FASB STAFF POSITION

No. FIN 46(R)-5

Title: Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and unrelated parties.)

Date Posted: March 3, 2005

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) to address whether a reporting enterprise should consider whether it holds an implicit variable interest in a variable interest entity (VIE) or potential VIE when specific conditions exist.

2. The identification of variable interests (implicit and explicit) may affect (a) the determination as to whether the potential VIE should be considered a VIE, (b) the calculation of expected losses and residual returns, and (c) the determination as to which party, if any, is the primary beneficiary of the VIE. Thus, identifying whether a reporting enterprise holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of Interpretation 46(R).

3. An implicit variable interest is an implied pecuniary interest in an entity that changes with changes in the fair value of the entity’s net assets exclusive of variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties. Paragraph B10 of Interpretation 46(R) provides one example of an implicit variable interest; that is, an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses. However, Appendix B to Interpretation 46(R) is not intended to provide a complete list of all possible variable interests.

4. The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in an entity directly absorb or receive the variability of the entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the entity, rather than
directly from the entity. Therefore, the identification of an implicit variable interest involves
determining whether an enterprise may be indirectly absorbing or receiving the variability of the
entity. The determination of whether an implicit variable interest exists is a matter of judgment
that depends on the relevant facts and circumstances. For example, an implicit variable interest
may exist if the reporting enterprise can be required to protect a variable interest holder in an
entity from absorbing losses incurred by the entity. Refer to the example in this FSP.

5. The FASB staff is aware of transactions where a reporting enterprise has an interest in, or
other involvement\(^1\) with, a VIE or potential VIE that is not considered a variable interest, and the
reporting enterprise’s related party\(^2\) holds a variable interest in the same entity. A reporting
enterprise’s interest in, or other pecuniary involvement with, a VIE may take many different
forms such as a lessee under a leasing arrangement or a party to a supply contract, service
contract, or derivative contract. For these and other types of transactions, the FASB staff
understands that there is diversity in practice as to whether the reporting enterprise should
consider whether an implicit variable interest exists between it and the VIE or potential VIE.

6. The FASB staff believes the reporting enterprise should consider whether it holds an implicit
variable interest in the VIE or potential VIE. The determination of whether an implicit variable
interest exists should be based on whether the reporting enterprise may absorb variability of the
VIE or potential VIE. A reporting enterprise that holds an implicit variable interest in a VIE and
is a related party\(^3\) to other variable interest holders should apply the guidance in paragraph 17 of
Interpretation 46(R) to determine whether it is the primary beneficiary of the VIE. That is, if the
aggregate variable interests held by the enterprise (both implicit and explicit variable interests)

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\(^1\) The significance of an enterprise’s involvement or interest should not be considered in determining whether the
enterprise holds an implicit variable interest in the entity. Rather, the significance of the enterprise’s variable
interest(s) (including its implicit variable interests as well as other variable interests held by the enterprise and its
related parties) should be considered, if the entity is a VIE, in determining whether the enterprise is the primary
beneficiary.

\(^2\) For purposes of this FSP, refer to paragraph 16 of Interpretation 46(R) for the definition of related party.

\(^3\) The guidance in this FSP applies to related parties as defined in paragraph 16 of Interpretation 46(R). For
example, the guidance in this FSP applies to situations in which (1) a reporting enterprise and a VIE are under
common control, (2) a reporting enterprise has an interest in, or other involvement with, a VIE and an officer of that
reporting enterprise has a variable interest in the same VIE, or (3) a reporting enterprise enters into a contractual
arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a
related party relationship.
and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment, and shall be based on an analysis of all relevant facts and circumstances. Paragraph 17 of Interpretation 46(R) provides factors to consider in making that determination. A reporting enterprise that is not the primary beneficiary but holds a significant implicit variable interest in a VIE should disclose the information in paragraph 24 of Interpretation 46(R).

**Effective Date and Transition**

7. For entities to which Interpretation 46(R) has been applied, the guidance in this FSP shall be applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) is permitted but not required. Early application is permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).

**Example**

One of the two owners of Manufacturing Company is also the sole owner of Leasing Company, which is a VIE. The owner of Leasing Company provides a guarantee of Leasing Company’s debt as required by the lender. Leasing Company owns no assets other than the manufacturing facility being leased to Manufacturing Company. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph B24 of Interpretation 46(R). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Company and Leasing Company.

Based on the guidance in this FSP, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company.
Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company as a result of the leasing arrangement and the relationship between it and the owner of Leasing Company. For example, Manufacturing Company would be considered to hold an implicit variable interest in Leasing Company if Manufacturing Company effectively guaranteed the owner’s investment in Leasing Company.\(^4\) Manufacturing Company may be expected to make funds available to Leasing Company to prevent the owner’s guarantee of Leasing Company’s debt from being called on, or Manufacturing Company may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Company’s debt guarantee. The determination as to whether Manufacturing Company is effectively guaranteeing all or a portion of the owner’s investment or would be expected to make funds available and, therefore, an implicit variable interest exists, should take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Company to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Company acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

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\(^4\) The guidance in this FSP should be used only to evaluate whether a variable interest exists under Interpretation 46(R) and should not be used in the evaluation of lease classification in accordance with FASB Statement No. 13, *Accounting for Leases*. Paragraph 29 of Statement 13 addresses leases between related parties and states “…the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed.”