Consolidation of Variable Interest Entities
Disclaimer

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Objectives

How the changes to the consolidation requirements for variable interest entities were affected:

- existing structures and future transactions
- your company's financial reporting and core business
Agenda

• Background
• Significant changes and examples
• Other discussion items
Why was Statement 167 issued?

- Elimination of QSPE
- Structured Investment Vehicle (SIV’s) and other entities
  - that were off-balance sheet
  - sponsor provided support to the entity
Why was Statement 167 issued? (cont'd)

- Practice issues-
  - quantitative risk and rewards test

- Improved Information to FS users
  - Reconsideration events
  - Disclosures
Big picture

- Eliminates quantitative risks-and-rewards approach to identifying primary beneficiary (PB)

- Replaces w/ "qualitative" analysis of who has both:
  - Power AND
  - Economic Interest
Power –
to direct activities which most significantly impact the economic performance of the VIE
Big picture (continued)

Economic Interest-
the obligation to absorb losses or receive benefits that could potentially be significant to the VIE
Big picture (continued)

- Emphasizes: only substantive terms, transactions, and arrangements to be considered

- Significant management judgment
  - considered & documented on adoption
  - on an *ongoing* basis
Big picture, continued

• Reconsideration of previous conclusions per FIN 46R:
  – Is entity a VIE?
  – Service provider or decision maker fees are VI's?
  – Is enterprise the PB?
  – Disclosures required and how aggregated?
What has NOT changed under FAS 167

• Scope exceptions (other than for QSPEs)

• Conditions that identify an entity as a VIE
  – Except -ASC 810-10-15-14(b) on the ability of equity holders as a group to make decisions

• Definition of a variable interest
  – Modification of whether fees paid to a decision maker or service provider are variable interests
What has not changed under FAS 167-(continued)

- Concept of expected losses and expected residual returns (expected variability)
  - still relevant for VIE determination
  - but NOT for PB identification

- Guidance on implicit variable interests from FSP FIN 46(R) – 5

- Guidance on evaluating the design of an entity from FSP FIN 46(R) – 6
Guidance issued to date

- FASB Statement 167: Amendments to FASB Interpretation No. 46(R)
  - Issued in June 2009

- Codified by Accounting Standards Update 2009-17
  - December 2009
  - Included in ASC 810: Consolidations
    - Amended by ASU 2010-10: Amendments for Certain Investment Funds, in February 2010
Agenda

• Background

• Significant changes and examples

• Implementing the new standard

• Other discussion items
Scope
Partial deferral now in place

- ASU 2010-10 deferred effective date for certain asset manager funds for either:
  - an investment company (ASC 946-10-15-2)
  - entity for which it is acceptable based on industry practice to apply measurement principles that are consistent with those of an investment company (mortgage real estate investment fund)
- SEE guidance for conditions
## Scope

### QSPEs

<table>
<thead>
<tr>
<th>FIN 46R</th>
<th>Observations and Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>(paragraph 4c and 4d / ASC 810-10-15-14)</td>
<td>• FAS 166 eliminated QSPE concept</td>
</tr>
<tr>
<td>Qualifying Special Purpose Entity (QSPE) not subject to consolidation</td>
<td>• Servicer of loans should evaluate if service contract gives it “power”</td>
</tr>
<tr>
<td><strong>FAS 167</strong></td>
<td>• Financial institutions have phased implementation/other regulatory capital changes (see link below)</td>
</tr>
</tbody>
</table>

The scope exceptions have been eliminated

### Scope

**Reasonableness exception**

<table>
<thead>
<tr>
<th>FIN 46R(paragraph 6)</th>
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</thead>
<tbody>
<tr>
<td><strong>Reporting enterprise not required to determine whether an entity is a VIE if:</strong></td>
</tr>
<tr>
<td>• Apparent that potential VI would <em>not</em> be a significant VI in the entity</td>
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<tr>
<td>• Reporting enterprise, its related parties, and its de facto agents did <em>not</em> participate significantly in the design or redesign of the entity</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FAS 167</th>
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<tbody>
<tr>
<td><strong>This exception has been deleted</strong></td>
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</table>

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Consolidation of variable interest entities

Economic substance

• Consider only **substantive** terms, transactions, and arrangements

• ? Is a reporting entity’s stated power to direct the most significant activities disproportionately < its economic interest in the entity? If so:
  – Increase level of skepticism about the enterprise’s apparent lack of power.
  – Is economic interest in an entity indicative of the amount of power the enterprise holds?
Consolidation of variable interest entities

Economic substance - SEC staff views

- Structures designed for an accounting or financial reporting result
- Inconsistencies of structure with economic substance of an arrangement
- Reduced transparency of financial reporting
- Recent proposed structures:
  - At least the appearance of shared power
  - With most of downside risk w/ sponsoring entity
• Structures designed to deconsolidate underperforming assets:
  – Reporting entity appears to have relinquished control
  – Perhaps creating the appearance of shared power?
  – In substance retains substantially all of the economic risks of ownership?
### Fees paid to decision makers or service providers

<table>
<thead>
<tr>
<th>FIN 46R</th>
<th>Observations and Implications</th>
</tr>
</thead>
</table>
| Fees paid to a decision maker or a service provider are not VIs if:  
• Include substantive kick-out rights (for decision maker fees) OR customary cancellation provisions (for service provider fees). | • Reassess previously existing fee arrangements  
  • Consolidation?  
  • Disclosure? |
| FAS 167 | |
| The conditions considered in VI analysis of fees paid to a decision maker or service provider have been consolidated and modified:  
• **Cannot consider kick-out rights or customary cancellation provisions.** | • What "power" does the fee arrangement provide to the decision maker/service provider? |
Are fees paid variable interests?

Fees paid are considered variable interests unless all of the following 6 conditions are met:

1. *Fees commensurate* with level of effort required to provide similar services

2. Fee is at or above the *same level of seniority* as entity’s other operating liabilities, such as trade payables.

3. Decision maker or service provider would *not absorb more than an insignificant amount* of expected losses or residual returns.
Are fees paid to decision makers or service providers variable interests?

Fees paid are considered variable interests unless all of the following 6 conditions are met:

4. The service arrangement’s terms, conditions, or amounts are *customary*

5. The anticipated *fees are insignificant relative* to the VIE’s anticipated economic performance.

6. The anticipated fees are expected to *absorb an insignificant amount of the variability*
What is a Variable Interest Entity?

ASC 810-10-15-14

- Legal entity
- With any of the following three conditions:
  1) Insufficient Equity investment at risk
  2) Substantially all activities involve or are conducted on behalf of a single investor with disproportionately few voting rights
What is a Variable Interest Entity?

ASC 810-10-15-14 (continued)

3) As a group the holders lack any one of the following characteristics:

- **power to direct activities** that most significantly impact entity’s economic performance
- **obligation** to absorb expected losses of the entity
- the **right** to receive the expected residual returns of the entity
### Revised definition of a VIE

<table>
<thead>
<tr>
<th>FIN 46R</th>
<th>Observations and Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>(paragraphs B18-21 / ASC 810-10-55-33 thru 36)</td>
<td><strong>• Many limited partnerships will now meet the definition of a variable interest entity</strong></td>
</tr>
<tr>
<td>Substantive kick-out rights considered in determining whether fees paid to a decision maker are a variable interest</td>
<td></td>
</tr>
<tr>
<td><strong>FAS 167</strong></td>
<td></td>
</tr>
<tr>
<td>• Kick-out and participating rights are ignored in determining whether a VIE</td>
<td></td>
</tr>
<tr>
<td>• Unless those rights are held by <em>single party</em>.</td>
<td></td>
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<tr>
<td>• Eliminates specific guidance on whether such a right is substantive.</td>
<td></td>
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</tbody>
</table>
## Determining the primary beneficiary - Overview

<table>
<thead>
<tr>
<th>FIN 46R</th>
<th>Observations and Implications</th>
</tr>
</thead>
</table>
| PB = Absorbs majority of VIE’s expected losses and/or receives majority of VIE’s expected residual returns. | • FIN 46R and FAS 167- PB must hold a variable interest  
• May be required to provide disclosures about its involvement with the VIE  
• Appendix C of FAS 167 provides nine examples -analysis required to identify the PB of a VIE.  
  • securitizations and other asset-backed financing arrangements  
  • a property leasing entity  
  • commercial operating entities. |

### FIN 46R

The PB is the enterprise that has both:

<table>
<thead>
<tr>
<th>(1) Power</th>
<th>The power to direct activities that most significantly impact the economic performance of the VIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2) Economics</td>
<td>the obligation to absorb losses or receive benefits that could potentially be significant to the VIE</td>
</tr>
</tbody>
</table>
Determining the PB

**Economic Interest**

The obligation to absorb losses or receive benefits that could potentially be significant to VIE

- Could potentially be significant
  - Need to consider various scenarios

- Not the same as expected losses and expected residual returns, as defined in FIN 46R
  - Lower threshold than the previous requirement
  - Prior based on majority of VIE’s expected losses and/or expected residual returns
Determining the PB

Economic Interest (continued)

• Generally, if an entity has power, it will have economics

• More than one party involved with a VIE may meet the economic criterion
  – but only one enterprise, if any, is expected to meet the power criterion
## Determining the PB-SEC Views – Assessing potential economic significance

<table>
<thead>
<tr>
<th>FAS 167</th>
<th>SEC staff views</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic Interest</strong></td>
<td>No bright-line test for potential significance</td>
</tr>
<tr>
<td>Obligation to absorb losses or</td>
<td>• Requires judgment</td>
</tr>
<tr>
<td>receive benefits that could</td>
<td>• Quantitative and qualitative</td>
</tr>
<tr>
<td>potentially be significant to the VIE</td>
<td>• Qualitative factors include, but are not limited to:</td>
</tr>
<tr>
<td></td>
<td>• Purpose and design</td>
</tr>
<tr>
<td></td>
<td>• Terms and characteristics of the financial interests</td>
</tr>
<tr>
<td></td>
<td>• Reporting enterprise’s business purpose for holding financial interest</td>
</tr>
</tbody>
</table>
Determining the PB

Power

The power to direct activities that most significantly impact the economic performance of the VIE

• Assess:
  – Enterprise’s variable interests
  – Related parties' variable interests
  – De facto agents' variable interests

• Both implicit & explicit interests considered
Determining the PB

**Power** (continued)

The power to direct activities that most significantly impact the economic performance of the VIE

- What is VIE’s purpose and design

- What are the risks the VIE was designed to create and pass through to its variable interest holders

(FSP FIN 46(R)-6/ ASC Section 810-10-25 and 810-10-55)
The power to direct activities that most significantly impact the economic performance of the VIE

- Identify activities that *most significantly* affect the VIE’s economic performance
- Kick-out rights and participation rights are not considered in PB determinations
  - unless exercisable by a single party (or a single related-party group).
Determining the PB

Power (continued)

The power to direct activities that most significantly impact the economic performance of the VIE

• Does enterprise’s significant involvement in the design:
  – Provide opportunity to establish arrangements resulting in "power"? Or NO power?
  – Direct the entity’s most significant activities?
  – Note: Should not view these in isolation

• Level of economic interest indicative of amount of power?
Determining the PB

Power (continued)

The power to direct activities that most significantly impact the economic performance of the VIE

• Is stated power to direct the entity’s most significant activities disproportionately less than its economic interest in the entity?

• Do not have to exercise its power to have power to direct the activities of an entity
  – (A38 of Basis for Conclusions)
Determining the PB

Shared Power

• If power is shared, there is NO primary beneficiary.
  – 2 or more unrelated parties together sharing power
  – Power to direct the *activities that most significantly impact* economic performance
  – Decisions *require* consent of *each* party
• If power is not shared, the nature of the activities each party is directing should be considered
  – Who's power most significantly impacts the VIE’s economic performance?
Determining the PB

EXAMPLE

<table>
<thead>
<tr>
<th>Facts</th>
</tr>
</thead>
<tbody>
<tr>
<td>• VIE owned by 2 unrelated parties, Company A and Company B</td>
</tr>
<tr>
<td>• Activities of VIE that most significantly impact performance:</td>
</tr>
<tr>
<td>• manufacturing, distributing and selling of a beverage</td>
</tr>
<tr>
<td>• Company A and B are both responsible for manufacturing activities</td>
</tr>
<tr>
<td>• Company B is also responsible for distribution and selling activities</td>
</tr>
</tbody>
</table>
When would power be shared?

- All decisions about the manufacturing, distribution, and selling activities require the consent of both companies.
When would power not be shared (mutual consent not required over any activities)?

- If the manufacturing activities are not the most significant → Company B would consolidate
- If the selling and distribution activities are not significant → need to evaluate who has the power over the majority of the manufacturing activities
## Determining the PB

### SEC Views - Most significant activities and kick-out rights

<table>
<thead>
<tr>
<th>FAS 167</th>
<th>SEC staff views</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant Activities</td>
<td>Skeptical about the existence of any entities with no significant activities</td>
</tr>
<tr>
<td>Kick-out and participation rights not considered in primary beneficiary determination, unless exercisable by a single party</td>
<td>An entity’s board of directors generally cannot be treated as a single party</td>
</tr>
<tr>
<td>Shared power</td>
<td>Approach assertions that power is shared with a healthy dose of skepticism.</td>
</tr>
</tbody>
</table>
### FIN 46R

Party within the group that is most closely associated with the VIE is the PB.

### FAS 167

If neither related party has **both** characteristics of PB, but as a group does, then the party within the group that is most closely associated with the VIE is the PB.
## Reconsideration of PB determination

- Reconsideration only when specified events occur.
- A troubled debt restructuring is not a reconsideration event.

### FAS 167

- Reconsideration on *ongoing basis* and is not limited to specified events.
- Consider *loss of power* to direct the entity’s most significant activities.
- A troubled debt restructuring is no longer exempt from reconsideration.
• Reevaluate each reporting period
• Must Consolidate VIE as of date it becomes PB, which may not be as of the beginning or end of a reporting period.
• May result in volatility between reporting periods due to ongoing reassessments
• Will require changes to processes, information systems, internal controls, and data requirements
• Will require management to obtain more timely information from the VIE
Presentation and disclosure

• Disclosures apply to both public and non public enterprises
• FAS 167 eliminates “significance” threshold for non PB disclosures
• Must consider disclosure objectives and need to supplement the required disclosures
• Disclosures are significant and may require management to obtain additional information from the variable interest entity
Presentation and disclosure (continued)

• Requires separate balance sheet presentation of consolidated VIE:
  – Assets that can only be used to settle obligations of the VIE
  – Liabilities for which the creditors or beneficial interest holders lack recourse to the general credit of the primary beneficiary

• How consolidation decision was made (assumptions, process, expectations)
Effective date

- All existing entities must be reevaluated on effective date
- Effective as of the beginning of the first annual reporting period that begins after November 15, 2009 (January 1, 2010 for calendar year-end enterprises)
- Earlier application is prohibited
Transition

- Assets, liabilities, and noncontrolling interests of a VIE that is newly consolidated should be measured at adoption-date carrying amounts
  - *Determined as if FAS 167 had been in effect when the reporting enterprise first met the PB conditions*
• If impracticable to determine adoption-date carrying amounts—required to either:
  – Measure everything at adoption-date fair values
  – Measure at unpaid balances and fair value items that do not have unpaid balance or that are otherwise required to be measured at fair value.
Securitization Example

- **Variable interest entity**
- Established by transferor
- Issue beneficial interest in two tranches; 90% senior interest and 10% junior interest

- **Transferor (reporting entity)**
- Transferred loans to VIE
- Obtains junior interest and primary servicing responsibilities
- Servicing responsibilities are administrative in nature
Securitization Example (continued)

Transferor (reporting entity) (continued)

• Earns a fixed fee determined as a percentage of unpaid principal balance of loans
• Can be replaced by majority vote of the third-party beneficial interest holders
Securitization Example (continued)

Special servicer

• When loans become 90 days delinquent, servicing responsibilities are transferred from transferor to special servicer
• Earns a fixed fee, and a performance
• fee in which it receives a portion of the entity’s profit above a targeted return
• Can be replaced by majority vote of the third-party beneficial interest holders
Securitization Example (continued)

Does the transferor have a variable interest in the VIE?

• Yes, the transferor’s junior interest represents a variable interest. In addition, the transferor’s servicing arrangement should be evaluated to determine if it results in a variable interest.
What are the other variable interests in the entity?

• Senior beneficial interests held by third parties

• Special servicer arrangement (based on the application of paragraph B22 of FIN 46R as amended by FAS 167)
What activities most significantly impact the VIEs economic performance?

• Ability to mitigate losses on loans that become delinquent
Which variable interest holder, if any, has the power to direct the VIEs most significant activities?

• The transferor through its servicing arrangement?
• Administrative in nature
• Cannot be kicked out by a single party
Securitization Example (continued)

Which variable interest holders meet the economic criterion?

- Transferor through its ownership of the junior interest which absorbs losses first
- Special servicer through its fee arrangement
- Senior beneficial interest holders potentially
Conclusion-The special servicer would consolidate because

1) Has power to direct activities that are most significant to the economic performance of the VIE as it is responsible for mitigating losses on loans that become delinquent

2) It has the right to receive benefits that could potentially be significant as a result of its performance fee arrangement
Facts and Assumptions

• An individual owns a majority voting equity interest in both a manufacturing entity and an entity designed to hold only the property leased to the manufacturing entity.

• Property held by the lessor entity is subject to bank financing that is personally guaranteed by the majority owner.
Related Party Lease Example (continued)

Facts and Assumptions (continued):

– The lease is classified as an operating lease
– Has market terms
– Provides no explicit guarantees or purchase options
– Contains no other terms or conditions that would indicate that the lease itself represents an explicit variable interest in the lessor entity
Related Party Lease Example (continued)

Facts and Assumptions (continued):

• Is the only contractual relationship between the two entities

• Lessor entity is a VIE

• Manufacturing entity has an implicit variable interest in the lessor entity
Related Party Lease Example (continued)

Does the manufacturing entity have a variable interest in the lessor entity?

• Yes, because this example assumes the existence of an implicit variable interest resulting from the leasing arrangement and the relationship between the manufacturing entity and the owner of the lessor entity.

• FAS 167 does not change existing guidance on identifying implicit variable interests.
What are the other variable interests in the lessor entity?

• Bank debt
• Guarantee of bank debt
• Equity interests
What are the activities that most significantly impact the economic performance of the lessor entity?

• Maintenance and operation of the leased property during both the explicit and implicit terms of the lease

• These activities impact the value of the market rents that the lessor entity is able to obtain by leasing the property and the amount the lessor entity could receive from the sale of the property
Related Party Lease Example (continued)

Does the manufacturing entity have the power to direct the most significant activities?

Yes, the manufacturing entity is responsible for the maintenance and operation of the leased property
Related Party Lease Example (continued)

Does the manufacturing entity have an obligation for losses or right to benefits of the lessor entity that are potentially significant to the lessor?

Yes
Conclusion

The manufacturing entity meets both the power and economic criteria that identify the primary beneficiary of a VIE under FAS 167, therefore

• The manufacturing entity is the primary beneficiary of the lessor entity

• The primary beneficiary determination in this example is not based on determining which party in a related party group is most closely associated with the lessor entity
## Codification cheat sheet

### ASC 810-10, Variable interest entities subsections

<table>
<thead>
<tr>
<th>Terminology</th>
<th>FIN 46R, as amended by Statement 167</th>
<th>Codification</th>
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<tr>
<td>Enterprise</td>
<td></td>
<td>Reporting entity</td>
</tr>
<tr>
<td>Legal entity or Variable Interest Entity (VIE)</td>
<td></td>
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</tr>
<tr>
<td>Paragraph 4</td>
<td>Paragraph 5</td>
<td>Paragraph 810-10-15-14</td>
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<tr>
<td>Paragraph 14 – 14G</td>
<td>Paragraph 14 – 14G</td>
<td>Paragraph 810-10-25-38 through 38G</td>
</tr>
<tr>
<td>Paragraphs B22-B23</td>
<td>Paragraph 810-10-55-37 through 55-38</td>
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<tr>
<td>Paragraph 22B-26</td>
<td>Section 810-10-50</td>
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<tr>
<td>Appendix C</td>
<td>Section 810-10-55</td>
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Questions?