MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Reager (ext. 393)		
Subject:	June 11, 2008 Board Meeting Minutes: Interpretation 46(R) Considerations	**Date:**	June 26, 2008
cc:	Golden, Bielstein, Leisenring, MacDonald, Wilkins, Lott, Cosper, Barker, Roberge, Cropsey, Mechanick, Nickell, Wyatt, Zecher, Reager, 140 Amendment Team, C. Smith, Glotzer, Chookaszian, Posta, Gabriele, Sutay, Allen, Klimek, FASB Intranet		

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Topic:	Interpretation 46(R) Considerations
Basis for Discussion:	Board Memorandum 6 & 7 and June 11, 2008 Board Meeting Handout
Length of Discussion:	1:33 p.m to 2:50 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, C. Smith, Donoghue, Nickell, Wyatt, Zecher, and Reager
Outside participants:	None

Summary of Decisions Reached:

At the June 11, 2008 meeting, the Board deliberated options regarding guidance on determining the primary beneficiary in a variable interest entity in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. The Board reaffirmed the decision reached at the April 9, 2008 meeting, which required an enterprise (including its related party and de facto agents) to determine whether it is 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 currently described in Interpretation 46(R) (that is, determine the primary beneficiary based on which enterprise quantitatively absorbs the majority of the expected losses, receives the majority of the residual returns, or both).

In making the qualitative assessment, an enterprise will assess if it has both (1) the power to direct matters that significantly impact the activities and success of the entity **and** (2) the right to receive benefits that could potentially be significant or the obligation to absorb losses that could potentially be significant. Criterion (2) is a qualitative assessment and, thus, is not based on the expected losses calculation provided in Interpretation 46(R). Specific guidance will be added to address an enterprise's implicit or explicit financial responsibility to ensure that a variable interest entity operates as designed. This guidance will also address concerns about an enterprise's reputation risk.

The Board also decided to include a current control notion for the qualitative analysis, particularly criterion (1) above. Specifically, if an enterprise's power is deemed to be other than temporary, kick-out rights should generally not be considered in the assessment until they are exercised. However, if a single enterprise holds the majority of substantive kick-out rights, kick-out rights should be factored into the qualitative assessment.

In addition, the Board decided to not revisit and potentially amend the guidance on determining the purpose and design of a variable interest entity, including the risks that were designed and created to be passed through to interest holders in FASB Staff Position

(FSP) FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R).*

Finally, the Board decided to provide examples of the application of the proposed amended guidance on determining the primary beneficiary in a variable interest entity to typical financial and nonfinancial entities in the proposed Exposure Draft on Interpretation 46(R).

Objective of Meeting:

The purpose of the meeting was for the Board to deliberate options regarding guidance on determining the primary beneficiary in a variable interest entity. The objective was met.

Matters Discussed and Decisions Reached:

Issue 1: Determining the Primary Beneficiary

1. Mr. Roberge stated that the staff has been asked to address the guidance on determining the primary beneficiary in a variable interest entity (VIE), which was also addressed at the April 9, 2008 Board meeting. He said that at the April Board meeting, the Board approved a model in which an enterprise with a variable interest in a VIE would first perform a qualitative assessment to determine primary beneficiary status. If a qualitative assessment could not determine primary beneficiary status, an entity would use the quantitative assessment that is currently in Interpretation 46(R). Mr. Roberge said that the Board also asked the staff to try to work through the approach by first reaching out to constituents and then by going through certain examples to evaluate what conclusions would be reached. The staff met with constituents through Working Groups and met with the Board through small group meetings and education sessions.

2. Mr. Roberge said that as a result of the work done since the April 9, 2008 Board meeting, the staff has established four views (Views A, A', B, and C) to be evaluated by the Board. Mr. Roberge noted that Views A and A' are similar. Mr. Roberge stated that the staff would like to go through the views and ask the Board for its preference.

3. Mr. Roberge stated that View A is attached to the Board handout as Appendix A. View A would require a qualitative assessment of if an enterprise has a controlling financial interest. If an enterprise cannot determine whether or not it is the primary beneficiary qualitatively, then the enterprise should perform the quantitative assessment that is currently in Interpretation 46(R).

4. Mr. Roberge said that View A' is similar to View A. He said that View A' does not explicitly require an entity to determine the risks that the variable interest creates and passes through to its interest holders as View A does. View A' can be seen in Appendix B of the Board handout.

5. Mr. Roberge said that in both View A and View A', the qualitative analysis includes evaluating whether an enterprise has the power to direct matters that significantly

impact the VIE. He stated that a key change from View A to View A' is that View A' requires an enterprise to determine if its rights to receive benefits can potentially be significant **or** its obligation to absorb losses can potentially be significant. In View A, there is an *and* instead of an *or* in reference to receiving benefits and absorbing losses.

6. Mr. Roberge stated that in View B, primary beneficiary status is based soley on a qualitative assessment of which enterprise if any controls a VIE. Mr. Roberge said that in View B, control is viewed as the right or rights to use the assets as if they were your own. In other words, you would have the rights to pledge or sell the assets as if they were your own, and you would have rights to defease any debt without restrictions.

7. Mr. Roberge said that View A and View A' both include a quantitative assessment of primary beneficiary status if an enterprise cannot identify the primary beneficiary through a qualitative assessment. In View B, the definition of control is different from the power to direct in View A and View A'.

8. Mr. Roberge stated that View C is to retain the current guidance in Interpretation 46(R), which would include only a quantitative assessment of primary beneficiary status.

9. Mr. Roberge said that all four of the views presented to the Board would include continuous reconsideration of primary beneficiary status (and whether an entity is a VIE) every period and additional enhanced disclosures.

Issue 1 Staff Recommendation

10. Mr. Roberge stated that the staff recommends View A'.

Issue 1 Board Vote

11. The Board voted in favor of View A'. Msrs. Herz, Batavick, Crooch, Linsmeier, Smith and Young supported View A'. Ms. Seidman stated that her preference is View A, but she would prefer to add the "could potentially be significant" language included in the second criterion of the qualitative analysis about benefits and risks in View A' into the second criterion of the qualitative analysis of View A.

Issue 1 Board Comments

12. Mr. Linsmeier stated that in the qualitative characteristics of the two criteria in Views A or A', you have to be able to identify the benefits or the losses and those arise as a result of the risks. Mr. Linsmeier asked if the staff believes that View A' does not require you to identify the risks in the qualitative analysis. Mr. Batavick then asked how you can do a qualitative assessment if you do not include an assessment of the VIE's characteristics and primary purpose. Mr. Roberge said that View A' does not say that you should not include an assessment of the VIE's characteristics and primary purpose in determining primary beneficiary status, but View A' does not explicitly require you to identify the risks in the words of the qualitative analysis in View A' as is explicitly required in the words of View A.

13. Mr. Golden suggested the staff discuss why View A' differs from View A, including why View A' would change the wording in View A as it relates to qualitatively determining primary beneficiary status. Mr. Golden suggested the staff discuss why View A' removes the wording in View A that refers to the *risks that the VIE was designed to create and pass through to its variable interest holders*.

14. Mr. Roberge stated that View A is a broader based look than View A'. Mr. Golden said that key distinctions between View A and View A' are the *or* in the second criterion of the qualitative analysis in View A' and the focus on responsibility in View A'. Mr. Herz said that he worked with the staff on View A' to try to operationalize his notion that "running the show" and having "skin in the game" should cause you to consolidate.

15. Mr. Young asked how the qualitative analysis about the design of the entity would affect reconsideration of primary beneficiary status in View A. Mr. Young asked how reconsideration would be affected if the dynamics of the marketplace changed. Mr. Roberge said that any change in the marketplace would then be included in the reconsideration of primary beneficiary status.

16. Mr. Golden said that some of the concerns today about the reconsideration events of primary beneficiary status are that primary beneficiary status is currently based on a quantitative analysis, which is a fairly subjective estimate that does not have to be reconsidered every period. Mr. Golden stated that under View A or View A', he does not believe reconsideration will affect the primary beneficiary status of a significant

number of enterprises every period. Instead, Mr. Golden said that he expects that more enterprises will have to consolidate a VIE when the VIE is created.

17. Mr. Golden stated that in View A', the "could potentially be significant" language in the qualitative analysis is important. Mr. Golden said that if you could have power if something bad happens, then you probably will be consolidating. Mr. Leisenring said that under the current quantitative analysis, we look at the current circumstances; but under the proposed model in View A', an enterprise must focus more on possible future circumstances even if they are unlikely.

18. Ms. Seidman said that she understands the difference between View A and View A' to be that View A builds on the evaluation of design and risk that is currently in Interpretation 46(R) and FSP FIN 46(R)-6, and View A' is more of an overall impression of who is in charge and who has skin in the game. However, View A' does not build on the evaluation of design and risk in Interpretation 46(R) and FSP FIN 46(R)-6. Mr. Roberge agreed. Mr. Linsmeier then asked how FSP FIN 46(R)-6 would remain appropriate if the Board decided on View A' because FSP FIN 46(R)-6 talks about the evaluation of risk and design. Ms. Seidman agreed with Mr. Linsmeier. Mr. Herz said that he thought View A' would include thinking about the design, but it would not be limited to the design. Mr. Linsmeier stated that View A' would be concerned with what the risks are now and what the risks could potentially be over time. Mr. Herz said that View A' would not be limited by an enterprise's initial assessment of the risks. Mr. Linsmeier said that practically in implementing View A', an entity would be doing some of the thinking in FSP FIN 46(R)-6. Mr. Smith said that if we compare the application of View A' to the expected losses calculation, people put an extremely low probablility assessment that some of the credit and liquidity guarantees would ever come into play. Mr. Smith said that the wording in the qualitative assessment of View A' would effectively trump the conclusions under the expected losses calculation. Mr. Linsmeier felt that FSP FIN 46(R)-6 currently identifies the risks in the expected losses calculation, and under View A', FSP FIN 46(R)-6 would still have a role; it would just have a different role.

19. Mr. Roberge asked if the wording in View A about *including the risks the VIE creates and passes through to its interest holders* was necessary in View A'. Mr. Batavick

said that it would be his preference to keep the wording, and Mr. Herz said that he did not feel the wording was necessary.

20. Mr. Herz said that his preference is View A', but kick-out rights still need to be discussed. Mr. Roberge said that the staff prefers View A'.

21. Mr. Linsmeier stated that the explicit guidance from the April 9, 2008 meeting that a passive interest would not under any circumstance be considered the primary beneficiary would be implicit in View A and View A', but there would be no explicit wording that a passive interest could not be the primary beneficiary. Mr. Roberge agreed.

22. Mr. Lott said that we are looking at the potential maximum loss instead of the expected loss. Mr. Lott was concerned about the writing of the second criterion in the qualitative analysis of View A'. His concern was that the right to receive benefits from the VIE does not seem to be related to FSP FIN 46(R)-6 because the benefits referred to in View A' are not necessarily related to expected residual returns. However, he felt that the obligation to absorb losses language in View A' is similar to the FSP FIN 46(R)-6 language related to losses experienced by the VIE. Mr. Lott said that the language in the second criterion of the qualitative analysis in View A' should be made clearer so it would be easier to understand if the language was meant to refer to FSP FIN 46(R)-6. Mr. Lott thought that the second criterion of the qualitative analysis in View A' referred to three different things: (1) *benefits* (which is not necessarily expected residual returns, but could just be good things that happen to the enterprise), (2) *losses* (which does sound like things that happen to the VIE and is just the variable interests), and (3) *design*.

23. Mr. Herz stated that he thought the language in the second criterion of the qualitative analysis is meant to refer to the idea of significant skin in the game. He said that he does not think this idea needs to be analogized to existing thinking about expected losses. Mr. Herz said that he did not want the language to be too prescriptive because he wants the language to encourage broader thinking. Mr. Herz stated that he thought the language in the second criterion of the qualitative analysis in View A' said that PB status should be based on if you have significant skin in the game and some power around that. Mr. Leisenring felt that the skin in the game thinking could be misleading

because he was not sure if an obligation to absorb losses would be considered skin in the game. Mr. Herz stated that an obligation to absorb losses would be considered skin in the game. Mr. Roberge said that this is why the wording in the qualitative analysis of View A' says *and/or* instead of *and* when referring to potential benefits and losses. Ms. Seidman said that she did not support the *and/or* language in the qualitative analysis of View A' because she did not feel that having skin in the game in the form of a potential obligation should require consolidation. Ms. Seidman stated that an enterprise with only a potential obligation should account for the potential obligation as a liability and not consolidate the VIE.

24. Mr. Roberge said that the "could potentially be significant" language in the second criterion of the qualitative analysis in View A' referred to being significant to the VIE. Mr. Golden said that whether something is significant to an enterprise is a question of materiality for each enterprise.

Issue 2: Whether to Include the Notion of "Current Control" in View A'

25. Mr. Roberge stated that the Board has discussed previously whether to include the notion of "current control" when requiring enterprises to assess the power to direct matters that significantly impact the activities and success of the VIE. Mr. Roberge said that the question is whether an enterprise should be considered in control if another enterprise has kick-out rights and that other enterprise can remove the original enterprise from control of the VIE. Mr. Roberge stated that the question is this: if an enterprise is the sponsor and meets the guidance in View A' to be the primary beneficiary, but another enterprise has substantive kick-out rights, is the original enterprise still the primary beneficiary?

Issue 2 Staff Recommendation

26. Mr. Roberge stated that the staff does not currently recommend the inclusion of a "current control" notion in a consolidation model.

Issue 2 Board Vote

27. The Board voted to include a current control notion for the qualitative analysis, particularly criterion (1) in View A'. Msrs. Herz, Batavick, Smith and Young and Ms. Seidman supported this view and Msrs. Crooch and Linsmeier did not support this

view. The Board voted that when an enterprise's power is deemed to be other than temporary, kick-out rights should generally not be considered in the assessment until they are exercised. However, if a single enterprise holds the majority of substantive kick-out rights, kick-out rights should be factored into the qualitative assessment.

28. The Board also voted to include a question in the Exposure Draft asking if the Board's current control notion for the qualitative analysis was appropriate.

Issue 2 Board Comments

29. Mr. Golden said that he thought the discussion on kick-out rights should focus on whether or not an enterprise is the primary beneficiary. Mr. Golden stated that in a voting interest entity, if a minority interest holder has substantive kick-out rights, there are circumstances in which the majority interest holder would be precluded from consolidating. He said that we are trying to determine if someone who is not the primary beneficiary has substantive kick-out rights, should this preclude consolidation for the enterprise that has current control. Mr. Golden stated that one of the difficult questions to address is whether kick-out rights are substantive.

30. Mr. Herz said that one of the problems with kick-out rights is that if things are going well for the VIE, it is likely that an enterprise will not be kicked out; and if things are going poorly for the VIE, any enterprise that would step into the VIE would require an adjustment to the current arrangement and more than just a market fee. Mr. Herz said he understands that if kick-out rights are not considered in the consolidation of VIEs, there would be an inconsistency with general partnership guidance in EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." However, Mr. Herz said that he was concerned that if kick-out rights are included as part of the consolidation guidance for VIEs, then kick-out rights might be used to allow an enterprise to avoid consolidation as the primary beneficiary.

31. Mr. Smith asked if the kick-out rights affect consolidation of the VIE under the current consolidation guidance. Mr. Herz said that under today's consolidation guidance for VIEs, power is not considered. Mr. Herz stated that he might be comfortable with "other than temporary" language. Mr. Golden said that the key thing to address is

whether kick-out rights should affect when an enterprise is considered the primary beneficiary.

32. Mr. Linsmeier said that in a VIE, the only reason to kick an enterprise out is if the enterprise is not managing the VIE well; but if that enterprise is ultimately responsible for the losses, there is less incentive to kick the enterprise out. Mr. Linsmeier said that we might want to ask in the Exposure Draft whether determination of the primary beneficiary as it relates to kick-out rights should be thought of differently for VIEs as compared to other guidance. Mr. Linsmeier said that he was concerned about changing the way kick-out rights are thought of in an isolated circumstance as compared to the rest of the literature.

33. Mr. Herz said that his preference is that if an enterprise has current control that is other than temporary, then an enterprise has power, and power is not negated by another enterprise's kick-out rights.

34. Mr. Smith said that he supports Mr. Herz's notion of current control, but he also supports a question in the exposure document relating to current control for consolidation of a VIE.

35. Mr. Golden stated that he thought there were two views of how VIEs should be consolidated as it relates to "current control." Mr. Golden said that the staff's view is that you should be consistent with Issue 04-5 and that substantive kick-out rights should be considered when an enterprise determines if it should consolidate a VIE. Mr. Golden said that Mr. Herz's view is that an enterprise should ignore kick-out rights when determining if it should consolidate a VIE.

36. Mr. Herz said that his approach is informed by the possibility of abuse.

37. Mr. Lott was concerned that the combination of View A' and "current control" could lead to abuse with enterprises attempting to avoid consolidation by having limited "current control" but having substantial kick-out rights.

38. Mr. Linsmeier stated concern that the issue regarding kick-out rights had not been sufficiently analyzed. Mr. Herz said that he wanted to make sure questions about "current control" and kick-out rights were asked in the Exposure Draft because he felt that it was a pivotal issue.

39. Mr. Young asked why it is necessary to include a discussion of current control and kick-out rights. He supported less prescriptive, more principled guidance focused on the power to direct matters that significantly affect the activities. Ms. Seidman said that guidance regarding kick-out rights is necessary because there is so much other U.S. GAAP guidance with respect to votes and powers. Mr. Golden said that Mr. Herz would say that you don't assess kick-out rights toward the power to direct matters.

40. Ms. Zecher asked what would happen if it is determined that the collateral manager does not have a variable interest because of substantive kick-out rights held by the investors. Would the primary beneficiary analysis under View A' ignore the kick-out rights held by the investors, even-though such kick-out rights were the reason that the collateral manager is not considered to have a variable interest in the VIE. Ms. Zecher asked: if such kick-out rights held by the investors are ignored, would it be determined that no variable interest holder has power over the VIE? Mr. Linsmeier and Ms. Zecher agreed that under the Board's decision on this issue, there would be no enterprise that would consolidate through qualitative analysis under View A' in this scenario introduced by Ms. Zecher.

41. Mr. Smith said that in the basis of the Exposure Draft, the staff should say that the Board struggled with this issue and needed feedback from constituents.

Issue 3: Addressing the Guidance in FSP FIN 46(R)-6 Related to the Purpose and Design of an Entity and the Risks It Is Designed and Created to Pass on to Its Interest Holders

Issue 3 Board Vote

42. The Board voted in favor of not changing the guidance in FSP FIN 46(R)-6 regarding the purpose and design of an entity and the risks it is designed and created to pass on to its interest holders.

Issue 3 Board Comments

43. Mr. Linsmeier said that from the earlier discussion in the Board meeting, it seems that FSP FIN 46(R)-6 has some relevance to the evaluation and the qualitative analysis of whether an enterprise should consolidate a VIE. However, Mr. Linsmeier also said

that Mr. Lott discussed earlier in the Board meeting that FSP FIN 46(R)-6 was designed to assist in quantitative analysis, not the qualitative analysis of primary beneficiary status. Mr. Golden said that it seems clear that FSP FIN 46(R)-6 affects quantitative analysis of primary beneficiary status, but he was unsure if the Board wanted FSP FIN 46(R)-6 to affect the qualitative analysis of primary beneficiary status. Mr. Linsmeier said that FSP FIN 46(R)-6 does have some relevance in thinking about the risks that drive the benefits and losses in the second criterion of the qualitative analysis in View A' because we need some guidance to help people think about those risks to help people think about the benefits and losses. Mr. Linsmeier said that FSP FIN 46(R)-6 does have some relevance in helping people think through that process. Ms. Seidman and Mr. Herz said that they felt FSP FIN 46(R)-6 is appropriate for the qualitative analysis.

44. Mr. Lott felt that the wording in the second criterion of the qualitative analysis of View A' was not consistent with the wording in FSP FIN 46(R)-6. He felt that the right to receive benefits language in the second criterion of the qualitative analysis in View A' should say *the right to receive residual returns*, which would be consistent with FSP FIN 46(R)-6.

45. Mr. Golden said that he had heard from the Board that they did not want to change the concepts of how by design works. Mr. Golden said that staff would work on the drafting of View A' to be consistent with this view.

Issue 4: Providing Examples in the Exposure Draft

46. Mr. Roberge asked if the Board believes that examples should be provided in the proposed Exposure Draft.

Issue 4 Board Vote

47. The Board voted in favor of including examples in the proposed Exposure Draft.

Issue 4 Board Comments

48. Mr. Herz said that examples would be helpful, but the examples should be more educational then prescriptive. Mr. Linsmeier said that examples should be included as sample implementation guidance in a separate appendix that says that this is how we

think these words would be applied. Mr. Linsmeier also suggested adding some non-financial examples to go along with the financial examples.

Follow-up Items:

None.

General Announcements:

49. Mr. Roberge said that he wanted to emphasize that no conclusions were reached during the previous week's Education Session, which covered some examples of specific structured finance vehicles, as the staff has been informed that practitioners are citing that discussion and asserting that the staff and Board did indeed conclude on specific structures.