

MEMO# 25642

November 16, 2011

FASB Proposes Amendments To Consolidation Guidance

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TO: ACCOUNTING/TREASURERS MEMBERS No. 29-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 63-11 RE: FASB PROPOSES
AMENDMENTS TO CONSOLIDATION GUIDANCE

The Financial Accounting Standards Board recently issued a proposal that amends the consolidation model for variable interest entities (VIEs) and limited partnerships. [\[1\]](#) The proposal would continue to require an evaluation to determine whether a decision maker has a variable interest in an entity. However, it would introduce a separate qualitative analysis to determine whether the decision maker is using its power in a principal or agent capacity. A decision maker acting as an agent would not consolidate the entity. Comments on the proposal are due January 17, 2012.

Background

In June 2009 the FASB issued FAS 167, which requires a reporting enterprise to perform a qualitative evaluation of its power and economics to determine whether it should consolidate a VIE. As a result of FAS 167, investment managers could have been required to consolidate certain funds that they manage. In response to concerns expressed by industry and others, the FASB indefinitely deferred the application of FAS 167. [\[2\]](#) The deferral applied to an adviser's interest in an investment company or an entity that reports in a manner consistent with Topic 946. The deferral, however, does not apply in situations in which the adviser has an explicit or implicit obligation to cover losses of a fund that could potentially be significant to the fund. The indefinite deferral also applied to an adviser's interest in a money market fund that complies with rule 2a-7. The separate deferral for money market funds is not conditioned on the absence of any explicit or implicit obligation of the adviser to cover losses or provide credit support to the money market fund. The current proposal would modify the consolidation guidance as described above and remove the indefinite deferral of FAS 167. The proposal does not include an effective date. The effective date will be determined after the Board receives comments.

Principal versus Agent Analysis

The proposal would require a qualitative analysis of the overall relationship between the decision maker, the entity being managed, and other interest holders. The analysis should consider the entity's purpose and design, including the risks the entity was designed to create and pass through to its interest holders. The analysis should be based on the following factors:

1. Rights held by other parties – Similar to FAS 167, the proposed amendments would include a provision that unilateral substantive kick-out or participating rights held by an unrelated single party are determinative that a decision maker is not a principal. Under the proposal, substantive kick-out or participating rights held by multiple parties could indicate that the decision maker is not a principal.

The proposal indicates that a board of directors for a fund established in accordance with the Investment Company Act of 1940 may be considered substantive and yield significant authority when assessing whether to retain a decision maker. A decision maker would need to consider these rights, along with the decision maker's fees and its other economic interests in the entity when determining whether the rights are indicative of an agency relationship.

2. Decision maker's compensation – Compensation that is not commensurate with the services provided by the decision maker or that includes terms that are not customary for similar services would likely indicate that the decision maker is a principal.
3. Other interests held by decision maker – The greater a decision maker's exposure to expected variable returns, through its compensation and other interests (e.g., investments in the entity or guarantees of its performance, including implicit guarantees), the more likely it is acting as principal.

The proposal differentiates between interests that expose the decision maker to negative returns (e.g., an equity interest or a guarantee) from interests that expose the decision maker to only positive returns (e.g., a performance incentive fee). Specifically, interests that expose the decision maker to negative returns (or both negative and positive returns) are more likely to indicate a principal relationship, while interests that expose the decision maker to only positive returns are less likely to indicate a principal relationship.

Money Market Funds

The proposal asks commenters to respond to a series of questions. Question 10 indicates: "The Board does not intend the application of the proposed Update to result in money market funds being consolidated. Do you agree that the application of the proposed Update will meet this objective? If not, why and what amendments would you recommend to address this issue?"

While the proposal elevates the importance of a board of directors in the analysis of rights held by other parties, it indicates that the presence of an independent board with the ability to terminate the decision maker is not determinative that the decision maker is not acting as principal. Accordingly, even if the fund has an independent board of directors that can terminate the adviser, the principal agent analysis must also consider the decision maker's compensation and its exposure to variability of returns from other interests that it holds, including implicit variable interests. The proposal's elevation of exposure to negative

returns through subordinated interests or guarantees relative to exposure to positive returns is another factor to consider in the application of the framework to money market funds.

The proposal contains a series of hypothetical fact scenarios intended to illustrate the application of the principal and agent model. None of these fact scenarios specifically address money market funds. One of the fact scenarios (Case D: 810-10-55-3AD) describes an investment fund that has a seven member board of directors that may terminate the adviser by majority vote. The adviser is paid a management fee equal to 2 percent of assets and is entitled to 20% of the fund's profits if a specified annual profit level is achieved. The adviser also holds a 20% pro rata equity investment in the fund and has no obligation to compensate the fund for losses beyond its 20% investment. The fact scenario concludes that the adviser is acting as agent because of the board's kick-out rights.

Another fact scenario (Case F: 810-10-55-3AY) describes a commercial paper conduit. The sponsor creates and sells interests in a commercial paper conduit to external investors. The entity is financed with \$98 of AAA rated short-term debt with a 3-month maturity and \$2 of subordinated notes, which are designed to absorb the first dollar risk of loss related to credit. The entity uses the proceeds to purchase medium term notes. The sponsor of the entity provides credit enhancement in the form of a letter of credit equal to 5 percent of the entity's assets, and it provides a liquidity facility to fund the cash flow shortfalls on 100 percent of the short-term debt. Cash flow shortfalls could occur due to mismatches between collections on the underlying assets and payments to the short-term debt holders, or due to the inability of the entity to roll-over its short-term debt on maturity. A credit default on the entity's assets are absorbed as follows: a) first by the subordinated note holders; b) second by the sponsor's letter of credit; c) third by the short-term debt holders. The sponsor collects a fixed fee based on assets that is commensurate with the services provided.

In this fact scenario, the proposal concludes that the sponsor is acting as principal because it has the implicit financial responsibility to ensure that the entity operates as designed in order to manage the risk to its reputation in the marketplace. Although the sponsor's economic exposure is evaluated primarily on the basis of returns expected from the activities of the entity, when considering the purpose and design of the credit and liquidity features, the sponsor would consider its implicit variable interest to absorb the first dollar risk of loss related to credit, liquidity, market value, and interest rate risk. The sponsor's implicit obligation to absorb a significant amount of losses through its credit and liquidity facilities, combined with its compensation and the lack of any voting rights by debt holders, indicate that the sponsor is using its decision making authority as principal.

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endnotes

[\[1\] FASB Proposed Accounting Standards Update, Principal versus Agent Analysis](#) (November 3, 2011).

[\[2\] See Accounting/Treasurers Members Memorandum](#) No. 11-10, Money Market Funds Advisory Committee Memorandum No. 7-10 (March 2, 2010) [24162].

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