MINUTES

To:	Board Members
From:	Miller (ext. 276)
Subject:	Minutes of the September 17, 2003 Board Meeting
Date:	October 3, 2003
cc:	Bielstein, Smith, Petrone, Leisenring, Project Team, Thompson, Sutay, Gabriele, Swift, Polley, FASB Intranet

Topic:	FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*—Deferral for Certain Interests Held by Public Entities and Proposed Modifications
Basis for Discussion:	Board memorandums dated September 11 and 12, 2003
Length of Discussion:	1:00 p.m. to 2:05 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:	McIntosh
Other staff at Board table:	Smith, Lott, and Miller
Outside participants:	None

<u>Summary for ACTION ALERT</u>:

The Board decided to modify FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* as follows:

1. Clarify that the scope exception provided in paragraph 4(a) of Interpretation 46 applies to all entities that meet the definition of not-for-profit organizations in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* which includes not-for-profit health care organizations.

2. Make the last sentence of paragraph 5 more effective by (a) applying footnote 6 only to part (ii) of that sentence and (b) changing footnote 6 to define *related parties* as those parties identified in paragraph 16, except for de facto agents under item 16(d).

3. Clarify that paragraph 11 provides guidance on the application of the equity sufficiency condition in paragraph 5(a) for development stage enterprises but does not exempt development stage enterprises from the requirements of paragraph 5(b) relating to the characteristics of equity.

4. Require an enterprise that holds a variable interest in a variable interest entity but is not the primary beneficiary of that entity to reconsider whether it is the primary beneficiary whenever the enterprise acquires additional interests in the variable interest entity.

5. Exclude a decision maker's fees from the paragraph 8(c) component of expected residual returns if (a) the fees are fixed in amount and timing and (b) the decision maker and its related parties have no exposure to expected losses of the entity and no right to receive expected residual returns of the entity (unless that decision maker's fees were included in paragraph 8(c)).

6. Provide a limited-scope exception to the application of Interpretation 46 to a reporting entity’s interest in a variable interest entity, or potential variable interest entity, when both of the following conditions exist:

    a. The interest in the variable interest entity or potential variable interest entity was acquired before February 1, 2003.

    b. The reporting entity, after making exhaustive efforts, is unable to obtain information necessary to determine if the entity is a variable interest entity or to determine whether the reporting entity is the primary beneficiary of the variable interest entity.

7. Clarify that a de facto agency relationship is created under paragraph 16(d)(1) if the approval rights effectively constrain the interest holder’s ability to control the economic risks or rewards of its interests by the sale, transfer, or encumbrance of such interests.

8. Change paragraph 17 guidance on determining which party in a related party group is the primary beneficiary to give primacy to the objective of identifying the party with activities that are most closely associated with the entity as the primary beneficiary.

The proposed Interpretation to modify Interpretation 46 would be applied retroactively as of the date Interpretation 46 was first applied and would require restatement. The proposed Interpretation would be exposed for a 30-day comment period.

Also, a majority of the Board directed the staff to issue a proposed FASB Staff Position (FSP) to defer the effective date of Interpretation 46 until the end of the first interim or annual period ending after December 15, 2003, for certain interests held by a public entity. All of the following conditions must be met to qualify for the deferral:

1. The public entity acquired its interests in a variable interest entity or potential variable interest entity before February 1, 2003.

2. The assets of the variable interest entity or potential variable interest entity are predominantly nonfinancial.

3. The variable interest entity or potential variable interest entity was not specifically created by or for the public entity to undertake a narrow well-defined objective, for example, to effect a lease or securitization of financial assets.

4. The determination of whether the entity is a variable interest entity or whether the public entity is the variable interest entity's primary beneficiary has not been completed as of the issuance of the financial statements for the interim or annual period beginning after June 15, 2003.

A public entity that defers application of Interpretation 46 to variable interests in one or more variable interest entities or potential variable interest entities under the provisions of this FSP would be required to make certain disclosures about such entities during the deferral period.

Matters Discussed and Decisions Reached:

Proposed FSP FIN 46-e, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* for Certain Interests Held by a Public Entity."

The Board discussed a proposed FASB Staff Position (FSP) to defer the effective date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* until the end of the first interim or annual period ending after December 15, 2003, for certain interests held by public entities.

Mr. Trott supported the issuance of the proposed FSP and highlighted several significant provisions. Only public entities would be eligible for deferral under the proposed FSP as nonpublic entities are not yet subject to adoption of the provisions of Interpretation 46. Also, the deferral would extend only until the end of the first interim or annual period ending after December 15, 2003. For calendar year entities, the deferral would extend to December 31, 2003, not January 1, 2004. Mr. Trott said that the limited deferral is important because it allows public entities more time to prepare information about their off balance sheet activities, noting the significant interest of market participants for such information. He also highlighted that the proposed FSP is intended to apply to those variable interest entities subject to the provisions of Interpretation 46 that were not previously considered a special purpose entity (SPE). Mr. Trott acknowledged that the proposed FSP provides an imprecise definition of such an entity.

Mr. Schieneman supported the provisions of the proposed FSP but questioned its issuance in the form of an FSP. Mr. Trott responded that the deferral provided in this proposed FSP was for a limited period, after which the FSP would cease to have significance.

Ms. Seidman and Mr. Batavick did not support the issuance of the proposed FSP primarily because (l) the Board has not addressed all the issues that in their opinion are critical for achieving more consistent application of consolidation policies to variable interest entities and (2) it does not provide a deferral of the effective date of Interpretation 46 for all entities to allow for efficient adoption of the Interpretation.

Ms. Seidman stated that there is currently a lack of clarity surrounding the application of the expected losses and expected residual return test, which is the gateway in determining whether an entity is a variable interest entity, and the key test for identifying who should consolidate an entity. The Board is addressing Interpretation 46 issues in a series of FASB Staff Positions, with cumulative-effect type transition for each clarification as it is issued. (Restatement is permitted, but not required.)

She observed that the limited-scope nature of the FSP would defer the effective date for some entities but would not apply to entities that are primarily financial in nature, including many special-purpose entities. Ms. Seidman said it would be preferable to defer the effective date of Interpretation 46 for all entities until the

Board has clarified its intended application of the expected loss and expected residual return calculations (that is, entities would be consolidated or not in the manner intended by the Board) and other issues including those in a proposed modification of Interpretation 46. Given the materiality of the assets and liabilities involved and the heightened awareness of these transactions in the marketplace, Ms. Seidman believes it is inappropriate to require some constituents to adopt the standard now and potentially have to report one or more material accounting changes in the near term. She believes it would be in the best interest of the capital markets for all affected entities to adopt a clarified Interpretation 46 concurrently.

Ms. Seidman proposed a broad deferral of the effective date of Interpretation 46 until January 1, 2004 for all entities until the Board has clarified the application of the expected loss and expected residual return test, which would be the basis for the initial application of Interpretation 46. This effective date would align the transition to the provisions of the Interpretation for public and nonpublic entities with calendar year ends. She would recommend that any revised guidance be issued early in 2004. Mr. Batavick supported Ms. Seidman’s proposal for a deferral of Interpretation 46 for all entities.

Ms. Schipper supported the staff’s proposed FSP but was concerned with the language of the third criteria because of the imprecise nature of the phrase *single-specified purpose*. Ms. Schipper directed the staff to edit the phrase for clarity.

Ms. Schipper shared Ms. Seidman’s concerns about issuing guidance on the application of Interpretation 46 in a “piecemeal” fashion through FSPs, noting drawbacks of (1) the potential failure to identify a complete inventory of the issues and (2) non-uniform adoption of the Interpretation. However, she said the drawback of not issuing the proposed FSP on limited deferral and required disclosures would result in a postponement of a significant improvement in financial reporting. Ms. Schipper felt that this was a more compelling reason to support the proposed FSP.

The Board (with Ms. Seidman and Mr. Batavick objecting) directed the staff to post the proposed FSP, as revised in accordance with Ms. Schipper's editorial suggestions, for comment.

Proposed Modifications to Interpretation 46

The Board discussed a proposed Interpretation to modify FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to clarify a number of issues.

The Board affirmed its decision, as reflected in a Board-directed FSP posted July 24, 2003, to clarify that the scope exception provided in paragraph 4(a) of Interpretation 46 applies to all entities that meet the definition of not-for-profit organizations in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* which includes not-for-profit health care organizations.

The Board decided to make the last sentence of paragraph 5 more effective by (a) applying footnote 6 only to part (ii) of that sentence and (b) modifying footnote 6. Mr. Trott noted that this modification is intended to capture a widely used structuring arrangement to keep assets and liabilities off an entity's balance sheet when an entity is acting like a subsidiary but is not being consolidated.

The Board agreed to make a technical correction to clarify that paragraph 11 provides guidance on the application of the equity sufficiency condition in paragraph 5(a) for development stage enterprises but does not exempt development stage enterprises from the requirements of paragraph 5(b) relating to the characteristics of equity.

The Board agreed to require an enterprise that holds a variable interest in a variable interest entity but is not the primary beneficiary of that entity to reconsider whether it is the primary beneficiary whenever the enterprise acquires additional interests in the variable interest entity.

The Board decided to exclude a decision maker's fees from the paragraph 8(c) component of expected residual returns if (a) the fees are fixed in amount and timing and (b) the decision maker and its related parties have no exposure to expected losses of the entity and no right to receive expected residual returns of the entity (unless that decision maker's fees were included in paragraph 8(c)). Mr. Smith questioned whether the reference to the *fixed* nature of a decision maker's fee in this modification excluded a decision maker's fee that is based on a fixed percentage of assets, if the value of those assets will vary over time. Mr. Trott stated that a fee that would have variability based on the outcome of a fixed percentage applied to an asset's variable value would not be included in the proposed exclusion from paragraph 8(c). The Board agreed with Mr. Trott's characterization of the proposed modification.

Provide a limited scope exception to the application of Interpretation 46 to a reporting entity's interest in a variable interest entity, or potential variable interest entity, when both of the following conditions exist:

a. All the reporting entity's interests in the entity were acquired before February 1, 2003.

b. The reporting entity, after making exhaustive efforts, is unable to obtain information necessary to determine if the entity is a variable interest entity or to determine whether the reporting entity is the primary beneficiary of the variable interest entity.

The reporting entity would be required to make certain disclosures and continue its efforts to obtain the necessary information. Mr. Herz noted that paragraph 6 of Interpretation 46 provides the basis for some enterprises to avoid the difficulties in obtaining information and should be applied with reasonable judgment. The proposed scope exception would apply to situations not covered by paragraph 6, that is, situations in which it is not apparent that an entity does not have a significant variable interest. He also noted that the Board does not intend to clarify the specific measurement of *exhaustive efforts*.

The Board decided to clarify that a de facto agency relationship is created under paragraph 16(d)(1) if the approval rights could effectively constrain the interest holder's ability to control the economic risks or rewards of its interests by the sale, transfer, or encumbrance of such interests. The Board agreed that an enterprise that can restrict, through approval rights, the sale, transfer, or encumbrance of another party's interests in a variable interest entity may effectively control the economic risks and rewards of those interests. Such control suggests that the party is acting as an agent of the enterprise and that the enterprise could exercise its approval rights to affect the economic risks and rewards associated with the enterprise's own interests in the same entity.

The Board decided to modify paragraph 17 guidance on determining which party in a related party group is the primary beneficiary to give primacy to the objective of identifying the party with activities that are most closely associated with the entity as the primary beneficiary.

The Board decided to propose that the Interpretation to modify Interpretation 46 be applied retroactively as of the date Interpretation 46 was first applied in accordance the provisions of that Interpretation and subsequent FSPs. Restatement of previously issued financial statements would be required. The Board noted that transition by restatement was indicated because the proposed modifications are primarily technical corrections that should not significantly affect the way Interpretation 46 is applied and because the effect, if any, of applying the modification would be to change the reporting entity.

The Board decided that the proposed Interpretation would be exposed for a 30-day comment period and that the staff should proceed with drafting a document for ballot.

Ms. Seidman and Mr. Batavick objected to the proposed Interpretation because the proposed modifications (1) do not address all the issues they view as most critical to the achievement of consistent application of consolidation policies to variable interest entities, and (2) do not provide a deferral of the effective date of Interpretation 46 for all entities. Ms. Seidman expressed the basis of their objections during the earlier discussion of the proposed FSP.

<u>Follow-up Items</u>:

The staff will post the proposed FASB Staff Position to the FASB website for comment upon editorial revision as directed by the Board.

<u>General Announcements</u>:

None.