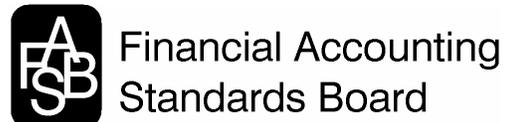


## MINUTES



**To:** Board Members

**From:** Miller (ext. 276)

**Subject:** Minutes of the October 15, 2003  
CON VIE Board Meeting

**Date:** October 15, 2003

**cc:** Bielstein, Smith, Petrone, Leisenring, Project Team, Thompson, Sutay, Gabriele, Swift, Polley, FASB Intranet, Allen, Bean

Topic: Proposed FSP FIN 46-c "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," and Proposed Modifications

Basis for Discussion: Board memorandum dated October 14, 2003

Length of Discussion: 3:05 p.m. to 3:55 p.m.

Attendance:

Board members present:	Herz, Crooch, Batavick, Schipper, Schieneman, Seidman, and Trott (by phone)
Board members absent:	None
Staff in charge of topic:	Smith
Other staff at Board table:	Lott, Miller
Outside participants:	None

**Summary for ACTION ALERT:**

The Board agreed to consider revisions to the guidance in proposed FSP FIN 46-c, "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." Proposed FSP FIN 46-c suggested guidance regarding the consideration of the ability of one or more parties to remove a decision maker (kick-out rights) in determining if a party is the decision maker of a variable interest entity under paragraph 8(c). The Board indicated that it was supportive of issuing guidance that states there is a presumption that kick-out rights alone do not allow an enterprise to avoid being a decision maker, provided the final FSP sufficiently clarifies the circumstances under which the presumption can be overcome.

The Board also agreed to consider expansion of the exemption from paragraph 8(c) of Interpretation 46 for certain decision maker fees. The Board directed the staff to develop an FSP to articulate the boundaries of the exemption, taking into consideration comment letters received on proposed FSP FIN 46-b, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers." The final FSP would exempt certain fees from being included in paragraph 8(c), rather than deferring the implementation date as provided in proposed FSP FIN 46-b.

**Matters Discussed and Decisions Reached:**

**FSP on Kick-Out Rights**

The Board discussed proposed FSP FIN 46-c, "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." The staff noted that the comment period on the proposed FSP ended October 3, 2003. The guidance exposed for comment stated that the ability of one or more parties to remove a decision maker (kick-out rights) should not be considered in determining if a party is the decision maker of

a VIE. In light of comments received, which disagreed with the proposed FSP position, the staff asked the Board to consider the following suggested revised guidance:

- a. The determination of whether a party is a decision maker should be based on a consideration of all relevant facts and circumstances.
- b. There is a presumption that kick-out rights alone do not allow an enterprise to avoid being a decision maker.
- c. That presumption can be overcome only if the kick-out rights are substantive. Kick-out rights are not substantive if the likelihood of exercise is not at least reasonably possible.

Mr. Herz relayed to the Board his understanding that the SEC would not object to the revised guidance as they believed it could be enforced as written. Mr. Herz noted that kick-out rights had been employed in the past to avoid consolidation. He noted that the revised guidance was intended to provide the circumstances under which kick-out rights would be considered for determination of a decision maker of a VIE. Such circumstances would be limited to kick-out rights that were substantive, and the likelihood of exercise was reasonably possible. Mr. Herz viewed this revision as balancing the current relevant practice and the guidance as provided in the proposed FSP FIN 46-c.

Ms. Seidman asked for clarification on the meaning of the term *substantive*. She asked whether “substantive” meant that if in the event that stake holders wanted to exercise their right of removal, it was (a) possible to exercise or (b) likely that the rights would be exercised. Ms. Seidman said she disagreed with the latter interpretation, noting that she would consider the right of removal substantive if a reasonable vote could be taken, not that the outcome of such a vote would likely result in removal. She supported language that would convey the notion that kick-out rights are substantive if it is reasonable to conclude that the right could be exercised without cause.

The staff noted that other factors could be included for consideration of whether kick-out rights should be determined substantive.

Ms. Schipper did not support the staff's proposed revised guidance. She was not aware of how the staff could describe a way to differentiate between rights that were substantive and rights that were created to achieve a desired accounting result. As a result, Ms. Schipper felt the Board's previous conclusion that kick-out rights should not be considered in determination of whether a party was a decision maker in a VIE had been the correct decision.

Ms. Seidman suggested that the notion of substantive rights was contained elsewhere in consolidation literature. She said that if the use of the term *substantive* was intended to curb abuse in the determination of a decision maker, perhaps the Board should consider another term to replace "decision maker". She suggested possibly "agent" or "principle" which would convey the notion that if a party had no interest other than a market-based fee, it was not a decision maker. Mr. Trott responded that such language had already been considered and that the difficulty was how to define "market-based fee".

Mr. Crooch said that he felt this issue was especially difficult, given his experience in practice. He recalled many arrangements he audited in which kick-out rights were asserted to be substantive, but there was no evidence to support this assertion. Mr. Crooch expressed his opinion that the population of kick-out rights that are truly substantive is very small. He said that this determination would be one that the audit profession would have difficulty with, and he was surprised with the comment letters received from the Big Four firms disagreeing with proposed FSP FIN 46-c. Mr. Crooch said that he would be supportive of the staff's proposed revised guidance if language other than the term *substantive* was used to describe the circumstances under which kick-out rights could be considered for determination of the decision maker of a VIE.

Mr. Herz cautioned that any factors for consideration that may be included be principles-based, rather than prescriptive rules.

Mr. Batavick supported the staff's revised guidance, provided the staff developed appropriate language to articulate the intent of "substantive".

Mr. Schieneman objected to the staff's revised guidance, and agreed with Ms. Schipper in supporting the Board's previous position on kick-out rights as originally suggested in proposed FSP FIN 46-c.

Mr. Trott objected to the staff's revised guidance. However, he said that if the Board were to revise the guidance as suggested in proposed FSP FIN 46-c, he supported the revision as written, including the phrase, "...likelihood of exercise is not at least reasonably possible". He acknowledged that he intended this language to mean that kick-out rights were substantive if they "might be" exercised, versus "could be" exercised.

Ms. Seidman clarified her intent that the term *substantive* should mean "feasible, not onerous" and the possibility of that right being exercised should not be remote, and such right was not constrained.

Mr. Crooch disagreed with the reasonableness of Mr. Trott's interpretation of substantive in that if, at the time of creation, there was a likelihood that a service provider "might be" removed, the provider would not be hired.

Mr. Herz said that he supported the revised guidance, provided that the staff could propose acceptable language to capture the intent of the term *substantive* to mean "capable of being exercised".

The Board directed the staff to prepare alternative language in revised proposed FSP FIN 46-c, and to circulate that revision among Board members for their vote. If the revised language was supported by a majority of the Board, the guidance would be released as a final FSP.

The Board decided that the transition method in proposed FSP FIN 46-c would be retained as exposed with the cumulative effect of the accounting change reported in the period ending after the final FSP is posted to the FASB website. Retroactive restatement would be permitted.

### **Certain Decision Maker's Fees**

The Board addressed the issue of the proposed exemption of decision maker fees that are fixed in terms of amount and timing discussed at the September 17<sup>th</sup> Board meeting from paragraph 8(c) of Interpretation 46. The intent of this proposed modification is to exclude a decision maker's interest from paragraph 8(c) if that decision maker lacks the characteristics of a controlling financial interest. The staff asked the Board to consider expanding the exemption from paragraph 8(c) of certain decision maker fees, based on comment letters received on proposed FSP FIN 46-b, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities for Certain Decision Makers*." The comment letters indicated that few decision makers receive a fee that is fixed in terms of amount and timing, but that there are decision makers with other fee arrangements that lack the characteristics of a controlling financial interest.

The staff suggested the Board consider what characteristics of a decision maker's fee would be indicative of a decision maker that does not have a controlling financial interest in the variable interest entity. The staff asked the Board to consider whether the following attributes could, individually or in some combination, identify the type of fees that should be excluded from paragraph 8(c):

- a. Fixed in terms of amount and timing (as originally proposed)
- b. Senior to other obligations of the VIE
- c. Market based
- d. Fixed percentage of assets or fixed dollar amount per hour of service
- e. Exclude any performance based mechanism.

Mr. Trott said he supported expanding the exemption from paragraph 8(c) of certain decision maker fees, but felt that the exemption should only be expanded to fees that were not based in part on net income. Additionally, he felt that the decision maker's other interests should be de minimus.

Ms. Schipper asked Mr. Trott whether he would allow an exemption for fees that were linked to a fixed percentage of assets, given that assets were valued at fair value, which is in part determined by net income. She concluded that this was a conundrum. She also noted that comment letters said that if a fee was senior and fixed, it likely did not exist. Ms. Schipper said she did not know how to evaluate the criteria upon which a decision maker's fee was based.

Mr. Trott stated that the concern was that fees could be designed to receive a significant amount of the residual returns of the entity. He acknowledged that a change in the fair value of assets on which a fee was based was linked to a change in net income.

Mr. Herz said that either the fee should be fixed or not designed to effectively receive the residual returns of the entity.

Ms. Seidman commented that it seemed that the Board was trying to define what is NOT a variable interest. She said that possibly another way of going about it was to include a definition of variable interest entity in the FSP.

Mr. Herz commented that he supported an expansion of the exemption, but he cautioned the staff not to over-engineer the expansion language.

The Board directed the staff to draft an FSP articulating an expanded exemption of certain fees from paragraph 8(c). The Board concluded that this exemption from paragraph 8(c) should be issued as a final FSP because the deferral in proposed FSP FIN 46-b was targeted at the same population of decision makers' fees that the Board decided to exempt from paragraph 8(c) on September 17, 2003. Consequently, the Board has already exposed and received comment letters on FSP FIN 46-b that specifically address the issue of how to define this

population of decision makers' fees. The Board decided that a final FSP could address both kick-out rights and decision makers' fees that are not indicative of a controlling financial interest.

**Follow-up Items:**

The staff will provide the Board with revised guidance on the treatment of kick-out rights and the description of decision maker's fees that should be exempted from paragraph 8(c).

**General Announcements:**

None.