificant relative to the amount of the VIE’s anticipated economic performance; and
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE’s anticipated economic performance.

The Board decided to eliminate these conditions.

⁶ FASB ASC paragraph 810-10-55-37, available at www.fasb.org.

Example 1: Asset-Backed Collateralized Debt Obligation Entity

A VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Bank A is the asset manager of the VIE and for its services, earns base, fixed-senior and subordinate fees and a performance-based fee in which it receives a portion of the VIE's profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions. Bank A also holds 5 percent of each class of the VIE's debt and equity and has the power to direct the activities that most significantly impact the VIE's economic performance. None of the VIE's other variable interest holders are related parties of Bank A.

Based on the new consolidation guidance, the fees paid to Bank A would not represent a variable interest in the VIE. Under current U.S. GAAP, the fees paid to Bank A would represent a variable interest in the VIE.⁷

Primary Beneficiary Determination

If a decision maker's fees represent a variable interest in a VIE, the decision maker must determine whether it is the VIE's primary beneficiary. Consistent with current U.S. GAAP, a variable interest holder is considered the primary beneficiary and consolidates a VIE when it has (a) the power to direct the activities that most significantly impact the VIE's economic performance (power), and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE and/or the right to receive benefits from the VIE that could potentially be significant to the VIE (potentially significant variable interest).⁸ The FASB decided to exclude fees paid to a decision maker or service provider from the potentially significant variable interest determination if:

- The compensation is commensurate with the services provided; and
- The arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated on an arm's-length basis.

When eligible fees meet the conditions above, the fees are excluded from the potentially significant variable interest determination in the primary beneficiary evaluation irrespective of whether they are subject to lock-up provisions, settled in variable interests (i.e., not cash) of the VIE, or other variable interests are held by the decision maker or service provider. Under current U.S. GAAP, fees paid to a decision maker or service provider are included in the potentially significant variable interest determination. The new consolidation guidance places more emphasis on variable interests other than fee arrangements because the FASB believes that these fee arrangements do not subject the decision maker to a risk of loss.



Under current U.S. GAAP, a decision maker or service provider fee considered a variable interest generally results in the decision maker or service provider having a potentially significant variable interest and therefore being the primary beneficiary of a VIE. Under the new guidance, it is less likely that the decision maker or service provider will be the primary beneficiary when the fees are at market and include only customary terms.

⁷ FASB ASC paragraphs 810-10-55-37 and 55-38, available at www.fasb.org.

⁸ FASB ASC paragraph 810-10-25-38A, available at www.fasb.org.

Fees or payments in connection with agreements that expose the decision maker or service provider to risk of loss in the VIE (e.g., fees related to guarantees of the value of the assets or liabilities of a VIE, fees in relation to obligations to fund operating losses, etc.) are not eligible for the above exclusion and therefore are included in evaluating whether a decision maker has a potentially significant variable interest.

Example 2: Asset-Backed Collateralized Debt Obligation Entity

Expanding on the facts of Example 1, assume that the VIE's other variable interest holders do not have the right to remove Bank A as the asset manager without cause and do not have any other rights to participate in the decisions about the VIE's activities.

Based on the new consolidation guidance, Bank A's fees would be excluded in determining whether Bank A has a potentially significant variable interest. Bank A would not be considered the VIE's primary beneficiary even though it provides 5 percent of the VIE's total capital and has the power to direct the activities that most significantly impact the VIE's economic performance.

Under current U.S. GAAP, Bank A's fees would be included in determining whether Bank A has a potentially significant variable interest and Bank A likely would be the VIE's primary beneficiary.⁹ (Bank A likely would be the VIE's primary beneficiary even without considering the impact of the fees under current U.S. GAAP.)

What Are the Implications?

A decision maker or service provider that consolidates a VIE under current U.S. GAAP will need to reconsider its primary beneficiary conclusion. If the decision maker has a variable interest but deconsolidates the VIE under the new VIE consolidation guidance, it will need to update its disclosures to those that apply to variable interest holders that do not consolidate a VIE.

The FASB's decision to eliminate three of the conditions under which fees are considered a variable interest in a VIE makes it less likely that a decision maker or service provider will be the primary beneficiary of a VIE solely due to its fee arrangement. A decision maker whose fee is not a variable interest is not likely to be the primary beneficiary of a VIE.

Consistent with current U.S. GAAP, reporting enterprises will need to continue to apply judgment in evaluating whether fees represent a variable interest. It will be particularly important to consider whether arrangements have been structured to reduce a decision maker's other variable interests so that they absorb insignificant variability of the VIE in exchange for an increase in the decision maker's fees. It will also be important to determine whether a

⁹ FASB ASC paragraph 810-10-25-38A, available at www.fasb.org.

fee arrangement relates to a unique service or reflects a change in what is considered customary for the services.

We do not believe the requirement to automatically consider fees or payments in connection with agreements that expose the decision maker or service provider to risk of loss in the VIE to be variable interests is likely to be particularly impactful. If the decision maker or service provider meets the criteria to be the primary beneficiary of a VIE on the basis of its decision making rights and the risks to which it is exposed through its variable interests, we believe considering the fees a variable interest is unlikely to change that conclusion. Likewise, if the decision maker or service provider does not meet the criteria to be the primary beneficiary of a VIE on the basis of its decision making rights and the risks to which it is exposed through its variable interests, we believe considering the fees a variable interest is unlikely to change that conclusion. This is because those fees are unlikely to provide the right to receive benefits that could potentially be significant to the VIE when the arrangement does not obligate the decision maker or service provider to absorb losses that could potentially be significant to the VIE.

Related Parties

The new consolidation guidance does not change the related party guidance for situations where power to direct the activities that most significantly impact a VIE's economic performance is shared between two or more parties. As depicted in the following table, the ASU changes the way in which related parties are considered in determining whether a fee paid to a decision maker or service provider is a variable interest and the way in which related party interests are considered in determining whether a single party with the power to direct the activities that most significantly impact a VIE's economic performance (i.e., a single decision maker) has a potentially significant variable interest that results in the decision maker meeting both criteria to be the VIE's primary beneficiary.¹⁰

Related Party Relationship		Impact on Evaluations of Whether Fees Are a Variable Interest and on Whether a Single Decision Maker Is the Primary Beneficiary of a VIE
Related parties in which the decision maker or service provider does not hold an interest		Exclude any interests held by these parties (including those under common control) in the applicable evaluation(s)
Related parties in which the decision maker or	Not under common control with decision maker or service provider	Consider any interests held by these parties in the applicable evaluation(s) on a proportionate basis

¹⁰ The term related parties includes those parties identified in FASB ASC Topic 850 and those considered de facto agents under FASB ASC paragraph 810-10-25-43, available at www.fasb.org.

Related Party Relationship		Impact on Evaluations of Whether Fees Are a Variable Interest and on Whether a Single Decision Maker Is the Primary Beneficiary of a VIE
service provider holds an interest	Under common control with decision maker or service provider	Consider any interests held by these parties in their entirety in the applicable evaluation(s)

The FASB also decided to change the current VIE guidance requiring an evaluation of which party in a related party group that collectively meets the characteristics to be a VIE's primary beneficiary should consolidate the VIE when none of the parties individually meets the characteristics to be the primary beneficiary. The new guidance is described in the following table.

Situation	Primary Beneficiary Determination
<ul style="list-style-type: none"> There is not a single decision maker, or A group of related parties under common control collectively meets the characteristics to be considered the VIE's primary beneficiary 	Perform the related party tiebreaker test to determine which party in the related party group is most closely associated with, and should consolidate, the VIE. ¹¹
<ul style="list-style-type: none"> There is a single decision maker, A group of related parties not under common control collectively meets the characteristics to be considered the VIE's primary beneficiary, and Substantially all of the activities of the VIE either involve or are conducted on behalf of a single variable interest holder (excluding the single decision maker) in the related party group 	The party for which substantially all of the VIE's activities either involve or are conducted (excluding the single decision maker) is the primary beneficiary and consolidates the VIE. ¹²
<ul style="list-style-type: none"> There is a single decision maker, There is not a group of related parties under common control that collectively meets the characteristics to be considered the VIE's primary beneficiary, and 	Stop consolidation analysis – related party tiebreaker test is not performed and none of the variable interest holders consolidates the VIE.

¹¹ FASB ASC paragraph 810-10-25-44, available at www.fasb.org.

¹² This requirement does not apply to a reporting enterprise's investment in an entity within the scope of FASB Accounting Standards Update No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, available at www.fasb.org.

Situation	Primary Beneficiary Determination
<ul style="list-style-type: none"> Substantially all of the activities of the VIE do not involve and are not conducted on behalf of a single variable interest holder (excluding the single decision maker) in the related party group 	

Example 3: Asset-Backed Collateralized Debt Obligation Entity

Modifying the facts of Examples 1 and 2, assume that Bank A holds 4% of each class of the VIE's debt and equity. Bank A's related party B (which is controlled by Bank A's parent company) holds a 1% interest in each class of the VIE's debt and equity. Bank A owns 0.5% of party B's equity. Bank A's CEO holds 0.2% of each class of the VIE's debt and equity. Bank A provided a loan to its CEO for half of the CEO's investment. Bank A's related party C holds a 50% interest in each class of the VIE's debt and equity. Bank A owns 20% of party C's equity.

Based on the new consolidation guidance, Bank A includes the following interests in determining if its fees are a variable interest and in determining whether it meets the potentially significant variable interest primary beneficiary criterion and therefore is the VIE's primary beneficiary:

- Its 4% direct interest in the VIE,
- Party B's 1% interest in the VIE in its entirety,
- Half of its CEO's 0.2% interest, and
- 20% of party C's 50% interest.

As a result, Bank A's fees would be considered a variable interest and Bank A would be the VIE's primary beneficiary. (This is the case even though Bank A's fees are excluded from the determination of whether it meets the potentially significant variable interest primary beneficiary criterion.)

There would be no related party primary beneficiary analysis because Bank A meets the criteria to be the primary beneficiary on the basis of its decision making rights together with its direct variable interests and indirect variable interests held through related parties. If Bank A did not own any of party B's equity the conclusion would not change. However, if Bank A also did not own any of party C's equity, Bank A would not be the VIE's primary beneficiary. In that case, no related party primary beneficiary analysis would be performed because the VIE has a single decision maker (Bank A), and there would not be a group of parties under common control that meets the criteria to be the VIE's primary beneficiary or a party for which substantially all of the VIE's activities involve or are conducted (excluding Bank A).



The new analysis of power in the VIE scope determination applies to *all* legal entities that are not similar to limited partnerships and represents a significant change to the VIE criteria on voting rights.

What Are the Implications?

A reporting enterprise that is part of a related party group that collectively meets the criteria to be a VIE's primary beneficiary may need to reconsider its consolidation conclusion. If the reporting enterprise previously consolidated the VIE but is required to deconsolidate it under the revised VIE consolidation guidance, the reporting enterprise will need to update its disclosures to those that apply to variable interest holders that do not consolidate a VIE. If the reporting enterprise previously did not consolidate the VIE but is required to consolidate it under the revised guidance, the reporting enterprise will need to update its disclosures to those that apply to the primary beneficiary of a VIE.

The FASB's decisions about the impact of related party interests on VIE consolidation evaluations aligns the VIE consolidation guidance more closely with the guidance for consolidation of entities other than VIEs. The changes to the related party requirements for VIEs also reduce the likelihood that a reporting enterprise will be required to consolidate a VIE for which it does not meet both of the criteria to be the primary beneficiary when related parties of the reporting enterprise also hold variable interests in the VIE. Likewise, the decisions about the impact of related party interests on the evaluation of whether a decision maker's fees represent a variable interest and on the primary beneficiary determination further reduce the likelihood that a decision maker will be the primary beneficiary of a VIE.

The term *common control* is not defined in U.S. GAAP. The FASB clarified in the Basis for Conclusions that its intent is for the term to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.

Interests held in the VIE by an employee of the decision maker are included as an indirect interest of the decision maker to the extent the employee's interest has been financed by the decision maker. It may be operationally difficult in practice to discern when an interest has been financed by a reporting enterprise (e.g., when an employee making an investment in an entity on its own may have received a general recourse loan from the reporting enterprise).

VIE Criteria

Voting Rights

With the new consolidation guidance eliminating the indefinite deferral of ASU 2009-17 provided for certain entities in ASU 2010-10, some constituents expressed concerns that certain mutual funds would be considered VIEs because the equity-at-risk investors would not have the power through voting rights to direct the activities that most significantly impact the funds' economic performance. Specifically, a single equity-at-risk investor would not have a substantive unilateral kick-out right or participating right over the asset manager when the asset manager's fee is considered a variable interest.¹³ This outcome

¹³ FASB ASC paragraph 810-10-15-14(b)(1), available at www.fasb.org.

would have potentially required consolidation of these entities by asset managers that hold a portion of the entities' investment interests until their interests fell below the potentially significant variable interest threshold (rather than the majority exposure to variability threshold in current U.S. GAAP). To address these concerns, the FASB decided to stipulate that two steps are required when evaluating the voting rights characteristic for entities that are not similar to limited partnerships:

- Step 1 – Determine whether the holders of the equity investment at risk have power through voting rights or similar rights to direct the activities that most significantly impact the entity's economic performance. If so, the entity would not be a VIE if no other VIE characteristics are met. If the equity at-risk holders do not have power to direct the activities that most significantly impact the entity's economic performance, Step 2 is performed.
- Step 2 – If a decision maker whose fee is a variable interest has power to direct the activities that most significantly impact the entity's economic performance through a contractual arrangement, the entity would be a VIE unless a single equity-at-risk holder has substantive kick-out rights or substantive participating rights over the decision maker and no other VIE characteristics are met.

The two-step analysis above applies to *all* legal entities that are not similar to limited partnerships, not just series mutual funds.

What Are the Implications?

The new two-step analysis introduced by the FASB represents a significant change to the VIE criteria on voting rights for entities that are not similar to limited partnerships. Under current U.S. GAAP, an entity is considered a VIE when a decision maker or service provider whose fee is a variable interest has the power to direct the activities that most significantly impact the entity's economic performance through a contractual arrangement and there is no single equity-at-risk investor with substantive unilateral kick-out rights or participating rights. A reporting enterprise may therefore need to reconsider its previous consolidation conclusions for these types of entities.

The FASB added an illustrative example in the implementation guidance related to series mutual funds to demonstrate how the equity holders may have power through voting rights even if the entity has an outsourced manager such as an investment manager. The example indicates that the equity-at-risk investors have power over the activities that most significantly impact the entity's economic performance, and therefore the entity is not a VIE based on this characteristic, because the equity at-risk holders have *simple majority* voting rights over all of the following (1) the replacement of the decision maker, (2) the approval of the decision maker's compensation and (3) the investment strategy of the entity.

Because certain simple majority voting rights may be considered in evaluating the voting rights characteristic, legal entities for which decision making rights are held through a contractual arrangement are less likely to be considered VIEs. The new two-step analysis appears to render the evaluation of single equity holder kick-out rights or participating rights irrelevant for purposes of determining whether an entity is a VIE. That is, if there were an

equity-at-risk investor with single-party kick-out rights or participating rights, it appears that the Step 1 requirement would be met and there would be no need to proceed to Step 2.

Because the clarifications made are not limited to series mutual funds, they are likely to have an impact on other legal entities for which decision making rights are held through a contractual arrangement.

Example 4: Research and Development Venture

Two investors create a separate legal entity intended to develop and commercialize a new medication. The entity does not qualify for the business scope exception in ASC paragraph 810-10-15-17(d). The investors hire an unrelated third-party manager to oversee the research and development activities. The investors hold simple majority voting rights over the removal of the manager, the compensation of the manager, and the strategy of the entity. As a result, the two investors, as a group, have the power through their voting rights to direct the activities that most significantly impact the entity's economic performance. The entity has no other characteristics of a VIE.

Under the current guidance, the entity is a VIE while it is in the research and development stage. The investors are required to determine which party, if any, is the primary beneficiary of the entity and provide the VIE disclosures about their involvement with the entity.

Under the new consolidation guidance, the entity is not a VIE. The investors may or may not consolidate the entity depending on their respective voting interests.

Limited Partnerships and Similar Legal Entities

The FASB decided to change the VIE criteria so that regardless of the sufficiency or other characteristics of its equity a limited partnership or similar entity is a VIE unless substantive kick-out rights or participating rights are exercisable by either a single limited partner or a simple majority of all limited partner voting interests.¹⁴ Limited partner voting interests held by the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner are excluded from that analysis. The analysis is not affected by whether the general partner interest qualifies as an equity-at-risk interest.

¹⁴ Kick-out rights are the ability to remove the general partner or to dissolve (liquidate) an entity without cause. Participating rights are the ability to participate in certain significant financial and operating decisions of the limited partnership that are made in the ordinary course of business. Participating rights do not require the holder of such rights to have the ability to initiate actions.

Entities for which investors are eligible to apply the pro rata method of consolidation based on industry practice in the construction industry or extractive industries are not within the scope of this provision. This allows investors in these entities to continue to apply the pro rata method of consolidation when applicable.

What Are the Implications?

Limited partnerships and similar entities are not automatically considered VIEs under current U.S. GAAP when the limited partners lack single-party or simple majority substantive kick-out or participating rights. However, the general partner or managing member is generally required to consolidate such limited partnerships. The changes to the VIE criteria will require investors in these entities to provide the VIE disclosures about their involvement with the entity, which are significantly more extensive than the disclosures for entities other than VIEs.

For general partners that currently consolidate limited partnerships and similar entities, those entities will become VIEs if they previously have not met the VIE criteria. A reporting enterprise will need to reconsider its consolidation conclusion and update its disclosures for limited partnerships and similar entities that become VIEs. For limited partnerships and similar entities that become VIEs, the general partner will either continue to consolidate the entity and become subject to the VIE primary beneficiary disclosure requirements or will no longer consolidate the entity under the revised VIE consolidation requirements. General partners that no longer consolidate a VIE will be subject to the disclosure requirements that apply to variable interest holders other than the primary beneficiary. General partners that hold only an insignificant investment interest in the partnership will likely deconsolidate the partnership under the new consolidation guidance provided that the general partner's fees are commensurate with the services provided and customarily present in arrangements for similar services negotiated on an arm's-length basis.

For general partners that currently do not consolidate limited partnerships and similar entities, those entities will remain voting interest entities if they previously have not met the VIE criteria and the general partner will continue not to consolidate the entity.

For general partners that currently consolidate limited partnerships and similar entities under the existing VIE guidance, a reporting enterprise will need to evaluate whether the partnership continues to meet the definition of a VIE under the new consolidation guidance. General partners that no longer consolidate a VIE will be subject to the disclosure requirements that apply to variable interest holders other than the primary beneficiary. If the partnership continues to be a VIE, general partners that hold only an insignificant investment interest in the partnership will likely deconsolidate the partnership under the new consolidation guidance provided that the general partner's fees are commensurate with the services provided and customarily present in arrangements for similar services negotiated on an arm's-length basis. For circumstances in which a partnership is no longer considered a VIE (e.g., the

partnership currently is considered a VIE only because the general partner's decision-making rights are not conveyed through its equity interest and the limited partners have simple majority substantive kick-out rights), the general partner will not consolidate the partnership under the voting interest entity model.

Example 5: Asset-Backed Investment Entity

A limited partnership is created to hold a portfolio of asset-backed securities and is financed with debt and equity. The limited partners hold 99% of the equity interests and are unrelated. The limited partners have simple majority substantive participating rights. No limited partner holds a majority of the LP interests. The general partner holds 1% of the equity interests, which is not considered equity-at-risk (e.g., the general partner receives a fee at the formation of the entity which exceeds its equity interest). The limited partnership has no other characteristics of a VIE. The general partner is the asset manager of the partnership and for its services earns base, fixed-senior, and subordinate fees and a performance-based fee in which it receives a portion of the partnership's profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions.

Under current U.S. GAAP, the limited partnership is a VIE and the general partner likely consolidates the entity.

Under the new consolidation guidance, the limited partnership is not a VIE because the limited partners have simple majority substantive participating rights. Neither the general partner nor the limited partners consolidate the entity.

Example 6: Real Estate Investment Limited Partnership

A limited partnership is created to acquire commercial real estate assets for \$100 million. The general partner's initial equity contribution is \$15 million. Two unrelated limited partners contribute the remaining initial partnership equity in the amount of \$25 million. The remaining funds required to purchase the real estate assets are financed with nonrecourse senior debt financing in the amount of \$60 million. The general partner's decision making rights are conveyed through its at-risk equity. The limited partners do not have substantive kick-out rights or participating rights. The limited partnership has no other characteristics of a VIE. For its services as property manager, the general partner earns management fees that are considered commensurate with the services provided and only include customary terms and conditions. Following the allocation of the management fee to the general partner, profits and losses of the partnership are shared in proportion to the investors' equity interests.

Under current U.S. GAAP, the limited partnership is not a VIE and the general partner consolidates the entity.

Under the new consolidation guidance, the limited partnership is a VIE because the limited partners do not have simple majority kick-out rights or participating rights. The general partner will continue to consolidate the partnership and become subject to the VIE primary beneficiary disclosure requirements.

Changes to Consolidation Requirements for Entities That Are Not VIEs



ASU 2015-02 eliminates the specialized consolidation model and guidance for limited partnerships and similar legal entities, including the presumption that a general partner should consolidate a limited partnership.

The FASB decided to eliminate the consolidation guidance for limited partnerships and similar entities that are not VIEs.¹⁵ Under the new consolidation requirements, those entities will be evaluated for consolidation in generally the same way as corporations that are not VIEs. Limited partner substantive kick-out rights held through voting interests of partnerships and similar entities that are not VIEs will be considered fully the equivalent of the equity interests of corporations that are not VIEs. Limited partner substantive participating rights held through voting interests of partnerships and similar entities will be considered equivalent to equity interests of corporations that are not VIEs for purposes of determining whether those entities are VIEs. However, substantive participating rights will not require consolidation of the entity by a partner with the ability to unilaterally exercise those rights.

What Are the Implications?

These changes are not likely to significantly affect consolidation evaluations for entities that are not VIEs. A limited partner that has the unilateral right to exercise substantive kick-out rights (e.g., because it holds a majority of the limited partner interests) will be required to consolidate a limited partnership that is not a VIE under the new consolidation guidance. Conversely, a limited partner that has the unilateral right to exercise substantive participating rights (e.g., because it holds a majority of the limited partner interests) will not be required to consolidate a limited partnership if it does not also have a unilateral right to exercise substantive kick-out rights. This is because participating rights only give a limited partner the right to block or participate in financial and operating decisions of the limited partnership that are made in the ordinary course of business. They do not give the limited partner the right to make those decisions without the agreement of the general partner.

A general partner is required to consolidate a limited partnership that is not a VIE under current U.S. GAAP when the limited partners have substantive simple majority kick-out or participating rights and its related parties hold some of the limited partner interests (such that a simple majority of the third-party limited partners cannot exercise those rights). Under the new consolidation guidance, the limited partnership will be a VIE and the general

¹⁵ FASB ASC Subtopic 810-20, Consolidation – Control of Partnerships and Similar Entities, available at www.fasb.org.

partner will be required to determine whether it is the primary beneficiary of the VIE.

Interests in Investment Entities

Money Market Funds

Similar to the deferral of the VIE consolidation requirements in ASU 2009-17, the FASB decided to exclude from the scope of ASC Topic 810 money market funds that:¹⁶

- Are required to comply with Rule 2a-7 of the 1940 Act; or
- Operate in accordance with requirements that are similar to those in Rule 2a-7 of the 1940 Act.

The FASB provided guidance to clarify the meaning of similar. The Board does not expect significant differences from how money market funds are currently evaluated for purposes of the deferral of ASU 2009-17. Fund sponsors of money market funds excluded from the scope of ASC Topic 810 will be required to disclose arrangements to provide support to the money market funds they manage as well as any instances of support provided for the periods presented in the performance statement.

Investment Entities Other Than Money Market Funds

ASU 2010-10 indefinitely deferred the effective date of the VIE consolidation requirements in ASU 2009-17 for reporting enterprises with interest in entities that either have all of the characteristics of investment companies or that apply measurement principles for financial reporting purposes that are consistent with those that apply to investment companies based on acceptable industry practice if the reporting enterprise meets other conditions. The new guidance eliminates this deferral so that the same VIE consolidation requirements apply to all VIEs. Reporting enterprises will no longer evaluate consolidation for these entities when they are VIEs based on majority exposure to variability.

What Are the Implications?

Reporting enterprises with an interest in investment entities that are VIEs but are not money market funds will need to reconsider their consolidation conclusions for those entities. If the consolidation conclusions change, the VIE disclosures will need to be updated.

Considerations Specific to Mutual Funds and Similar Entities

Mutual funds often are organized in a series structure that allows an umbrella entity (frequently organized as a master trust with a single board of trustees) to issue several mutual funds (the series funds) under the umbrella entity and reduce administrative costs. Some stakeholders questioned whether an individual series fund would meet the FASB ASC definition of a legal entity.¹⁷

¹⁶ FASB ASC paragraph 810-10-65-2, available at www.fasb.org.

¹⁷ FASB ASC master glossary, available at www.fasb.org.

The FASB decided that series funds required to comply with the 1940 Act for registered mutual funds meet the FASB ASC definition of a legal entity. The Board observed that each individual series:

- Has its own investment objectives and policies;
- Has its own custodial agreement;
- Has its own shareholders separate from other series within the umbrella entity;
- Has a unique tax identification;
- Files separate tax returns with the IRS;
- Has separate audited financial statements; and
- Is considered a separate investment company for purposes of investor protection afforded by the 1940 Act by the SEC staff's Division of Investment Management.

What Are the Implications?

Determining whether a series fund meets the definition of a legal entity is important because the consolidation guidance applies to legal entities. Portions of legal entities are subject to consolidation requirements only if the legal entity itself is a VIE. Consequently, prior to the FASB's decision to consider as legal entities the series funds that must comply with the 1940 Act, the consolidation analysis for the series began with an analysis of whether the umbrella entity was a VIE. In circumstances where the umbrella entity met the criteria to be considered a VIE, each series within the umbrella entity was evaluated for consolidation as a separate VIE. In circumstances where the umbrella entity did not meet the criteria to be considered a VIE, only the umbrella entity was evaluated for consolidation; each series within the umbrella entity was not separately evaluated for consolidation.

The new consolidation guidance is silent with respect to how to determine whether investment funds or legal entities, other than series funds required to comply with the 1940 Act for registered mutual funds that are not stand-alone legal entities, are legal entities for purposes of applying the consolidation requirements. It is possible that entities similar to series funds that are organized outside the United States would not meet the FASB ASC definition of a legal entity if the series cannot enter into contracts or hold assets in its name, and voting rights are held at the umbrella-entity level. If the umbrella entity is determined to be the legal entity, the umbrella entity may be a VIE if the equity at-risk holders do not have the ability to remove and replace the board of trustees.

For funds that are similar to those required to comply with the 1940 Act, some practitioners may conclude that the umbrella entity does not have sufficient equity at risk resulting in the entity being a VIE because the various shareholders in each series do not significantly participate in the umbrella entity's profits and losses. If so, the umbrella entity would be a VIE, and each series would likely be considered a separate silo entity under the VIE consolidation requirements. We believe it would be unusual for an entity similar to a series fund that is required to comply with the 1940 Act to meet the FASB ASC definition of a legal entity.

Effective Date and Transition

The new consolidation guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. For all other entities, the guidance is effective for annual periods in fiscal years beginning after December 15, 2016, and for interim periods in fiscal years beginning after December 15, 2017. At the effective date, all previous consolidation analyses that the guidance affects must be reconsidered. This includes the consolidation analyses for all VIEs and for all limited partnerships and similar entities that previously were consolidated by the general partner even though the entities were not VIEs. Early adoption is permitted, including early adoption in an interim period. If a reporting enterprise chooses to early adopt in an interim period, adjustments resulting from the revised consolidation analyses must be reflected as of the beginning of the fiscal year that includes that interim period.

Transition provisions for all entities will require reporting enterprises to initially measure any newly consolidated subsidiaries at their *carrying amount* at the date that the guidance first applies. The carrying amount is the amount at which the subsidiaries' assets, liabilities, and noncontrolling interests would have been carried in the reporting enterprises' consolidated financial statements if the guidance had been effective when they first met the conditions to consolidate the entity. However, reporting enterprises will be permitted to measure newly consolidated subsidiaries' assets, liabilities, and noncontrolling interests at fair value at the date the guidance first applies if it is not practicable to determine the carrying amounts.

Reporting enterprises required to consolidate a subsidiary when they adopt the new guidance will recognize a cumulative-effect adjustment to retained earnings for any difference between the net amount added to the balance sheet and the amount of previously recognized interests (if any) in newly consolidated subsidiaries.

Reporting enterprises required to deconsolidate entities when they adopt the new guidance will be required to determine the *carrying amount* of any retained interests in the deconsolidated entities and recognize a cumulative-effect adjustment to retained earnings for any difference between the retained interests and the net amount removed from the balance sheet as a result of derecognizing the entities' assets, liabilities, and noncontrolling interests (if any). The carrying amount of the retained interests is the amount at which they would have been measured in the financial statements if the new guidance had always been effective. However, reporting enterprises will also be permitted to measure the retained interests at fair value at the date the guidance first applies if it is not practicable to determine the carrying amounts.

Reporting enterprises will be permitted, but not required, to apply the new guidance using a modified retrospective approach with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. Reporting enterprises may also restate 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.

Finally, reporting enterprises that are required to initially consolidate a subsidiary upon adoption of the new guidance will be permitted to elect the fair value option in ASC Subtopic 825-10 for eligible financial assets and financial liabilities of those subsidiaries on an entity-by-entity basis if the fair value election is applied to all of the subsidiary's eligible financial assets and financial liabilities.¹⁸

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Kimber K. Bascom, Robert B. Malhotra, Thomas Faineteau, and Danielle Imperiale

Earlier editions are available at: <http://www.kpmg-institutes.com>

Legal—The descriptive and summary statements in this newsletter are not intended to be a substitute for the potential requirements of the standard or any other potential or applicable requirements of the accounting literature or SEC regulations. Companies applying U.S. GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors. Defining Issues® is a registered trademark of KPMG LLP.

¹⁸ FASB ASC Subtopic 825-10, Financial Instruments – Overall, available at www.fasb.org.