

MINUTES



**To:** Board Members  
**From:** Reager (ext. 393)  
**Subject:** April 9, 2008 Board Meeting Minutes: Interpretation 46(R)—Potential Amendments  
**Date:** April 29, 2008  
**cc:** Golden, Bielstein, Leisenring, MacDonald, Wilkins, Lott, Cospers, Barker, Roberge, Cropsey, Mechanick, Nickell, Wyatt, 140 Amendment Team, C. Smith, Glotzer, Chookaszian, Posta, Gabriele, Sutay, Allen, Klimek, FASB Intranet

*The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FSP.*

Topic: Interpretation 46(R) —Potential Amendments  
Basis for Discussion: Board Memorandum 4  
Length of Discussion: 11:53 a.m. to 12:40 p.m. and 1:10 p.m to 2:00 p.m.  
Attendance:  
Board members present: FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, Smith, and Young  
Board members present: IASB: Leisenring  
Staff in charge of topic: Roberge  
Other staff at Board table: Golden, Lott, Donoghue, Nickell, Zecher, and Reager  
Outside participants: None

Summary of Decisions Reached:

The Board deliberated the staff's recommendations for amending certain key provisions in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, primarily as a result of the potential elimination of the qualifying special-purpose entity (QSPE) concept in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, and in Interpretation 46(R) along with the recent activities in the credit markets. By a vote of four to three, the Board supported requiring an enterprise (including its related party and de facto agents) to determine whether it is the enterprise that must consolidate a variable interest entity (the primary beneficiary) primarily through a thorough qualitative assessment. If an enterprise is unable to determine if a primary beneficiary exists (or does not exist) through the qualitative assessment, the enterprise would perform the current quantitative analysis described in Interpretation 46(R). (That is, determining the primary beneficiary based on which enterprise quantitatively absorbs the majority of the expected losses, receives the majority of the residual returns, or both).

The Board also approved the addition of the "passive interest" concept. A passive interest is an interest in a variable interest entity:

- (1) That has a maximum exposure that is capped (it cannot exceed an amount determinable at the date of the enterprise's involvement with the entity)
- (2) In which the enterprise (including related parties and de facto agents) with the interest has no involvement with the design or redesign of the variable interest entity
- (3) In which the enterprise has no additional involvement or interests with the variable interest entity
- (4) In which the interest does not give the entity significant control rights (guidance and factors are within the qualitative assessment guidance)
- (5) In which the interest is insignificant (the Board agreed that the guidance for insignificant interests would be established by the staff at a later date).

The Board agreed that an enterprise with a passive interest would not be considered the primary beneficiary in any circumstance when the interest is passive.

In supporting the addition and the emphasis on a qualitative assessment, the Board requested that the staff establish an overall objective of the qualitative analysis and suggested criteria supporting that objective that can be easily understood and applied by

constituents. The Board agreed that the criteria would not be considered all-inclusive and that constituents would have to apply professional judgment.

The Board unanimously agreed that the current guidance regarding reconsidering when an entity is a variable interest entity and which enterprise, if any, with a variable interest in a variable interest entity shall consolidate the entity as provided in paragraphs 7 and 15, respectively, of Interpretation 46(R), be rescinded. The Board unanimously agreed that the reconsideration of the status of an entity and the primary beneficiary should be made during each reporting period using the amended guidance requiring that the primary assessment be based on a qualitative analysis.

Finally, the Board unanimously agreed that the exemption of troubled debt restructurings from the reconsideration guidance in paragraphs 7 and 15 of Interpretation 46(R) should be rescinded.

Objective of Meeting:

The purpose of the meeting was for the Board to address key areas of significant guidance related to Interpretation 46(R), including:

1. Determining the Primary Beneficiary (PB)
2. Reconsideration Events—Variable Interest Entity (VIE) Status and PB Determination
3. Reconsideration Events Relating to Troubled Debt Restructurings (TDRs)— VIE Status and PB Determination.

Matters Discussed and Decisions Reached:

**Issue 1: Determining the PB**

1. Mr. Roberge stated that as a result of the Board decision to end the qualifying special-purpose entity (QSPE) concept and as a result of recent conditions in the market, the staff has been asked to look at some of the issues surrounding Interpretation 46(R).
2. Mr. Roberge stated that currently, an enterprise with an interest in a VIE typically determines if it is the PB based solely on a quantitative analysis that determines if the enterprise absorbs the majority of the VIE's expected losses, residual returns, or both. The staff believes, based on discussions with various constituents, that this quantitative analysis may result in enterprises consolidating VIEs even if the enterprises do not have any characteristics of substantive control.
3. Mr. Roberge stated that in determining whether they will be the PB of a VIE, enterprises may perform a qualitative assessment and form conclusions that conflict with those resulting from the quantitative analysis. That is, an enterprise may look at the traits and characteristics of a VIE and its variable interests from a qualitative assessment and informally conclude that a certain interest effectively controls the entity through characteristics other than voting rights, but an expected losses calculation yields a different result.
4. Mr. Roberge stated that the staff wanted to introduce the concept of a passive interest. A passive interest is an interest whose exposure to loss is capped (maximum exposure is fixed and can be calculated) and the interest has no features of substantive control. In addition, the enterprise (and its related parties and de facto agents) with the interest didn't participate in the design or redesign of the entity, has no other involvement in the entity, and its interest is insignificant as compared to some benchmark (such as the total assets of the VIE) to be established at a later time by the staff. Whether an interest is insignificant could depend on the nature and traits of the VIE including the type of assets it holds.
5. Mr. Roberge stated that the staff developed two views to amend the guidance that currently exists in Interpretation 46(R) on determining which enterprise, if any, with an interest in a VIE is the PB.

6. Mr. Roberge described View A as a process in which an enterprise with an interest in a VIE would be required to perform a qualitative assessment to determine which enterprise, if any, has effective control over a VIE. This qualitative assessment would be the primary analysis to be performed by an enterprise when determining if the enterprise is required to consolidate. Mr. Roberge explained that the expectation is that practice would not default to the quantitative analysis or be required to commonly use it. The quantitative analysis that is currently employed to determine the PB is expected to be used only if the qualitative analysis did not determine if a PB exists (or does not exist) and which enterprise is the PB. Mr. Roberge explained the steps listed in the Board meeting handout were to facilitate discussion with the Board and would not be how the staff would ultimately draft guidance if View A was approved.
7. Step 2 of View A represents a list of factors and characteristics to be considered in determining qualitatively if an entity has control. It was asserted by the staff that this was a preliminary list and was not meant to be all-inclusive. Mr. Roberge stated that the staff will be seeking input on the critical factors to be included as guidance for practitioners. The factors would be included to facilitate an enterprise's assessment of its consolidation status. Mr. Roberge expanded on View A to clarify that if an enterprise concludes that a PB exists or does not exist based on the qualitative assessment, no further analysis (quantitative) is necessary.
8. In situations where an enterprise believes that control and a PB exist, but after a thorough qualitative analysis it cannot be definitely concluded which enterprise is the PB, the enterprise shall perform a quantitative assessment to determine which enterprise absorbs the majority of a VIE's expected losses, realizes its residual returns, or both. However, Mr. Roberge stated that under View A, a passive interest cannot be the PB.
9. Mr. Golden described View A' as not allowing the quantitative analysis, but instead basing the consolidation decision solely on a qualitative assessment. View A' would address a concern in which View A could potentially "force" a quantitative calculation because a qualitative assessment couldn't identify a PB.
10. Mr. Roberge described View B as a two-step approach. The first step is to perform the qualitative assessment described in View A. If the qualitative assessment identifies a

PB, no further analysis would be performed and the enterprise identified would consolidate. If a PB is not identified in the qualitative analysis, enterprises with an interest in a VIE would be required to perform the quantitative analysis pursuant to the guidance in Interpretation 46(R). Specifically, View B would not allow the qualitative analysis to determine that no PB exists and would not recognize the passive interest concept.

### **Issue 1 Staff Recommendation**

11. Mr. Roberge stated that the staff recommends View A.

### **Issue 1 Board Vote**

12. The Board voted in favor of View A. Msrs. Herz, Batavick, Crooch, and Smith supported View A. Ms. Seidman stated that her preference is View A', but that she would support View A. Mr. Linsmeier supported View B, but stated that depending on the factors developed by the staff as guidance for determining which enterprise, if any, effectively controls the entity, he may support View A. Mr. Young did not support any of the views, but preferred View B over View A.

### **Issue 1 Board Comments**

13. Mr. Herz stated that many of the expected loss note holders are hedge funds or other mark-to-market entities that may not consolidate even if they are deemed to be the PB, as they may be subject to the scope out for investment companies provided in Interpretation 46(R). Mr. Herz noted that the financial institutions that created conduits and other investment vehicles would sell an expected loss note that absorbs 50.1 percent of the expected loss calculation. Mr. Roberge agreed with Mr. Herz.
14. Mr. Smith noted that while he supports the passive interest notion, he asked Mr. Roberge if an implied relationship also would be considered in the description of a passive interest.
15. Mr. Roberge stated that a passive interest's implied relationship with an entity would be considered and that an interest with an implied guarantee would not be passive.
16. Mr. Smith asked how a quantitative calculation of View A would affect the expected losses absorbed by a passive interest.

17. Mr. Golden stated that a passive interest would never be considered the PB. The reason for this is that it makes it easier to determine the PB in a qualitative analysis. However, the passive interest would still absorb its portion of the loss pursuant to the calculation.
18. Mr. Herz stated that both Views A and B would assume that practitioners perform a thorough qualitative analysis and not immediately revert to the quantitative approach. Further, Mr. Herz stated that the original notion behind Interpretation 46 was that one could not define classic control so the Board decided on the risk and rewards model. The notion behind the risk and rewards model was that it could act as a surrogate for equity and be calculated through a quantitative assessment.
19. Mr. Lott stated that, originally, Interpretation 46 was designed to look at the risk and rewards model, not control. There was a concern that ARB No. 51, *Consolidated Financial Statements*, deals with control, but Interpretation 46, which is an interpretation of ARB 51, places an emphasis on the risk and rewards model. Mr. Lott noted there is a challenge in identifying who a structure is created for (either the party that wants to sell the assets or the party that wants to purchase the assets). Oftentimes, an entity is created on behalf of both parties. The risk and rewards notion was meant to be a way to address that vagueness; however, the problems with the expected loss calculation (such as a minimal amount of first loss note determining who consolidates) are apparent. Over time, the idea of expected losses has become much more quantitative than initially anticipated by the Board (expected losses were intended to be a surrogate for equity).
20. Mr. Leisenring stated that he was in favor of the staff's approach to try to do something about making Interpretation 46(R) more consistent with the objective of SIC Interpretation 12, *Consolidation—Special Purpose Entities*, and ARB 51; however, he was unsure if it could be made operational. However, Mr. Leisenring emphasized that there is evidence that SIC 12 is inconsistently applied in practice. In addition, he noted that certain of the criteria in SIC 12 are vacuous. The first two criteria can be difficult to apply, for example, the activities of an SPE are often conducted on behalf of all entities involved with the entity (otherwise, why would the

entities have become involved in the first place?) Also, he noted there is no clear notion of what “autopilot” means.

21. Mr. Herz stated that one could expect there to be inconsistencies in practice in anything with an objective without a clear rule or calculation.
22. Mr. Leisenring stated that if a passive investor can never consolidate, as View A would suggest, then there is significant pressure placed on the definition of a passive investor. He also questioned why a cap on the investor’s investment would be a factor that indicates the investor should not consolidate. Mr. Leisenring noted that even interests in voting entities are capped.
23. Mr. Smith agreed with Mr. Leisenring about the potential problems associated with never having a passive investor consolidate.
24. Mr. Smith indicated that some constituents are currently determining the PB based on a qualitative analysis, and they only perform a quantitative calculation when the qualitative analysis is not clear. Mr. Golden noted that the qualitative assessment currently being performed is based on expected losses (not control).
25. Mr. Herz stated that some of the same problems that come from never allowing a passive investor to consolidate also are present with a qualitative focus in general.
26. Mr. Lott stated that it should be considered if having responsibility should be considered in determining who consolidates. Mr. Lott also noted that two previous attempts had been made to base consolidation on control.
27. Mr. Golden stated that the discussion is about a shift in how the FASB requires enterprises to evaluate consolidation. One option is keeping a pure risk and rewards model to determine a VIE and another is a shift to a more qualitative analysis on control followed by a quantitative analysis.
28. Mr. Lott noted that any objective should describe the reasons why one thinks an entity should consolidate another entity. Mr. Herz noted the reason would either be that an enterprise controls the entity (through direct or indirect means), or that the entity is clearly integrated with an enterprise’s business, or that an enterprise has the majority of the risks and rewards.

29. Mr. Leisenring and Ms. Seidman questioned whether the application of that objective would result in assets and liabilities on an entity's books that do not meet the definitions of assets and liabilities.
30. Mr. Linsmeier noted that representatives from the Investors Technical Advisory Committee questioned structures where the sponsor has reputation risk and how that reputation risk would factor into the PB analysis. He suggested that reputation risk should potentially be listed as an explicit criteria in the PB analysis.
31. Mr. Linsmeier stated that it would be hard for him to support View A or View B without knowing the quality of the ability to make a judgment under the list in Step 2 of View A. He described the fundamental difference in Views A and B as being that in View A, it is assumed that a qualitative approach can be done well enough that it should be the driving consideration. In View B, there is a qualitative approach that determines who has to consolidate, but if this approach does not identify a PB, then a quantitative approach must be used.
32. Mr. Herz noted that Interpretation 46(R) used risks and rewards to impute control. Ms. Seidman responded that part of the problem today is that the quantitative test does not always result in a controlling party being the PB (for example, a first loss note holder that doesn't control). She noted that unless a passive interest exception is provided, the same problem would persist under View A.
33. Mr. Batavick wanted to make sure that an interest that would have to evaluate if it is the PB would have the necessary information to perform a qualitative review.
34. Mr. Roberge stated that an interest could look at the traits and the set up of the VIE. There is an assumption that an enterprise with an interest in a VIE would currently need to understand its risks from involvement in a VIE to conform with current accounting guidance, such as testing for impairment.
35. Ms. Seidman raised concerns over leaving a quantitative test in place that is not indicative of control to determine the PB if the intent is to clarify that the principal in Interpretation 46(R) be more indicative of control as control is used elsewhere in the consolidation literature.

36. Mr. Linsmeier stated that he believes the indicators of who is the PB have to do with control and risk and rewards.
37. Ms. Seidman stated a preference for View A', which is a consolidation model based purely on the qualitative analysis of control as set forth in View A. Ms. Seidman feels that the qualitative analysis of control is consistent with the direction of the reporting entity project in that there should be indicators of power and benefit. She also felt it was similar to the controlling financial interest concept. Ms. Seidman questioned the purpose of retaining a quantitative assessment that determines the majority of risks and rewards that has caused so much difficulty in practice and inconsistency in application. Ms. Seidman noted a situation where the only involvement is that a guarantee (while it would indicate risk) does not indicate that the guarantor has present rights to the assets. Ms. Seidman noted that one could gain control through a default or another reconsideration event, but she is concerned with a situation where a liability causes an entity to consolidate. Ms. Seidman does not believe that conclusion is consistent when the concept of control is based on power and present rights to benefits. She also emphasized that under View A', the concept of a passive interest could be eliminated. Finally, Ms. Seidman stated that her preference, if View A' was not approved, was View A.
38. Mr. Linsmeier noted View A' would put pressure on identifying the appropriate qualitative factors.
39. Mr. Linsmeier said he would vote for View B, but he was open to View A. He stated that he had a preference for View A, but expressed concern about the ability to draft proper language for View A because of the difficulty involved in determining the appropriate factors and characteristics to include that would help an enterprise properly identify the PB, if any, in a VIE. Mr. Linsmeier asserted that if the language drafted in View A is convincing and complete enough that an enterprise could effectively make a qualitative assessment of whether or not a PB exists based on control or the majority of risks and rewards (or the two combined), he would support View A. He stated, that at this time, View B might be a better compromise because it would help prevent abuse of a qualitative assessment where entities start concluding that no PB exists in a majority of situations.

40. Mr. Herz noted that on a qualitative basis, one should generally conclude that a passive investor would not consolidate.
41. Mr. Batavick expressed a preference for View A because he felt it would be effective with the proposed amendments in the Interpretation 46(R) reconsideration events guidance.
42. Mr. Linsmeier raised the question of whether a fiduciary responsibility could cause consolidation.
43. Ms. Seidman indicated that the staff should talk to preparers and auditors who follow International Financial Reporting Standards and who have experience in applying SIC 12.
44. Mr. Herz agreed with Mr. Batavick and also preferred View A, but requested that the staff develop an objective that would provide the overall purpose of the qualitative assessment. He stated that the staff should focus on control, how the qualitative factors tie into an enterprise's business activities, and risks and rewards.
45. Mr. Crooch preferred View A, but shared Mr. Linsmeier's concerns about the difficulty in wording a View A that would be properly followed in practice.
46. Mr. Young did not support either View A or View B. He believes the passive investor concept will result in structuring to meet the passive investor criteria. He stated his concern that the staff did not perform enough analysis with users of financial statements in developing the alternatives presented. He also stated that analyses performed by enterprises should not be performed under the assumption that only a single PB exists in a VIE. Mr. Young stated that View B was the least damaging view.
47. Mr. Smith expressed an interest in View A' but asserted that he would support View A. Like Ms. Seidman, he emphasized a concern with the quantitative calculation that may be performed under View A if the qualitative assessment does not identify if a PB exists. He also expressed concern about which enterprise is the PB, as the calculation does not appear to be functioning as originally anticipated by the Board members who approved Interpretation 46(R).
48. Mr. Golden said the staff would have discussions with constituent groups over the next three to four weeks related to the wording of the objective and factors as requested by

Mr. Herz. Mr. Golden also asserted that meeting with the constituent groups would assist the staff in determining if the proposal is operational, if it benefits users, what would the cost be to preparers and auditors, and how would the factors be applied. Mr. Golden requested that the Board further consider the factors for consolidation. He indicated that the staff would bring the factors back to the Board if they change based on feedback from constituent groups.

49. Mr. Herz emphasized that any qualitative or quantitative assessment should be inclusive of all the potential risks including implicit support arrangements. He noted that (with hindsight) it is clear that the expected loss calculations didn't consider implied commitments and arrangements.

### **Issue 2: Reconsideration Events—VIE Status and PB Determination**

50. Mr. Roberge stated that currently in Interpretation 46(R), there is an exemption from reconsideration for losses that are in excess of expected losses both in determining if an entity is a VIE and who the PB is. He further stated that users of financial statements (and auditors) have expressed concern over this exemption.

### **Issue 2 Staff Recommendation**

51. Mr. Roberge expressed that the staff's recommendation was to not allow an exemption for losses that are a result of unanticipated events. Mr. Roberge referred to a list of unanticipated events in the Board meeting handout that could be considered to trigger reconsideration. He noted that the list was not meant to be all-inclusive.
52. Mr. Roberge stated that by having a reconsideration event triggered by unanticipated events, it would be possible to have VIE and PB status reconsidered before actual losses occur.
53. Mr. Roberge stated that the staff recommends an annual reassessment of VIE and PB status by enterprises with interests in an entity. If a triggering event occurred, the staff's recommendation is that the status of an entity or which enterprise is the PB would be reviewed between annual periods.
54. Notwithstanding the staff recommendation, the Board voted in favor of : (a) removing specific reconsideration events for both determining when an entity is a VIE as well as which enterprise, if any, is the PB and (b) requiring an on going assessment of VIE

and PB status (currently the direction that the IASB is taking in its consolidations project).

## **Issue 2 Board Comments**

55. Mr. Young expressed concern over how the reassessment events of VIE and PB status described in of the Board meeting handout would be implemented. Mr. Young cited an example of a drop in the fair value of a mortgage asset in which the underlying cash flows continue as there has been no default. Mr. Roberge pointed Mr. Young to the factor regarding “a significant change in market factors” in the list of factors.
56. Ms. Seidman asked what would happen if expected losses were not used as the primary approach. She asked if the “deviation from plan” was expected to be based on an expected loss basis or on GAAP financials.
57. Mr. Golden stated that he expected it to be based on GAAP financials and Ms. Seidman agreed that this was appropriate. Ms. Seidman noted that implicit in the qualitative approach is the fact that a plan exists and that it can be benchmarked against. She stated that this implicit fact should be explicitly stated in the factors.
58. Mr. Golden stated that the staff does not feel there are currently enough reconsideration events in practice.
59. Mr. Herz suggested getting rid of the idea of specific reconsideration events.
60. Mr. Leisenring suggested having an on going assessment of VIE and PB status which is consistent with recent IASB discussions on consolidation.
61. Mr. Herz suggested the principle for reconsideration should be that a prior assessment might change because of structural changes, losses in excess of what one expected, or other market events.
62. Mr. Young suggested that instead of looking for changes and reconsideration events, an entity should just perform the same test for VIE and PB status every time financials are produced.

63. Mr. Leisenring stated that it should be explicit as to who is required to do what regarding the evaluation of VIE and PB status (that is, the entity or the enterprise involved with the entity).

64. Mr. Herz was in favor of a having a principle that talked about evaluating consolidation each time financials are reported and then explaining that the evaluation could change based on the current reconsideration events or the proposed additional reconsideration events.

**Issue 3: Reconsideration Events Relating to TDRs— VIE Status and PB Determination**

65. Mr. Roberge asked the Board to consider rescinding the exemption for TDRs in Interpretation 46(R) related to reconsideration events. He described the exception as applying to the guidance in Interpretation 46(R) for businesses that meet certain criteria. He expects that a significant amount of TDRs encountered by lenders are with businesses. However, he cautioned that the business exception is not permitted in instances where the funding provided is greater than 50 percent of the entity's equity and represents subordinated debt or other forms of subordinated financial support.

**Issue 3 Staff Recommendation**

66. Mr. Roberge stated that the staff recommended removing the exemption for TDRs in Interpretation 46(R) related to reconsideration events.

**Issue 3 Board Vote**

67. The Board voted in favor of removing the exemption for TDRs in Interpretation 46(R) related to reconsideration events.

**Issue 3 Board Comments**

68. Ms. Seidman stated that she did not feel a bank restructuring the debt of a business should trigger an entity coming into the scope of a reconsideration event unless something extraordinary occurs.

Follow-up Items:

None.

General Announcements:

None.