



MFA on Accounting: The Continuing Evolution of Consolidation Rules as they Affect Sponsors of Investment Funds

BOB ZINK, CPA, ARTHUR BELL, CERTIFIED PUBLIC ACCOUNTANTS

In June 2009, the Financial Accounting Standards Board (FASB) issued Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). FAS 167 modified the accounting principles governing consolidation of "variable interest entities," as that term was previously defined in FASB Interpretation No. 46(R) (FIN 46(R)). The provisions of FAS 167 were to become effective as of the beginning of a company's first annual reporting period that began after November 15, 2009, and for interim reporting periods within that first annual reporting period. For calendar year companies, this meant that FAS 167 was initially to be effective for the 2010 calendar year. In February 2010, the FASB issued Accounting Standards Update No. 2010-10 (ASU 2010-10) which amends certain provisions of FAS 167. The requirements of FAS 167, including the amendments from ASU 2010-10, are incorporated into the FASB's Accounting Standards Codification in Topic 810, *Consolidation*.

The intent of FAS 167 was to limit the ability of sponsors of certain variable interest entities to avoid the consolidation of those entities. The investment funds sponsored by trading advisers may meet the definition of a variable interest entity. As such, FAS 167 could have a significant impact on the financial reporting by trading advisers because trading adviser entities may have to consolidate the assets, liabilities, revenues and expenses of their sponsored funds in preparing their own financial statements.

The investment management industry, and other interested parties, objected to the FASB shortly after the release of FAS 167 regarding the results of the revised consolidation guidance. Investment managers complained that the consolidation of the assets, liabilities, revenues and expenses of their sponsored funds with the adviser's own financial statements would result in less meaningful, and potentially misleading, financial information. For example, if a trading adviser is required to consolidate a sponsored fund, the income statement of the consolidated adviser entity would not present management and incentive fee revenues in its consolidated financial statements because such transactions occur between the adviser entity and the consolidated fund and, therefore, are eliminated in consolidation.

While the investment management community was expressing its concerns with the provisions of FAS 167, the International Accounting Standards Board (IASB) also expressed concerns with the FASB's new consolidation guidance, particularly as it related to the consolidation of investment funds. This was particularly important because the FASB and the IASB, as well as the Securities and Exchange Commission, and other entities, are working towards convergence between accounting principles in the United States and other global accounting standards. Due to these concerns, the FASB decided to defer the effective date of FAS 167 to allow the FASB and the IASB time to develop consistent consolidation principles. As a result, in February 2010, the FASB issued ASU 2010-10 which amends certain provisions of Codification Topic 810, *Consolidation*.

The provisions of ASU 2010-10 are narrow in focus and relate only to reporting entities with interests in an entity (1) that has all of the attributes of an investment company or (2) for which it is industry practice to apply measurement principles for financial reporting that are consistent with those in Codification Topic 946 (Financial Services - Investment Companies). In addition, the amendments of ASU 2010-10 could also affect reporting entities with interests in entities that are required to comply with the requirements of Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. As such, ASU 2010-10 is expected to mainly affect entities in the investment management industry.

Under the provisions of ASU 2010-10, the deferral of FAS 167 is not available to entities where the reporting entity has the explicit or implicit obligation to fund losses of an entity that could be potentially significant to the entity. The deferral under ASU 2010-10 also does not apply to interests in securitization entities, asset-backed financing entities, or entities formerly considered qualifying special-purpose entities.

Based upon the deferral criteria described in ASU 2010-10, mutual funds, hedge funds, mortgage real estate investment funds, private equity funds and venture capital funds will likely meet the conditions for deferral. However, the nature of the applicable entity needs to be carefully considered in determining whether the conditions for deferral under ASU 2010-10 are met. An entity that qualifies for the deferral should continue to be evaluated under the overall consolidation guidance of variable interest entities in Codification Subtopic 810-10 (before the FAS 167 amendments) or other applicable consolidation guidance, such as the guidance related to the consolidation of partnerships which is found in Codification Subtopic 810-20.

ASU 2010-10 also provides clarification of certain provisions found in FAS 167 addressing the consideration of related parties when evaluating whether a decision maker or service provider fee (e.g., the management and incentive fees assessed by the sponsor of an investment fund) represents a variable interest. Additionally, ASU 2010-10 modifies FAS 167 to clarify the FASB's intention that a quantitative calculation should not be the sole basis for the evaluation as to whether a decision maker or service provider's fee represents a variable interest.

The amendments under ASU 2010-10 are effective as of the beginning of a reporting entity's first annual period that begins after November 15, 2009, and for interim periods within that first annual reporting period. As such, this effective date coincides with the effective date of FAS 167.

The FASB and the IASB are currently working on a joint project to provide comprehensive guidance for consolidation of all entities. As part of this project, the FASB and IASB are meeting monthly to discuss a variety of issues on consolidation guidance. The FASB's goal is to publish in the second quarter of 2010 an Exposure Draft of its proposed consolidation guidance which is expected to be consistent with the IASB's consolidation guidance. A final Accounting Standards Update is expected to be issued by the FASB in the first half of 2011. This Accounting Standards Update will represent revised consolidation guidance under accounting principles generally accepted in the United States of America.

Investment managers and other interested parties should continue to monitor the developments of the FASB's consolidation project. The FASB publishes updates to the consolidation project on its website after each monthly meeting. Summaries of the joint FASB and IASB meetings on the consolidation project can be found at www.fasb.org under the Projects - Technical Plan and Project Updates tabs.

*Arthur Bell, Certified Public Accountants, is a public accounting firm providing a full range of accounting, audit, tax and consulting services to the hedge fund and managed futures industry.
Web: www.arthurbellcpas.com E-mail: bob.zink@arthurbellcpas.com*

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