IASB/FASB Joint Meeting

- weeks beginning 15 and 22 March 2010

IASB Agenda reference	**8C**
FASB Memo reference	**10**

Project	**Consolidation**
Topic	**Agency Relationships**

Introduction

1. At the January 2010 joint Board meeting, the boards discussed alternatives for evaluating whether a decision maker is a principal or an agent. The boards directed the staff to develop a model based on the requirements of view 1 presented at that meeting. View 1 discussed at the January meeting set out an approach that considered the overall relationship between a decision maker and the entity that it manages. This paper provides additional guidance on how the staff believe that relationship should be evaluated to determine if a decision maker is a principal or an agent.[1]

Identifying an agency relationship

2. The staff believe that, when evaluating whether a decision maker is an agent or a principal, the assessment should focus on whether the decision maker has (1) the power to direct the activities of an entity ("power"), and (2) the ability to generate benefits (or limit losses) for itself through that power ("economics"). The assessment should be made on the basis of the overall relationship between the decision maker, the entity being managed and other interest holders, and should consider all of the following factors:

   (a) decision-making authority (paragraphs 4-7).

[1] Refer to agenda paper 3D from the January 2010 joint board meeting for further background regarding the agent/principal issue.

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(b) rights held by other parties (paragraphs 8-13).

(c) remuneration of the decision-maker (paragraph 14).

(d) the decision maker's exposure to variability of returns because of other interests that it holds in the entity (paragraphs 15-17).

3. When evaluating the relationship, the assessment should not be solely on the basis of any one factor, but rather should take into consideration the overall nature of the arrangement. Accordingly, the staff does not believe that any relative weighting of each of the factors should be provided, as the arrangement should be evaluated in its totality. However, as discussed below, in some circumstances, a particular factor may be a strong indicator of a principal or agent relationship.

Decision-making authority

4. A decision maker cannot control an entity if it does not have the current ability to direct the activities of the entity that significantly affect the returns.

5. The decision-maker should consider the extent of its decision-making authority to assess whether it has that ability. It would do this by assessing the range of decisions, activities or both that it is permitted to direct on the basis of the decision-making contractual arrangement(s) and any restrictions that are specified by law or regulation. The greater the range of decisions and/or activities that the decision maker can direct, the more likely it is that the decision maker is a principal.

6. When evaluating this criterion, the reporting entity should consider if it was responsible for imposing the restrictions on the range of activities that are required to be performed. If the decision maker were to create an entity and, through the incorporation documents and investor's prospectus, limits the range of activities that may be performed, the decision maker should consider the decisions that are embedded in the incorporation documents as part of the range of its decisions. In other words, a decision maker of an entity that was previously considered a qualifying special purpose entity according to U.S. GAAP may still conclude that the decision maker is a principal.

7. If the decision-maker must operate the entity according to policies that have been determined and are governed by law or regulation (for example a traditional money market mutual fund that is required to operate in accordance with strict regulatory requirements), this would be an indication that the decision maker is an agent and does not have the ability to direct the activities that significantly affect the returns—ie, it is administering the fund for others and, even though it makes decisions in accordance with the predefined policies, it does so for others.

Rights held by other parties

8. The decision-maker shall consider the extent of its decision-making authority by assessing:

   (a) the discretion that it has when making decisions about those activities.

   (b) if it can be removed by any other parties.

9. As mentioned above, a decision maker cannot control an entity if it does not have the current ability to direct the activities of the entity that significantly affect the returns. Accordingly, when assessing the relationship, the entity should consider the level of discretion that it has when making decisions about those activities.

10. When evaluating the level of discretion of a decision maker, the entity should consider if any other parties hold participating or veto rights that would require the decision maker to obtain approval for any decisions that it makes. A decision maker that is required to obtain approval for any of its actions, regardless of whether the entity has a wide range of activities, would generally be an agent. The evaluation should consider whether the participating or veto rights are non-substantive, which may be the case in situations in which multiple unrelated parties are required to act together to enforce these rights.

11. The staff also believe that substantive kick-out rights can have an effect on the assessment as to whether the decision maker has the power to direct the significant activities of an entity. Under an agency relationship, the principal will

often insist on having the right to remove the agent if it is unhappy with the services being provided.

12. Situations in which a single party holds substantive kick out rights and can remove the decision maker without cause would, in isolation, be sufficient to conclude that the decision maker is an agent. However, if numerous investors hold such rights (such that no individual party can remove the decision maker without the agreement of the other unrelated investors), consideration of these rights would not, in isolation, be determinative as to whether a decision maker is an agent or a principal. We are not aware of many situations in which substantive kick-out rights are held by more than one party but the entity only has a few unrelated investors with these rights. In such situations, we would expect that these unrelated investors would be required to consent to the decisions that significantly affect an entity's returns and, thus, power would be shared.

13. Kick-out rights are considered to be substantive only if the investors have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:

    (a) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise

    (b) Financial penalties or operational barriers associated with dissolving (liquidating) the entity or replacing the decision maker that would act as a significant disincentive for dissolution (liquidation) or removal

    (c) The absence of an adequate number of qualified replacement decision makers or the lack of adequate compensation to attract a qualified replacement

    (d) The absence of an explicit, reasonable mechanism in the agreement with the investors or in the applicable laws or regulations, by which the investors holding the rights can call for and conduct a vote to exercise those rights

(e) The inability of the investors holding the rights to obtain the information necessary to exercise them.

The remuneration of the decision-maker

14. Paragraph 810-10-55-37 of the FASB's Accounting Standards Codification (formerly paragraph B22 of Statement No.167) currently provides five criteria that need to be evaluated to determine whether a decision maker is a principal or an agent. Paragraph 810-10-55-37 also includes an additional criterion which focuses on other interests held by the reporting entity (see paragraphs 15-17 below). The staff has evaluated each of the five criteria below as they believe that only certain of these criteria should be retained.

    (a) Compensation for services provided are commensurate with the level of effort required to provide those services

    This criterion was designed to identify arrangements that clearly provide a decision maker with a significant off-market fee element or that are designed in a manner such that the fee determined or earned is inconsistent with the decision maker's role. The staff believe that this requirement should be retained. In addition, the staff believe that this factor must be present in order to conclude that a decision maker is an agent, but in isolation would not be determinative.

    (b) The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

    Unique and non-customary provisions indicate that the decision maker acts in a manner that is inconsistent with the behaviour of a provider of customary fiduciary-type services to the entity. The staff also believe that this requirement should be retained and that this factor must be present in order to conclude that a decision maker is an agent, but in isolation would not be determinative.

(c) 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 an entity's activities such as trade payables.

Paragraph 810-10-55-37 includes a requirement that to be considered an agent, substantially all of the decision maker's fee needs to be at or above the same level of seniority as the entity's other operating liabilities that arise in the normal course of business. This requirement was intended to identify those arrangements for which the fees accrue in a manner that is not similar to other service providers. However, the staff believe that this requirement should be not retained for the following reasons:

(i) The staff believe that, when evaluating a fee arrangement, the focus should not be on whether the fee is subordinate to the operating liabilities of the entity that arise in the normal course of an entity's activities. Rather, the evaluation should be on the basis of the overall design of the fee arrangement and the underlying fee economics. For example, managers of a collateralized debt obligation (CDO) typically receive (1) senior management fees which are paid with other expenses at the top of the waterfall before payments are made to the debt investors; and (2) subordinated management fees that are paid after payments are made to the debt holders, but before the equity investors. Both of these fees are typically calculated as a percentage of the principal balance of the assets in the CDO. The staff believe that, although a portion of the decision making fee is subordinate to the debt holders, this portion represents compensation for the decision maker acting as an agent on behalf of the equity holders. Accordingly, although the fees are subordinate to the entity's other operating liabilities, they may still relate to an agency relationship. The manager of a CDO may also receive a performance-related fee (typically based on whether the equity holders receive a return that is above a stated rate of return hurdle) that is payable only after the stated return has been paid to the equity holders. However, we think that the fact that a fee is structured to vary along with the returns of the investors should not, alone, affect the agent/principal assessment.

Such a fee structure is to ensure that the decision maker acts in the best interest of the investors.

(ii) The guidance lacks clarity as to whether the evaluation of seniority of the fee should be based on priority in liquidation (e.g., bankruptcy) or based on how the fee is determined (i.e., how the fee is calculated and whether it becomes payable only upon a specified level of performance being achieved).

(d) The total amount of the anticipated fees is insignificant relative to the total amount of the entity's anticipated economic performance.

(e) The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

The conditions (d) and (e) above focus on the significance of the reporting entity's fee and the entity's exposure to variability through its fee on the basis of the decisions that it makes. The staff believe that the magnitude of the decision maker's fee and the variability associated with the fee relative to the entity's anticipated economic performance would be an indicator of whether the decision maker is an agent. The staff does not believe that this is a bright line analysis, but rather should be assessed taking into account the facts and circumstances.

Based on discussions with both preparers and users of financial statements, some believe that when assessing the decision maker's relationship, the decision maker should only consider its exposure to "downside" risk (broadly considered to be monetary losses through a decrease in an investment in the entity or the obligation to fund losses). Therefore, the analysis should not consider the economics received through the fee. The staff, however, think that the decision maker's actions are influenced by how it is remunerated and it will act in a manner to attempt to earn and receive any performance-related fee. Therefore, it is appropriate to consider the magnitude of, and variability absorbed by, a decision-maker's fees.

The staff believe that the evaluation of the fee structure would be based on the anticipated performance of the entity i.e. it would consider probability. For example, if the decision maker receives a performance-related fee that is structured so that the fee is payable only after achieving an extremely high return threshold that is not expected to be met, this would have little effect on the overall agent/principal assessment.

The decision maker's exposure to variability of returns because of other interests that it holds in the entity

15. In situations in which a decision maker holds another interest or interests in the other entity, it should consider whether the other interests could absorb a significant amount of the variability associated with the anticipated economic performance of the other entity. The greater the exposure to variability associated with the anticipated economic performance, the more likely it is that the decision-maker is a principal.

16. The staff believe that the analysis should incorporate both explicit (contractual or legal) and implicit obligations when assessing the decision maker's exposure to variability as a result of its other interests. However, because the staff believe that the assessment of how other interests affect the assessment should incorporate probability, the staff believe that these obligations may not have a significant effect on the overall assessment in situations in which a decision maker can, with reasonable judgement, conclude that the probability of being required to perform under the obligation is remote.

17. The staff believe that, if the decision maker has the ability to direct the activities of the entity, the interests held by the decision maker (including investments in the entity or guarantees provided by the decision maker) would be a strong indicator of the nature of the relationship because these other interest would typically expose the decision maker to "downside" risk. For example, the staff believe that a performance-related fee of 20 percent of net income (where the decision maker has no exposure to "downside risk") should have less of an effect on the overall agent/principal assessment than situations in which the decision maker either holds a 20% interest in the entity that has both upside and downside risk or provides a guarantee which inherently only has downside exposure.

Other factors considered

18. A number of respondents to the recently issued FASB Accounting Standards Update (ASU) 2010-10 commented that they believe that the evaluation as to whether a party is a principal or an agent should consider whether the entity has the right to use the underlying assets of the entity for its own purposes and whether it has an obligation for the entity's liabilities.

19. The staff is concerned with including such a factor would result in inappropriate conclusions. The staff believe that many structured entities and investment funds place restrictions on a principal as to what they can do with the underlying investments in a fund. For example, most asset-backed financing structures and securitizations include restrictions on the disposal or purchase of assets to protect the investors in the fund. The staff does not believe that these restrictions should affect the agent/principal analysis.

20. The staff understands the concerns that excluding this factor may result in the reporting entity presenting assets (including cash reserves) in its consolidated financial statements even though the reporting entity is unable to use these assets as if they were its own. The staff believe that the presentation requirements in Statement 167 for this type of situation would resolve this issue. Those presentation requirements are discussed as part of the disclosure papers being discussed by the boards at this meeting.

21. The following examples illustrate the application of the proposed model.

Examples to illustrate the agency guidance	***Agent/principal evaluation***
Example 1: Fund manager A manages fund B according to narrowly defined parameters set out in the investment mandate. The investors in B do not hold substantive kick out rights or other rights. Fund Manager A has no investment in Fund B and receives an annual fee equal to 1% of B's net asset value.	Entity A is considered an agent on the basis of: - restricted decision-making authority. - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance. - no other interests in the fund.

Examples to illustrate the agency guidance	***Agent/principal evaluation***
Example 2: General partner A manages partnership B and has no other interest in B. A receives a fixed fee of 1% of assets under management, and 20% of all of B's profits exceeding a specified hurdle level (the fee is a market fee commensurate with such services). The limited partners do not hold substantive kick out rights or other rights. A must make decisions in the best interests of all investors in B but has wide decision-making discretion.	Entity A is considered an agent on the basis of: - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance. - no other interests in the fund. These factors outweigh the wide decision-making authority of Entity A such that A is considered to be making those decisions primarily for the benefit of others.
Example 3: Reporting entity A manages investment fund B. A holds a 10% investment in B (pro rata—all investors have equal rights). The investors do not hold substantive kick out or participating rights. Entity A operates B according to narrowly defined parameters set out in the investment mandate and receives a fee for its services equal to 2% of B's net asset value.	Entity A is considered an agent on the basis of: - restricted decision-making authority. - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance. - 10% investment in entity B, together with entity A's remuneration, is not considered to create significant exposure to variability of returns.
Example 4: General partner A manages Investment Fund B. A holds a 40% investment in B (pro rata—all investors have equal rights). The three limited partners (each with a 20% interest) can collectively remove A without cause. They have no other rights. Reporting entity A has wide decision-making discretion and receives a fixed (1%) and performance related (10%) fee based on the returns to the partners.	Entity A is considered a principal on the basis of: - wide decision-making authority. - significant exposure to variability of its 40% investment in entity B. - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance. These factors outweigh the following: - investors collectively hold substantive kick out rights.

Examples to illustrate the agency guidance	***Agent/principal evaluation***
Example 5: Reporting entity A services the assets of securitisation entity B (including managing any defaulting assets—assumed to be the only activity of B that significantly affect the returns) according to narrowly defined parameters set out in the securitisation mandate. A holds 30% of the junior notes in B. A receives a market fee for servicing, commensurate with the services provided. There are numerous other investors who collectively hold rights to remove A—if removed, A's junior notes must be acquired by the replacement manager or the other investors.	Entity A is considered a principal on the basis of: - the exposure to variability from holding 30% of the junior notes. - kick-out rights held by the investors not considered to be substantive. - A's decision-making authority (entity A set the parameters in the securitisation mandate and manages any defaulting assets). Those factors outweigh the following: - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance.
Example 6: Reporting entity A services the assets of Securitisation entity B (including managing any defaulting assets—assumed to be the only activity of B that significantly affect the returns) according to narrowly defined parameters set out in the securitisation mandate. A receives a market fee for servicing, commensurate with the services provided. A holds 30% of the junior notes in B. Investor C holds the remaining 70% of the junior notes in B and has the right to change the operating policies in the securitisation mandate or replace A, without cause, at any time.	Entity A is considered an agent on the basis of: - substantive kick-out rights held by one investor. The 30% interest in the junior notes may create significant exposure to variability; however, the substantive rights held by investor C would outweigh this factor. Entity C is considered a principal on the basis of: - substantive rights that give it the ability to direct the activities of B that significantly affect the returns. - the exposure to significant variability of returns from its investment representing 70% of the junior notes.
Example 7: Reporting entity A manages CDO entity B according to an investment mandate that sets out the operating policies of B (the investing activities performed by A are the only activities of B that significantly affect the returns). A receives fixed (2%) and performance related (20%) fees based on the return to equity holders which is subordinate to the equity holders for its service. The fees are considered commensurate with the services performed. A holds 20% of the equity of the entity. The other investors do not hold substantive participating rights.	Entity A is considered a principal on the basis of: - decision-making authority that results in entity A having the ability to direct the activities that significantly affect the returns. -20% equity interest (this interest by itself may not be considered to create significant exposure to variability), and - the magnitude and variability of the remuneration compared with the entity's anticipated economic performance. Investors do not hold substantive rights.

Question for the boards
1. Do the board members support the staff view that the evaluation of whether a decision maker is an agent or a principal should be made on the basis of the following four factors that focus on the nature and design of the relationship: (a) decision-making authority (b) rights held by other parties (c) remuneration of the decision maker (d) the decision maker's exposure to variability of returns because of other interests that it holds in the entity? If not, which factors would you amend or remove, and are there others that you would add?