

## Statement 167 Adoption Issues Insights for the Asset Management Industry

The Financial Accounting Standards Board (“FASB”) recently issued Statement 167,<sup>1</sup> which significantly changes the consolidation determination for variable interest entities (“VIEs”). Currently, Interpretation 46(R)<sup>2</sup> focuses primarily on a quantitative determination of which party is exposed to a majority of the VIE’s risk and rewards. However, under the new standard, a two step process is introduced such that an enterprise will need to qualitatively consider both its power and its economic interests in the VIE. (See Figure 1. Statement 167 Consolidation Decision Model.)

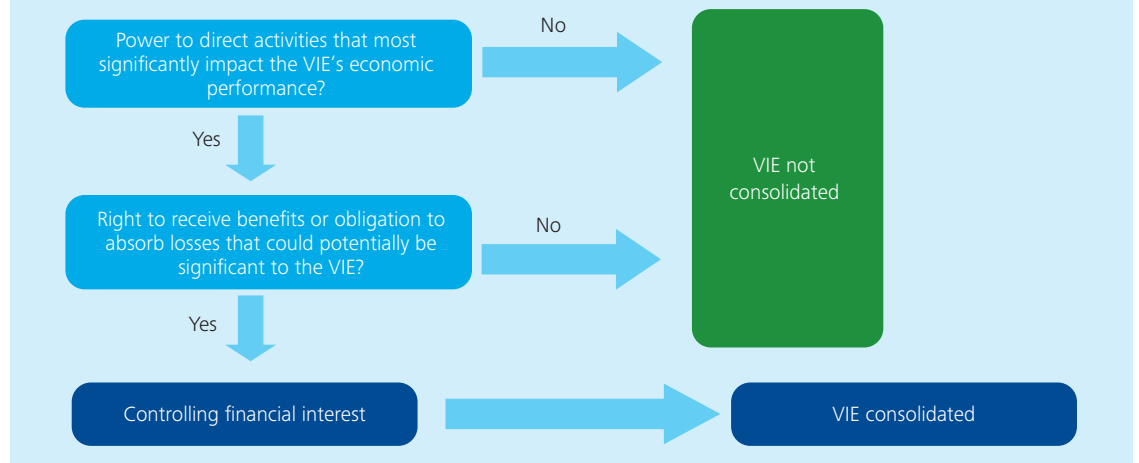
The amendments will also require a continual reassessment of the consolidation conclusion, rather than only under certain reconsideration events as currently required under Interpretation 46(R). Statement 167 affects many aspects of an Interpretation 46(R) analysis, including the consolidation determination and what is considered a VIE. In fact, for the asset management industry, there could be a significant change in the VIE determination as a result of the way rights granted to investors (i.e., kickout or participating rights) are now viewed; this will be discussed in greater detail below. For additional details on the revised

consolidation guidance in Statement 167, please see our June 16, 2009 [Heads Up, FASB Amends the Consolidation Guidance Related to Variable Interest Entities](#).

Statement 167 will likely have considerable implications on the financial reporting of the asset management industry. Asset managers are likely to consolidate the funds that they sponsor, which are VIEs, because of their decision making authority over the fund’s investments and their economic interests in the fund through management fees, incentive fees, or a direct equity investment.

It’s possible that some within the industry might not be aware of the significant impact Statement 167 will have on them, as the amendments to Interpretation 46(R) were largely viewed as addressing securitization structures and the FASB’s elimination of qualified special purpose entities in its amendments to Statement 140.<sup>3</sup> This document is intended to highlight some of the implications and issues asset managers are likely to encounter as they begin to implement the new accounting requirements.

**Figure 1. Statement 167 Consolidation Decision Model**



<sup>1</sup> FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*.

<sup>2</sup> FASB Interpretation No. 46(R), (revised December 2003), *Consolidation of Variable Interest Entities*.

<sup>3</sup> Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

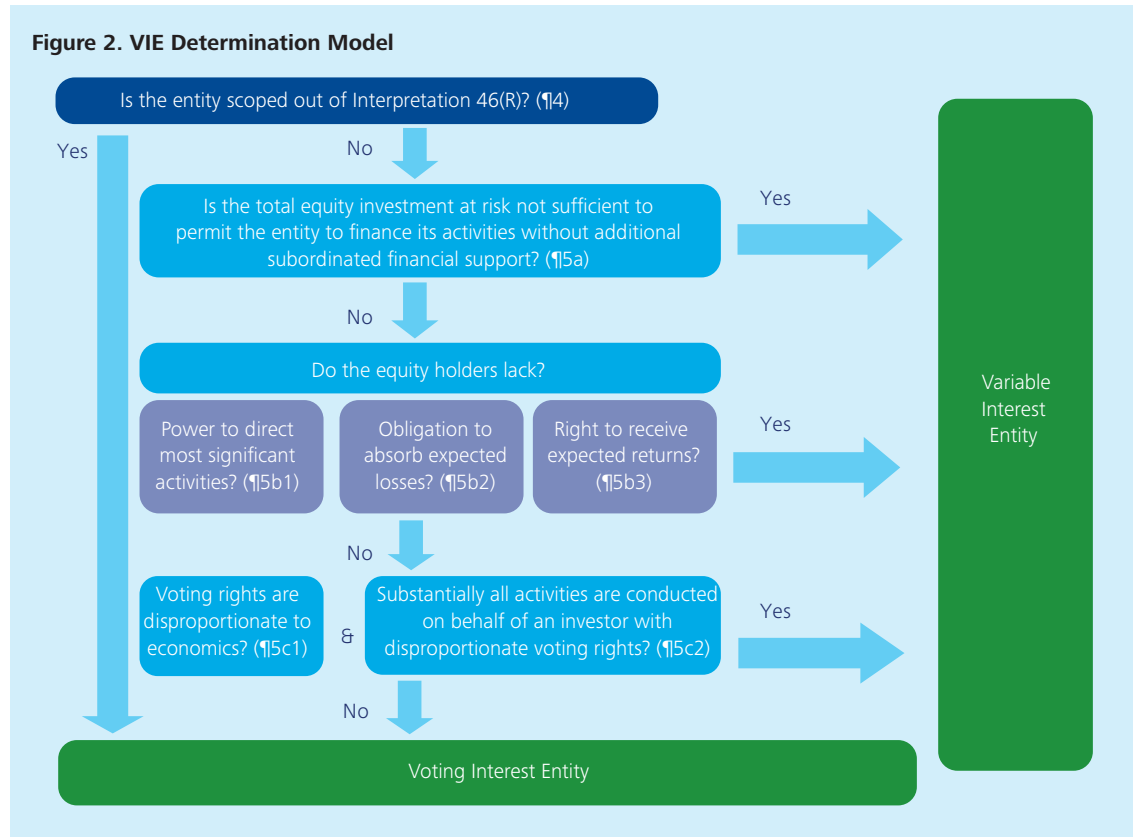
**Two consolidation models**

In the asset management industry, the investment partnerships and limited company structures – often used for offshore investment funds – currently apply Interpretation 46(R) for VIEs and Emerging Issues Task Force (“EITF”) Issue 04-5<sup>4</sup> or ARB 51<sup>5</sup> for voting interest entities, as the consolidation model. The model used is dependent on the specific structure of the entity.

Under the current Interpretation 46(R) model, the reason a fund is usually considered a VIE, rather than a voting interest entity, is that the equity investors do not have the power to direct the entity’s significant activities [¶ 5(b)(1)]; or the voting rights of some investors are not proportional to their risk of loss and right of returns of the entity; and substantially all of the entity’s activities are performed

on the behalf of an investor with disproportionately few voting rights [¶ 5(c)]. The criterion regarding the equity investors not having the power to direct the entity’s significant activities often hinges on the level of the asset manager’s investment in the fund (industry typically considers 1% a sufficient equity investment, although consideration should be given to the level of equity investment of the other investors). However, if an asset manager is not deemed to have sufficient equity, the equity investors would still be considered to have the power to direct the activities of the entity, if the asset manager grants the equity investors substantive kickout or participating rights. The “substantially all” criterion is typically met when an investment fund is established on behalf of a single party and its related parties, such as a corporate pension fund or government retirement fund.

**Figure 2. VIE Determination Model**



<sup>4</sup> EITF Issue No. 04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights.”

<sup>5</sup> Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.

Statement 167 will change the way in which kickout and participating rights are considered, both in determining whether an entity is a VIE and also who is the primary beneficiary. Now a single party (including its related parties and de facto agents) must be able to exercise those rights rather than a simple majority as currently required. During its deliberations on the amendments to Interpretation 46(R), the FASB acknowledged inconsistencies in this view and other guidance under U.S. Generally Accepted Accounting Principles (“U.S. GAAP”)—particularly EITF Issue 04-5 and EITF Issue 96-16<sup>6</sup>, in which these rights are considered substantive if they are being held by a simple majority. This is expected to create a significant issue for the asset management industry because entities previously identified as voting interest entities, as a result of granting these rights to investors, could now be considered VIEs unless a single party is able to exercise those rights. As a result of this change in how kickout rights are viewed, investment funds with substantially similar structures could apply different consolidation models merely because of a difference in the level of the asset manager’s equity investment in the fund and will likely reach different consolidation conclusions for those funds. The basis for conclusions of Statement 167 indicates the FASB will address this inconsistency as part of a project to reconsider consolidation accounting more broadly, so it’s not currently known how long this inconsistency will exist.

#### Consideration of economic involvements

As mentioned earlier, in addition to having the power to direct the most significant activities of the VIE, Statement 167 also requires that an entity have economics in the VIE (the right to receive benefits or the obligation to absorb losses from the VIE that could potentially be significant to the VIE) in order to have a controlling financial interest and consolidate the VIE. The basis for conclusions of Statement 167 provides that the FASB intentionally did not provide additional guidance or an analysis on how an entity should conclude what could potentially be significant to the VIE to avoid establishing bright lines. Rather, the FASB believes this decision requires significant judgment and consideration of all facts and circumstances.

For asset managers, variable interests in a fund often include management and incentive fees, as well as any direct equity investment in the fund. During the comment

period on the Exposure Draft of Statement 167, one asset manager communicated to the FASB that their role is strictly in a fiduciary capacity and therefore they should not be required to consolidate their managed funds. In its redeliberations, the FASB did provide a narrow exception by providing that fees paid to a decision maker or service provider are not variable interests when they meet **all** of the following criteria from paragraph B22 of Statement 167:

- a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services,
- b. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity’s activities, such as trade payables,
- c. The decision maker or service provider and its related parties, if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity’s expected losses or receive more than an insignificant amount of the entity’s expected residual returns,
- d. The service arrangement includes terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length,
- e. The total amount of the anticipated fees are insignificant relative to the total amount of the variable interest entity’s anticipated economic performance, and
- f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity’s anticipated economic performance.

Based on the criteria set forth within Statement 167, an equity investment in the fund by the manager could result in the management or incentive fee being considered a variable interest under criterion c above. Similarly, incentive fee arrangements could also represent a variable interest under criteria e and f above. Fixed management fees might not be considered a variable interest in the fund, but an evaluation under all criteria above would need to be performed, including an assessment of any subordination and significance of the fees.

<sup>6</sup> EITF Issue No. 96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights.”

### Implications for financial statement presentation

The business model for asset managers is typically to earn fees through the management of investment portfolios rather than capital appreciation from direct investment in those funds. Asset managers will sometimes invest capital in their investment funds to align their interests with those of the investors. Those fees earned by asset managers can include management fees based on assets under management, as well as incentive fees based on a fund achieving returns above predetermined levels.

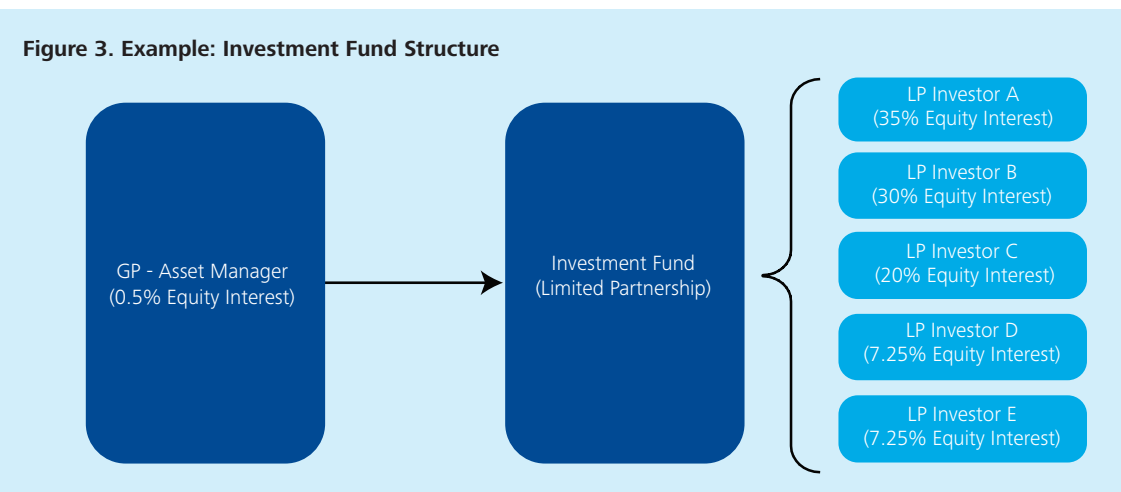
Under current practice, asset managers typically account for any investment in their non-consolidated funds under the equity method of accounting, in which the investment balance is adjusted for fund performance and distributions. However under Statement 167, because more asset managers will likely be identified as having a controlling financial interest, the manager will consolidate all of the fund's assets and liabilities with the third party investors reflected as noncontrolling interest holders. This is expected to result in a variety of financial reporting implications. One implication is the elimination of intercompany transactions between the fund and the asset manager, which will result in no recognition of management or incentive fee income by the manager. Instead, the manager will recognize the investment performance of the fund within its consolidated income statement with net income allocated between the manager and the noncontrolling interest, as prescribed within Statement 160.<sup>7</sup>

Another financial reporting issue is the exponential gross-up of the consolidated balance sheet. Consolidating the assets under management within the funds is likely to add hundreds of millions of dollars, if not billions of investments, debt (if the fund utilizes leverage) and either mezzanine equity (if the investors' interest is redeemable under EITF Topic D-98<sup>8</sup>) or equity (in accordance with Statement 160) to the consolidated balance sheet. The significant gross-up in the balance sheet can impact a variety of metrics that analysts may use in evaluating the manager, including return on assets, return on equity, and operating margins.

Asset managers may want to consider how best to "tell their story" to investors and analysts as a result of the significant changes to their consolidated financial statements. Additional insight and transparency will likely be needed, particularly within the notes to the financial statements, as well as the Management's Discussion and Analysis portion of the quarterly and annual filings with the Securities and Exchange Commission ("SEC") for those asset managers that are public registrants.

### Example application

The following example scenario is intended to help visualize the issues discussed above. (See Figure 3. Example: Investment Fund Structure.) Assume a limited partnership investment fund with \$1,000 of assets under management having five limited partner investors (none constitute related parties) holding equity interests of 35%,



<sup>7</sup> FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51.*"

<sup>8</sup> EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities."

30%, 20%, 7.25%, and 7.25%, respectively. The asset manager acts as the partnership's general partner and has a .5% equity interest in the fund.

For its role as the asset manager, the fund pays a management fee of 2% of assets under management and an incentive fee of 20% of returns above 10%.

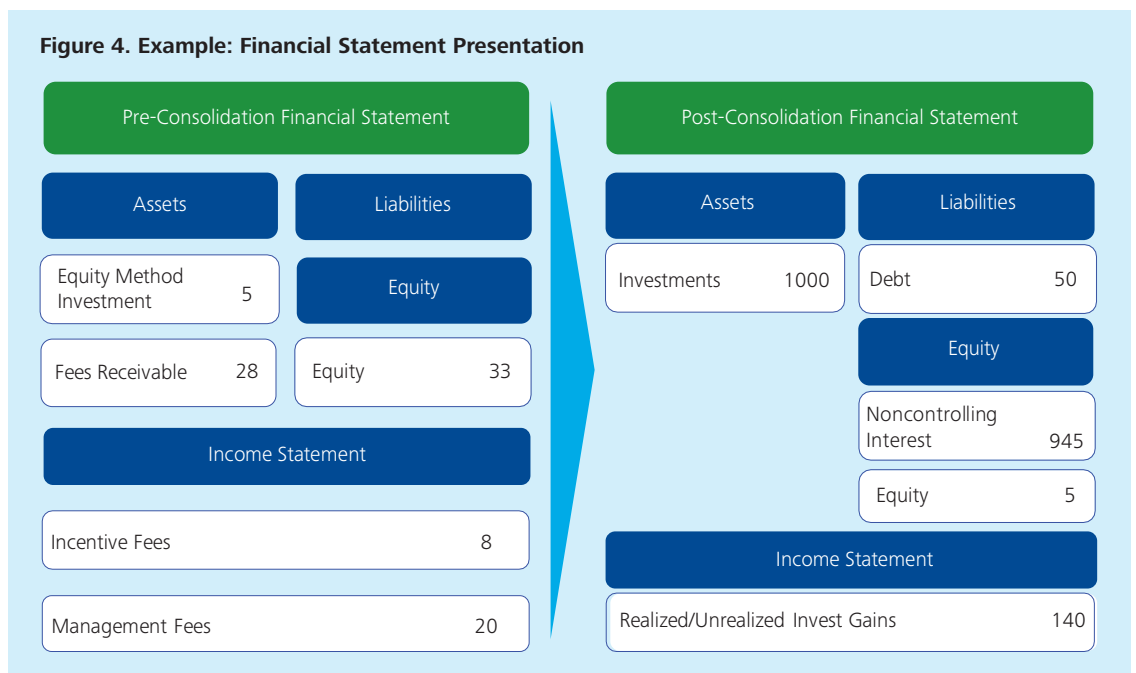
The general partner has the sole ability to make all investment and other decisions regarding the fund's activities; however the limited partners can remove the general partner with a simple majority vote. Historically, the substantive kickout rights provided to the limited partners has allowed the equity holders as a group to have the ability to make decisions under paragraph 5(b)(1) of Interpretation 46(R) even though the general partner's minimal equity interest would not generally be sufficient to be considered part of the equity holding group under the paragraph 5(b)(1) criteria. As a result, an investment fund has generally been considered a voting interest entity and was not consolidated under EITF Issue 04-5 because of the existence of the substantive kickout rights granted to the limited partners.

However, in applying Statement 167, the kickout rights would not be considered in the paragraph 5(b)(1) analysis as no single limited partner has the ability to exercise the

rights. As such, the fund will likely be considered a VIE and the manager would need to perform an assessment to determine whether it is the primary beneficiary and must consolidate the fund. As the asset manager makes all decisions regarding the fund, it would have the power over the activities that most significantly impact the fund's economic performance. Similar to the paragraph 5(b)(1) analysis, the kickout rights would not overcome the conclusion on power since they cannot be exercised by a single investor. Additionally, the asset manager's .5% interest in the fund as well as the management and incentive fee arrangements would likely provide the manager with the right to receive benefits potentially significant to the VIE. As a result, the manager would likely be required to consolidate the fund within its consolidated financial statements.

As Figure 4 displays, the asset manager's balance sheet went from showing a \$5 investment in the fund and a receivable for the management and incentive fees to the entire \$1,000 of assets under management being consolidated. In addition, the \$50 of leverage and the \$945 of the limited partner's equity interest are recognized in debt and equity respectively. Likewise the \$8 of incentive fees (20% of the \$40 of returns in excess of a 10% return) and the \$20 of management fees are no longer recognized in the income statement, rather the fund's periodic

**Figure 4. Example: Financial Statement Presentation**



performance of \$140 of gains is recognized. Obviously, this results in a dramatic difference in the consolidated financial statement presentation of the asset manager.

However, in the above example, if there were 99 limited partners each with a 1% investment in the fund, and the asset manager also had a 1% investment in the fund, the asset manager would be considered part of the equity holder group and therefore would not be considered a VIE under paragraph 5(b)(1). The fund would be analyzed under EITF Issue 04-5 and the ability for a majority of the limited partners to exercise kickout rights would overcome the presumption that the asset manager has control and would therefore not consolidate the fund.

#### Implementation issues

Outside of the potentially confusing financial statement presentation from applying Statement 167, the other major challenge asset managers will likely face is the operational burden of implementation. Asset managers will first need to identify the complete population of entities requiring assessment under the new standard. In addition to the numerous investment funds they sponsor – which could be up to several hundred dependent on the size of the firm – asset managers could also have involvements with a variety of other structures requiring assessment including collateralized debt obligations (“CDOs”), asset-backed security special purpose vehicles and strategic joint ventures. As mentioned earlier, the change in kickout rights application for both VIE determination and power determination will also require a reassessment of those entities previously identified as voting interest entities. Each fund may have unique arrangements, so the assessment will likely require a significant amount of time and effort.

Once the consolidation assessment is complete, the asset manager must then consider how to go about consolidating those funds identified during the assessment. The level of effort required will greatly depend on the level of integration between the fund’s accounting system and the asset manager’s general ledger system. Given that historically the asset manager generally recognized only its equity method investment and fee income for accounting

purposes, it is likely that the fund accounting and general ledger systems of several asset managers have little to no integration.

If the systems are not integrated, the asset manager must then consider the best approach to manually consolidate what could be several hundred entities into its financial statements. Additionally, for those asset managers that are SEC registrants, they also need to consider implementing and testing appropriate financial reporting controls to ensure this process is compliant with the requirements of Section 404 of the Sarbanes-Oxley Act.

The asset manager should also consider how best to accumulate the information needed for the additional disclosures required, and not just those under Statement 167 (which are substantially similar to those already required under FSP FAS 140-4 and FIN 46(R)-8<sup>9</sup>). For example, the consolidated investments of the funds will require disclosures under Statement 107<sup>10</sup> and Statement 157<sup>11</sup> while the noncontrolling interest balances will likely require disclosure under Statement 160. Additionally, in the periods prior to adoption of Statement 167, public registrant asset managers will need to begin the process of accumulating information required for their disclosures under SAB Topic 11.M<sup>12</sup> to “discuss the potential effects of adoption.”

Once the appropriate funds have been consolidated and the financial statements have been issued, the asset manager should then develop a process to perform a continual reconsideration assessment. This will likely involve coordination between multiple parties including accounting policy, corporate accounting, legal department, and the investment advisory business units. Consideration should be given as to whether the current reporting systems have the functionality to house the consolidation conclusions and whether automation of the reassessment process is possible.

<sup>9</sup> FASB Staff Position No. FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*.

<sup>10</sup> FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

<sup>11</sup> FASB Statement No. 157, *Fair Value Measurements*.

<sup>12</sup> SEC Staff Accounting Bulletin Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*.

### **Final commentary**

Implementation of Statement 167 may have a significant impact on asset managers both from a financial reporting standpoint and the level of effort required to comply. Additionally, SEC registrant asset managers with a calendar year-end have less than nine months to complete all phases of the implementation and file their initial quarterly financial statements. The task ahead may be formidable, but it is not impossible – the key will be timely reaction, finding the right resources and developing the right action plan.

### **Deloitte contacts**

#### **Tom Omberg**

Financial Accounting & Reporting Services Leader  
Deloitte & Touche LLP

[tomberg@deloitte.com](mailto:tomberg@deloitte.com)

+1 212 436 4126

#### **Bob Walley**

Financial Operations & Controls Transformation  
Deloitte & Touche LLP

[rwalley@deloitte.com](mailto:rwalley@deloitte.com)

+1 212 436 3212

#### **Robert Fabio**

Professional Practice Director – Asset Management Industry  
Deloitte & Touche LLP

[rfabio@deloitte.com](mailto:rfabio@deloitte.com)

+1 212 436 5492

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

### **About Deloitte**

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.