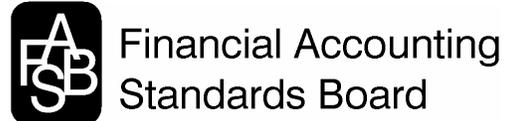


## MINUTES



**To:** Board Members

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

**Subject:** Minutes of the October 8, 2003 Board Meeting      **Date:** October 9, 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 October 6, October 7, and October 9, 2003

Length of Discussion: 1:20 p.m. to 2:30 p.m.

Attendance:

Board members present: Herz, Crooch, Batavick, Schipper, Schieneman, Seidman, and Trott

Board members absent: None

Staff in charge of topic: McIntosh

Other staff at Board table: Smith, Miller

Outside participants: None

**Summary for ACTION ALERT:**

**Final FSP: Deferral of Interpretation 46**

A majority of the Board directed the FASB staff to release the final FSP FIN 46-6, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." This FSP finalizes two proposed FSPs: FIN 46-a, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Nonregistered Investment Companies," and FIN 46-e, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Interests Held by a Public Entity." FSP FIN 46-6 differs from Proposed FSP FIN 46-e in that it defers the implementation date of Interpretation 46 for public companies for arrangements existing prior to February 1, 2003, to fiscal periods ending after December 15, 2003, rather than deferring the implementation for public companies in only certain circumstances. Based on comments received from constituents, the Board decided additional time is needed for companies to complete the evaluation of existing variable interest entities to determine which of those entities are required to be included in their consolidated financial statements.

This final FSP is effective as of October 9, 2003, and is available on the FASB website.

**Modifications of Interpretation 46**

The Board discussed additional proposed modifications of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*. The Board decided the following with respect to those issues:

1. Expand the proposed scope exception for a reporting entity's inability to obtain information about its interests acquired before February 1, 2003, to include circumstances in which the reporting entity is unable to obtain financial information necessary to consolidate a variable interest entity.
2. Make the first sentence of paragraph 5(a) more effective by removing the phrase "from other parties" after "additional subordinated financial support."

3. Clarify that investors should consider only rights and obligations embodied in the equity investment for purposes of applying paragraph 5(b).
4. Clarify that an investor should consider rights and obligations obtained through all of its interests in the entity for purposes of applying the last sentence in paragraph 5.
5. Modify paragraph 15 to indicate that a variable interest holder should reconsider whether it is the primary beneficiary of a variable interest entity whenever an event occurs that could change its status.
6. Clarify that the amount attributable to the primary beneficiary under the last sentence of paragraph 22 is the effect of intercompany eliminations of fees or other sources of income or expense on net income of the variable interest entity.

#### **Matters Discussed and Decisions Reached:**

##### **Final FSP: Deferral of Interpretation 46**

The Board discussed deferring the effective date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for public companies for arrangements existing prior to February 1, 2003, to fiscal periods ending after December 15, 2003.

The staff asked the Board to consider a broader deferral in light of comments received from constituents, due to in process guidance that would be incorporated into the modification of Interpretation 46.

Mr. Herz relayed to the Board recent information he had received indicating that the SEC would not oppose a broad deferral of the application of Interpretation 46. He said that the SEC was concerned that the number of new registrants, or changes in registration, occurring as a result of the application of Interpretation 46 would create an administrative and mechanical challenge to the SEC registration process. He noted that this information was fact-based, and was not reflective of comments received in constituent letters.

Mr. Trott said that he was disappointed by the need to address a broad deferral of Interpretation 46. He did not agree with constituent comments that the application of Interpretation 46 was causing “unintended consequences” or “surprises”. Rather he noted that the Board had considered the consequences that constituents were facing now when Interpretation 46 was initially deliberated. Mr. Trott cited the Board’s decision to use the term *variable interest entity* as one of the Board’s attempts to effectively communicate that Interpretation 46 would apply to entities that were not commonly thought of as special-purpose entities (SPEs). He said that the criteria in the Interpretation focused on entities without sufficient equity and equity that did not have characteristics of voting control.

Mr. Trott disagreed with the assertion that it was an unintended consequence for Collateralized Debt Obligation (CDO) sponsors to be exposed to recognition of losses due to the mixed attribute situation in which assets were valued on a basis different from liabilities. He did not feel that these effects should now be characterized as a surprise to constituents, especially given the large quantity of time he has spent meeting with representatives from the bond market, CDO sponsors and participants, and banks to discuss these issues.

Mr. Trott stated that it would be dangerous to develop unique consolidation methods to deal with the existing phenomena of the fair value measurement mismatch between assets and liabilities. He believes that holding off on making improvements to current GAAP until this phenomena is resolved would be irresponsible. Mr. Trott noted the evolutionary nature of accounting standard setting, and how changes to improve accounting standards must be made with that nature in mind.

In conclusion, Mr. Trott agreed to defer the implementation of Interpretation 46. He pointed out that the majority of the additional guidance that FASB has provided regarding the implementation of Interpretation 46 has been confirming the intent of the application of the provisions, rather than providing new insight into the application. He supported the broad deferral for no longer than the end

of fiscal periods ending after December 15, 2003, as he felt that the investor community would benefit from the information that would be provided by the application of Interpretation 46.

Mr. Trott then cautioned enterprises to closely adhere during the deferral period to the disclosure provisions of the document contained in paragraph 26. These provisions require entities to disclose the nature, purpose, size, activities, and maximum exposure to losses. He stated that if reporting entities took the interests of the investing public to heart and made a meaningful application of the provisions of Interpretation 46, then the Board could afford to make the broad deferral until December 15, 2003.

Mr. Crooch echoed Mr. Trott's sentiments that the consequences of Interpretation 46 were not unintended. Rather, Mr. Crooch said the Board focused on these consequences and decided against giving dispensation to the entities affected by the provisions of the Interpretation. He agreed with reluctance that it was now time to back off and grant the broad deferral. Mr. Crooch said that during the deferral period, the disclosures would be very informative. He agreed with Mr. Trott that the Board could not afford to defer the effective date longer than December 15, 2003.

Mr. Schieneman said that he believed the most important information resulting from Interpretation 46 were the disclosures themselves, not the act of consolidation. He felt that users would deal adequately with the disclosed information in the short term. Mr. Schieneman concluded from the comment letters received that constituents would need longer than the deferral period proposed by Mr. Trott. He favored deferral of the effective date to fiscal periods beginning after December 31, 2003.

Ms. Seidman agreed with Mr. Schieneman that entities, including those considered single purpose SPEs, needed more time to meaningfully apply Interpretation 46. She expressed concern that the outstanding proposed

guidance would not be finalized sooner than December, and that entities would need time to implement the provisions after having a chance to react to the additional guidance. Ms. Seidman voted to defer until periods beginning after December 31, 2003.

Mr. Batavick also supported deferral until periods beginning after December 31, 2003, based on constituent comment letters. He did not feel that deferring until the end of periods ending after December 15, 2003 would allow enough time to consider and resolve additional implementation issues that may arise.

Ms. Schipper stated that she agreed wholeheartedly with Mr. Trott's comments. She, too, disagreed with constituents who felt that the Board had failed to consider the consequences of Interpretation 46. Ms. Schipper said the only result of Interpretation 46 that she was surprised to learn of was the number of entities that were unable to attain reporting information. She felt that the Board had articulated its view on who would be subject to Interpretation 46, and had communicated the arithmetic required for entities to make this determination. She agreed that many entities might have been alarmed that they were subject to the provisions of Interpretation 46 based on the outcome of their analysis, but she disagreed that this was unintended. Ms. Schipper supported deferral until the end of periods ending after December 15, 2003.

Mr. Herz said that he also was disappointed with the comment letters the Board had received in the last 10 to 12 days requesting a deferral of Interpretation 46, given that the original implementation date was July 1, 2003. He understood the reality that the time and attention of many constituents had been consumed by interpreting the provisions of the Sarbanes Oxley Act, specifically Rule 404.

Mr. Herz said that for single-purpose SPE's, no doubt should exist regarding who should consolidate the entity. He said that the market demanded quantified information about those single-purpose SPE's. If he had his preference, a deferral would not extend to those entities, such as synthetic leases.

Mr. Herz commented that when Interpretation 46 was originally issued, the SEC and others had felt that this information was critical to investors. Now, nine months later, he felt that the information provided by the application of Interpretation 46 was no less critical, and that deferral should be for no longer than until the periods ending after December 15, 2003.

Mr. Herz directed the staff to communicate with the SEC regarding the implications of the deferral.

The Board then discussed the entities to which the deferral should apply. The Board decided that an entity need not apply the provisions of Interpretation 46 until the end of the first interim or annual period ending after December 15, 2003, to interests held in a variable interest entity if both of the following conditions applied:

1. The variable interest entity was created before February 1, 2003
2. The public entity has not issued financial statements reporting variable interest entities in accordance with Interpretation 46, other than in the disclosures required by paragraph 26 of the Interpretation.

Ms. Seidman dissented from this decision, as she was concerned that reporting entities that had already issued financial statements in accordance with Interpretation 46 would not be receiving equitable treatment.

The Board then addressed the Proposed FSP FIN 46-a, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Nonregistered Investment Companies." The Board decided to finalize this proposed FSP through incorporation into the broad deferral FSP previously discussed. The application of Interpretation 46 to investments held by investment companies not subject to SEC Regulation S-X, Rule 6-03(c)(1) but currently accounting for their investments in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, *Audits of*

*Investment Companies*, would be delayed until the AICPA finalizes its proposed Statement of Position on the scope of the Audit Guide.

The Board noted that the proposed FSP FIN 46-b, “Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers,” would be effectively addressed through the issuance of the broad deferral as previously discussed.

The Board decided to postpone the discussion of 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*,” until the October 15, 2003 Board meeting.

Ms. Seidman was concerned with the Board’s timing in addressing the impact of kick-out rights, as she noted that consolidation for some entities hinged on the Board’s decision regarding this issue.

#### **Modifications of Interpretation 46**

The Board discussed additional proposed modifications of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

Issue 1—The Board unanimously agreed with the staff’s recommendation to expand the proposed scope exception for a reporting entity’s inability to obtain information about its interests acquired before February 1, 2003, to include circumstances in which the reporting entity is unable to obtain financial information necessary to consolidate a variable interest entity.

Issue 2—The Board also unanimously agreed to make the first sentence of paragraph 5(a) more effective by removing the phrase “from other parties” after “additional subordinated financial support.” The staff noted that this was considered a technical correction.

Issue 3—The Board agreed to clarify that investors should consider only rights and obligations embodied in the equity investment for purposes of applying paragraph 5(b).

The Board then discussed whether an investor should consider rights and obligations obtained through all of its interests in the entity for purposes of applying the last sentence in paragraph 5.

Mr. Trott asked the staff what this additional clarification was intended to communicate. The staff explained that if an investor considered only the obligation to absorb an entity's expected losses and rights to receive the entity's expected residual returns provided by its equity investment without regard to the risks and rewards obtained from its other interests in the entity, the investor might conclude that it does not have a disproportionate share of the voting rights of the equity group. However, if the investor also looks to its other interests in the entity outside of the equity investment, its obligations to absorb the expected losses of the entity and to receive the expected residual returns of the entity may be disproportionate to its voting rights.

Ms. Schipper agreed with the clarification of 5(b), though she felt that the choice of language in the clarification was important.

Mr. Herz commented that this was a clarification of what was intended by paragraph 5(b).

The Board agreed that an investor should consider rights to receive expected residual returns and obligations to absorb expected losses provided by all of its interests in an entity for purposes of applying the last sentence in paragraph 5.

Issue 4—The Board decided to defer the discussion of whether to expand the proposed exemption from paragraph 8(c) of decision maker fees that are fixed in terms of amount and timing until the October 15, 2003 Board meeting.

Issue 5—The Board decided to modify paragraph 15 to indicate that a variable interest holder should reconsider whether it is the primary beneficiary of a variable interest entity whenever an event occurs that could change its status. That staff noted that this modification of paragraph 15 was intended to be all inclusive, such that any event that may occur would trigger reconsideration. The events currently described in paragraph 15 as reconsideration events would be included in the modification of Interpretation 46 as examples.

Issue 6—The Board discussed whether to clarify that the amount attributable to the primary beneficiary under the last sentence of paragraph 22 is the effect of intercompany eliminations of fees or other sources of income or expense on net income of the variable interest entity.

Mr. Batavick questioned the staff about the expected timing of the modification of Interpretation 46. The staff responded that it will make its best effort to address all issues promptly, and issue an Exposure Draft of the modification by the end of October for a 30-day comment period.

**Follow-up Items:**

Discussion of the following issues was deferred until the October 15, 2003 Board meeting:

1. 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*"

2. Consideration of proposed modifications to paragraph 8(c) of Interpretation 46.

**General Announcements:**

The final FSP 46-6, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*" will be effective as of October 9, 2003 and will be posted to the FASB website on October 10, 2003.