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Financial Accounting Series

EXPOSURE DRAFT

Proposed Interpretation

Consolidation of Variable Interest Entities

a modification of FASB Interpretation No. 46

This Exposure Draft of a proposed Interpretation is issued by the Board for public comment. Written comments should be addressed to:

Director of Technical Application and Implementation Activities
File Reference No. 1082-300

Comment Deadline: December 1, 2003



Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

This proposed Interpretation would modify FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to:

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. Provide an exception to the application of Interpretation 46 to entities created before February 1, 2003, for which a reporting entity is unable to obtain the information necessary to apply that Interpretation.
3. Provide an exception to the application of Interpretation 46 to mutual funds in the form of trusts and trusts of a bank's trust department and similar arrangements, unless they are used by a business enterprise to circumvent the provisions of that Interpretation.
4. Clarify that the equity investment in a potential variable interest entity is insufficient under paragraph 5(a) of Interpretation 46 if the entity cannot finance its activities without additional subordinated financial support provided by any party, including the equity investors.
5. Clarify that qualitative considerations may be important in determining whether an entity's equity investment at risk is sufficient to finance its activities without additional subordinated financial support.
6. Clarify that the objective of paragraph 5(b) of Interpretation 46 is to identify as a variable interest entity those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest.
7. Make the last sentence of paragraph 5 of Interpretation 46 more effective in identifying arrangements in which voting interests are not aligned with income interests.
8. Clarify that an entity's expected losses and expected residual returns are based on the expected variability in the entity's long-term return to variable interests.
9. Clarify that paragraph 11 of Interpretation 46 does not exempt development stage enterprises from the requirements of paragraph 5(b) relating to the characteristics of equity.
10. Clarify the guidance for determining which variable interest holder will absorb a majority of the variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both.
11. Require an enterprise involved with an entity that was previously not considered a variable interest entity to reconsider whether the entity is a variable interest entity whenever the design of the entity or ownership of interests in the entity changes in a manner that could affect the determination.
12. Require an enterprise that holds a variable interest in a variable interest entity to reconsider whether it is the primary beneficiary of that entity whenever the design of the entity or ownership of interests in the entity changes in a manner that could affect that determination.

13. Clarify that a de facto agency relationship is created under paragraph 16(d)(1) of Interpretation 46 if the approval rights effectively constrain the interest holder's ability to manage the economic risks or realize the economic rewards of its interests.
14. Change the guidance in paragraph 17 of Interpretation 46 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.
15. Require an enterprise to recognize goodwill if it becomes the primary beneficiary of a variable interest entity that is a business.
16. Clarify that the effects of the intercompany eliminations on the variable interest entity's net income or expense should be attributed to the primary beneficiary in the consolidated financial statements.
17. Delete paragraphs B1–B10 of Appendix B of Interpretation 46.

Reasons for Issuing This Proposed Interpretation

Interpretation 46 clarifies the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investment at risk does not have the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support. For those entities, a controlling financial interest cannot be identified based on an evaluation of voting interests. Since the issuance of Interpretation 46, the Board has learned that certain provisions of that Interpretation are not being consistently interpreted as the Board intended. The Board decided to address certain technical corrections and implementation issues that have arisen.

How This Proposed Interpretation Would Improve Financial Reporting

The modifications to Interpretation 46 in this proposed Interpretation would clarify and provide certain limited-scope exceptions to the application of Interpretation 46. The Board expects that the proposed modifications would provide for more consistent application of consolidation policies to variable interest entities in accordance with the objective of requiring an enterprise to consolidate entities in which it has a controlling financial interest.

Benefits and Costs

The Board acknowledges that this proposed Interpretation may increase the costs of initial implementation of Interpretation 46 for an enterprise that would need to reevaluate whether an entity in which the enterprise holds an interest is a variable interest entity and whether the enterprise is the primary beneficiary of that entity based on the guidance in this proposed Interpretation. The expected benefit of these incremental costs is the improvement in financial reporting resulting from a more consistent application of consolidation policies to variable interest entities. For an enterprise that has not yet applied the provisions of Interpretation 46, the proposed modifications are not expected to increase significantly the cost of implementing that Interpretation, and, in some cases, the proposed modifications may reduce costs to implement Interpretation 46.

The Effective Date of This Proposed Interpretation

This proposed Interpretation would be effective for financial statements issued for the first reporting period ending after December 15, 2003, for variable interests and variable interest entities to which the provisions of Interpretation 46 have been applied. The cumulative effect of applying this proposed Interpretation would be recognized in that period. Early application would be encouraged. Restatement of previously issued financial statements to apply the provisions of this proposed Interpretation retroactively to the date Interpretation 46 was first applied, with a cumulative-effect adjustment as of the beginning of the earliest year restated, would be encouraged but not required.

For variable interest entities to which the provisions of Interpretation 46 have not been applied, this proposed Interpretation would be applied in accordance with the effective date and transition provisions in Interpretation 46 and related FASB Staff Positions.

Proposed Interpretation

Consolidation of Variable Interest Entities

a modification of FASB Interpretation No. 46

October 31, 2003

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Proposed Interpretation

Consolidation of Variable Interest Entities

a modification of FASB Interpretation No. 46

October 31, 2003

INTRODUCTION

1. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, clarifies the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support. This Interpretation clarifies and modifies certain provisions of Interpretation 46.

INTERPRETATION

Modifications to Interpretation 46

2. Paragraph 2 is amended as follows:

- a. The last sentence in subparagraph (c) is deleted.
- b. In subparagraph (e), *if they occur* is deleted.

3. Paragraph 4 is amended as follows:

a. The following is added before the first sentence:

This Interpretation clarifies the application of ARB 51.

b. The first sentence in subparagraph (a) is replaced by the following:

Not-for-profit organizations as defined in paragraph 168 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, are not subject to this Interpretation, except that they may be related parties for purposes of applying paragraphs 16 and 17 of this Interpretation.

c. The following subparagraphs and related footnote are added:

- g. An enterprise with an interest in a variable interest entity or potential variable interest entity created before February 1, 2003, is not required to apply this Interpretation to that entity if the enterprise, after making an exhaustive effort, is unable to obtain the information* necessary to (1) determine whether the

entity is a variable interest entity, (2) determine whether the enterprise is the variable interest entity's primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary. The scope exception in this provision applies only as long as the reporting enterprise continues to be unable to obtain the information necessary to (1) determine whether the entity is a variable interest entity, (2) determine whether the enterprise is the variable interest entity's primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary. The enterprise shall continue its efforts to obtain such information as long as it holds an interest in the entity. Paragraph 25A requires certain disclosures to be made about entities that fall under this provision. Paragraph 30 provides transition guidance for an enterprise that subsequently obtains the information necessary to apply this Interpretation to an entity subject to this exception.

- h. Mutual funds in the form of trusts and trusts of a bank's trust department and similar arrangements that are organized and operated in a manner consistent with customary existing practices are not subject to consolidation according to the requirements of this Interpretation. However, if a fund or trust is used by business enterprises in an effort to circumvent the provisions of this Interpretation, that fund or trust shall be subject to this Interpretation.

*This inability to obtain the necessary information is expected to be infrequent, especially if the enterprise was involved in the creation of the entity.

- 3. Paragraph 5 is amended as follows:
 - a. In the first sentence *either of the following conditions exists* is replaced by *the conditions in a or b exist*.
 - b. The first three sentences in subparagraph (a) are replaced with the following:

The total equity investment² at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. An analysis of the entity's expected losses is the benchmark for assessing sufficiency of equity. (Refer to Appendix A for discussion of expected losses.) However, computation of expected losses will often depend on subjective judgments about probabilities of future events, and the value of the equity investment at risk may also be an estimate affected by assumptions. Consequently, qualitative considerations may also be important in determining whether an entity's equity investment at risk is sufficient.

- c. The following footnote is added after *characteristics* in the first sentence of subparagraph (b):

†The objective of this provision is to identify as variable interest entities those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest. If interests other than the equity investment at risk provide the holders of that investment with the characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the necessary characteristics, the entity is a variable interest entity.

- d. In subparagraphs (b)(2) and (b)(3), *if they occur* is deleted.

- e. Footnote 4 is deleted.

- f. The last sentence is replaced by the following:

- c. The equity investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights.^{6,7} For purposes of applying this requirement, enterprises shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's interests in the entity and not only its equity investment at risk.

- g. Footnote 6 is replaced by the following:

Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term *related parties* in this footnote refers to all parties identified in paragraph 16, except for de facto agents under item 16(d)(1).

- 4. In the second sentence of paragraph 6, both references to *if they occur* are deleted.

- 5. Paragraph 7 is replaced by the following:

An entity that previously was not subject to this Interpretation shall not become subject to it simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether an entity is a variable interest entity shall be reconsidered whenever the design of the entity or ownership of interests in the entity changes in a manner that could change that determination. Examples of such reconsideration events include:

- a. The entity's governing documents, contractual arrangements among the parties involved with the entity, or contractual arrangements with the entity change significantly.
- b. The equity investment or some part thereof is returned to the investors, and other interests become exposed to expected losses.
- c. The entity undertakes additional activities or acquires additional assets beyond those that were anticipated at the inception of the entity that increase the entity's expected losses.

Neither the incurrence of operating losses by an entity nor renegotiation of the entity's debts or other contracts caused by the incurrence of operating losses shall cause a change in the determination of whether an entity is a variable interest entity unless, by design, the characteristics of the equity investment at risk in the entity or the level of subordinated financial support provided to the entity are modified.

6. Paragraph 8 is replaced by the following:

A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's long-term return to variable interests, (b) fees to the decision maker (if there is a decision maker), and (c) fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

7. The following paragraph is added after paragraph 9:

9A. Qualitative assessments shall be carefully considered before attempting to estimate the entity's expected losses and equity investment at risk in paragraph 9(c). If, after diligent effort, a reasonable conclusion cannot be reached based solely on qualitative considerations, the amounts required by paragraph 9(c) shall be estimated.

8. In the third sentence of paragraph 11, *paragraph 5* is replaced by *paragraph 5(a)*.

9. In the first sentence of paragraph 14, both references to *if they occur* are deleted.

10. In paragraph 15, the last three sentences are replaced by the following:

An enterprise with a variable interest in a variable interest entity shall reconsider whether it is the primary beneficiary of that entity whenever the design of the entity or ownership of interests in the entity changes in a manner that could affect the determination of whether the enterprise is the primary beneficiary. Examples of such reconsideration events include:

- a. The entity's governing documents, contractual arrangements among the parties involved with the entity, or contractual arrangements with the entity change significantly.
- b. The primary beneficiary sells or otherwise disposes of all or part of its variable interest to unrelated parties.
- c. The variable interest entity issues new interests to parties other than the existing primary beneficiary or the primary beneficiary's related parties.
- d. A variable interest holder that is not the primary beneficiary acquires additional interests in the variable interest entity.

Neither the incurrence of operating losses by a variable interest entity nor renegotiation of the entity's debts or other contracts caused by the incurrence of operating losses shall cause a change in the determination of the primary beneficiary unless the losses or the renegotiation result, by design, in a reallocation between the existing primary beneficiary and other parties of significant decision-making ability, the obligation to absorb expected losses, or the right to receive expected residual returns of the variable interest entity.

11. Paragraph 16 is amended as follows:

- a. In the second sentence, *or de facto principals* is added after *and certain other parties that are acting as de facto agents*.
- b. The following is added at the end of subparagraph (d):

The right of prior approval creates a de facto agency relationship only if the right could constrain the party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity.

12. Paragraph 17 is replaced by the following:

If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, the party with activities that are most closely associated with the entity is the primary beneficiary. If two or more parties with variable interests have an agency (or de facto agency) relationship, the principal (or de facto principal) is presumed to be the primary beneficiary unless another party within the related party group has activities that are more closely associated with the entity.

13. Paragraph 20 is replaced by the following:

The primary beneficiary of a variable interest entity shall initially measure assets and liabilities that it has transferred to that variable interest entity shortly before, at, or after the date that the enterprise became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had

not been transferred. No gain or loss shall be recognized because of such transfers.

14. In paragraph 21, the last sentence is replaced by the following:

The excess, if any, of (a) the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests over (b) the fair value of the newly consolidated identifiable assets and the reported amount of identifiable assets transferred by the primary beneficiary to the variable interest entity shall be reported in the period in which the enterprise becomes the primary beneficiary as:

- a. Goodwill, if the variable interest entity is a business[‡]
- b. An extraordinary loss, if the variable interest entity is not a business.

[‡]EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” provides guidance on determining whether an entity constitutes a business.

15. In the last sentence of paragraph 22, , *and the resulting* is replaced by *The resulting effect of that elimination on the*.

16. The following paragraph is added after paragraph 25:

25A. An enterprise that does not apply this Interpretation to one or more variable interest entities or potential variable interest entities because of the condition described in paragraph 4(g) shall disclose the following information:

- a. The number of entities to which the Interpretation is not being applied and the reason why the information required to apply the Interpretation is not available
- b. The nature, purpose, size (if available), and activities of the entity(ies) and the nature of the enterprise’s involvement with the entity(ies)
- c. The reporting enterprise’s maximum exposure to loss because of its involvement with the entity(ies)
- d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting enterprise and the entity(ies) for all periods presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

17. The following paragraph is added after paragraph 29:

30. An enterprise that has not applied this Interpretation to an entity because of the condition described in paragraph 4(g) and that subsequently obtains the information necessary to apply this Interpretation to that entity shall apply the provisions of this Interpretation as of the date the information is acquired in accordance with paragraph 28. Restatement in accordance with paragraph 29 is encouraged but not required.

18. The last sentence in paragraph A5 is deleted.
19. Paragraphs B1–B10 are deleted.

Effective Date and Transition

20. This Interpretation shall be effective for financial statements issued for the first reporting period ending after December 15, 2003, for variable interests and variable interest entities to which the provisions of Interpretation 46 have been applied. The cumulative effect of applying this Interpretation shall be recognized in that period. Early application is encouraged. Restatement of previously issued financial statements to apply the provisions of this Interpretation retroactively to the date Interpretation 46 was first applied,¹ with a cumulative-effect adjustment as of the beginning of the earliest year restated, is encouraged but not required.

21. For variable interests to which the provisions of Interpretation 46 have not been applied, this Interpretation shall be applied in accordance with the effective date and transition provisions in Interpretation 46 and related FASB Staff Positions.

¹The determination of the date Interpretation 46 was first applied to a variable interest shall be in accordance with paragraphs 27–29 of Interpretation 46 and any related FASB Staff Positions.

Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

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Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

Introduction and Background

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Interpretation. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than others.

A2. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, clarifies the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support. For those entities, a controlling financial interest cannot be identified based on voting interests. Since the issuance of Interpretation 46, the Board has learned that certain provisions of that Interpretation are not being interpreted as the Board intended. The Board decided to modify Interpretation 46 to address certain technical corrections and implementation issues that have arisen.

Benefits and Costs

A3. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A4. The Board's assessment of the benefits and costs of clarifying and modifying Interpretation 46 was based on discussions with preparers and auditors of financial statements and on consideration of the needs of users for more consistent application of that Interpretation. The Board acknowledges that this Interpretation may increase the costs of initial implementation of Interpretation 46 for an enterprise that would need to reevaluate whether an entity in which the enterprise holds an interest is a variable interest entity and whether the enterprise is the primary beneficiary of that entity based on the guidance in this Interpretation. The expected benefit of these incremental costs is improved financial reporting resulting from a more consistent application of consolidation policies to variable interest entities. For an enterprise that has not yet applied the provisions of Interpretation 46, the modifications in this Interpretation are not expected to

significantly increase the cost of implementing Interpretation 46, and in some cases, the clarifications and additional scope exceptions may reduce implementation costs.

Modifications to Interpretation 46

Scope Exception for Not-for-Profit Health Care Organizations

A5. Paragraph 4(a) of Interpretation 46 excludes from the scope of that Interpretation not-for-profit organizations subject to the consolidation criteria of AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, unless a not-for-profit organization is used by a business enterprise to circumvent that Interpretation. SOP 94-3 applies to entities following the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*. That Guide applies to all organizations that meet the definition of a not-for-profit organization in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, except for entities following the AICPA Audit and Accounting Guide, *Health Care Organizations*. Thus, questions were raised as to whether not-for-profit organizations following the health care Guide were excluded from the scope of Interpretation 46.

A6. The Board's intent is clear in Interpretation 46's summary and basis for conclusions. The summary states:

Not-for-profit organizations are not subject to this Interpretation unless they are used by business enterprises in an attempt to circumvent the provisions of this Interpretation.

A7. Paragraph C8 of Interpretation 46 explains the Board's reason for this exclusion:

The Board considered it inappropriate to extend the requirements of this Interpretation to not-for-profit organizations because the document being interpreted does not specifically apply to them.

A8. Consequently, the Board directed that an FASB Staff Position (FSP) be issued to explain 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. That FSP was issued on July 24, 2003. At the same time, the Board agreed that paragraph 4(a) should be modified to correspond with its original intent as expressed in Interpretation 46.

Scope Exception for Certain Enterprises That Are Unable to Obtain Information

A9. Arrangements created before the issuance of Interpretation 46 may not have included provisions assuring that parties involved would have access to information required to apply that Interpretation. Therefore, an enterprise with an interest in an entity created before the issuance of Interpretation 46 may be unable to obtain information to (a) determine whether the entity is a variable interest entity, (b) determine whether the

enterprise is the primary beneficiary of the entity, or (c) consolidate the variable interest entity for which it is determined to be the primary beneficiary.

A10. According to paragraph 6 of Interpretation 46, an enterprise is not required to determine whether the entity with which it is involved is a variable interest entity if it is apparent that the enterprise's interests would not be significant variable interests in the entity and if the enterprise, its related parties, and its de facto agents (as described in paragraph 16 of Interpretation 46) were not involved in forming the entity. That paragraph provides the basis for some enterprises to avoid difficulties in obtaining information. However, the Board has been informed that the inability to obtain sufficient information was broader than the situation described in paragraph 6.

A11. Consequently, the Board decided that in situations not covered by paragraph 6 of Interpretation 46, an enterprise is not required to apply Interpretation 46 to entities created before February 1, 2003, if the enterprise is unable to obtain information necessary to (a) determine whether the entity is a variable interest entity, (b) determine whether the enterprise is the primary beneficiary, or (c) perform the accounting required to consolidate the entity. To qualify for this scope exception, the enterprise must have made and must continue to make exhaustive efforts to obtain the information. The scope exception applies to individual variable interest entities or potential variable interest entities, not to a class of entities if information is not available for some members of the class.

A12. The Board expects the application of the scope exception in paragraph 4(g) to be infrequent, especially if the reporting enterprise was involved in the creation of the entity. An enterprise that is exposed to substantial risks of another entity would normally obtain information about that entity to monitor its exposure (even if the exposure is limited).

Scope Exception for Mutual Funds and Trusts Held by a Bank's Trust Department

A13. The activities of mutual funds organized as trusts and personal trusts in bank trust departments are by design, customary practice, and law, not for the benefit of the trustee or related parties of the trustee. Therefore, the Board did not expect trustees to be deemed to be the primary beneficiaries of those trusts unless they were being used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of Interpretation 46. However, the Board has been informed that some mutual fund sponsors and banks have been determined to be primary beneficiaries of mutual funds organized as trusts and trusts in bank trust departments even though those trusts were not being used to circumvent the provisions of Interpretation 46. Therefore, the Board decided to add paragraph 4(g) to explicitly exclude those entities from the scope of Interpretation 46.

Variable Interest Entities

A14. Paragraph 5(a) of Interpretation 46 identifies an entity with insufficient equity at risk as a variable interest entity. The Board decided to modify the first sentence in paragraph 5(a) to clarify that equity is insufficient if the entity cannot finance its activities without additional subordinated financial support provided by any party, including the equity holders.

A15. Paragraph 5(b) of Interpretation 46 describes the characteristics of a controlling financial interest. If the rights and obligations of the total equity investment at risk lack any of those characteristics, then the ownership of a majority of the equity investment at risk would not provide all the characteristics of a controlling financial interest and would not be an appropriate basis for consolidating the entity. In that situation, the entity is a variable interest entity. Paragraph 5(b) might not be effective in identifying a variable interest entity if the equity holders treated the rights and obligations provided by their other interests in the entity as though those rights and obligations were derived from the equity investment at risk. Therefore, the Board decided to modify paragraph 5(b) to clarify that the objective of this provision is to identify as a variable interest entity those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest in that entity.

A16. The last sentence in paragraph 5 of Interpretation 46, as explained in footnote 7, was designed to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with nonsubstantive voting interests. Footnote 6 requires that in applying the last sentence in paragraph 5, the term *investor* include the investor's related parties. The Board did not intend for footnote 6 to apply to part (i) of the last sentence. In applying footnote 6 to part (ii) of the last sentence in paragraph 5, the Board intended that the investor with disproportionately few voting rights treat activities of the entity that involve or are conducted on behalf of the investor's related parties as if they involve or are conducted on behalf of the investor. Otherwise, the provision designed to identify nonproportional voting and economic interests would not be effective if the investors are related parties, because each investor's interests would be combined and voting and economic interest would not be disproportional. Also, footnote 6 made part (ii) of the last sentence in paragraph 5 ineffective in identifying the type of arrangement the Board intended to be considered a variable interest entity in some cases in which the investors are related by the de facto agency provisions of paragraph 16(d)(1). That is, certain entities for which the investors are considered to be related parties only because they have a de facto agency relationship under paragraph 16(d)(1) would be inappropriately identified as variable interest entities.

A17. Another question related to the last sentence of paragraph 5 is whether the investors' obligations to absorb an entity's expected losses and rights to receive the entity's expected residual returns provided by interests outside the equity investment should be considered for purposes of determining if some investors have voting rights that are not proportional to their risks and rewards. The Board intended this provision to be broadly applied; that is, an investor's obligation to absorb expected losses or right to receive expected residual returns of the entity provided by any of the investor's interests in the entity should be considered.

A18. The Board therefore decided to modify footnote 6 and the last sentence in paragraph 5 to make this sentence more effective in identifying arrangements with nonsubstantive voting interests.

Expected Losses and Expected Residual Returns

A19. In specifying what is to be considered in determining the expected losses and expected residual returns of a variable interest entity, paragraph 8 of Interpretation 46 refers to the expected variability in the entity's net income or loss and the expected variability in the fair value of the entity's assets if it is not included in net income or loss. The Board's intention was to refer to variability in long-term return to variable interests. However, others did not understand how the term *net income* was intended to apply because net income is conventionally understood to refer to returns to equity investors in voting interest entities. In referring to change in fair values of assets as part of the computation of expected losses, the Board intended to refer to the net change over the life of assets to be distributed to variable interest holders in lieu of cash. To clarify its intentions, the Board decided to replace items (a) and (b) in paragraph 8 with a reference to long-term returns available to variable interests.

A20. In paragraph 9, the Board described the use of qualitative and quantitative evidence to determine the sufficiency of the equity invested in an entity with the expectation that computations of expected losses would not be required in many cases. However, the Board has been informed that the determination frequently begins and ends with the quantitative assessment in paragraph 9(c). Consequently, the Board decided to modify paragraph 5 to focus on the objective of determining whether the equity investment is sufficient to permit the entity to finance its activities and to deemphasize the quantitative consideration of expected losses. Paragraph 9A was added to further emphasize the importance of qualitative analysis and to illustrate the process that the Board expects enterprises to apply.

A21. The design of the entity (for example, its capital structure) and the apparent intentions of the parties that created the entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates and other terms of its financing arrangements, and its relationship with and reliance on other parties, especially its creators and their related parties. Often, no single factor will be conclusive and the determination will be based on the preponderance of evidence. For example, if an entity does not have a limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the enterprise has been able to obtain commercial financing arrangements on customary terms, that entity would not be expected to be a variable interest entity. In contrast, if an entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, that entity would be expected to be a variable interest entity.

Development Stage Enterprises

A22. Paragraph 11 of Interpretation 46 provides guidance on the application of the equity sufficiency conditions in paragraph 5(a) for determining whether a development stage entity is a variable interest entity. The third sentence in paragraph 11 states that a

development stage entity does not meet the conditions in paragraph 5 if it can demonstrate that it has sufficient equity. The Board modified paragraph 11 to clarify that the guidance in paragraph 11 applies only to the application of paragraph 5(a). Parties involved with a development stage entity also must consider whether the equity investment held by its equity holders as a group have the characteristics of equity described in paragraph 5(b).

Consolidation Based on Variable Interests

A23. Many constituents have found it difficult in certain situations to apply the requirement in paragraph 14 for an enterprise to consolidate a variable interest entity if it has variable interests in that entity “that will absorb a majority of the entity’s expected losses if they occur, receive a majority of the entity’s expected residual returns if they occur, or both.” In addition, the statement in paragraph A5 that “each party would determine its own expected losses and expected residual returns and compare that amount with the total” can be interpreted to be inconsistent with the requirement in paragraph 14. Different techniques are being used by different enterprises. To remove possible inconsistencies, the Board decided to delete paragraph A5 and the phrase *if they occur* each time it appears in the body of Interpretation 46. The Board did not decide to specify a single technique or otherwise limit an enterprise’s ability to choose the technique it believes applies in its own specific circumstances, but it may choose to do so in the future.

Reconsideration Events

A24. Paragraph 7 of Interpretation 46 provides that an entity that previously was not subject to that Interpretation must reconsider whether it is a variable interest entity when specified events occur. The Board’s intention was to provide a list of reconsideration events so that entities did not need to reconsider at each reporting date. The Board was aware that paragraph 7 does not list all of the events that could change the determination of whether an entity is a variable interest entity. In addition, some constituents believed that an entity that restructures its financing arrangements as a result of operating losses automatically becomes a variable interest entity even though footnote 1 to paragraph 5 of Interpretation 46 states that an entity does not become a variable interest entity because of operating losses.

A25. The Board decided to describe the nature of a reconsideration event for an entity as one that could change the determination of whether the entity is a variable interest entity instead of just adding new items to the list. The Board also decided to be more specific about the effects of operating losses by clarifying that neither the incurrence of losses by an entity nor consequential renegotiation of the entity’s debts or other contracts would be a reconsideration event unless, by design, the characteristics of the equity investment at risk in the entity or the level of subordinated financial support provided to the entity are modified. For example, if an existing lender to an entity that is in financial trouble restructures the debt in a manner that creates a new level of subordinated financial support for the entity, the structural design of the entity has changed, and the initial determination of whether an entity is a variable interest entity must be reconsidered. Conversely, if a lender only reduces the outstanding balance or extends the maturity date of the loan to a troubled entity without changing any other terms of the loan, the lender may be

acknowledging expected losses of the entity that have occurred already. If the lender's exposure to the entity's expected losses is essentially the same immediately before and immediately after the restructuring, the lender has not provided additional subordinated financial support to the entity. This debt restructuring would not be a reconsideration event unless the new arrangement modified the characteristics of the equity investment at risk, for example, by providing the lender with new voting rights. Furthermore, the transfer of troubled debt between lenders would not be a reconsideration event if the transaction does not change the characteristics of the equity investment at risk or increase the subordinated financial support provided to the entity. An arrangement would increase the subordinated financial support provided to an entity if it increased the entity's expected losses. Finally, operating losses alone could lead to a reconsideration event if, for example, an existing debt agreement includes provisions that change the characteristics of the equity investment at risk at some predetermined level of loss.

A26. Paragraph 15 of Interpretation 46 provides that an enterprise with an interest in a variable interest entity must reconsider whether it is the primary beneficiary of that entity when specified events occur. Paragraph 15 does not list all of the events that could change the determination of which variable interest holder is the primary beneficiary. For example, the issuance of new variable interests in a variable interest entity to parties other than the primary beneficiary is not identified as a reconsideration event, although newly issued interests could change which interest holder would absorb a majority of the expected losses or receive a majority of the expected residual returns of the entity. In addition, paragraph 15 does not require reconsideration when a variable interest holder that is not the primary beneficiary acquires existing interests from parties other than the primary beneficiary.

A27. The Board decided to describe the nature of a reconsideration event for an enterprise as one that could change the determination of whether the enterprise is the primary beneficiary. The Board also decided to be more specific about how the effects of operating losses should be treated in determining whether the primary beneficiary has changed.

De Facto Agency Relationship Created by Approval Rights

A28. Paragraph 16(d)(1) of Interpretation 46 says that a party is a de facto agent of an enterprise if that party has an agreement that it cannot sell, transfer, or encumber its interests in a variable interest entity without the prior approval of an enterprise with a variable interest in the same entity. In that situation, the holder of the approval rights is the de facto principal of the party that is the de facto agent.

A29. Paragraph C38 in the basis for conclusions of Interpretation 46 describes the purpose of paragraph 16 as follows:

An enterprise and its affiliates, managers, agents, and other related parties may work as a group to establish and manage a variable interest entity even if no single party in the group meets the conditions in paragraph 14 of this Interpretation. Paragraph 16 includes a provision intended to

prevent a variable interest holder from avoiding consolidation of a variable interest entity by arranging to protect its interest or indirectly expand its holdings through other parties.

A30. 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. Those rights suggest that the party is acting as an agent and that the enterprise with the approval rights could avoid consolidation of a variable interest entity by arranging to protect its interests or indirectly expand its holdings through other parties. The Board decided to clarify that the right of prior approval creates a de facto agency relationship under paragraph 16(d)(1) if the right could constrain the party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity.

A31. Whether a party is a de facto agent under the provisions of paragraph 16(d)(1) depends on the facts and circumstances. Judgment is required to assess the significance of conditions in an agreement providing an enterprise the right to approve the sale, transfer, or encumbrance of a party's interests in a variable interest entity.

A32. For example, a de facto agency relationship would exist if a party's ability to realize the economic benefits of its interest could be constrained by an enterprise's exercise of its right to approve all sales, transfers, *and* encumbrances of that interest. In contrast, a de facto agency relationship presumptively is not created under paragraph 16(d)(1) if a party has the ability to realize the economic benefits of its interest by selling that interest without the enterprise's approval, even if the enterprise's prior approval is required for all other transfers or encumbrances of that interest. Also, if the right of prior approval is designed solely to prevent transfer of the interest to a competitor or to a less creditworthy, or otherwise less qualified, holder, and such parties are not the only potential purchasers of the interest, the right would not create a de facto agency relationship.

Related Parties

A33. Paragraph 17 of Interpretation 46 provides the following guidance for determining which of two or more related parties is the primary beneficiary of a variable interest entity:

If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, the following guidelines shall be used for deciding which is the primary beneficiary:

- a. If two or more parties with variable interests have an agency relationship, the principal is the primary beneficiary.
- b. If the relationship is not that of a principal and an agent, the party with activities that are most closely associated with the entity is the primary beneficiary.

A34. The Board has been informed that the application of paragraph 17(a) may have unintended consequences in the following circumstances:

A variable interest entity is owned by two parties that have an aggregate interest in the entity sufficient to identify one of the parties as a primary beneficiary. The party that has a minority interest in the entity has a nonreciprocal right of prior approval for all sales, transfers, or encumbrances of the interests of the majority interest holder. This approval right creates a de facto agency relationship between the two parties under paragraph 16(d)(1). These two parties are related only by the provisions of paragraph 16(d)(1). Paragraph 17(a) identifies the minority interest holder as the primary beneficiary regardless of which party's activities are most closely associated with the entity.

A35. The Board decided to modify paragraph 17 to emphasize the objective of identifying the party with activities that are most closely associated with the entity as the primary beneficiary. Qualitative and quantitative factors may be considered in the application of this guidance. If two or more parties with variable interests have an agency (or de facto agency) relationship, the principal (or de facto principal) is presumed to be the primary beneficiary unless another party within the related party group has activities that are more closely associated with the entity. This presumption is not appropriate, for example, if one party in the related party group has a direct agency relationship with two or more parties within the group. The Board understands that the application of this guidance to specific situations requires an enterprise to make judgments about the nature of the activities of the various parties and how those activities are associated with the variable interest entity. The Board expects that the modified guidance will put more emphasis on the need to make reasonable judgments in those circumstances.

Initial Measurement

A36. Paragraph C45 of Interpretation 46 explains that the Board decided that many of the initial measurement requirements of Statement No. 141, *Business Combinations*, are appropriate for variable interest entities. Paragraph C45 continues with the following:

One exception is that goodwill is not recognized. The difference, if any, between the reported amounts of the variable interest entity's assets and the reported amounts of its liabilities and noncontrolling interests is recognized in consolidated net income if that difference results in a loss. Many variable interest entities hold either financial assets or newly acquired assets, and the Board did not believe it would be appropriate to allocate a loss to increase the reported values of those assets over their fair values.

The Board continues to support the decision not to permit goodwill recognition when an enterprise becomes the primary beneficiary of a variable interest entity that is not a business.

A37. However, the Board has been informed that some enterprises might consider structuring entities they plan to acquire as variable interest entities to avoid goodwill recognition. In addition, that measurement guidance would require the write-off of previously reported goodwill for an investee accounted for using the equity method if the investor is the primary beneficiary of that entity.

A38. In light of those concerns, the Board decided that the primary beneficiary of a variable interest entity that is a business should record goodwill, if applicable, rather than an extraordinary loss. Consistent with Statement 141, enterprises should follow the guidance in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” in determining if a variable interest entity is a business.

A39. The Board also clarified that the requirement in paragraph 20 of Interpretation 46 on measuring assets transferred to a variable interest entity does not apply to transfers that occurred more than a short time before the variable interest entity was first consolidated.

Accounting after Initial Measurement

A40. Paragraph 14 of ARB 51 states, “The elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests.” Paragraph 22 of Interpretation 46 provides guidance on the treatment in consolidation of the effects of intercompany eliminations on the net income or expense of a variable interest entity. The modification to paragraph 22 clarifies that any effects on income of eliminating intercompany transactions should be attributed to the primary beneficiary in the consolidated financial statements. For example, if the primary beneficiary has no equity interest in the variable interest entity and receives a fee from the entity, the amount of the fee that is eliminated in consolidation would be attributed to the primary beneficiary even if the remainder of the entity’s net income is allocated to the entity’s noncontrolling interest, the equity holders.

Appendix B of Interpretation 46

A41. Constituents have informed the Board that some of the descriptions of variable interests in paragraphs B1–B10 of Appendix B are difficult to apply without additional discussion of the context in which they were intended to apply. The Board agreed that some of the statements in those paragraphs may not be as generally applicable as the phrasing would indicate and decided to delete those paragraphs. The Board intends to provide guidance about similar matters in another form, possibly as an FSP, prior to the effective date of this Interpretation.

Effective Date and Transition

A42. The Board considered whether this Interpretation should require restatement of previously issued financial statements. The Board has been informed that while many entities have applied Interpretation 46 in a manner that is consistent with the clarification guidance provided by this Interpretation, a significant number have not. In addition, certain modifications, such as the treatment of goodwill in a variable interest entity that is

a business, change the provisions of Interpretation 46 in response to issues that have arisen since that Interpretation's issuance. Therefore, the Board decided to require that if there is a cumulative-effect adjustment, it be reported in the first reporting period ending after December 15, 2003. Restatement of previously issued financial statements is permitted but not required.

Alternative Views

A43. Three Board members disagree with the issuance of this Interpretation. Those Board members believe the Interpretation (a) does not address all the issues that they view as most critical to achieve more consistent application of consolidation policies to variable interest entities and (b) does not provide a deferral of the effective date of Interpretation 46 for all entities to allow for efficient adoption.

A44. Those Board members believe, for example, that there is currently a lack of clarity surrounding the application of the expected losses and expected residual returns test, which is the gateway for 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, which are expected to allow for cumulative-effect-type transition for each clarification as it is issued. (Restatement would be permitted, but not required.)

A45. A related FSP defers the effective date for entities that had not yet adopted Interpretation 46 until the end of the first interim or annual period ending after December 15, 2003. Those Board members believe 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 this proposed Interpretation. Given the materiality of the assets and liabilities involved and the heightened awareness of these transactions in the marketplace, they believe 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. They believe it would be in the best interest of the capital markets for all affected entities to adopt a clarified Interpretation 46 concurrently.

A46. These Board members believe that, in the interim, the disclosures required by Interpretation 46, together with the additional disclosures required by this modification, should enable users to assess the risks and rewards attributable to an enterprise's involvement with a variable interest entity.

Appendix B

AMENDED PARAGRAPHS OF INTERPRETATION 46 MARKED TO SHOW MODIFICATIONS MADE BY THIS INTERPRETATION

B1. This appendix contains paragraphs of Interpretation 46 marked to integrate changes from this modification.

Subparagraphs 2(c) and 2(e)

- c. *Variable interests* in a variable interest entity are contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value. Equity interests with or without voting rights are considered variable interests if the entity is a variable interest entity. Paragraph 12 explains how to determine whether a variable interest in specified assets of an entity is a variable interest in the entity. ~~Appendix B describes various types of variable interests and explains in general how they affect the determination of the primary beneficiary of a variable interest entity.~~
- e. *Subordinated financial support* refers to variable interests that will absorb some or all of an entity's expected losses ~~if they occur.~~

Paragraph 4

- 4. This Interpretation clarifies the application of ARB 51. With the following exceptions, this Interpretation applies to all entities:
 - a. Not-for-profit organizations as defined in paragraph 168 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, ~~subject to the consolidation requirements of AICPA Statement of Position 94-3, *Reporting of Related Entities by Not for Profit Organizations*,~~ are not subject to this Interpretation, except that they may be related parties for purposes of applying paragraphs 16 and 17 of this Interpretation. In addition, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation, that not-for-profit entity shall be subject to this Interpretation.
 - b. An employer shall not consolidate an employee benefit plan subject to the provisions of FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 112, *Employers' Accounting for Postemployment Benefits*.
 - c. Neither a transferor of financial assets nor its affiliates shall consolidate a qualifying special-purpose entity as described in paragraph 35 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or a "formerly qualifying SPE" as described in paragraph 25 of Statement 140. A transferor reports its rights and obligations related to the qualifying special-purpose entity according to the requirements of Statement 140.

- d. An enterprise that holds variable interests in a qualifying special-purpose entity or a “formerly qualifying SPE,” as described in paragraph 25 of Statement 140, shall not consolidate that entity unless that enterprise has the unilateral ability to cause the entity to liquidate or to change the entity so that it no longer meets the conditions in paragraph 25 or 35 of Statement 140. If the entity is not consolidated, the enterprise reports its rights and obligations related to the entity.
- e. An enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule.
- f. Separate accounts of life insurance entities as described in the AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*, are not subject to consolidation according to the requirements of this Interpretation.
- g. An enterprise with an interest in a variable interest entity or potential variable interest entity created before February 1, 2003, is not required to apply this Interpretation to that entity if the enterprise, after making an exhaustive effort, is unable to obtain the information* necessary to (1) determine whether the entity is a variable interest entity, (2) determine whether the enterprise is the variable interest entity’s primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary. The scope exception in this provision applies only as long as the reporting enterprise continues to be unable to obtain the information necessary to (1) determine whether the entity is a variable interest entity, (2) determine whether the enterprise is the variable interest entity’s primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary. The enterprise shall continue its efforts to obtain such information as long as it holds an interest in the entity. Paragraph 25A requires certain disclosures to be made about entities that fall under this provision. Paragraph 30 provides transition guidance for an enterprise that subsequently obtains the information necessary to apply this Interpretation to an entity subject to this exception.
- h. Mutual funds in the form of trusts and trusts of a bank’s trust department and similar arrangements that are organized and operated in a manner consistent with customary existing practices are not subject to consolidation according to the requirements of this Interpretation. However, if a fund or trust is used by business enterprises in an effort to circumvent the provisions of this Interpretation, that fund or trust shall be subject to this Interpretation.

Paragraph 5

5. An entity shall be subject to consolidation according to the provisions of this Interpretation if, by design,¹ ~~either of the following~~ conditions in a or b exists:
- a. The total equity investment² at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties,

*This inability to obtain the necessary information is expected to be infrequent, especially if the enterprise was involved in the creation of the entity.

¹The phrase *by design* refers to entities that meet the conditions in the paragraph because of the way they are structured. For example, an enterprise under the control of its equity investors that originally was not a variable interest entity does not become one because of operating losses.

including equity holders from other parties. That is, the equity investment at risk is not greater than the expected losses of the entity. An analysis of the entity's expected losses is the benchmark for assessing sufficiency of equity. (Refer to Appendix A for discussion of expected losses.) However, computation of expected losses will often depend on subjective judgments about probabilities of future events, and the value of the equity investment at risk may also be an estimate affected by assumptions. Consequently, qualitative considerations may also be important in determining whether an entity's equity investment at risk is sufficient. For this purpose, the total equity investment at risk:

- (1) Includes only equity investments in the entity that participate significantly in profits and losses even if those investments do not carry voting rights
- (2) Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities
- (3) Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor
- (4) Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

Paragraphs 8–10 discuss the amount of the total equity investment at risk that is necessary to permit an entity to finance its activities.

- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics[‡] of a controlling financial interest:
 - (1) The direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar

²Equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements.

[‡]The objective of this provision is to identify as variable interest entities those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest. If interests other than the equity investment at risk provide the holders of that investment with the characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the necessary characteristics, the entity is a variable interest entity.

rights (such as those of a common shareholder in a corporation or a general partner in a partnership).³

- (2) The obligation to absorb the expected losses of the entity ~~if they occur~~.⁴ The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.
- (3) The right to receive the expected residual returns of the entity ~~if they occur~~. The investors do not have that right if their return is capped by the entity's governing documents or arrangements with other variable interest holders or with the entity.⁵

c. The equity investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor⁶ that has disproportionately few voting rights.^{6,7} For purposes of applying this requirement, enterprises shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's interests in the entity and not only its equity investment at risk.

Paragraph 6

6. An entity subject to this Interpretation is called a variable interest entity. The investments or other interests that will absorb portions of a variable interest entity's expected losses ~~if they occur~~ or receive portions of the entity's expected residual returns ~~if they occur~~ are called variable interests. The initial determination of whether an entity is a variable interest entity shall be made on the date at which an enterprise becomes involved⁸

³Enterprises that are not controlled by the holder of a majority voting interest because of minority veto rights as discussed in EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," are not variable interest entities if the shareholders as a group have the power to control the enterprise and the equity investment meets the other requirements of this Interpretation.

⁴The phrase ~~if they occur~~ is used because no interest absorbs expected losses or receives expected residual returns unless they occur. It is not intended to imply that no determination need be made until expected losses or expected residual returns occur.

⁵For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options on those instruments are exercised, the holders will become additional equity investors.

⁶Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term *related parties* in this footnote refers to all parties identified in paragraph 16, except for de facto agents under item 16(d)(1). ~~The term *investor* in this sentence includes the investor's related parties.~~

⁷This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with nonsubstantive voting interests.

⁸For purposes of this Interpretation, *involvement with an entity* refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests.

with the entity. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements. An enterprise is not required to determine whether an entity with which it is involved is a variable interest entity if it is apparent that the enterprise's interest would not be a significant variable interest and if the enterprise, its related parties, and its de facto agents (as described in paragraph 16) were not involved in forming the entity.

Paragraph 7

7. An entity that previously was not subject to this Interpretation shall not become subject to it simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether an entity is a variable interest entity shall be reconsidered ~~only if one or more of the following occur~~ whenever the design of the entity or ownership of interests in the entity changes in a manner that could change that determination. Examples of such reconsideration events include:

- a. The entity's governing documents, ~~or the contractual arrangements among the parties involved~~ with the entity, or contractual arrangements with the entity change significantly.
- b. The equity investment or some part thereof is returned to the investors, and other ~~interests~~ parties become exposed to expected losses.
- c. The entity undertakes additional activities or acquires additional assets beyond those that were anticipated at the inception of the entity that increase the entity's expected losses.

Neither the incurrence of operating losses by an entity nor renegotiation of the entity's debts or other contracts caused by the incurrence of operating losses shall cause a change in the determination of whether an entity is a variable interest entity unless, by design, the characteristics of the equity investment at risk in the entity or the level of subordinated financial support provided to the entity are modified.

Paragraph 8

8. A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's long-term return to variable interests ~~net income or loss,~~ (b) ~~the expected variability in the fair value of the entity's assets (except as explained in paragraph 12) if it is not included in net income or loss,~~ (be) fees to the decision maker (if there is a decision maker), and (cd) fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

Paragraph 9A

9A. Qualitative assessments shall be carefully considered before attempting to estimate the entity's expected losses and equity investment at risk in paragraph 9(c). If, after

diligent effort, a reasonable conclusion cannot be reached based solely on qualitative considerations, the amounts required by paragraph 9(c) shall be estimated.

Paragraph 11

11. Because reconsideration of whether an entity is subject to this Interpretation is required only in certain circumstances, the initial application to an entity that is in the development stage⁹ is very important. A development stage entity is a variable interest entity if it meets the conditions in paragraph 5. A development stage entity does not meet the conditions in paragraph 5(a) if it can be demonstrated that the equity invested in the entity is sufficient to permit it to finance the activities it is currently engaged in (for example, if the entity has already obtained financing without additional subordinated financial support) and provisions in the entity's governing documents and contractual arrangements allow additional equity investments. However, sufficiency of the equity investment should be reconsidered as required by paragraph 7, for example, when the entity undertakes additional activities or acquires additional assets.

Paragraph 14

14. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses ~~if they occur~~, receive a majority of the entity's expected residual returns ~~if they occur~~, or both. An enterprise shall consider the rights and obligations conveyed by its variable interests and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both. A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics that would require consolidation of the variable interest entity. If one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity.

Paragraph 15

15. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. An enterprise shall determine whether it is the primary beneficiary of a variable interest entity at the time the enterprise becomes involved with the entity. ~~An enterprise with an interest in a variable interest entity shall reconsider whether it is the primary beneficiary of the entity if the entity's governing documents or the contractual arrangements among the parties involved change. The primary beneficiary also shall reconsider its initial decision to consolidate a variable interest entity if the primary beneficiary sells or otherwise disposes of all or part of its variable interest to~~

⁹Guidelines for identifying a development stage enterprise appear in paragraphs 8 and 9 of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*.

~~unrelated parties. A holder of a variable interest that is not the primary beneficiary also shall reconsider whether it is the primary beneficiary of a variable interest entity if the enterprise acquires newly issued interests in the entity or a portion of the primary beneficiary's interest in the entity.~~An enterprise with a variable interest in a variable interest entity shall reconsider whether it is the primary beneficiary of that entity whenever the design of the entity or ownership of interests in the entity changes in a manner that could affect the determination of whether the enterprise is the primary beneficiary. Examples of such reconsideration events include:

- a. The entity's governing documents, contractual arrangements among the parties involved with the entity or contractual arrangements with the entity change significantly.
- b. The primary beneficiary sells or otherwise disposes of all or part of its variable interest to unrelated parties.
- c. The variable interest entity issues new interests to parties other than the existing primary beneficiary or the primary beneficiary's related parties.
- d. A variable interest holder that is not the primary beneficiary acquires additional interests in the variable interest entity.

Neither the incurrence of operating losses by a variable interest entity nor renegotiation of the entity's debts or other contracts caused by the incurrence of operating losses shall cause a change in the determination of the primary beneficiary unless the losses or the renegotiation result, by design, in a reallocation between the existing primary beneficiary and other parties of significant decision-making ability, the obligation to absorb expected losses, or the right to receive expected residual returns of the variable interest entity.

Paragraph 16

16. For purposes of determining whether it is the primary beneficiary of a variable interest entity, an enterprise with a variable interest shall treat variable interests in that same entity held by its related parties as its own interests. For purposes of this Interpretation, the term *related parties* includes those parties identified in FASB Statement No. 57, *Related Party Disclosures*, and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. The following are considered to be de facto agents of an enterprise:

- a. A party that cannot finance its operations without subordinated financial support from the enterprise, for example, another variable interest entity of which the enterprise is the primary beneficiary
- b. A party that received its interests as a contribution or loan from the enterprise
- c. An officer, employee, or member of the governing board of the enterprise
- d. A party that has (1) an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the enterprise or (2) a close business relationship like the relationship between a professional service provider and one of its significant clients. The right of prior approval creates a de facto agency relationship only if the right could constrain the party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity.

Paragraph 17

17. If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, the party with activities that are most closely associated with the entity is the primary beneficiary. If two or more parties with variable interests have an agency (or de facto agency) relationship, the principal (or de facto principal) is presumed to be the primary beneficiary unless another party within the related party group has activities that are more closely associated with the entity.~~following guidelines shall be used for deciding which is the primary beneficiary:~~

- a. ~~If two or more parties with variable interests have an agency relationship, the principal is the primary beneficiary.~~
- b. ~~If the relationship is not that of a principal and an agent, the party with activities that are most closely associated with the entity is the primary beneficiary.~~

Paragraph 20

20. The primary beneficiary of a variable interest entity shall initially measure assets and liabilities that it has transferred to that variable interest entity shortly before, at, or after the date that the enterprise became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of ~~the~~such transfers ~~even if the enterprise was not the primary beneficiary until shortly after the transfer occurred.~~

Paragraph 21

21. The excess, if any, of the fair values of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the variable interest entity over the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of newly consolidated liabilities and noncontrolling interests shall be allocated and reported as a pro rata adjustment of the amounts that would have been assigned to all of the newly consolidated assets as specified in paragraphs 44 and 45 of FASB Statement No. 141, *Business Combinations*, as if the initial consolidation had resulted from a business combination. The excess, if any, of (a) the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests over (b) the fair value of the newly consolidated identifiable assets and the reported amount of identifiable assets transferred by the primary beneficiary to the

variable interest entity shall be reported ~~as an extraordinary loss~~ in the period in which the enterprise becomes the primary beneficiary as:

- a. Goodwill, if the variable interest entity is a business[‡]
- b. An extraordinary loss, if the variable interest entity is not a business.

Paragraph 22

22. The principles of consolidated financial statements in ARB 51 apply to primary beneficiaries' accounting for consolidated variable interest entities. After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated variable interest entity shall be accounted for in consolidated financial statements as if the entity were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the variable interest entity operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated enterprise shall follow the requirements for elimination of intercompany balances and transactions and other matters described in paragraphs 6–15 of ARB 51 and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated variable interest entity shall be eliminated against the related expense or income of the variable interest entity, ~~and~~ The resulting effect of that elimination on the net income or expense of the variable interest entity shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

Paragraph 25A

25A. An enterprise that does not apply this Interpretation to one or more variable interest entities or potential variable interest entities because of the condition described in paragraph 4(g) shall disclose the following information:

- a. The number of entities to which the Interpretation is not being applied and the reason why the information required to apply the Interpretation is not available
- b. The nature, purpose, size (if available), and activities of the entity(ies) and the nature of the enterprise's involvement with the entity(ies)
- c. The reporting enterprise's maximum exposure to loss because of its involvement with the entity(ies)
- d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting enterprise and the entity(ies) for all periods presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

[‡]EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," provides guidance on determining whether an entity constitutes a business.

Paragraph 30

30. An enterprise that has not applied this Interpretation to an entity because of the condition described in paragraph 4(g) and that subsequently obtains the information necessary to apply this Interpretation to that entity shall apply the provisions of this Interpretation as of the date the information is acquired in accordance with paragraph 28. Restatement in accordance with paragraph 29 is encouraged but not required.

Paragraph A5

A5. This appendix uses a simple case intended to illustrate the concepts of expected losses, expected residual returns, and expected variability. Since it is assumed that there is only one party involved, the identity of the primary beneficiary is obvious. ~~If different parties with different rights and obligations are involved, each party would determine its own expected losses and expected residual returns and compare that amount with the total to determine whether it is the primary beneficiary.~~

Appendix B

(Paragraphs B1–B10 are deleted.)