

MFA Perspective

Consolidating Variable Interest Entities
Six Steps to Prepare for the New Rules



MOODY, FAMIGLIETTI & ANDRONICO
Certified Public Accountants & Consultants

CONSOLIDATING VARIABLE INTEREST ENTITIES

Six Steps to Prepare for the New Rules

“Variable Interest Entity” is a term that often signals difficult work to come for accountants. Historically, FASB Interpretation No. (FIN) 46R, *Consolidation of Variable Interest Entities*, dictated a myriad of quantitative and formula driven criteria under which to evaluate the existence of a variable interest entity (VIE), the primary beneficiary associated with the VIE, and the appropriate entity to consolidate the VIE.

Adding to the challenge, there was frequently a disconnect between the perceived compliance with the rules surrounding FIN 46R and the related accounting; the guidance was technically followed but the substance was open to interpretation. As a result, the party that ultimately held the risks and rewards for the VIE was frequently not the party that the guidance dictated should consolidate it.

A perfect example of this issue was inherent in the accounting concept of the “Qualified Special Purpose Entity” (QSPE). QSPE’s represented passive entities developed to facilitate securitizations. Under Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125* (FAS 140), financial assets transferred to a QSPE were not recorded on the financial statements of the transferor.

In practice, many companies were allowed to remove certain financial assets from the balance sheet, even though they retained effective control over those assets. The big-name financial institution failures and the mortgage-backed securities market crash of the past couple years involved QSPE’s and securitization transactions, which occurred as a result of “transaction structuring” and lenient accounting designed to exploit the vulnerable points within the former rules-based guidance.

Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets* (FAS 166) and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167) will change the rules of the consolidation game going forward entirely in hopes of avoiding any more “missing” financial asset or consolidated entity debacles. Bright line rules, checklists, mathematical calculations and outlandish exceptions have been removed from this new guidance; instead, the principles behind the new standards encourage professional judgment and consideration of all the related facts and circumstances. The FASB expects financial statement preparers to utilize their

professional judgment to reflect the principles and objectives of the new standards, instead of exploring avenues to distort GAAP to achieve their companies’ specific ends. The bottom line is that the VIE assessment model is switching from a “Risks and Rewards” to a “Power and Economics” focus.

The Standards will be effective as of the beginning of the first fiscal year after November 15, 2009. That deadline is fast approaching, and that there are six key steps that should be undertaken in preparation:

- 1) Identify involvement with and investments in other entities.** Some common contractual and ownership arrangements with other entities to look out for include: Equity Securities, Beneficial Interests, Debt Instruments, Guarantees (including Residual Value), Put/Call/Purchase Options, Management Contracts, Franchise/Co-Marketing Arrangements, Cost-Plus Arrangements, Forward Contracts, Service Contracts, Derivatives, and Technology Licenses. As part of this process, ensure that you are validating the completeness and accuracy of your list with the subject matter experts – those in the Legal, Investment, M&A, Marketing and/or Operations departments actually involved with the contractual and legal arrangements with those entities. Leave no stone unturned in nailing down the potential population.
- 2) Determine whether that involvement and those investments constitute variable interests.** In performing this analysis, keep in mind the points noted within this Perspective. The “new” qualitative assessment should determine whether the reporting enterprise is the primary beneficiary of the VIE, based upon it having both the power to direct VIE activities, and also the obligation to absorb losses of the entity. The prior quantitative FIN 46R-based bright-line “rules” are irrelevant to the FAS 167 assessment.
- 3) Determine informational and data requirements for VIE’s to be consolidated.** In order to consolidate the VIE(s) into the reporting entity, timely, accurate, reliable, and comparable general ledger detail and financial statement information will need to be available from the VIE’s in relation to the reporting entity’s month-end close, consolidation and financial statement reporting and disclosure process. Planning with the appropriate parties will need to occur beforehand, to ensure that the guidance implementation transition goes smoothly – with mutual consensus on items such as the level of detail and format provided, deliverable timeframes, contractual support and documentation.
- 4) Evaluate necessary system update and close process changes.** Consider opportunities for automation in terms of general ledger interface feeds and data transfer (of VIE info)

within the consolidation process. Then work backward from financial statement issuance in order to clearly define and communicate (to VIE data providers) the appropriate deadlines within the financial statement close schedule for VIE information feeds and data transmission in order to avoid delays and potentially miss overall consolidated financial statement issuance deadlines.

5) Establish controls for ongoing monitoring of primary beneficiary designation and VIE reconsideration events.

Remember, financial statement preparers will need to ensure they have controls and processes in place for ongoing monitoring of primary beneficiary designation and for VIE reconsideration events under FAS 167. That discipline and related procedures need to be formally defined, communicated, and followed by the reporting entity's financial reporting team.

6) Consider relevant disclosure requirements. FAS 167 requires disclosures which illustrate an entity's involvement with VIE's and any significant changes in risk exposure due to that involvement, with explanation included of any significant judgments and assumptions made within the consolidation analysis. FAS 166 disclosure requirements seek to improve transparency of any continuing involvement with financial asset transfers, including the nature of any restrictions and how the financial asset transfer affects the Company's balance sheet, earnings and cash flows. Given that more VIE's may need to be consolidated for a given reporting entity, preparing these disclosures will require advance preparation in terms of contractual and operational information gathering, and actual financial statement disclosure preparation time.

In regard to VIE's, the new qualitative assessment focus of FAS 167 will require the financial statement preparer to assess whether the related enterprise is the primary beneficiary of a VIE, based upon it having both (1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance; and (2) the obligation to absorb losses of the entity that could potentially be significant to the VIE, or the right to receive benefits from the entity that could potentially be significant to the VIE.

The good news is that not all entities will end up needing to be consolidated. As an example, for a joint venture that shares power to direct the most significant activities of the VIE with unrelated parties, consolidation will not apply (i.e., no primary beneficiary exists).

Regarding go-forward application of the new VIE consolidation guidelines, whereas FIN 46R required an enterprise to reassess whether an entity is a VIE and whether it is the primary

beneficiary only upon the occurrence of specific triggering events, FAS 167 will require ongoing assessments of which enterprise is the primary beneficiary of the VIE, while reconsideration of whether an entity is a VIE will still be based on the occurrence of specific events.

The overarching message is that early planning will take much of the sting out of the new guidelines, but the real work will continue beyond implementation. As with many standards, FAS 166 and FAS 167 will act as safeguards, and as such financial statement preparers will need to ensure they have controls and processes in place for ongoing monitoring of primary beneficiary designation and for VIE reconsideration events under FAS 167. Analysis and application of the new guidelines will not be a one-time exercise, but will in fact require ongoing attention.

FOR MORE INFORMATION, PLEASE CONTACT:

Travis Drouin, CPA, CIA
Partner
tdrouin@mfa-cpa.com
(978) 557-5335

Michael A. Piessens, CPA, CMA, CFM
Director of Financial Reporting
mpiessens@mfa-cpa.com
(978) 569-2919

Material Discussed in this Perspective Issue is meant to provide general information and should not be acted on without obtaining professional advice tailored to your firm's individual and specific needs. This information is for general guidance only and is not a substitute for professional advice.

IRS CIRCULAR 230 DISCLOSURE: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.



MOODY, FAMIGLIETTI & ANDRONICO
Certified Public Accountants & Consultants

MFA - Moody, Famiglietti & Andronico, LLP
1 Highwood Drive, Tewksbury, MA 01876
(978) 557-5300 www.mfa-cpa.com