

## FIN 46 (R) revised again Now it's all about who holds the "power"



You can call it FIN 46R<sup>1</sup> "squared," or Statement 167<sup>2</sup>, or Accounting Standards Codification Topic 810, but no matter how you slice it, the FASB's latest guidance certainly simplifies the rules of the road around consolidation in Corporate Partnering arrangements. Historically, teaming between a private equity investor (PEI) and a Corporate Partner who wanted to deconsolidate a portion of its business was tricky at best. Control often didn't matter, as the FASB's consolidation model for variable interest entities (VIEs) seemed to sweep many structures into its grasp. And, once swept in, deal terms commonly requested by a PEI (e.g., liquidation preferences and puts) invariably left the Corporate Partner faced with the prospects of consolidating the entity.

Enter Statement 167 — a standard that still focuses on economic interests, but only to the extent that such interests are accompanied by the "power to direct the activities of the entity that most significantly impact the entity's economic performance." To truly understand the significance of this change, let's take a look at how the existing model (the "Old Rules") works.

### Old rules

Consolidation accounting in the U.S. historically focused on the concept of control under ARB 51<sup>3</sup>. Post-Enron, however, the FASB instituted FIN 46R, an economic-based model that had to be applied to ALL arrangements before the control-based model of ARB 51 could even be considered.

Practically speaking, the FIN 46 (R) analysis has focused on three primary determinations:

- Does the entity meet the business scope exception?
- Is the entity a variable interest entity?
- Who is the primary beneficiary of the entity?

While the questions appear simple on the surface, countless hours have been spent by companies and their advisors in trying to arrive at the answers. More often than not, in a Corporate Partnering scenario, the entity failed to meet the business scope exception because the Corporate Partner was deemed to have participated in the design or redesign of the entity, as would be the case when a carved-out portion of a business is placed into a Newco. Failure to meet the business scope exception forced Corporate Partners to address the other two questions — both of which tended to result in a cumbersome quantitative analysis around *expected losses*<sup>4</sup>.

First, Corporate Partners had to wrestle with whether or not the entity had sufficient equity at risk to finance its activities without additional subordinated financial support provided by any parties. For new entities, especially those that were thinly capitalized, highly leveraged, or in their infancy, demonstrating the sufficiency of equity at risk was challenging to say the least. Second, if equity at risk was deemed to not be sufficient, or if the entity was otherwise determined to be a variable interest entity, Corporate Partners would then need to assess whether they would be required to consolidate the entity as its primary beneficiary. For purposes of this test, economics were the sole driving factor, and because expected losses had to be carefully

<sup>1</sup> FASB Interpretation No. 46 (R), *Consolidation of Variable Interest Entities — an interpretation of ARB No. 51*

<sup>2</sup> FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*

<sup>3</sup> Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

<sup>4</sup> Expected losses are the negative variability in the fair value of an entity's net assets exclusive of variable interests and do not equate to GAAP losses. For example, if discounted cash flows are expected to be \$100, any scenario in which the discounted cash flows fall short of that (e.g., \$80) would result in expected losses.

allocated to all *variable interests*<sup>5</sup>, this test could be very challenging to apply and often required the involvement of specialists. Ultimately, if the Corporate Partner was expected to absorb a majority of the entity's expected losses, it was the primary beneficiary no matter what the corporate governing documents might have indicated.

And, it is in this determination that the light at the end of the tunnel now appears in the form of Statement 167.

## New rules

### Power and the primary beneficiary test

While Statement 167 still leaves Steps 1 and 2 above largely unchanged, it drastically alters the application of Step 3 by incorporating the concept of "power" into the primary beneficiary test. Unlike the old rules that focused solely on economics, the new rules now require the primary beneficiary to have BOTH of the following:

- The power to direct the activities of a VIE that most significantly impact the entity's economic performance.
- 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.

While "power" is not defined in Statement 167, or any other piece of literature for that matter, in a Corporate Partnering situation involving an operating entity, it probably looks and smells a lot more like the concept of "control" that most are familiar with under ARB 51. Accordingly, while economics continue to be a factor under Statement 167, they are no longer the sole determinant of the primary beneficiary, thereby opening up a number of other possibilities with respect to Corporate Partnering situations.

*Caution: While "power" may often be linked to a controlling vote, there will be exceptions. For example, the existence of management contracts, other forms of delegation of oversight over day-to-day operations, and/or the need for specialized management knowledge may each give rise to circumstances where a controlling entity does not necessarily have power.*

### Example 1:<sup>6</sup>

**FACTS:** PEI and Corporate Partner team up in a Newco comprised of what used to be Segment A of Corporate Partner. Newco's \$100 of equity is split 60/40 in favor of the PEI and the vote and board of directors (BOD) seats follow proportionately. Former management of the Corporate Partner will run Newco at inception based on the parameters set forth by a majority of the BOD. Corporate Partner will also provide funding to Newco of \$50 in the form of a note.

**ANALYSIS:** While the Corporate Partner is subjected to significant losses (perhaps even the majority of the expected losses depending on the quantitative analysis required under the Old Rules), the Corporate Partner does not have the *power* to direct the activities of the entity that most significantly impact the entity's economic performance. Accordingly, Corporate Partner would not consolidate Newco.

*Deal Tip: The above analysis would still apply even if the PEI's investment was in the form of a voting preferred stock and the Corporate Partner's stock was in the form of a straight common security.*

This concept of power also makes Corporate Partners far less likely to consolidate "true" joint ventures in which joint control over the significant activities of the entity exists. Under the Old Rules, joint ventures could be scoped out under the business scope exception, but only if certain other hurdles were met (i.e., substantially all of the operations were not for the benefit of the Corporate Partner and the Corporate Partner was not providing more than 50% of the subordinated financial support). Accordingly, in situations where other variable interests were at play (e.g., loans and contracts), or where the economic interests were not 50/50, the joint venture might still be swept into the model and the Corporate Partner might still become the primary beneficiary. While a joint venture might still be considered a VIE for the same reasons, Statement 167 simplifies the primary beneficiary analysis by stating that if power is truly "shared" between two unrelated parties, then neither party is the primary beneficiary. For power over the JV to be considered shared under Statement 167, both ventures must consent to all decisions regarding the significant activities of the JV.

<sup>5</sup> Debt securities, guarantees, and off-market contracts are all examples of variable interests that could potentially absorb losses and impact the primary beneficiary computation.

<sup>6</sup> Assume for each of the examples that Newco is a VIE because it has failed the business scope exception, as well as one of the other criteria in paragraph 5 of FIN 46R (e.g., insufficient equity at risk) and, unless specifically stated, the stated voting rights provide power as no other unusual management arrangements or delegations exist, nor is specialized management knowledge required.

That said, economics cannot be completely ignored and will continue to be a factor in the primary beneficiary analysis, as the new standard notes that:

**Consideration should be given to situations in which an enterprise's economic interest in a VIE is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the entity's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of an enterprise's economic interest may be indicative of the amount of power the enterprise holds.**

Accordingly, significant judgment may still be required in determining the primary beneficiary in some structures.

#### Example 2:

**FACTS:** Corporate Partner forms a Newco, contributes Segment A into the Newco, and then sells a 25 percent equity interest in Newco to PEI. PEI is awarded super-voting rights for a 2-year period, but Newco will be managed by the former management of Segment A and Corporate Partner will retain significant oversight with respect to pricing and volumes produced via participation on a steering committee. At the end of two years, PEI has a put right at the greater of fair value or 2.5X multiple of invested capital.

**ANALYSIS:** While the PEI appears on the surface to have the "power" to direct the entity's activities for at least a two-year period by virtue of its super-voting rights, the disproportionate nature of the economic interests in the entity, when coupled with the put feature, continuity of management and Corporate Partner's participation on the steering committee, *may* indicate that power has not truly been ceded to the PEI. Accordingly, Corporate Partner *may* still need to consolidate Newco.

Additionally, the primary beneficiary test is not a "one and done" test. Under the Old Rules, the primary beneficiary test was done at inception and typically not revisited unless and until certain triggering events occurred. Under Statement 167, the primary beneficiary test will become an ongoing assessment.

#### Potential thorns

While the new primary beneficiary test has its advantages, Statement 167 is not without some thorns. For example, *kick-out rights*<sup>7</sup> held by other parties, if substantive, have historically been looked to as a means of "control" over the party currently in "power." Under Statement 167,

<sup>7</sup> Kick-out rights are the ability to remove the enterprise with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

however, unless those rights can be exercised by a single party (including related parties and de facto agents), they are ignored for purposes of assessing power. Similar rules apply to *participating rights*<sup>8</sup> held by other investors.

#### Example 3:

**FACTS:** Corporate Partner forms a Newco and, in a "club deal," three PEIs each purchase a 15 percent ownership interest in Newco. Corporate Partner is appointed as the decision-maker and manager of Newco. The PEIs, however, receive participating rights (e.g., rights regarding hiring, firing and setting compensation of management and approving operating and capital budgets), but only if they, as a group, act in concert with one another.

**ANALYSIS:** The participating rights would be ignored for purposes of assessing which party had the "power" to direct the activities of the partnership that most significantly impact the partnership's performance. Accordingly, Corporate Partner would be the primary beneficiary of Newco and be required to consolidate it.

*Deal Tip:* Protective rights<sup>9</sup> can be provided to a Corporate Partner without creating a situation where the Corporate Partner would need to consolidate under either the power/economic-based model of Statement 167 or the control-based model of ARB 51.

Another thorn in the model relates to related party situations. In the event power is shared (i.e., no party is individually identified as the primary beneficiary), but related parties (including de facto agents), as a collective group, have the power to direct the activities that most significantly impact the entity's economic performance and exposure to potentially significant losses or benefits, then the party within the related party group that is *most closely associated*<sup>10</sup> with the entity will be deemed the primary beneficiary. That said, the rules around whether a related party relationship exists under the new standard have been relaxed a bit in that certain *mutual transfer*

<sup>8</sup> Participating rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

<sup>9</sup> Protective rights include, for example, approval or veto rights granted to the Corporate Partner that do not affect the activities that most significantly impact the entity's economic performance (e.g. amendments to articles of incorporation, pricing on transactions with the majority holder, acquisitions or dispositions outside the ordinary course of business, ability to remove PEI in the event of bankruptcy or breach on the part of the PEI).

<sup>10</sup> The determination of the entity most closely associated with a VIE requires consideration of principal-agency relationships within the related party group, the significance of the VIE's activities to entities within the related party group, an entity's exposure to variability associated with the anticipated economic performance of the VIE and the design of the VIE.

restrictions<sup>11</sup> among equity holders no longer create a related party relationship. One-way transfer restrictions, where the restriction constrains the other party's ability to manage the economic risks or realize the economic rewards from its interests in the VIE, will create a de facto agency situation between the investors.

#### Example 4:

**FACTS:** Corporate Partner and two PEIs team up in a Newco comprised of what used to be Segment A of Corporate Partner. Segment A sells the majority of its products to Segments B and C of Corporate Partner. Each PEI receives a 30 percent interest in Newco, along with 30 percent of the vote. Corporate Partner retains the other 40 percent vote/interest. No party has unilateral decision making power. Corporate Partner also obtains a transfer restriction from the PEIs, whereby each PEI agrees not to sell, transfer, or encumber its interest in Newco without prior approval from Corporate Partner. No caveats exist around Corporate Partner's approval process.

**ANALYSIS:** The "one-way" transfer restriction on the PEIs' investments in Newco creates a "de facto agency" situation between Corporate Partner and the PEIs. No investor within the related party group would individually be considered the primary beneficiary; but because the parties, collectively, have the "power" to direct Newco's activities and significant economic exposure, the related party "tie-breaker" rules kick-in and Corporate Partner, by virtue of its overall relationship, would be the party most closely associated with Newco and, hence, would still be required to consolidate.

*Deal Tip: If, however, in the above example, the Corporate Partner had teamed up with a single PEI and placed the same transfer restrictions on the PEIs interest, the PEI would have been deemed the primary beneficiary because it would have had the power to direct the activities of the entity by virtue of its 60 percent vote/interest and the related party "tie-breaker" rules would not have been applicable.*

*Caution: No one deal term can be analyzed in a vacuum. For example, a transfer restriction that results in a related party relationship could change the analysis of the primary beneficiary in what otherwise appeared to be a joint venture with shared power.*

#### Tax considerations

While the objectives of structuring a joint venture may include deconsolidating operations and assets from the Corporate Partner for financial accounting purposes, the opposite objective may apply for tax purposes. That is, a Corporate Partner may wish its economic share of the profit or loss of the venture to be included with the rest of its operations on its federal income tax return. This objective can generally be achieved by structuring the joint venture as a partnership or limited liability company. In such a case, the income and expense of the joint venture would "flow-through" to the venturers, generally free of joint venture level income tax (at least in the U.S.), without regard to the governance arrangements relevant for accounting purposes.

#### Transition

While Statement 167 doesn't become effective until January 1, 2010 for calendar-year companies, PEIs and Corporate Partners should take the intervening period to re-evaluate existing deal structures since the standard will apply to both new and *existing* structures. Stated another way, deals that previously resulted in deconsolidation under the old economic-based rules might result in consolidation under the new power/economic-based rules or vice versa.

*Deal Tip: Corporate Partners and PEI portfolio companies alike should proactively assess the impact of Statement 167, as changes in consolidated entities could affect balance sheet and income statement presentation, financial ratios, and debt covenants.*

#### The bottom line

Although still very restrictive on "structured" entities, Statement 167's practicality around the primary beneficiary test and focus on power should make corporate partnering arrangements involving operating companies much more user-friendly to Corporate Partners. While it's not a total bed of roses, if the answer historically was "No, that won't work," Statement 167 might just be the remedy the doctor ordered.

---

<sup>11</sup>Allowable mutual transfer restrictions include those where both parties have right of prior approval and those rights are based on mutually agreed terms by willing, independent parties.

# Contacts

For more information, please contact:

## National M&A Transaction Services Leader

Eva Sejjido  
Deloitte Tax LLP  
+1 212 436 3322  
esejjido@deloitte.com

## Midwest

Michael Slattery  
Deloitte Tax LLP  
+1 312 486 3125  
mslattery@deloitte.com

## Northeast

Russell Thomson  
Deloitte & Touche LLP  
+1 212 436 3322  
rthomson@deloitte.com

## Pacific Southwest & NorPac

Bryan Boghosian  
Deloitte & Touche LLP  
+1 213 688 5435  
bboghosian@deloitte.com

## Southeast

Steve Joiner  
Deloitte & Touche LLP  
+1 404 220 1439  
sjoiner@deloitte.com

## Mid-America

Cliff Braly  
Deloitte Tax LLP  
+1 214 840 7165  
cbraly@deloitte.com

## Boston

Kevin Masse  
Deloitte & Touche LLP  
+1 617 437 2415  
kmasse@deloitte.com

## Accounting Consultation

Matthew Himmelman  
Deloitte & Touche LLP  
+1 714 436 7277  
mhimmelman@deloitte.com

Please visit the online merger and acquisition library which showcases the best current thinking about mergers, acquisitions and divestitures. If you're looking for guidance on how to tackle the toughest issues in M&A today, we think you'll find this a great place to start.

[www.deloitte.com/us/MALibrary](http://www.deloitte.com/us/MALibrary)

## About the Publication

This publication contains general information only and is based on the experiences and research of Deloitte practitioners. Deloitte is not, by means of this publication, rendering business, financial, investment, 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.

Copyright © 2009 Deloitte Development LLC. All rights reserved.  
Member of Deloitte Touche Tohmatsu