

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Amendments to FASB Interpretation No. 46(R)

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

Technical Director
File Reference No. 1620-100

Comment Deadline: November 14, 2008



Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be **received** in writing by November 14, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1620-100. Those without email may send their comments to the “Technical Director—File Reference No. 1620-100” at the address at the bottom of this page. Responses should **not** be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

An electronic copy of this Exposure Draft is available on the FASB’s website until the FASB issues a final document. Any individual or organization may obtain one copy of this Exposure Draft without charge until November 14, 2008, by written request only. **Please ask for our Product Code No. E199.** For information on applicable prices for additional copies and copies requested after November 14, 2008, contact:

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Financial Accounting Standards Board
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Notice for Recipients of This Exposure Draft

This proposed Statement would amend FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. It would require ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity. Interpretation 46(R) currently requires reconsideration of whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occur. Interpretation 46(R) also includes certain exceptions from reconsideration (including an exception related to losses that exceed expected losses experienced by a variable interest entity). Under this proposed Statement, the exception from reconsideration for troubled debt restructurings as defined in paragraph 2 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, that currently exists in Interpretation 46(R) would be rescinded.

This proposed Statement would amend the guidance for determining which enterprise, if any, is the primary beneficiary of a variable interest entity by requiring the enterprise to initially perform a qualitative analysis to determine if the enterprise's variable interest or interests give it a controlling financial interest. In performing this qualitative analysis, an enterprise would be required to assess if it has an implicit financial responsibility to ensure that a variable interest entity operates as designed. A primary beneficiary is expected to be identified through the qualitative analysis. If an enterprise cannot determine whether it has a controlling financial interest through the qualitative analysis, the enterprise would have to perform a quantitative analysis. Interpretation 46(R) currently requires that an enterprise use a generally quantitative analysis to determine if it has a controlling financial interest in a variable interest entity.

This proposed Statement would require enhanced disclosures to provide users of financial statements with more transparent information about an enterprise's involvement in a variable interest entity, including a requirement for sponsors of a variable interest entity to disclose information even if they do not hold a significant variable interest in the variable interest entity.

Effective Date and Transition

This proposed Statement would be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application would be prohibited.

If an enterprise is required to consolidate an entity upon the implementation of this proposed Statement, the enterprise would recognize and measure all assets and liabilities pursuant to paragraphs 18–21 of Interpretation 46(R) as of the date the requirements of this proposed Statement would be applicable, except that any amounts that were ordinarily recognized as goodwill or a gain or loss would be recognized as a cumulative effect adjustment to retained earnings.

Request for Comments

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement, particularly on the questions listed below. Respondents need not comment on each issue and are encouraged to comment on additional matters they believe should be brought to the Board's attention. Comments are requested from those who agree with the provisions of this proposed Statement as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the reasons for the positions taken. Those who disagree with the provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning. Respondents must submit comments in writing by November 14, 2008.

The Board requests that constituents provide comments on the following questions:

1. Will the proposed Statement meet the project's objectives to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements?
2. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits to users of financial statements?
3. The Board decided to adopt a more principles-based approach to determine the primary beneficiary of a variable interest entity. Do you believe the principles in paragraphs 14–14B of Interpretation 46(R), as amended by this proposed Statement, are sufficiently clear and operational?
4. The Board concluded that it would be helpful to provide examples of the application of the principles in this proposed Statement. Do you believe that the examples in Appendix A clearly indicate how the principles in paragraphs 14–14B of Interpretation 46(R), as amended by this proposed Statement, would be applied? If not, please articulate what additional information or guidance is necessary, considering the basis for the Board's conclusions.
5. This proposed Statement retains the quantitative analysis for situations in which an enterprise cannot determine whether it is the primary beneficiary through the qualitative analysis in paragraph 14A of Interpretation 46(R), as amended by this proposed Statement. In Appendix A, each example either identifies a primary beneficiary or concludes that no primary beneficiary exists through a qualitative analysis. The Board may consider removing the quantitative analysis for determining whether an enterprise is the primary beneficiary of a variable interest entity. Do you believe that the quantitative analysis is necessary based on the proposed amended guidance for determining the primary beneficiary? Do you believe that the quantitative analysis would be performed in many situations? Why or why not?
6. For the reasons stated in paragraphs B6–B15 of this proposed Statement, the Board decided to require ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary

beneficiary of a variable interest entity. Do you agree with the Board's decision to require ongoing assessments? If not, please provide reasons (conceptual or otherwise) as to why you disagree with these requirements considering all of the proposed amendments in this proposed Statement.

7. Do you believe that any exceptions to this proposed Statement should be made for private or not-for-profit entities? If so, please articulate the conceptual basis and reasons for the exceptions.
8. Financial statement users indicated that the information disclosed in accordance with Interpretation 46(R) about an enterprise's involvement or involvements with variable interest entities and the associated risks are often insufficient and untimely. Do you believe the disclosure requirements in this proposed Statement address those concerns?
9. Should the elements of a consolidated variable interest entity be required or permitted to be classified separately from other elements in an enterprise's financial statements?

Public Roundtable Meeting

The Board plans to hold a public roundtable meeting on this Exposure Draft on November 6, 2008. The purpose of roundtable meetings is to listen to the views of, and obtain information from, interested constituents about the Exposure Draft. The Board plans to seek participants for the meetings that represent a wide variety of constituents, including financial statement users, preparers, auditors, and others to ensure that it receives broad input. Any individual or organization desiring to participate must notify the FASB by sending an email to director@fasb.org by October 27, 2008, and submitting their comments on the Exposure Draft in writing by October 30, 2008. Roundtable meetings can accommodate a limited number of participants. Depending on the number of responses received, the Board may not be able to accommodate all requests to participate.

Summary

Why Is the FASB Issuing This Proposed Statement and When Will It Be Effective?

The Board's objective in issuing this proposed Statement is to improve financial reporting by enterprises involved with variable interest entities. The Board undertook this project to address (1) potential impacts on certain provisions of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as a result of the proposed elimination of the qualifying special-purpose entity concept in the proposed FASB Statement, *Accounting for Transfers of Financial Assets*, and (2) constituent concerns about the application of certain key provisions of Interpretation 46(R), including those in which the accounting and disclosures under the Interpretation do not always provide timely and useful information about an enterprise's involvement or involvements in a variable interest entity.

This proposed Statement would be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application would be prohibited.

What Is the Scope of This Proposed Statement?

This proposed Statement has the same scope as Interpretation 46(R), as amended by the proposed FASB Statement on accounting for transfers of financial assets, which proposes the elimination of the exemptions relating to qualifying special-purpose entities.

How Will This Proposed Statement Change Current Practice?

This proposed Statement would require ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity. Interpretation 46(R) currently requires reconsideration of whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occur. Interpretation 46(R) also includes certain exceptions from reconsideration (including an exception related to losses that exceed expected losses experienced by a variable interest entity).

Under Interpretation 46(R), a troubled debt restructuring as defined in paragraph 2 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, was not an event that required reconsideration of whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity. This proposed Statement would eliminate this exception.

This proposed Statement would require an enterprise to perform a qualitative analysis to determine if the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. In performing this qualitative analysis, an enterprise would be required to assess if it has an implicit financial responsibility to ensure that a variable interest entity operates as designed. This proposed Statement would require a quantitative analysis only if an enterprise cannot determine whether it has a controlling financial interest through the qualitative analysis. Interpretation 46(R)

currently requires an enterprise to determine if it has a controlling financial interest in a variable interest entity through an analysis that is generally quantitative.

This proposed Statement would require enhanced disclosures to provide users of financial statements with more transparent information about an enterprise's involvement in a variable interest entity. It would also require that sponsors disclose information even if they do not hold a significant variable interest in the variable interest entity.

How Will This Proposed Statement Improve Financial Reporting?

By requiring ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity, this proposed Statement would provide users with more relevant and timely information related to an enterprise's involvement in a variable interest entity.

This proposed Statement would replace a quantitative-based risks and rewards calculation to determine which enterprise (if any) has a controlling financial interest in a variable interest entity with a principles-based approach focused on identifying which enterprise has the power over the entity and (1) the rights to receive benefits from the entity or (2) the obligation to absorb losses of the entity.

This proposed Statement would enhance the information provided to users of financial statements about an enterprise's involvement in a variable interest entity.

What Is the Effect of This Proposed Statement on Convergence with International Financial Reporting Standards?

The International Accounting Standards Board (IASB) has a project on its agenda to reconsider its consolidation guidance; however, the IASB project is a broader reconsideration of all consolidation guidance (not just the guidance for variable interest entities), and the timeline of the IASB project is different from the timeline for this project. In this project, the FASB is attempting to improve financial reporting by enterprises involved with variable interest entities in an expeditious manner. Ultimately, the two Boards will seek to issue a converged consolidations standard.

This proposed Statement is needed to address the potential impacts on Interpretation 46(R) as a result of the proposed elimination of the qualifying special-purpose entity concept in the proposed FASB Statement on accounting for transfers of financial assets until such time as convergent standards on consolidation are developed with the IASB.

Proposed Statement of Financial Accounting Standards

Amendments to FASB Interpretation No. 46(R)

September 15, 2008

CONTENTS

	Paragraph Numbers
Objective	1–2
Standards of Financial Accounting and Reporting:	
Scope.....	3
Amendments to Interpretation 46(R)	4
Effective Date and Transition	5–6
Appendix A: Implementation Guidance	A1–A108
Appendix B: Background Information and Basis for Conclusions	B1–B53
Appendix C: Amendments to Existing FASB Pronouncements.....	C1
Appendix D: Amendments to Other Authoritative Literature	D1–D29
Appendix E: Interpretation 46(R) Marked to Show Changes That Would Be Made by This Proposed Statement.....	E1–E2

Proposed Statement of Financial Accounting Standards

Amendments to FASB Interpretation No. 46(R)

September 15, 2008

OBJECTIVES

1. FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, was issued to clarify the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which the party with a controlling financial interest might not be identified solely through voting rights. An entity within the scope of Interpretation 46(R), referred to as a variable interest entity, has one or more of the following characteristics:

- a. The total equity investment 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.
- b. As a group the holders of the equity investment at risk lack one or more of the following characteristics:
 - (1) The direct or indirect ability through voting rights or similar rights to make decisions about the entity's activities that have a significant effect on the success of the entity
 - (2) The obligation to absorb the expected losses of the entity
 - (3) The right to receive the expected residual returns of the entity.
- c. The equity investors have voting rights that are not proportional to their obligation to absorb the expected losses of the entity, their rights to receive expected residual returns of the entity, or both, and the activities of the entity involve or are conducted on behalf of an investor with disproportionately few voting rights.

This Statement does not change the criteria for determining whether or not an entity is a variable interest entity.

2. The objectives of this Statement are to amend certain requirements of Interpretation 46(R) to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. To accomplish this objective, this Statement will address:

- a. The guidance for reconsideration by an enterprise of an entity's status as a variable interest entity and whether the enterprise is the primary beneficiary of a variable interest entity. Under Interpretation 46(R), reconsideration is not required for losses in excess of expected losses. Under Interpretation 46(R), reconsideration is not required for losses in excess of expected losses and excludes from its scope troubled debt restructurings, as defined in paragraph 2 of FASB Statement No. 15, *Accounting by Debtors and Creditors for*

Troubled Debt Restructurings. This Statement removes specific guidance and exceptions for reconsideration of:

- (1) Whether an entity in which the enterprise has a significant variable interest is a variable interest entity
- (2) Whether an enterprise is the primary beneficiary of the variable interest entity.

This Statement requires ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity.

- b. The guidance in Interpretation 46(R) requires an enterprise to consolidate a variable interest entity if the enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected returns, or both. This analysis generally is quantitative and is a computation of expected losses, expected residual returns, and variability. Although the purpose of Interpretation 46(R) is to identify the party that has a controlling financial interest in a variable interest entity, it does not explicitly require a qualitative analysis to determine if the enterprise's interest or interests give the enterprise a controlling financial interest in a variable interest entity. This Statement requires an enterprise to initially perform a qualitative analysis to determine if the enterprise's interest or interests give the enterprise a controlling financial interest in a variable interest entity. This Statement requires a quantitative analysis only if the enterprise cannot determine whether or not it has a controlling financial interest through the qualitative analysis.
- c. The disclosure requirements in Interpretation 46(R), including those related to enterprises that are the primary beneficiary, that have a significant variable interest in a variable interest entity, or that are the sponsor of a variable interest entity. This Statement requires additional disclosures to provide users of financial statements with more transparent information about an enterprise's involvement in a variable interest entity.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

3. This Statement has the same scope as Interpretation 46(R), as amended by the proposed FASB Statement, *Accounting for Transfers of Financial Assets*, which proposes the elimination of the exemptions relating to qualifying special-purpose entities.

Amendments to Interpretation 46(R)

4. Interpretation 46(R) is amended as follows: [Added text is underlined and deleted text is ~~struck-out~~.]

a. Paragraph 1:

This Interpretation, which replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors ~~do not have the characteristics of a controlling financial interest or~~ do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support or lack any one of the following three characteristics:

- a. The direct or indirect ability through voting rights or similar rights to make decisions about the entity's activities that have a significant effect on the success of the entity
- b. The obligation to absorb the expected losses of the entity
- c. The right to receive the expected residual returns of the entity.

Paragraph 1 of ARB 51 states that consolidated financial statements are “usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.” Paragraph 2 states that “the usual condition for a controlling financial interest is ownership of a majority voting interest. . . .” However, application of the majority voting interest requirement in ARB 51 to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests.

b. Paragraph 1A is added as follows:

The enterprise with a variable interest or interests that provide the enterprise with a controlling financial interest in a variable interest entity will have both of the following characteristics:

- a. The power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity's economic performance; and
- b. The right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity.

Determining whether an enterprise has a controlling financial interest based on the above characteristics typically will be achieved through a qualitative analysis of the enterprise's interest or interests and the characteristics of the variable interest entity, including the involvement of other variable interest holders. However, if an enterprise cannot determine whether it meets both of the criteria in paragraph 14A, the enterprise is then required to perform a quantitative analysis to determine whether it has the obligation to absorb the

majority of a variable interest entity's expected losses, the right to receive a majority of its expected residual returns, or both. However, if an enterprise determines that power is, in fact, shared among multiple parties such that no one party meets the criteria of paragraph 14A, the enterprise is not the primary beneficiary.

c. Footnotes a and 2 to paragraph 4:

^aAICPA Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, discusses the circumstances in which the specialized accounting in the Audit Guide shall not be retained by a noninvestment company parent or equity method investor of an investment company. In those cases, Interpretation 46(R) applies to the investments held by the investment company subsidiary or equity method investee for the purposes of the parent or equity method investor's financial statements. The effective date of SOP 07-1 has been deferred indefinitely by FASB Staff Position SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1.

~~²An entity that previously was not evaluated to determine if it was a variable interest entity because of this provision need not be evaluated in future periods as long as the entity continues to meet the conditions in this paragraph. The determination of whether the conditions in this paragraph exist shall be evaluated based on the current facts and circumstances of the entity.~~

d. Paragraph 5 and its related footnotes:

An entity shall be subject to consolidation during a reporting period (not limited to the end of a reporting period) according to the provisions of this Interpretation if, by design⁵, or as a result of changes in facts and circumstances, the conditions in a, b, or c exist:

- a. The total equity investment⁶ 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. 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 9 and 10 discuss the amount of the total equity investment at risk that is necessary to permit an entity to finance its activities without additional subordinated financial support.

- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics⁷ ~~of a controlling financial interest:~~

- (1) The direct or indirect ability through voting rights or similar rights to make decisions about an entity's activities that have a significant effect on the success of the entity. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).⁸

- (2) The obligation to absorb the expected losses of the entity.⁹ 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. 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 the entity.¹⁰

- 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.¹¹ 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 to its equity investment at risk.

⁵The phrase *by design* refers to entities that meet the conditions in this 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.~~

⁶Equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements.

~~⁷The 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 in criteria b(1)–b(3) of this paragraph of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the ~~necessary~~ characteristics in criteria b(1)–b(3) of this paragraph, the entity is a variable interest entity.~~

⁸Enterprises 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.

⁹Refer to paragraphs 8 and 12 and Appendix A for discussion of expected losses.

¹⁰For 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 in those instruments are exercised, the holders will become additional equity investors.

¹¹This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with nonsubstantive voting interests. 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).

e. Paragraph 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 or receive portions of the entity's expected residual returns 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 involved¹² 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) did not participate significantly in the design or redesign of the entity. An enterprise has a significant variable interest if the interest is significant to either the variable interest entity or to the enterprise.

f. Paragraph 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 if one or more of the following occur:

- ~~a. The entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.~~
- ~~b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity.~~
- ~~c. The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.~~
- ~~d. The entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses.~~

~~A troubled debt restructuring, as defined in paragraph 2 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended, shall be accounted for in accordance with that Statement and is not an event that requires the reconsideration of whether the entity involved is a variable interest entity.~~

g. Paragraph 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 stage¹³ is very important. A development stage entity¹³ is a variable interest entity if it meets one of the conditions in paragraph 5. A development stage entity does not meet the condition 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.~~

¹³Guidelines for identifying a development stage enterprise appear in paragraphs 8 and 9 of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*.

h. Paragraph 14:

An enterprise shall consolidate a variable interest entity during a reporting period (not limited to the end of a reporting period) if that enterprise has a variable interest (or combination of variable interests) that provides the

~~enterprise with a controlling financial interest based on the provisions in paragraphs 14A–14C. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. Only one enterprise, if any, is expected to be identified as the primary beneficiary. will absorb a majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, 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. 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.~~

- i. Paragraphs 14A–14C and their related headings are added as follows:

Step 1—Qualitative Analysis

14A. An enterprise with a variable interest in a variable interest entity shall qualitatively assess whether the enterprise has a controlling financial interest in the entity and, thus, is the entity’s primary beneficiary. This qualitative assessment shall include an assessment of the characteristics of the enterprise’s variable interest or interests and other involvement (including those of related parties and de facto agents),^{15a} if any, in the variable interest entity, as well as the involvement of other variable interest holders. Additionally, the qualitative assessment shall consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders. An enterprise shall be deemed to have a controlling financial interest in a variable interest entity if it has both of the following characteristics:

- a. The power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity’s economic performance. An enterprise’s determination of whether it has the power to direct matters shall not be affected by the existence of substantive kick-out rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such substantive kick-out rights.^{15b} A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise substantive kick-out rights may be the party with the power to direct matters that most significantly impact the activities of the entity; and
- b. The right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity. For purposes of applying this criterion,

determining benefits and losses shall not be performed using the quantitative analysis prescribed in Step 2 (paragraph 14C). This criterion includes an enterprise's implicit or explicit financial responsibility to ensure that a variable interest entity operates as designed.

14B. An enterprise that meets both of the criteria in paragraph 14A is the primary beneficiary of the variable interest entity. The qualitative assessment required by paragraph 14A should enable an enterprise to determine whether it is the primary beneficiary of a variable interest entity. If an enterprise cannot determine whether it meets both of the criteria in paragraph 14A, the enterprise shall then perform the quantitative analysis pursuant to Step 2 below. However, if an enterprise determines that power is, in fact, shared among multiple parties such that no one party meets the criteria of paragraph 14A, the enterprise is not the primary beneficiary.

Step 2 (If Necessary)—Quantitative Analysis

14C. An enterprise shall consolidate a variable interest entity if that enterprise has a controlling financial interest in the entity through a variable interest (or combination of variable interests) that requires the enterprise to absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, 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, and, thus, provide the enterprise with a controlling financial interest. 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 be deemed to hold the controlling financial interest and consolidate the variable interest entity.

^{15a}Paragraph 16 provides guidance on related parties and de facto agents.

^{15b}This requirement is limited to this particular analysis and is not applicable to other areas within Interpretation 46(R), as amended, or transactions accounted for under other interpretative guidance.

j. Paragraph 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 contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties (a) the obligation to absorb the expected losses of the variable interest entity or (b) the right to receive the expected residual returns of the variable interest entity. 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 interests to unrelated parties or if the variable interest entity issues new variable interests to parties other than the primary beneficiary or the primary beneficiary's related 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 that enterprise acquires additional variable interests in the variable interest entity. A troubled debt restructuring, as defined in paragraph 2 of Statement 15, as amended, shall be accounted for in accordance with that Statement and is not an event that requires the reconsideration of whether an enterprise is the primary beneficiary of the variable interest entity.~~

k. Paragraph 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, 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, including:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the variable interest entity to the various parties within the related party group
- c. A party's exposure to the expected losses of the variable interest entity
- d. The design of the variable interest entity;
- e. The extent to which a party meets criteria a and b in paragraph 14A.

l. Paragraphs 22A–22C are added as follows under “Disclosures”:

22A. The principal objectives of the disclosures required by paragraphs 22B–26 are to provide users of financial statements with an understanding of:

- a. The judgments and assumptions made by the enterprise in determining whether the enterprise must consolidate a variable interest entity

and/or disclose information about its involvement in a variable interest entity

- b. The nature of restrictions on a consolidated variable interest entity's assets reported in an enterprise's statement of financial position, including the carrying amounts of such assets
- c. The nature of, and changes in, the risks associated with the enterprise's involvement with the variable interest entity
- d. The current and potential financial effects from an enterprise's involvement with a variable interest entity on the enterprise's financial position, financial performance, and cash flows.

An enterprise shall consider these overall objectives in providing the disclosures required by this Interpretation. To achieve these objectives, an enterprise may need to supplement the disclosures required by paragraphs 22B–26, depending on the facts and circumstances surrounding the variable interest entity and the enterprise's interest in that entity. Accordingly, if the enterprise's economic relationship with the variable interest entity or exposure to risk is not addressed by any of the disclosures provided in paragraphs 22B–26, the enterprise shall provide further information, as needed.

22B. Disclosures about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not provide useful incremental information to financial statement users. An enterprise shall disclose how similar entities are aggregated and shall distinguish between:

- a. Variable interest entities that are not consolidated because the enterprise is not the primary beneficiary but is either the sponsor or has a significant variable interest
- b. Variable interest entities that are consolidated.

In determining whether to aggregate variable interest entities, the enterprise shall consider quantitative and qualitative information about the different risk and reward characteristics of each variable interest entity and the significance of each variable interest entity to the enterprise.

22C. An enterprise that is a primary beneficiary in a variable interest entity, holds a significant variable interest in a variable interest entity but is not the primary beneficiary, or is a sponsor that holds a variable interest in a variable interest entity (irrespective of the significance of the variable interest) shall disclose:

- a. Its methodology for determining whether the enterprise is (or is not) the primary beneficiary of a variable interest entity, including, but not limited to:
 - (1) Significant factors considered.

the following (unless the primary beneficiary also holds a majority voting interest):¹⁷

- a. ~~The nature, purpose, size, and activities of the variable interest entity~~
The carrying amount and classification of the consolidated variable interest entity's assets and liabilities in the statement of financial position that are consolidated pursuant to this Interpretation
- b. ~~The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations~~
If the variable interest entity's assets can only be used to settle obligations of the variable interest entity:
 - (1) The carrying amount and classification of the consolidated variable interest entity's assets and associated liabilities
 - (2) Qualitative information about the nature of the restrictions on those assets
- c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary-
- d. Quantitative and qualitative information about liquidity facilities, guarantees, and other commitments to the variable interest entity provided by third parties
- e. The fair value of the consolidated variable interest entity's financial assets and financial liabilities (separately from those disclosed pursuant to Statement 107).

¹⁷A variable interest entity may issue voting equity interests, and the enterprise that holds a majority voting interest also may be the primary beneficiary of the entity. If so, and if the entity meets the definition of a business in Statement 141(R) and the entity's assets can be used for purposes other than the settlement of the entity's obligations, the disclosures in paragraphs 22C, 23, and 27 are not required.

n. Paragraph 24:

In addition to disclosures required by other standards, an~~An~~ enterprise that holds a significant variable interest or is a sponsor that holds a variable interest in a variable interest entity (irrespective of the significance of the variable interest), but is not the entity's primary beneficiary, shall disclose:

- a. ~~The nature of its involvement with the variable interest entity and when that involvement began~~
The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity, including how the maximum exposure is determined and the significant sources of the enterprise's exposure to the variable interest entity. If the enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity cannot be quantified, that fact shall be disclosed.

- b. ~~The nature, purpose, size, and activities of the variable interest entity~~
The enterprise's estimated exposure to loss or range of that loss if it believes that the amount of the maximum exposure to loss is not representative of its estimated exposure to loss. If this disclosure is made, the enterprise shall disclose the methodology used to determine the estimated loss exposure. This description shall include qualitative and quantitative information, such as:
 - (1) Significant factors considered, assumptions made, and primary risks of the variable interest entity
 - (2) Liquidity, guarantees, and other commitments to the variable interest entity by third parties.
- c. ~~The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.~~The carrying amount and classification in the enterprise's statement of financial position of the enterprise's variable interest in the variable interest entity.

o. Paragraph 25:

~~Disclosures required by Statement 140 about a variable interest entity shall be included in the same note to the financial statements as the information required by this Interpretation. Information about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not add material information.~~

p. Paragraph 25A is added as follows:

The disclosures required by this Interpretation may be provided in more than one note to the financial statements, as long as the objectives in paragraph 22A are met. If the disclosures are provided in more than one note to the financial statements, the enterprise shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Interpretation for similar entities.

q. Paragraph B1:

This Interpretation provides guidance for identifying entities for which analysis of voting interests, and the holdings of those voting interests, is not effective in determining whether a controlling financial interest exists because the entity does not have adequate equity capital or the equity instruments do not have the normal characteristics of equity that provide its holders with a potential controlling financial interest. Those entities are called variable interest entities. This Interpretation also provides guidance for determining whether an enterprise shall consolidate a variable interest entity. An enterprise that consolidates a variable interest entity is called the primary beneficiary of that variable interest entity. ~~The guidance in this Interpretation identifies the primary beneficiary as a holder of variable interests in a variable interest entity that absorb or receive a majority of the~~

~~entity's expected losses or expected residual returns. This appendix provides guidance for identifying variable interests, and explains in general how they may affect the determination of the primary beneficiary.~~

r. Paragraph B9:

Any of a variable interest entity's liabilities may be variable interests because a decrease in the fair value of an entity's assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the entity's expected variability, ~~and therefore, a holder of only the most senior interests of a variable interest entity likely would not be the primary beneficiary of that entity, unless the subordinated interests of the variable interest entity are not large enough to absorb the entity's expected losses (or unless there are provisions such as embedded derivatives that expose the senior interests to losses).~~ By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the entity's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.

s. Footnote 27 to paragraph B26:

~~This analysis describes variable interests in all variable interest entities including qualifying special purpose entities. However, a special requirement applies to qualifying special purpose entities. Refer to paragraphs 4(c) and 4(d).~~

Effective Date and Transition

5. This Statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited.

6. If an enterprise is required to consolidate an entity upon the implementation of this Statement, the enterprise shall recognize and measure all assets and liabilities pursuant to paragraphs 18–21 of Interpretation 46(R), as amended, as of the date the requirements of this Statement are applicable, except that any amounts that would have been recognized as goodwill or a gain or loss shall be recognized as a cumulative effect adjustment to retained earnings.

<p>The provisions of this Statement need not be applied to immaterial items.</p>

Appendix A

IMPLEMENTATION GUIDANCE

A1. The following example fact patterns and related evaluations are provided solely to illustrate the application of the guidance in this Statement (specifically, paragraphs 14–14C of Interpretation 46(R), as amended by this Statement). The identification of a primary beneficiary, if any, in the following examples is based solely on the specific facts and circumstances presented. The examples are hypothetical and are not meant to represent actual transactions in the marketplace. Although certain aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a specific fact pattern or structure would need to be evaluated to reach an accounting conclusion. All the entities in the examples are presumed to be variable interest entities. All variable interests are presumed to be variable interests in the variable interest entity (as a whole), rather than variable interests in specified assets of the variable interest entity, based on the guidance in paragraphs 12 and 13 of Interpretation 46(R). Determination of the primary beneficiary in accordance with the guidance in this Statement requires judgment, is based on individual facts and circumstances of the variable interest entity and the enterprise with the variable interest or interests, and requires a quantitative analysis if an enterprise cannot determine whether or not it meets the qualitative criteria. If an enterprise determines that power is, in fact, shared among multiple parties such that no one party meets the criteria in paragraph 14A of Interpretation 46(R), as amended by this Statement, the enterprise is not the primary beneficiary.

Example 1

Facts and Circumstances

A2. An entity is created and financed with \$94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and \$6 of equity. The bonds are held by third-party investors. The equity is held by the Transferor. The equity tranche was designed to absorb the first dollar risk of loss and to receive any residual return from the entity. The entity uses the proceeds to purchase \$100 of BB-rated fixed-rate commercial mortgage loans with contractual maturities of 7 years from the Transferor. The commercial mortgage loans contain provisions that require each borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity. The transaction was marketed to potential bond holders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

A3. Each month, interest received from all of the pooled loans is paid to the investors in the fixed-rate bonds, in order of seniority, until all accrued interest on those bonds is paid. The same distribution occurs when principal payments are received.

A4. If there is a shortfall in contractual payments from the borrowers or if loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all

bond classes, the equity tranche and then the most subordinate bond class will incur losses, with further losses impacting more senior bond classes in reverse order of priority.

A5. The Transferor retains the primary servicing and special servicing responsibilities. The primary servicing activities performed are administrative in nature and include remittance of payments on the loans, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by the borrower, the responsibility for administration of the loan is transferred from the Transferor as the primary servicer to the Transferor as the special servicer. Furthermore, the Transferor, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

A6. For its services as primary servicer and special servicer, the Transferor earns a fixed fee. No party has the ability to remove the Transferor as primary servicer or special servicer.

Evaluation

Design of the Entity

A7. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide liquidity to the Transferor to originate additional loans and (2) provide investors with the ability to invest in a pool of commercial mortgage loans.
- b. The entity was marketed to debt investors as an entity that would be exposed to the credit risk associated with the possible default by the borrowers with respect to principal and interest payments, with the equity tranche designed to absorb the first dollar risk of loss. Additionally, the marketing of the transaction indicated that such risks would be mitigated by subordination of the equity tranche.
- c. The entity is not exposed to prepayment risk because the commercial mortgage loans contain provisions that require the borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A8. The Transferor and the bondholders are the variable interest holders in the variable interest entity. The fees paid to the Transferor represent a variable interest based on a consideration of the conditions and factors in paragraphs B19 and B21 of Interpretation 46(R).

A9. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic

performance. The economic performance of the entity is impacted primarily by the performance of its underlying assets. The Transferor, as special servicer, has the ability to manage the entity's assets that are delinquent or in default to improve the economic performance of the entity. Additionally, the Transferor, as the equity holder, can approve budgets, leases, and property managers on foreclosed property. The special servicing activities are performed only upon delinquency or default of the underlying assets. Thus, the Transferor is the only variable interest holder with the power to direct matters that most significantly impact the primary risk of the entity and, therefore, the overall economic performance of the entity.

A10. The bondholders do not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A11. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Transferor, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the entity, which may or may not potentially be significant. However, the Transferor, as the equity tranche holder, has the right to receive benefits and the obligation to absorb losses, either of which could potentially be significant to the variable interest entity. As equity tranche holder, the Transferor is the most subordinate tranche and therefore absorbs the first dollar risk of loss and has the right to receive benefits, including the entity's actual residual returns, if any.

A12. Based on the specific facts and circumstances presented above and the analysis performed, the Transferor would be deemed to be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) as the equity tranche holder, it has the right to receive benefits from the variable interest entity and the obligation to absorb losses of the variable interest entity, either of which could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A13. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 2

Facts and Circumstances

A14. An entity is created and financed with \$90 of AAA-rated fixed-rate debt securities, \$6 BB-rated fixed-rate debt securities, and \$4 of equity. All debt securities issued by the entity are held by third-party investors. The equity tranche is held 35 percent by the manager of the entity (Manager) and 65 percent by a third-party investor. The entity uses the proceeds to purchase a portfolio of asset-backed securities with varying tenors and interest rates.

A15. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the active management of the portfolio. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of investments in the portfolio.

A16. The assets of the entity are managed within the parameters established by the underlying trust documents. The parameters provide the Manager with the latitude to manage the entity's assets while maintaining an average portfolio rating of single B-plus or higher. If the average rating of the portfolio declines, the entity's governing documents require that the Manager's discretion in managing the portfolio be curtailed.

A17. For its services, the Manager earns a base fixed fee and a performance fee in which it receives a portion of the entity's profit above a targeted return. The Manager can be removed, without cause, by a simple majority decision of the AAA-rated debt holders. As the debt of the entity is widely disbursed, no one party has the ability to unilaterally remove the Manager. If removal of the Manager occurs, the Manager will continue to hold a 35 percent equity interest in the entity.

A18. The third-party equity investor has rights that are limited to administrative matters.

Evaluation

Design of the Entity

A19. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of asset-backed securities, (2) earn a positive spread between the interest that the entity earns on its portfolio and the

- interest paid to the debt investors, and (3) generate management fees for the Manager.
- b. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the active management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the credit support from the equity tranche.
 - c. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of asset-backed securities in the portfolio.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A20. The third-party debt investors, the third-party equity investor, and the Manager are the variable interest holders in the variable interest entity. The fees paid to the Manager represent a variable interest based on a consideration of the conditions and factors in paragraphs B19 and B21 of Interpretation 46(R).

A21. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is primarily impacted by the performance of the entity's portfolio of assets. The Manager has the ability to impact the economic performance of the entity because it can actively manage the entity's assets within the parameters of the trust documents. If the average rating of the portfolio declines, the entity's governing documents require that the Manager's discretion in managing the portfolio be curtailed. Although the AAA-rated debt holders can remove the Manager without cause, no one party has the unilateral ability to exercise the kick-out rights over the Manager. Therefore, such kick-out rights would not be considered in this primary beneficiary analysis.

A22. The debt holders and the third-party equity investor do not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A23. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Manager, as the 35 percent equity tranche holder, has the right to receive benefits and the obligation to absorb losses. As equity tranche holder, the Manager has the most subordinate tranche and therefore absorbs 35 percent of the first dollar risk of loss and has the right to receive 35 percent of any residual benefits. Furthermore, the Manager receives a performance-based fee that provides it with the right to receive the

benefits of the entity. Through the equity interest and performance-based fee, the Manager has the right to receive benefits that could potentially be significant to the variable interest entity and the obligation to absorb losses that could potentially be significant to the variable interest entity.

A24. Based on the specific facts and circumstances presented above and the analysis performed, the Manager would be deemed to be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity, including activities that impact the overall economic performance of the entity (and no single enterprise has the unilateral ability to exercise substantive kick-out rights), and (b) through its equity interest and performance-based fee, it has the right to receive benefits that could potentially be significant to the variable interest entity and the obligation to absorb losses that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A25. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 3

Facts and Circumstances

A26. An entity is created and financed with \$94 of AAA-rated fixed-rate short-term debt with a 6-month maturity and \$6 of equity. The entity uses the proceeds to purchase a portfolio of floating-rate debt with an average life of four years and varying interest rates and short-term deposits with highly rated banks. The short-term debt securities and equity are held by multiple third-party investors. Upon maturity of the short-term debt, the entity will either refinance the debt with existing investors or reissue the debt to new investors at existing market rates.

A27. The primary purpose of the entity is to generate profits by maximizing the spread it earns on its asset portfolio and its weighted-average cost of funding. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio. The equity tranche is designed to absorb the first dollar risk of loss related to credit, liquidity, market value, and interest rate risk and to receive any benefit from a favorable change in credit, market value, and interest rates.

A28. The entity is exposed to liquidity risk because the average tenor of the assets is greater than its liabilities. To mitigate liquidity risk, the entity maintains a certain portion of its assets in short-term deposits with highly rated banks. The entity has not entered into a liquidity facility to further mitigate liquidity risk.

A29. The Sponsor of the entity was significantly involved with the creation of the entity. The Sponsor performs various functions to manage the operations of the entity, which include:

- a. Investment management—Such management must adhere to the investment guidelines established at inception of the entity. These guidelines include descriptions of eligible investments and requirements regarding the composition of the credit portfolio (including limits on country risk exposures, diversification limits, and ratings requirements).
- b. Funding management—This function provides funding management and operational support in relation to the debt issued and the equity with the objective of minimizing the cost of borrowing, managing interest rate and liquidity risks, and managing the capital adequacy of the entity.
- c. Defeasance management—An event of defeasance occurs upon the failure of the rating agencies to maintain the ratings of the debt securities issued by the entity at or above certain specified levels. In the event of defeasance, the Sponsor is responsible for overseeing the orderly liquidation of the investment portfolio and the orderly discharge of the entity's obligations. This includes managing the market and credit risks of the portfolio.

A30. For its services, the Sponsor receives a fee of 20 basis points, calculated as an annual percentage of the aggregate equity outstanding, and a performance fee, calculated as a percentage of the entity's profit above a targeted return. The Sponsor can be removed as the provider of these functions only in the event of a material breach in its obligations.

A31. The debt security holders of the entity have no voting rights. The equity holders have limited voting rights that are typically limited to voting on amendments to the constitutional documents of the entity.

Evaluation

Design of the Entity

A32. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of high-quality debt, (2) maximize the spread it earns on its asset portfolio and its weighted-average cost of funding, and (3) generate management fees to the Sponsor.
- b. The oitransaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio.

- c. The equity tranche is negotiated to absorb the first dollar risk of loss related to credit, liquidity, market value, and interest rate risk and to receive a portion of the benefit from a favorable change in credit, market value, and interest rates.
- d. The principal risks to which the entity is exposed include credit, interest rate, and liquidity risk.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A33. The third-party debt investors, the third-party equity investors, and the Sponsor are the variable interest holders in the variable interest entity. The fees paid to the Sponsor represent a variable interest based on a consideration of the conditions and factors in paragraphs B19 and B21 of Interpretation 46(R).

A34. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is primarily impacted by the performance of the entity's portfolio of assets. The Sponsor has the ability to impact the economic performance of the entity because it manages the entity's investment, funding, and defeasance activities. As such, the Sponsor is the variable interest holder with the power to direct matters that most significantly impact the activities of the entity, including, but not limited to, activities that impact the entity's economic performance. Furthermore, the Sponsor can be removed from its role only upon a material breach of its obligations. The fact that the Sponsor was significantly involved with the creation of the entity does not, in isolation, result in the Sponsor being the primary beneficiary of the entity. However, the fact that the Sponsor was involved with the creation of the entity may indicate that the Sponsor had the opportunity to establish arrangements that result in the Sponsor being the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance.

A35. The debt security holders of the entity have no voting rights and no other rights that provide them with the power to direct matters that most significantly impact the activities that impact the entity's economic performance. Although the equity holders have limited voting rights, which are typically limited to voting on amendments to the constitutional documents of the entity, such rights do not provide the equity holder with the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A36. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Sponsor, through its fee arrangement, receives benefits that could potentially be significant to the variable interest entity. Specifically, the Sponsor receives a performance-based fee that is tied to the returns of the assets in excess of a benchmark

rate. As the entity is designed to create an arbitrage between the returns on the assets and the liabilities, the Sponsor receives a significant portion of the primary benefit the entity was designed to create. The Sponsor also considered whether it had an implicit financial responsibility to ensure that the variable interest entity operates as designed. The Sponsor determined that it has an implicit financial responsibility and that such obligation could potentially be significant. This determination was influenced by the Sponsor's concern regarding the risk to its reputation in the marketplace if the variable interest entity did not operate as designed.

A37. Based on the specific facts and circumstances presented above and the analysis performed, the Sponsor would be deemed to be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its fee arrangement and implicit financial responsibility to ensure that the variable interest entity operates as designed, it has the right to receive benefits that could potentially be significant to the variable interest entity and the obligation to absorb losses that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A38. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 4

Facts and Circumstances

A39. An entity is created by an enterprise (the Sponsor) and financed with \$98 of AAA-rated fixed-rate short-term debt with a 3-month maturity and \$2 of subordinated notes. The entity uses the proceeds to purchase a portfolio of medium-term assets with average tenors of three years. The asset portfolio is obtained from multiple sellers. The short-term debt and subordinated notes are held by multiple third-party investors. Upon maturity of the short-term debt, the entity will either refinance the debt with existing investors or reissue the debt to new investors.

A40. The Sponsor of the entity provides (a) credit enhancement in the form of a letter of credit equal to 5 percent of the entity's assets and (b) a liquidity facility to fund the cash flow shortfalls on 100 percent of the short-term debt. Cash flow shortfalls could arise due to a mismatch between collections on the underlying assets of the entity and payments due to the short-term debt holders or to the inability of the entity to refinance or reissue the short-term debt upon maturity.

A41. A credit default of the entity's asset resulting in deficient cash flows is absorbed first by the subordinated note holders, second by the Sponsor's letter of credit, and third

by the short-term debt holders. The Sponsor's liquidity facility does not advance against defaulted assets.

A42. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated notes were designed to absorb the first dollar risk of loss related to credit. The entity is marketed to all investors as having a low probability of credit exposure due to the nature of the assets obtained. Furthermore, the entity is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the Sponsor.

A43. The entity is exposed to liquidity risk because the average tenor of the assets is greater than that of its liabilities. The entity enters into a liquidity facility with the Sponsor to mitigate liquidity risk.

A44. The Sponsor of the entity performs various functions to manage the operations of the entity. Specifically, the Sponsor establishes the terms of the entity, approves the sellers permitted to sell to the entity, approves the assets to be purchased by the entity, makes decisions regarding the funding of the entity including determining the tenor and other features of the short-term debt issued, and administers the entity by monitoring the assets, arranging for debt placement, compiling monthly reports, and ensuring compliance with the entity's credit and investment policies.

A45. For providing credit and liquidity facilities and management services, the Sponsor receives a total fee of 100 basis points calculated as an annual percentage of the asset value.

A46. The Sponsor can be removed as the provider of these functions only in the event of a material breach in its obligations. The short-term debt holders and subordinated note holders have no voting rights.

Evaluation

Design of the Entity

A47. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of highly rated medium-term assets, (2) provide the multiple sellers to the entity with access to lower-cost funding, (3) earn a positive spread between the interest that the entity earns on its asset portfolio and its weighted-average cost of funding, and (4) generate fees to the Sponsor.

- b. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated debt is designed to absorb the first dollar risk of loss related to credit and interest rate risk. The entity is marketed to all investors as having a low probability of credit loss due to the nature of the assets obtained. Furthermore, the entity is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the Sponsor.
- c. The principal risks to which the entity is exposed include credit, interest rate, and liquidity.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A48. The short-term debt holders, the third-party subordinated note holders, and the Sponsor are the variable interest holders in the variable interest entity. The fees paid to the Sponsor represent a variable interest based on a consideration of the conditions and factors in paragraphs B19 and B21 of Interpretation 46(R).

A49. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is primarily impacted by the performance of the entity's portfolio of assets. The Sponsor has the ability to impact the economic performance of the entity because it manages the operations of the entity. Specifically, the Sponsor establishes the terms of the entity, approves the sellers permitted to sell to the entity, approves the assets to be purchased by the entity, makes decisions regarding the funding of the entity including determining the tenor and other features of the short-term debt issued, and administers the entity by monitoring the assets, arranging for debt placement, and ensuring compliance with the entity's credit and investment policies. As such, the Sponsor is the variable interest holder with the power to direct matters that most significantly impact the activities of the entity, including, but not limited to, activities that most impact the entity's economic performance. Furthermore, the Sponsor can be removed from its role only upon a material breach of its obligations.

A50. The short-term debt holders and subordinated note holders of the entity have no voting rights and no other rights that provide them with power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A51. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Sponsor, through its fee arrangement, receives benefits from the variable interest entity that could potentially be significant to the variable interest entity. The Sponsor, through its letter of credit and liquidity facility, also has the obligation to absorb

losses of the variable interest entity that could potentially be significant to the variable interest entity.

A52. Based on the specific facts and circumstances presented above and the analysis performed, the Sponsor would be deemed to be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its letter of credit and liquidity facility, the Sponsor has the obligation to absorb losses that could potentially be significant to the variable interest entity, and, through its fee arrangement, the Sponsor has the right to receive benefits that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A53. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 5

Facts and Circumstances

A54. An entity is created and financed with \$100 of a single class of investment grade 30-year fixed-rate debt securities. The entity uses the proceeds to purchase \$100 of 30-year fixed-rate residential mortgage loans from the Transferor. The entity enters into a guarantee facility that absorbs 100 percent of the credit losses incurred on the entity's assets. The assets acquired by the entity are underwritten by the Transferor in accordance with the parameters established by the Guarantor. Additionally, all activities of the entity are prespecified by the trust agreement and servicing guide, which are both established by the Guarantor. No critical decisions are generally required for the entity unless default of an underlying asset is reasonably foreseeable or occurs.

A55. The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the Guarantor and to the prepayment risk associated with the underlying loans of the entity. Each month, the security holders receive interest and principal payments in proportion to their percentage ownership of the underlying loans.

A56. If there is a shortfall in contractually required loan payments from the borrowers or if the loan is foreclosed on and the liquidation of the underlying property does not generate sufficient proceeds to meet the required payments on all securities, the Guarantor will make payments to the debt securities holders to ensure timely payment of principal and accrued interest on the debt securities.

A57. The Guarantor also serves as the Master Servicer for the entity. As Master Servicer, the Guarantor services the securities issued by the entity. Generally, if a

mortgage loan is 120 days (or 4 consecutive months) delinquent, and if other circumstances are met, the Guarantor has the right to buy the loan from the entity. The Master Servicer can only be removed for a material breach in its obligations. As compensation for the guarantee and services provided, the Guarantor receives a fee of 25 basis points calculated as a percentage of the asset value.

A58. As Master Servicer, the Guarantor also is responsible for supervising and monitoring the servicing of the residential mortgage loans (primary servicing). The entity's governing documents provide that the Guarantor is responsible for the primary servicing of the loans; however, the Guarantor is allowed to, and does, hire the Transferor to perform primary servicing activities that are conducted under the supervision of the Guarantor. The Guarantor monitors the primary servicer's performance and has the right to remove the primary servicer at any time it considers such a removal to be in the best interest of the security holders.

A59. The primary servicing activities are performed under the servicing guide established by the Guarantor. Examples of the primary servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, and default management. When a loan becomes delinquent or it is reasonably foreseeable of becoming delinquent, the primary servicer can propose a default mitigation strategy in which the Guarantor can approve, reject, or require another course of action if it considers such action is in the best interest of the security holders. As compensation for servicing the underlying loans, the Transferor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

Evaluation

Design of the Entity

A60. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of residential mortgage loans with a third-party guarantee for 100 percent of the principal and interest payments due on the mortgage loans in the entity, (2) provide the Transferor to the entity with access to liquidity and an ongoing servicing fee, and (3) generate fees for the Guarantor.
- b. The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the Guarantor and prepayment risk associated with the underlying assets of the entity.
- c. The principal risks to which the entity is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate. The credit risk of the underlying assets and the risk of fluctuations in the value of the underlying real estate are fully absorbed by the Guarantor.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A61. The debt securities holders, the Transferor (as primary servicer), and the Guarantor are the variable interest holders in the variable interest entity. For purposes of this analysis, it is assumed that the fee paid to the Transferor (in its role as primary servicer) represents a variable interest based on a consideration of the conditions in paragraph B22 of Interpretation 46(R).

A62. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is impacted primarily by the performance of the underlying assets. The Guarantor, who is also the Master Servicer, has the ability (through establishment of the servicing terms, to appoint and remove the primary servicer, to direct default mitigation, and to purchase defaulted assets) to manage the entity's assets that become delinquent (or may become delinquent in the reasonably foreseeable future) to improve the economic performance of the entity. Consequently, the Guarantor is the variable interest holder with the power to direct matters that most significantly impact the activities related to the credit risk of the assets in the entity and, thus, the overall economic performance of the entity.

A63. Prepayment risk is also a risk that the entity was designed to create and pass through. However, no variable interest holder has the power to direct matters related to such risk.

A64. Because the Guarantor is able to appoint and replace the primary servicer and direct default mitigation, the primary servicer does not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance. Furthermore, the security holders have no voting rights and, thus, no power to direct matters that most significantly impact the activities that impact the entity's economic performance. As such, the Guarantor is the variable interest holder with the power to direct matters that most significantly impact the activities of the entity, including, but not limited to, activities that impact the entity's economic performance.

A65. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Guarantor, through its fee arrangement, receives benefits, which may or may not potentially be significant under this analysis; however, the Guarantor has the obligation to absorb losses of the entity that could potentially be significant through its guarantee obligation.

A66. Based on the specific facts and circumstances presented above and the analysis performed, the Guarantor would be deemed to be the primary beneficiary of the entity because (a) it is the variable interest holder with the power to direct matters that most

significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its guarantee, it has the obligation to absorb losses of the variable interest entity that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A67. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 6

Facts and Circumstances

A68. An entity is created and financed with \$100 of 30-year fixed-rate debt securities. The securities are issued in 2 tranches (a \$90 senior tranche and a \$10 residual tranche). The senior tranche securities are investment grade and are widely dispersed among third-party investors. The residual tranche securities are held by the Transferor. The entity uses the proceeds to purchase \$100 of 30-year fixed-rate residential mortgage loans from a Transferor. A default on the underlying loans is absorbed first by the residual tranche held by the Transferor. All activities of the entity are prespecified by a pooling and servicing agreement for the transaction. No critical decisions are generally required for the entity unless default of an underlying asset is reasonably foreseeable or occurs.

A69. The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the underlying loan borrowers and to the prepayment risk associated with the underlying loans of the entity. Each month, the security holders receive interest and principal payments in proportion to their percentage of ownership of the underlying loans. The residual tranche was designed to provide a credit enhancement to the transaction and to absorb the first dollar risk of loss related to credit.

A70. The primary servicing responsibilities are retained by the Transferor. No party has the ability to remove the Transferor as servicer.

A71. The servicing activities are performed in accordance with the pooling and servicing agreement. Examples of the servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, monitoring overdue payments, and overall default management. Default management includes evaluating the borrower's financial condition to determine which loss mitigation strategy (specified in the pooling and servicing agreement) will maximize recoveries on a particular loan. The acceptable default management strategies are limited to the actions specified in the pooling and servicing agreement and include (a) modifying the terms of loans when default is reasonably foreseeable, (b) temporary forbearance on collections of principal and interest (such amounts would be added to the unpaid balance on the loan), and (c) short sales in which the servicer allows the underlying borrower to sell the mortgaged property even if

the anticipated sale price will not permit full recovery of the contractual loan amounts. As compensation for servicing the underlying loans, the Transferor receives a fee, calculated monthly as a percentage of the unpaid principal balance on the underlying loans. Although the servicing activities, particularly default management, are required to be performed in accordance with the pooling and servicing agreement, the Transferor, as servicer, has discretion in determining which strategies within the pooling and servicing agreement to utilize to attempt to maximize the entity's economic performance.

Evaluation

Design of the Entity

A72. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of residential mortgage loans and (2) provide the Transferor to the entity with access to liquidity and an ongoing servicing fee and potential residual returns.
- b. The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with credit enhancement provided by the residual tranche and prepayment risk associated with the underlying assets of the entity. The marketing of the transaction indicated that credit risk would be mitigated by the subordination of the residual tranche.
- c. The principal risks to which the entity is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate.

Determination of Primary Beneficiary

Step 1: Qualitative analysis

A73. The debt security holders and the Transferor are the variable interest holders in the variable interest entity. The fee paid to the Transferor (in its role as servicer) represents a variable interest based on a consideration of the conditions and factors in paragraphs B19 and B21 of Interpretation 46(R).

A74. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is impacted primarily by the performance of the underlying assets. The Transferor, as servicer, has the ability to manage the entity's assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of the entity. Additionally, no party can remove the Transferor in its role as servicer. Although default management

activities are performed only after default of the underlying assets or when default is reasonably foreseeable, the Transferor is the variable interest holder with the power to direct matters that most significantly impact the activities related to the credit risk of the assets in the entity and, thus, the overall economic performance of the entity.

A75. Prepayment risk is also a risk that the entity was designed to create and pass through. However, no variable interest holder has the power to direct matters related to such risk.

A76. The senior security holders have no voting rights and, thus, no power to direct matters that most significantly impact the activities that impact the entity's economic performance. As such, the Transferor is the variable interest holder with the power to direct matters that most significantly impact the activities of the entity, including, but not limited to, activities that impact the entity's economic performance.

A77. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The Transferor, through its servicing fee arrangement and its residual tranche ownership, has the right to receive benefits and the obligation to absorb losses, either of which could potentially be significant to the variable interest entity.

A78. Based on the specific facts and circumstances presented above and the analysis performed, the Transferor would be deemed to be the primary beneficiary of the entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its servicing fee arrangement and residual tranche ownership, it has the right to receive benefits and the obligation to absorb losses, either of which could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A79. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 7

Facts and Circumstances

A80. An entity is created and financed with \$950 of 5-year fixed-rate debt and \$50 of equity. The entity uses the proceeds from the issuance to purchase property to be leased to a lessee with an AA credit rating. The equity is subordinate to the debt because the debt is paid before any cash flows are available to the equity investors. The lease has a five-year term and is classified as a direct finance lease by the lessor and as an operating lease by the lessee. The lessee, however, is considered the owner of the property for tax purposes and, thus, receives tax depreciation benefits.

A81. The lessee is required to provide a first-loss residual value guarantee for the expected future value of the leased property at the end of five years (the option price) up to a specified percentage of the option price, and it has a fixed-price purchase option to acquire the property for the option price. If the lessee does not exercise the fixed-price purchase option at the end of the lease term, the lessee is required to remarket the property on behalf of the entity. If the property is sold for an amount less than the option price, the lessee is required to pay the entity the difference between the option price and the sales proceeds, which is not to exceed a specified percentage of the option price. If the property is sold for an amount greater than the option price, the lessee is entitled to the excess of the sales proceeds over the option price. A third-party residual value guarantor provides a very small additional residual value guarantee to the lessor entity, which allows the lessor to achieve direct financing lease treatment.

A82. The governing documents for the entity do not permit the entity to buy additional assets or sell existing assets during the five-year holding period, and the terms of the lease agreement and the governing documents for the entity do not provide the equity holders with any ability to direct matters that most significantly impact the activities of the variable interest entity. The entity was formed so that the lessee would (a) have rights to use the property under an operating lease and (b) retain substantially all of the risks and rewards from appreciation or depreciation in value of the leased property.

A83. The transaction was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt.

Evaluation

Purpose and Design of the Entity

A84. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purpose for which the variable interest entity was created was to provide the lessee with use of the property for five years with substantially all of the rights and obligations of ownership, including tax benefits.
- b. The entity was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt.
- c. The residual value guarantee effectively transfers substantially all of the risk associated with the underlying property (that is, decreases in value) to the lessee and the fixed-price purchase option effectively transfers substantially all of the rewards from the underlying property (that is, increases in value) to the lessee.
- d. The entity is designed to be exposed to the risks associated with a cumulative change in fair value of the leased property at the end of five years as well as credit risk related to the potential default by the lessee of its contractually required lease payments.

Determination of the Primary Beneficiary

Step 1: Qualitative analysis

A85. The debt investors, the equity investors, and the lessee are the variable interest holders in the variable interest entity.

A86. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the variable interest entity is impacted primarily by the fair value of the underlying property and the credit of the lessee. The lessee's maintenance and operation of the leased property has a direct effect on the fair value of the underlying property. The lessee also has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the property and directs the activities of the entity. Additionally, the lessee's residual value guarantee ensures that the debt and equity holders are protected from market factors that impact the fair value of the underlying property.

A87. The debt holders do not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance. Although the equity holders establish the terms of the lease agreement, the terms of the lease agreement do not provide the equity holders with the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A88. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The lessee has both the right to receive benefits that could potentially be significant in relation to the variable interest entity and the obligation to absorb losses that could potentially be significant to the variable interest entity through the purchase option and residual value guarantee, respectively.

A89. Based on the specific facts and circumstances presented above and the analysis performed, the lessee would be deemed the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its residual value guarantee and purchase option, it has the right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity and the obligation to absorb losses of the variable interest entity that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A90. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Example 8

Facts and Circumstances

A91. An entity is funded with \$95 million of 20-year fixed-rate debt and \$5 million of equity to acquire a hotel. The debt is widely dispersed among third-party investors. The equity is equally held by two unrelated parties: Company A and Company B. Company A, a hotel operator, enters into a 20-year contract with the entity, allowing the entity the right to use the brand name of Company A. Company B is a strategic investment company. Company A and Company B each have 50 percent voting rights and each represent 50 percent of the Board of Directors. All significant decisions related to the hotel, including decisions that impact its economic performance, are jointly decided by Company A and Company B through their voting interests and equal Board representation. Any matters that cannot be resolved or agreed upon must be resolved through a third-party arbitration process. As Company A has expertise in hotel management, it performs the day-to-day operating activities of the hotel under a service agreement.

A92. The transaction was marketed to investors as a real estate investment operated as a hotel. Investors anticipate their returns will be provided from the operations of the hotel and property appreciation (through the ability to refinance the outstanding debt and distribute the proceeds). Interest is paid to the fixed-rate debt investors from operations before funds are available to the equity holders. The debt holders have no voting rights in the entity.

Evaluation

Purpose and Design of the Entity

A93. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purpose for which the variable interest entity was created was to provide Company A and Company B with the ability to invest in and operate a hotel.
- b. The entity was marketed to debt investors as an entity that will be exposed to the performance risk of Company A and Company B, as well as to fluctuations in the value of the hotel.

Determination of the Primary Beneficiary

Step 1: Qualitative analysis

A94. The debt investors, Company A and Company B (through their equity investment), are the variable interest holders in the variable interest entity. The fee paid to Company A under the service agreement and contract does not represent a variable interest based on a consideration of the conditions in paragraph B22 of Interpretation 46(R).

A95. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is impacted by the (a) operations of the hotel because the operating cash flows of the entity are used to repay debt and equity holders and (b) the fair value of the hotel property.

A96. Company A and Company B, as a group, have the power to direct matters that will most significantly impact the economic performance of the entity through their ability to manage the significant activities of the entity through their voting interests and Board representation.

A97. The debt holders do not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A98. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. Company A and Company B both have the right to receive benefits and the obligation to absorb losses that could potentially be significant to the variable interest entity through their equity interests.

A99. Based on the specific facts and circumstances presented above and the analysis performed, the entity does not have a primary beneficiary because the power to direct matters that most significantly impact the activities of the variable interest entity, including activities that impact the overall economic performance of the entity, is, in fact, shared among multiple parties (Company A and Company B) such that no one party has the power to direct matters that most significantly impact the activities of the variable interest entity, including but not limited to, the entity's economic performance.

Step 2: Quantitative analysis

A100. The quantitative analysis (Step 2) would not be necessary in this example because it was determined that power is shared among multiple parties (and, thus, there is no primary beneficiary of the entity).

Example 9

Facts and Circumstances

A101. An entity is created by a furniture manufacturer and a financial investor to sell wood furniture to retail customers in a particular geographic region. The entity was created because the furniture manufacturer has no viable distribution channel in that particular geographic region. The entity is established with \$100 of equity, contributed by the furniture manufacturer, and \$3 million of 10-year fixed-rate debt, provided by a financial investor. The furniture manufacturer establishes the sales and marketing strategy of the entity, manages the day-to-day activities of the entity, and is responsible for preparing and implementing the annual budget for the entity. The entity has a distribution contract with a third party that does not represent a variable interest in the variable interest entity. Interest is paid to the fixed-rate debt holder (the financial investor) from operations before funds are available to the equity holder. The furniture manufacturer has guaranteed the fixed-rate debt to the financial investor.

Evaluation

Purpose and Design of the Entity

A102. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purpose for which the entity was created was to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.
- b. The entity was marketed to the financial investor as a fixed-rate investment in a retail operating entity, supported by the furniture manufacturer's expertise and guarantee.
- c. The furniture manufacturer's guarantee of the debt effectively transfers all of the operating risk of the entity to the furniture manufacturer.

Determination of the Primary Beneficiary

Step 1: Qualitative analysis

A103. The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the variable interest entity.

A104. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is impacted primarily by the operations of the entity because the operating cash flows of the entity are used to repay the financial investor. The furniture manufacturer has the power to direct matters that most significantly impact the economic performance of the entity through its abilities to establish the sales and marketing strategy of the entity and manage the day-to-day activities of the entity. The debt guarantee provided by the furniture manufacturer further mitigates the risk that the financial investor will not be repaid, inclusive of interest.

A105. The debt holder does not have the power to direct matters that most significantly impact the activities that impact the entity's economic performance.

A106. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The furniture manufacturer has the right to receive benefits that could potentially be significant through its equity interest and the obligation to absorb losses that could potentially be significant through its equity interest and debt guarantee.

A107. Based on the specific facts and circumstances presented above and the analysis performed, the furniture manufacturer would be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its equity interest and debt guarantee, it has the right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity and the obligation to absorb losses of the variable interest entity that could potentially be significant to the variable interest entity.

Step 2: Quantitative analysis

A108. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this proposed Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than others.

Background Information

B2. In March 2008, the Board added a project to its agenda to potentially amend and enhance certain guidance in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. This project was undertaken to do the following:

- a. Address the potential effects on certain provisions of Interpretation 46(R) of the proposed elimination of the qualifying special-purpose entity concept in the proposed FASB Statement, *Accounting for Transfers and Servicing of Financial Assets*. As a result of the elimination of the qualifying special-purpose entity concept, many entities may become subject to the consolidation guidance in Interpretation 46(R).
- b. Address constituent concerns about the application of certain key provisions of Interpretation 46(R), including those in which the accounting and disclosures do not always provide timely and useful information about an enterprise's involvement or involvements in a variable interest entity that assists users in assessing the potential financial effects on the enterprise.

B3. Constituents' primary concerns about Interpretation 46(R) relate to the following guidance:

- a. The timeliness of the reconsideration of whether an entity is or is not a variable interest entity in paragraph 7 of the Interpretation and the narrow reconsideration events listed in that paragraph
- b. The timeliness of the reconsideration of which enterprise, if any, is the primary beneficiary of a variable interest entity in paragraph 15 of the Interpretation and the narrow reconsideration events listed in that paragraph
- c. The method for determining which enterprise, if any, is the primary beneficiary in a variable interest entity in paragraph 14 of the Interpretation
- d. The sufficiency of the disclosure requirements in paragraphs 23–26 of the Interpretation.

B4. To address these concerns, this proposed Statement would amend the guidance related to items B3(a)–B3(d) above and would expand the disclosure requirements of Interpretation 46(R).

Reconsideration Events

B5. The guidance in Interpretation 46(R) for reconsidering whether an entity is or is not a variable interest entity and which enterprise, if any, with a variable interest in a variable interest entity is the primary beneficiary is primarily focused on the entity’s design and capital structure and on transactions that change the sufficiency of the entity’s equity at risk. An enterprise is required to determine whether it is the primary beneficiary of a variable interest entity at the time it becomes involved with the entity. The reconsideration guidance in paragraph 7 of Interpretation 46(R) explicitly exempts losses in excess of expected losses as a reconsideration event, while paragraph 15 of the Interpretation, which includes a list of events that would require reconsideration, also does not include losses in excess of expected losses as a reconsideration event. Further, troubled debt restructurings as defined in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, are explicitly exempted from Interpretation 46(R).

B6. Certain constituents have expressed significant concerns about the current guidance on reconsideration events in Interpretation 46(R), especially the lack of a reconsideration event for situations in which an entity experiences unanticipated economic results. The Board agrees with these constituents and believes that the application of the current guidance in the Interpretation often has resulted in inappropriate classification of an entity as a variable interest entity or a voting interest entity. Additionally, the Board noted that under the Interpretation’s current reconsideration guidance, the enterprise identified as a primary beneficiary at the inception of a variable interest entity may remain the entity’s primary beneficiary throughout the life of the entity, even when that enterprise no longer has the majority of exposure to the variable interest entity’s estimated losses or rights to receive the entity’s residual returns.

B7. As a result of the concerns noted in paragraph B6, the Board decided to eliminate the reconsideration guidance in Interpretation 46(R) and to require ongoing assessments of an entity’s status as a variable interest entity and as the primary beneficiary. The Board reasoned that enterprises are required to continuously reconsider if they must consolidate voting interest entities and that there was no conceptual basis for different treatment for variable interest entities. The Board amended the guidance in paragraph 5 of Interpretation 46(R) to apply to both the design of the entity and to changes in facts and circumstances in a variable interest entity. Paragraph 5 should be used both (a) when an enterprise becomes involved with an entity and (b) on an ongoing basis to determine whether an entity is a variable interest entity or voting interest entity. Further, the guidance in this proposed Statement that would amend paragraph 14 of Interpretation 46(R) should be used both (1) when an enterprise becomes involved with an entity and (2) on an ongoing basis to determine whether an enterprise is a primary beneficiary of a variable interest entity.

B8. The Board believes that these ongoing assessments should not be limited to the end of each reporting period but, rather, should occur when circumstances warrant a change in an entity's status as a variable interest entity or an enterprise's status as primary beneficiary. The Board reasoned that if circumstances change during a reporting period, limiting the assessment to the end of the reporting period would result in potential misstatement in an enterprise's financial statements, particularly the impact on earnings. The Board believes that eliminating the specific reconsideration guidance and requiring ongoing assessments would provide users with more relevant and timely information, such as the nature of an enterprise's interest or interests in a variable interest entity and the associated risks and obligations associated with that interest.

B9. During its deliberations, the Board considered but ultimately rejected providing additional reconsideration requirements, along with retaining the existing guidance in paragraphs 7 and 15 of Interpretation 46(R). The Board considered adding the following reconsideration events: significant changes in the management of the entity; relevant market factors, including the overall business climate; and the primary purpose or risk that the entity was designed to create and pass through to interest holders. The Board also considered including, as specific reconsideration events, an entity's exposure to significant new risks or its expectation that actual results will deviate significantly, on an other-than-temporary basis, from the entity's original plan.

B10. Although the Board acknowledges that the factors in paragraph B9 and those currently within the guidance of Interpretation 46(R) could be important to the analyses required by paragraphs 5 and 14 of Interpretation 46(R), as amended by this proposed Statement, the Board believes that providing specific factors may unnecessarily limit an enterprise's analysis of whether an entity is a variable interest entity and whether an enterprise is a primary beneficiary.

B11. The Board also considered certain alternatives for determining when an enterprise would be required to assess an entity's status as a variable interest entity and as a primary beneficiary of a variable interest entity. These alternatives included (a) requiring an enterprise to perform assessments only upon the occurrence of a specified criterion or (b) requiring an annual assessment with interim assessments if specified triggering events occurred. The Board rejected these alternatives in favor of ongoing assessments because, in part, it was concerned that the approaches rejected could cause a delay in an entity's change in status or a change in the appropriate primary beneficiary.

B12. The Board is aware that an entity previously considered a variable interest entity may become a voting interest entity as a result of subsequent changes in events and circumstances. For example, an entity's equity may have been considered insufficient at the inception of the entity; however, actual subsequent financial results substantiate that the entity's equity was indeed sufficient. The Board considered adding a provision to preclude an entity from changing its status as a variable interest entity. The Board ultimately concluded that if, after considering the provisions in paragraph 5 of Interpretation 46(R), as amended by this proposed Statement, an entity is no longer a variable interest entity; it should be classified as a voting interest entity. The Board reasoned that, often, the same enterprise would consolidate the entity under a voting

interest model or a variable interest model because the enterprise would have the majority of voting and power along with (a) the right to benefits that could be significant or (b) the obligation to absorb losses that could be significant.

B13. The Board decided to remove the exception for troubled debt restructurings in Interpretation 46(R). The Board reasoned that in a troubled debt restructuring, the proposed amended guidance would typically identify an entity as a variable interest entity, since economic events have proven that the entity's equity is not sufficient to permit it to finance its activities without additional subordinated financial support or a restructuring of the terms of its financing. Further, the Board noted that, as a result of unanticipated economic results, it would not be uncommon for the primary beneficiary of an entity involved in a troubled debt restructuring to change to a different enterprise under the proposed guidance for determining the primary beneficiary when circumstances change.

B14. In reaching its conclusions to require ongoing assessments of an entity's status as a variable interest entity and an enterprise's status as primary beneficiary and to rescind the exception for troubled debt restructurings, the Board considered the magnitude of effort that would be required by constituents to comply with this amendment. The Board weighed that effort against the anticipated benefits to users of financial statements. Users would receive more timely information (including disclosures) about the identification of an entity as a variable interest entity or voting interest entity. They also would receive more timely information about consolidation of a variable interest entity by an enterprise that has (a) the power to direct matters that most significantly impact the activities of the entity, including, but not limited to, activities that impact the entity's economic performance and (b) the rights to receive benefits of the entity that could potentially be significant or the obligation to absorb actual losses of the entity that could potentially be significant.

B15. Because the guidance for determining the primary beneficiary in paragraph 14 of Interpretation 46(R), as amended by this proposed Statement, is expected to be primarily qualitative, the Board expects that these assessments will require less effort and be less costly than quantitative assessments for an enterprise with a variable interest in a variable interest entity. Further, the Board expects that a qualitative model for determining if an enterprise is the primary beneficiary of an entity will reduce the frequency in which the enterprise with the controlling financial interest changes. The Board understands that the ongoing reassessments pursuant to paragraphs 5 and 14 of Interpretation 46(R), as amended by this proposed Statement, may require significant effort for reporting enterprises with involvements in numerous variable interest entities. However, the Board noted that enterprises currently must obtain data for interest or interests in variable interest entities to appropriately account for such interests. The Board concluded that requiring reconsideration in response to changes in facts and circumstances would provide benefits to users that would outweigh the anticipated costs to comply with this requirement. Finally, the Board noted that removing explicit reconsideration events is consistent with the current requirements of ARB No. 51, *Consolidated Financial Statements*, as well as SIC Interpretation 12, *Consolidation—Special Purpose Entities*, and the current direction of the IASB's project on consolidations.

Primary Beneficiary Determination

B16. Paragraph 14 of Interpretation 46(R) currently provides the guidance for determining which enterprise, if any, is the primary beneficiary of a variable interest entity. Currently, an enterprise is required to consolidate a variable interest entity if the enterprise has a variable interest or interests that will absorb the majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. That assessment is performed by calculating (quantitative analysis) the variable interest entity's expected losses and expected residual returns to determine which enterprise, if any, is required to consolidate the variable interest entity. A variable interest entity's expected losses and expected residual returns are determined by calculating the expected negative variability (for losses) and positive variability (for returns) in the fair value of its net assets, exclusive of variable interests.

B17. Some constituents have expressed significant concerns about the application of the current guidance in determining the primary beneficiary because they believe that the quantitative analysis currently required by Interpretation 46(R) is difficult to understand, apply, and audit. These constituents maintain that the calculation often requires a high degree of mathematical expertise and that entities often perform a significant number of calculations for a single variable interest entity, particularly structured financial vehicles, to determine the primary beneficiary. Constituents also noted that, in practice, several different approaches and methodologies are used to apply the expected losses calculation. This leads to inconsistent application and results for variable interest entities with similar characteristics and traits.

B18. Certain constituents were troubled that the quantitative analysis often seems to identify a different primary beneficiary of a variable interest entity from that identified by applying a qualitative analysis to the same entity. They asserted that a qualitative analysis would consider the purpose and primary characteristics of the entity. For example, to avoid consolidation of certain structured finance vehicles that are variable interest entities, sponsors of these vehicles sell interests to third parties that would absorb the majority of the expected losses (expected loss note holders). The expected loss note holder receives a substantial return on its investment but typically has very limited power, if any, to direct matters that most significantly impact the activities of the variable interest entity. Additionally, the maximum exposure to economic losses that can be absorbed by the expected loss note holders is typically limited to their investment in the notes, while other variable interest holders may be at risk of incurring significantly larger economic losses. Although a quantitative analysis identifies the expected loss note holder as the primary beneficiary, the Board believes that applying the qualitative analysis in this proposed Statement may not result in the same conclusions. The Board was troubled by those disparate outcomes.

B19. Users were particularly concerned that the quantitative analysis would not capture situations in which enterprises involved with a variable interest entity provided financial support, including credit and liquidity, to entities and that this support represented an implicit arrangement (such as a guarantee). Users stated (with the benefit of hindsight) that the quantitative analysis sometimes contained overly optimistic assumptions about

the entity's performance and that Interpretation 46(R) did not require these assumptions to be updated unless one of the specific reconsideration events currently listed in that Interpretation occurred. Users asserted that a qualitative approach that analyzes the characteristics of an enterprise's variable interest and the variable interest entity, including its purpose and design, may more readily identify implicit arrangements that indicate which party has a controlling financial interest in a variable interest entity.

B20. The Board generally agreed with the concerns about the application of the quantitative analysis required by Interpretation 46(R) and the related results. Some Board members asserted that the predominant issues may not be attributed to the calculation itself but to the quality of inputs into the analysis, including the use of overly optimistic assumptions that did not contemplate all the relevant risks. However, these Board members acknowledged that the calculation was complex and difficult to apply. The Board noted that although the purpose of Interpretation 46(R) was to determine which enterprise had a controlling financial interest, the required quantitative model for determining such interests is effectively a risks and rewards model. The Board considered several approaches to amending the guidance in Interpretation 46(R) for determining the primary beneficiary of a variable interest entity and to addressing constituent and Board concerns about the current guidance. These proposed approaches included the following:

- a. A qualitative analysis that includes a quantitative analysis based on the expected losses calculation to be performed only if an enterprise believed it could be the primary beneficiary but couldn't determine its status qualitatively
- b. A qualitative analysis in which the expected losses calculation is required as a second step if no primary beneficiary was identified qualitatively
- c. No change to the expected losses calculation with reliance on the new requirement for enterprises to consider whether or not they are a primary beneficiary on an ongoing basis and through enhanced disclosures in this proposed Statement.

B21. The Board decided on an approach that would require an enterprise to initially perform a qualitative analysis as proposed in paragraph 14 of Interpretation 46(R), as amended by this proposed Statement, which includes a quantitative analysis based on the expected losses calculation only when an enterprise cannot determine whether or not it meets the qualitative criteria. The Board expects it to be uncommon for an enterprise to default to the quantitative analysis and has proposed a disclosure requirement for an enterprise to provide an explanation substantiating the use of the quantitative analysis. The Board stated that a goal of paragraph 14 of Interpretation 46(R), as amended by this proposed Statement, was to provide a more principles-based approach to determining a primary beneficiary. The Board opposed a more rules-based approach that would provide a list of specific qualitative criteria that would have to be considered or met. The Board expressed its desire for constituents to apply judgment in applying the amended guidance in this proposed Statement to determine the appropriate primary beneficiary, if any, in a variable interest entity. The Board acknowledges that this more principles-based approach may result in inconsistent application in certain situations. However, the Board believes that if (a) the information used in the assessment is complete and accurate and

(b) the analyses of the pertinent factors and characteristics of both the variable interests and the variable interest entity are performed using sound judgment, the risk of inconsistency should be mitigated to an acceptable level.

B22. The qualitative analysis developed by the Board is designed to identify the enterprise with a controlling financial interest in a variable interest entity. This guidance requires a controlling financial interest to have both (a) power and (b) the right to receive benefits or the obligation to absorb losses.

B23. The Board concluded that power is specific to the ability to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The Board acknowledges that matters that most significantly impact the activities of a variable interest entity may differ by the type of entity being analyzed. The Board concluded that an enterprise will have to apply judgment to determine what matters are most significant to a variable interest entity (generally, the matters that most significantly impact the entity's economic performance) and then determine if the enterprise has the power to direct such matters. The Board also acknowledges that in certain circumstances, an enterprise may conclude that power is shared among multiple parties. The Board concluded that if an enterprise can demonstrate that the power to direct matters that most significantly impact the activities of a variable interest entity is, in fact, shared among multiple parties, such that no one party meets the criteria of paragraph 14A of Interpretation 46(R), as amended by this proposed Statement, then no primary beneficiary exists. That is, the Board concluded that shared power exists when no one party alone has the power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The Board also concluded that although a party may be significantly involved with the creation of an entity, that involvement does not, in isolation, establish the party as the primary beneficiary of the entity. However, that involvement may indicate that the party had the opportunity to establish arrangements that result in the party being the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance.

B24. The Board concluded that the right to receive benefits or the obligation to absorb losses would have to potentially be significant to the variable interest entity to meet the criterion in paragraph 14A(b) of Interpretation 46(R), as amended by this proposed Statement. The Board reasoned that although an enterprise might not have rights or obligations that currently are significant, its interest may provide it with rights or obligations that may be significant to the variable interest entity in the future. The Board concluded that this guidance was imperative, since rights or obligations that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct matters that most significantly impact the activities of a variable interest entity, which typically will be the activities that impact the entity's economic performance. To emphasize the necessity for enterprises to assess whether they have an implicit financial responsibility to ensure that a variable interest entity operates as designed, the Board stated in paragraph 14A(b) of Interpretation 46(R), as amended by

this proposed Statement, that implicit financial responsibility should be considered (for example, an enterprise may implicitly agree to fund an entity's losses to protect the enterprise's reputation). The Board acknowledges that multiple enterprises may have rights or obligations that could "potentially be significant" but that only one enterprise can meet the criteria in paragraph 14A(a) of Interpretation 46(R), as amended by this proposed Statement; thus, this criteria would not result in an enterprise identifying more than one party as the primary beneficiary.

B25. The Board acknowledged that the reference to significance in the guidance for determining the primary beneficiary in paragraph 14 of Interpretation 46(R), as amended by this proposed Statement, is different from the guidance in paragraph 6 of Interpretation 46(R), as amended by this proposed Statement. Paragraph 6 requires an enterprise to assess significance in relation to either the variable interest entity or the enterprise, as opposed to just the variable interest entity. The Board reasoned that it is important to consider significance to both the variable interest entity and the enterprise in paragraph 6 since the financial reporting and disclosures are important to users of an enterprise's financial statements when an enterprise's variable interest is significant to the enterprise. However, the Board concluded that significance in relation to the enterprise was irrelevant when determining the primary beneficiary because determining the primary beneficiary is specific to the variable interest entity.

B26. The Board discussed the role of kick-out rights in the analysis for determining a primary beneficiary. The Board concluded that the qualitative analysis should not consider substantive kick-out rights unless a single enterprise (including related parties and de facto agents) has the unilateral ability to exercise such kick-out rights. The Board acknowledged that excluding such kick-out rights is in conflict with other authoritative guidance, including other areas of Interpretation 46(R). However, the Board reasoned that many entities within the scope of Interpretation 46(R) are highly structured, and while other accounting guidance would recognize the existence of substantive kick-out rights, they typically are not exercised and, thus, should not be considered until exercised.

B27. The Board concluded that if kick-out rights are included in the analysis of which enterprise has the power to direct matters that most significantly impact the activities of a variable interest entity, enterprises may have structuring opportunities to achieve a conclusion that no single party with a variable interest in a variable interest entity had power pursuant to paragraph 14A(a) of Interpretation 46(R), as amended by this proposed Statement. The Board found these structuring opportunities to be troubling and, thus, was willing to accept an inconsistency in the kick-out right concept between the primary beneficiary analysis in this proposed Statement and other authoritative literature (including other areas within Interpretation 46(R)). The Board also concluded that if a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise substantive kick-out rights and remove the party that is considered to have power, then the rights should be considered in the analysis required by paragraph 14A(a). The Board reasoned that such rights would effectively give the single enterprise overall power over the entity.

B28. The Board deliberated whether the proposed guidance should require an enterprise to have both the right to receive benefits from the variable interest entity and the obligation to absorb actual losses of the entity, or just one of these criteria. The majority of the Board voted to require the presence of just one of the criteria; however, it requested additional language to clarify that either the right to receive benefits or the obligation to absorb actual losses could potentially be significant. The Board believes that an enterprise with power often will have rights to benefits that could potentially be significant or the obligation and responsibility to absorb actual losses that could potentially be significant. Therefore, the potential to have losses that could potentially be significant should be considered when determining whether the enterprise has a controlling financial interest in a variable interest entity.

B29. The Board noted that in the current marketplace, financial institutions with significant involvement in financial variable interest entities are absorbing losses without the explicit contractual obligation to do so and, thus, protecting other interest holders from losses that such holders otherwise would have incurred. These financial institutions often did not factor such support into their consolidation analysis pursuant to Interpretation 46(R). To partially address the issue of reputation risk, the Board added the language in the last sentence of paragraph 14A(b) of Interpretation 46(R), as amended by this proposed Statement, which states that the enterprise shall consider “. . . implicit or explicit financial responsibility to ensure that a variable interest entity operates as designed.” The Board also noted that the consideration of implicit variable interests is already required by FASB Staff Position (FSP) FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*.

B30. The Board also deliberated whether the qualitative assessment of the proposed guidance should specifically require enterprises with variable interests in a variable interest entity to base their assessment in part on the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders; that approach would be consistent with the requirements of FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*. Although the guidance in FSP FIN 46(R)-6 was developed for purposes of applying the quantitative analysis, the majority of the Board felt that the criteria established in that FSP were pertinent to both the qualitative and quantitative (if necessary) analyses. Consequently, the Board included language (see paragraph 14A of Interpretation 46(R), as amended by this proposed Statement) that requires enterprises to “consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders.”

B31. The Board also considered a linked presentation model, similar to the model being considered by the IASB as part of the long-term project on derecognition of financial assets. In a linked presentation model, certain assets are classified separately on an enterprise’s statement of financial position. Any liabilities that are funded solely from the cash flows from such assets would be reflected as a deduction from the related assets on the statement of financial position with a subtotal for a net amount.

B32. The Board initially considered a linked presentation model in its short-term project to amend Statement 140. When the Board added the related project to amend Interpretation 46(R), it considered whether the scope of linked presentation should be included in Interpretation 46(R) or expanded to other guidance related to the presentation of financial and nonfinancial assets with related liabilities. The Board concluded that extending the scope of linked presentation to a much broader population of assets and liabilities, including those that are nonfinancial, is a significant change that would be more appropriate to develop as part of the joint projects with the IASB on derecognition and/or financial statement presentation. Further, the Board decided that it would need to address significant issues related to linked presentation that could not be completed in the short term, such as issues related to measurement of the linked assets and liabilities and determining which assets and liabilities would be shown as linked. Several Board members concluded that the subsequent measurement attribute should be fair value and that the application of fair value to a broad spectrum of assets and liabilities needed significant further analysis. Consequently, the Board decided not to pursue a linked presentation model at this time because of the short-term nature of this project.

B33. Because the guidance in this proposed Statement would significantly change the way an enterprise determines whether it is the primary beneficiary of a variable interest entity, the Board decided to provide examples to illustrate the application of the proposed guidance. The Board believes that illustrative examples would help increase the understandability of the new principle.

Disclosures

B34. In developing the incremental disclosures included in this proposed Statement, the Board noted that existing U.S. generally accepted accounting principles (GAAP) already require numerous disclosures related to variable interest entities, transactions involving variable interest entities, guarantees, risks and uncertainties, and credit concentrations (for example, the existing disclosures in Interpretation 46(R), FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, and FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*, among others).

B35. The Board spoke to various constituent groups, but primarily considered recommendations made by financial statement users. Additionally, the Board considered existing Securities and Exchange Commission disclosure requirements, existing or contemplated disclosure requirements of other standard setters (including the IASB), and various other studies and articles on the topic of perceived gaps in the disclosure requirements in general.

B36. The general view expressed by users was that the information disclosed about an enterprise's involvement or involvements with variable interest entities and the associated risks was often insufficient and untimely, regardless of whether the variable interest entity was consolidated by the enterprise or off-balance sheet. Users told the Board that enhanced disclosure requirements are necessary to improve transparency in financial

reporting for variable interest entities and suggested many of the proposed incremental disclosures in this proposed Statement.

B37. In developing the proposed disclosures, the Board decided that it was important to first develop overall objectives for disclosures on variable interest entities and then enhance the required disclosures in Interpretation 46(R). Additionally, the Board considered whether certain disclosures in the April 2008 Senior Supervisors Group Report, *Leading-Practice Disclosures for Selected Exposures*, which was issued by banking commissions and regulators from five countries, should be specifically required; however, the Board concluded that the objectives would be sufficient. As a result, the Board believes that the principal objectives of the disclosures required by paragraphs 22B–26 of Interpretation 46(R), as amended by this proposed Statement, are to provide users of financial statements with an understanding of the following:

- a. The judgments and assumptions made by the enterprise in determining whether the enterprise must consolidate a variable interest entity or disclose information about its involvement in a variable interest entity
- b. The nature of restrictions on the consolidated variable interest entity's assets reported by the enterprise in its statement of financial position, including the carrying amounts of such assets
- c. The nature of, and changes in, the risks associated with the enterprise's involvement with the variable interest entity
- d. The current and potential financial effects of an enterprise's involvement with a variable interest entity on the enterprise's financial position, financial performance, and cash flows.

B38. The Board decided to enhance the aggregation principle in the proposed amendments to the disclosure requirements of Interpretation 46(R), as amended by this proposed Statement. The Board concluded that the current aggregation guidance was not adequate and noted that in some cases the application of the aggregation principle in Interpretation 46(R) did not result in meaningful information. Further, the Board concluded that disclosures for variable interest entities that either are consolidated or not consolidated should be separately reported.

B39. The Board noted that there was diversity in practice in the way an enterprise determined whether a variable interest was significant, which would affect which disclosures were provided for an off-balance-sheet variable interest entity. Accordingly, the Board decided to clarify that the disclosures required for a significant variable interest in a variable interest entity should be provided (a) when the variable interest is significant to the variable interest entity or (b) when the variable interest is significant to the enterprise.

B40. The Board also decided to require a sponsor that holds a variable interest to disclose the same information required for an enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary. The Board included this requirement based on observed situations in which sponsors have (a) provided financial support to variable interest entities that they did not previously consolidate or (b)

provided disclosures to allow financial statement users to understand their involvement with those variable interest entities. In addition, the Board concluded that certain disclosures should be required for all enterprises that have a variable interest in a variable interest entity.

B41. In addition to the specific amendments to the disclosure requirements in Interpretation 46(R), the Board also considered the effect of deleting the exception from the consolidation guidance for qualifying special-purpose entities in Statement 140 and Interpretation 46(R). The Board noted that this proposed amendment would result in additional disclosures if the variable interest entity involves transferred financial assets under Statement 140. Accordingly, the Board considered the disclosure enhancements made to Statement 140 and included some of those disclosures in both proposed Statements.

Effective Date and Transition

B42. The Board concluded that the requirements of this proposed Statement should be effective as soon as reasonably possible for the following reasons:

- a. There is an urgent need to improve transparency related to many variable interest entities that are not recognized in an enterprise's financial statements.
- b. There is significant diversity in practice in the application of key provisions of Interpretation 46(R) and the financial reporting results of that application.
- c. There are user concerns about the insufficiency of information being provided by enterprises relating to their involvement in variable interest entities, as well as the extent and timeliness of information being provided through disclosures.

The Board decided that it is important to provide the same effective date for this proposed Statement and the proposed FASB Statement on accounting for transfers of financial assets because many transactions would be affected by both proposed Statements.

B43. The Board considered three approaches to the effective dates:

- a. A single effective date that would require Interpretation 46(R), as amended by this proposed Statement, to be applied in fiscal years beginning after November 15, 2009
- b. A dual effective date that would require Interpretation 46(R), as amended by this proposed Statement, to be applied in fiscal years beginning after November 15, 2008, for all interests in entities, but that would delay evaluation of existing qualifying special-purpose entities for consolidation until fiscal years beginning after November 15, 2009
- c. A dual effective date that would require Interpretation 46(R), as amended by this proposed Statement, to be applied in fiscal years beginning after November 15, 2008, for all interests in entities, but that would delay evaluation of existing qualifying special-purpose entities and variable interest

entities for consolidation until fiscal years beginning after November 15, 2009.

B44. The Board recognizes that with the removal of the qualifying special-purpose entity and the guidance in this proposed Statement, more entities may be required to be consolidated; thus, regulatory agencies would be required to analyze these changes to determine whether a change to regulatory capital guidelines is necessary. Further, the Board acknowledges that preparers with involvement in numerous variable interest entities would be required to gather significant amounts of data that must be analyzed to initially apply the proposed amendments to Interpretation 46(R) in this proposed Statement for entities, including those previously exempt from the consolidation guidance in Interpretation 46(R) (qualifying special-purpose entities). However, the Board believes that enterprises that previously applied Interpretation 46(R) already should have much of the data necessary to apply the proposed amendments in this proposed Statement for variable interest entities that are not qualifying special-purpose entities, in part because enterprises need such data to ensure that they are appropriately accounting for their particular variable interest or interests.

B45. Notwithstanding the goal to develop and finalize guidance as soon as reasonably possible, the Board decided that the guidance in this proposed Statement should be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009, with earlier application prohibited. The Board consulted with several financial statement users to determine whether such a delay of the effective date for eliminating the qualifying special-purpose entity concept and providing implementation guidance would be troublesome and not responsive to investor needs. The majority of users asserted that a single effective date would provide for a more rational and understandable implementation and would not result in dual accounting models for similar entities and transactions. A few investors that consulted with the Board suggested that the Board eliminate the concept of qualifying special-purpose entities for fiscal years beginning after November 15, 2008, and require such entities to comply with the guidance in this proposed Statement.

B46. The Board also reasoned that an effective date for fiscal periods beginning after November 15, 2009, provides sufficient time for preparers and regulators to review the capital adequacy of regulated financial institutions along with providing preparers with ample time to renegotiate items such as debt covenants, if necessary. Further, the Board concluded that this effective date would allow preparers adequate time to gather the data necessary to apply this proposed Statement and to properly analyze the effects of the proposed amended guidance on financial reporting.

B47. The Board decided to first issue an FSP that would amend and enhance the disclosures required by Statement 140 and Interpretation 46(R) until this proposed Statement becomes effective. The purpose of a disclosure-only FSP is to expeditiously meet financial statement user needs for greater transparency of off-balance-sheet transactions as well as to provide preparers and others with adequate time to consider and implement the other proposed amendments to Statement 140 and Interpretation 46(R).

Similarities and Differences with International Accounting Standards

B48. The IASB is currently reconsidering its consolidation guidance as a separate project that is a broader reconsideration of all consolidation guidance (not just guidance for variable interest entities). The IASB's current consolidation guidance is provided under both IAS 27, *Consolidated and Separate Financial Statements*, and SIC 12. Although this proposed Statement is not being conducted as a joint project with the IASB, both organizations are communicating issues and deliberations to understand the direction that each project is taking. The ultimate goal is for both projects to provide timely, transparent information about interests in other entities; however, the timeline of the IASB project is different from the timeline for this project. In this project, the FASB is attempting to improve financial reporting by enterprises involved with variable interest entities in an expeditious manner. The March 2008 *Policy Statement on Financial Market Developments* from the President's Working Group on Financial Markets suggested that the FASB evaluate the role of accounting standards in the current market turmoil, including assessing the need for further modifications to accounting standards related to consolidation, to improve the transparency and operation of U.S. GAAP in the short term. Additionally, the Policy Statement encouraged the FASB to work to achieve convergence in this area; however, that is a broader project that will require a longer timeframe to complete. Because the project to amend Statement 140 eliminates the qualifying special-purpose entity concept, the Board decided that the timing of this project and the Statement 140 project should be the same. The Board will consider convergence of Interpretation 46(R) and IAS 27 as part of its broader effort to adopt International Financial Reporting Standards in the future.

Benefits and Costs

B49. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Current and potential investors, creditors, donors, and other users of financial information benefit from the improvements in financial reporting, while the costs to implement a new standard are borne primarily by current investors. The Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements.

B50. The Board's assessment of this proposed Statement's benefits and costs is based on discussions with preparers, auditors, regulators, users of financial statements, and a review of published studies and other information related to Interpretation 46(R). After considering the incremental costs of (a) continuous reconsideration of whether an entity is a variable interest entity, (b) the proposed amendments to the approach for determining which enterprise, if any, with a variable interest in a variable interest entity is the primary beneficiary, and (c) the incremental disclosure requirements, the Board concluded that

these costs do not outweigh the potential significant benefits of improved information about variable interest entities.

B51. The Board recognizes that this proposed Statement may require significant effort for many entities to gather the necessary data for conformance, and that the review and audit procedures to ensure compliance with the proposed amendments to Interpretation 46(R) may require additional effort. Notwithstanding those additional costs, the Board developed the proposed amendments to Interpretation 46(R) to provide users of financial statements with pertinent information about an enterprise's involvement with a variable interest entity or entities. Specifically, the proposed amendments are expected to better reflect the power and responsibility that may be associated with the enterprise's variable interest or interests along with the enterprise's right to benefits or the obligation to absorb actual losses of the entity. The proposed disclosures are expected to enhance, among other things, a user's ability to understand and assess an enterprise's critical judgments in determining (a) if it is the primary beneficiary and (b) the risks that it is exposed to through its interest or interests in the entity.

B52. The Board acknowledges that this proposed Statement would require significant costs and time to gather and update information. However, the Board believes that many enterprises already have the information necessary to perform these analyses. Further, the Board believes that the time allotted for transition is sufficient to comply with the guidance in this proposed Statement. The Board intends to hold a public roundtable meeting that will allow constituents to further elaborate on the costs and efforts needed to properly implement the requirements of this proposed Statement.

B53. To avoid consolidating certain entities that were not previously consolidated under Interpretation 46(R), entities may incur costs to restructure existing entities, contracts, and agreements. It is not possible to estimate these costs, in part because they are elective and some entities may choose not to restructure existing arrangements. The Board expects that any restructuring of existing entities, contracts, or agreements to avoid consolidating entities under this proposed Statement would be done in a substantive manner that truly changes the enterprise's power and/or rights to receive benefits or obligations to absorb losses.

Appendix C

AMENDMENTS TO EXISTING FASB PRONOUNCEMENTS

C1. FASB Staff Position FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 16:

An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved ~~and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R)~~ beginning the first day of the first reporting period beginning after June 15, 2006, or upon adoption of FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

b. Paragraph A1:

The following example fact patterns and related evaluations are provided solely to illustrate the application of the guidance in this FSP. All the entities in the following examples are presumed to be VIEs. All variable interests are presumed to be variable interests in the VIE (as a whole) rather than variable interests in specified assets of the VIE, based on the guidance in paragraphs 12 and 13 of Interpretation 46(R). ~~A primary beneficiary has not been identified in the following examples because the determination of the primary beneficiary may require a quantitative analysis and extends beyond illustrating the application of the guidance in this FSP.~~ The determination of the primary beneficiary requires professional judgment, is based on individual facts and circumstances of the VIE and the enterprise, and may require a quantitative analysis if an enterprise cannot determine whether it meets both criteria in paragraph 14A of Interpretation 46(R), as amended by Statement 16X.

Appendix D

AMENDMENTS TO OTHER AUTHORITATIVE LITERATURE

D1. This appendix addresses the effect of this Statement on authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy discussed in FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*.

D2. EITF Issue No. 84-4, “Acquisition, Development, and Construction Loans,” is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

- a. The ninth paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which may include structures used to facilitate ADC loans. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D3. EITF Issue No. 84-15, “Grantor Trusts Consolidation,” is amended as follows:

- a. The third paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include grantor trusts if they meet certain conditions. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of

Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D4. EITF Issue No. 86-21, "Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property," is amended as follows:

- a. The eighth paragraph of the STATUS section:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include corporations that are thinly capitalized or in which shareholders lack certain rights and obligations traditionally associated with corporate shareholders. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14-14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D5. EITF Issue No. 88-22, "Securitization of Credit Card and Other Receivable Portfolios," is amended as follows:

- a. The eighth paragraph of the STATUS section:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many trusts that are not qualifying special purpose entities under Statement 140. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity, will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

- b. The following paragraph is added as the twelfth paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D6. EITF Issue No. 88-25, “Ongoing Accounting and Reporting for a Newly Created Liquidating Bank,” is amended as follows:

- a. The third paragraph of the STATUS section:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include corporations that are thinly capitalized or in which shareholders lack certain rights and obligations traditionally associated with corporate shareholders. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity, will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting

entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D7. EITF Issue No. 89-20, "Accounting for Cross Border Tax Benefit Leases," is amended as follows:

- a. The second paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in leasing transactions. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. ~~will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D8. EITF Issue No. 91-10, "Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs)," is amended as follows:

- a. The second paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which may include many special-purpose entities of the type used as TIFEs. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. ~~will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~ Interpretation 46(R), as amended by Statement 16X,

does not require an enterprise to consolidate a governmental organization and generally does not require an enterprise to consolidate a financing entity established by a governmental organization.

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D9. EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects," is amended as follows:

- a. The second paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which may include some limited partnerships. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest in a variable interest entity. Paragraphs 14-14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest. ~~will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D10. EITF Issue No. 95-6, "Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation," is amended as follows:

- a. The following paragraph is added as the fifth paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D11. 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," is amended as follows:

- a. The following paragraph is added as the sixth paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D12. EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," is amended as follows:

- a. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D13. EITF Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities," is amended as follows:

- a. The following paragraph is added as the second-to-last paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D14. EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements," is amended as follows:

- a. The following paragraph is added as the seventh paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D15. EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction," is amended as follows:

- a. The second paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many of the entities used in leasing arrangements of the type discussed in this Issue. ~~Interpretation 46 and~~ Interpretation 46(R) requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14-14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. ~~will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the sixth paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D16. EITF Issue No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested," is amended as follows:

- a. The second paragraph of the STATUS section:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many types of trusts. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14-14C of Interpretation 46(R), as

~~amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the sixth paragraph of the STATUS section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D17. EITF Issue No. 98-2, "Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner," is amended as follows:

- a. Paragraph 12:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose corporations and joint ventures. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. Paragraph 15A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D18. EITF Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," is amended as follows:

a. Paragraph 11:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include some corporations that may have been accounted for by investors under the equity method. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

b. Paragraph 14A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D19. EITF Issue No. 99-13, “Application of Issue No. 97-10 and FASB Interpretation No. 23 to Entities That Enter into Leases with Governmental Entities,” is amended as follows:

a. Paragraph 8:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in leasing transactions. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity. will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~ Interpretation 46(R), as amended by Statement 16X, does not require an enterprise to consolidate a governmental organization and generally does not require an enterprise to consolidate a financing entity established by a governmental organization.

- b. Paragraph 11A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D20. EITF Issue No. 99-16, "Accounting for Transactions with Elements of Research and Development Arrangements," is amended as follows:

- a. Paragraph 8:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in research and development arrangements. ~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest in a variable interest entity. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest. ~~will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. Paragraph 11A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D21. EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," is amended as follows:

- a. Paragraph 21:

[Paragraph 21 includes amendments that are proposed in the proposed Statement on amendments to Statement 140.]

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in securitization transactions if they are not qualifying special-purpose entities. Interpretation

~~46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

- b. Paragraph 24A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D22. EITF Issue No. 00-4, “Majority Owner’s Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary,” is amended as follows:

- a. Paragraph 11:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include corporations that are thinly capitalized or in which shareholders lack certain rights and obligations traditionally associated with corporate shareholders. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

- b. Paragraph 14A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D23. EITF Issue No. 00-6, “Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary,” is amended as follows:

a. Paragraph 14:

~~Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include corporations that are thinly capitalized or in which shareholders lack certain rights and obligations traditionally associated with corporate shareholders. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest in a variable interest entity. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest.~~ Interpretation 46(R), as amended by Statement 16X, addresses consolidation by business enterprises of variable interest entities, which include corporations that are thinly capitalized or in which shareholders lack certain rights and obligations traditionally associated with corporate shareholders. Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest in a variable interest entity. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest. ~~will absorb a majority of the entity’s expected losses or is entitled to receive a majority of the entity’s expected residual returns or both.~~

b. Paragraph 17A is added as follows:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity’s first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D24. EITF Topic No. D-66, “Effect of a Special-Purpose Entity’s Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125,” is amended as follows:

a. The seventh paragraph of the Subsequent Developments section:

~~FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as amended by FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities. Interpretation 46 and Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity.~~ FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as amended by FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities. Interpretation 46(R), as amended by Statement 16X, requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of Interpretation 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity.

~~absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.~~

- b. The following paragraph is added as the last paragraph of the Subsequent Developments section:

Statement 16X was issued in month/year and amends Interpretation 46(R). Statement 16X shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 16X, addresses consolidation of variable interest entities.

D25. AICPA Audit and Accounting Guide, *Agricultural Producers and Agricultural Cooperatives*, is amended as follows:

- a. Paragraph 12.28:

FIN 46R, as amended by FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*, changes prior practices by requiring a company to consolidate a VIE if that company has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of FIN 46R, as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity, either is subject to a majority of the risk of loss from the VIE's activities or is entitled to receive a majority of the VIE's residual returns, or both.⁴

D26. AICPA Audit and Accounting Guide, *Construction Contractors*, is amended as follows:

- a. Paragraph 3.18:

In December 1971 the staff of the American Institute of Certified Public Accountants issued an accounting interpretation of APB Opinion No. 18 that concludes that many of the provisions of APB Opinion No. 18 are usually appropriate in accounting for investments in certain unincorporated entities. The principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that a condition that would usually indicate control of a general partnership is ownership of a majority (over 50 percent) of the financial interests in profits or losses. The power to control a general partnership may also exist with a lesser percentage of ownership, for example, by contract, by agreement with other partners, or by court decree. Under FASB Interpretation No. 46(R), as amended by FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*, a company is required to consolidate a VIE if that company has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of FASB Interpretation No. 46(R), as amended by Statement 16X, provide guidance

~~on determining whether an enterprise has a controlling financial interest in a variable interest entity is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both.~~ On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners. A controlling investor in a general partnership should account for the investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should be guided by the provisions of APB Opinion No. 18.

D27. AICPA Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Saving Institutions, Credit Unions, Finance Companies and Mortgage Companies*, is amended as follows:

- a. Paragraph 7.81 and its related footnotes:

[Paragraph 7.81 includes amendments that are proposed in the proposed Statement on amendments to Statement 140.]

FIN No. 46(R),^{12 13} ~~as amended by FASB Statement No. 16X, *Amendments to FASB Interpretation No. 46(R)*, clarified the application of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. FIN No. 46(R), as amended by Statement 16X, may impact financial institutions by adding assets and debt back onto the balance sheet, increasing capital levels. VIEs may appear in various forms, such as TPSs, synthetic leases, asset-backed commercial paper conduits, and collateralized debt obligations. ~~FIN No. 46(R) does not apply to the transferor of a qualified SPE covered by paragraph 35 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or to grandfathered special purpose entities. ABSs or MBSs that were transferred to a qualifying SPE are exempt from FIN No. 46(R) unless the holder of the security has the unilateral ability to cause the entity to liquidate or to change the entity such that it no longer meets the criteria of paragraph 25 or 35 of FASB Statement No. 140.~~~~

¹²Application of FIN No. 46(R) is required for public entities that have interests in entities that are commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* was required at various dates in 2004 and 2005.

¹³The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities.*"
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities.*"
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities.*"
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs are applied in accordance with the effective date and transition provisions of FIN 46(R). FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FIN 46-2, FIN 46-5, and FIN 46-8, respectively.

5. FSP FIN 46(R)-5, "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 previously unrelated parties.*) For entities to which Interpretation 46(R) has been applied, the guidance in this FSP 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) was permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) had not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).
6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities.*" Effective for all arrangements to which FIN 46 has been or will be applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change should be reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).
7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)." An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved ~~and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FIN 46(R)~~ beginning the first day of the first reporting period beginning after June 15, 2006.
8. FSP FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies." This staff position addresses the application of FIN 46(R) by an entity that accounts for its investments in accordance with the specialized accounting in the AICPA Accounting and Auditing Guide, *Investment Companies*.

D28. AICPA Audit and Accounting Guide, *Health Care Organizations*, is amended as follows:

a. Paragraph 11.14:

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as amended by FASB Statement No. 16X, Amendments to FASB Interpretation No. 46(R), clarifies the application of ARB No. 51 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. An entity subject to consolidation according to the provisions of FASB Interpretation No. 46(R) is referred to in that interpretation as a variable interest entity. An entity shall be subject to consolidation according to the provisions of FASB Interpretation No. 46(R) if, by design, the conditions in paragraph 5 of that interpretation exist. Paragraphs 14–14C of FASB Interpretation No. 46(R) provides guidance for consolidation based on variable interests. FASB Interpretation No. 46(R) also requires certain disclosures. Not-for-profit organizations are not subject to FASB Interpretation No. 46(R), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that interpretation. Also, 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 FASB Interpretation No. 46(R), as amended by Statement 16X, that not-for-profit entity is subject to that interpretation.

D29. AICPA Audit and Accounting Guide, *Investment Companies*, is amended as follows:

a. Paragraph 5.07:

In 2003, the Financial Accounting Standards Board (FASB) issued FASB ~~Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, and Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*~~, which replaced FIN 46. Until the issuance of FIN 46, investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. FIN 46 and FIN 46(R), as amended by FASB Statement No. 16X, Amendments to FASB Interpretation No. 46(R), changed the model for determining when to consolidate a variable interest entity (VIE) controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of FIN 46(R), as amended by Statement 16X, provide

~~guidance on determining whether an enterprise has a controlling financial interest in a VIE is subject to a majority of the risk of loss from the VIE's activities or is entitled to receive a majority of the entity's residual returns, or both. Those interpretations FIN 46(R) also requires disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company.~~

b. Paragraph 7.06 and its related footnotes:

~~In 2003, FASB issued FASB Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*,* and FIN FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, which replaced FIN 46. FIN 46(R), as amended by Statement 16X, requires a variable interest entity (VIE) to be consolidated when the investment company has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. Paragraphs 14–14C of FIN 46(R), as amended by Statement 16X, provide guidance on determining whether an enterprise has a controlling financial interest in a variable interest entity is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. Those interpretations FIN 46(R) also requires disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company.¹⁵~~

~~* In December 2007, Financial Accounting Standards Board (FASB) issued FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*. The objective of FASB Statement No. 160 is to improve comparability and transparency of consolidated financial statements by establishing, accounting and reporting standards that require:~~

- ~~1. Reporting of ownership interest in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated balance sheet within equity but separate from the parent's equity.~~
- ~~2. Consolidated net income should clearly identify the portion of income attributable to the parent and the noncontrolling interest on the face of the income statement.~~
- ~~3. Changes in ownership interest should be accounted for consistently.~~
- ~~4. When a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary should be measured at fair value.~~
- ~~5. Provision of all appropriate disclosures to distinguish between interest of the parent and the interests of the noncontrolling owners.~~

~~FASB Statement No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year ends). Early adoption is prohibited. FASB Statement No. 160 should be applied prospectively as of the beginning of the fiscal year in which the statement is initially adopted. Presentation and disclosure requirements shall be applied retrospectively for all periods presented.~~

¹⁵Paragraph 36 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, states that the effective date for applying the provisions of FASB Interpretation No. 46 or FASB Interpretation No. 46(R) is deferred for investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1) but are currently accounting for their investments in accordance with the specialized accounting guidance in this guide until the date that the investment company initially adopts AICPA Statement of Position SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. AICPA, *Technical Practice Aids*, ACC sec. 10,930). ~~The effective date of SOP 07-1 has been deferred indefinitely by FASB Staff Position 07-1-1, *Effective Date of AICPA Statement of Position 07-1*. FASB recently issued FASB, Staff Position (FSP) SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, which delays the effective date of SOP 07-1. FSP SOP 07-1-1 also prohibits an entity from early adopting the SOP 07-1 unless it had done so before issuance of the final FSP. The FSP is effective beginning December 15, 2007. Readers are advised to monitor the FASB Web site for updates. FASB staff also completed FSP FIN 46(R) 7, *Application of FASB Interpretation No. 46(R) to Investment Companies*. This FSP amends FIN 46(R) by providing an exception to the scope of the interpretation for companies within the scope of this guide. However, FSP FIN 46(R) 7 remains effective only upon initial adoption of SOP 07-1.~~

c. Paragraph 12.01:

Paragraphs 7.04–.05 of this guide provide that consolidation or use of the equity method of accounting by an investment company of a noninvestment company investee is not appropriate, except for an investment in an operating company that provides services to the investment company. In contrast, Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires consolidation of all majority-owned subsidiaries unless control does not rest with the majority owner. FASB Statement No. 94’s application to investment companies is unclear. Although investment companies are not specifically excluded from the scope of FASB Statement No. 94, FASB Statement No. 94 acknowledges in paragraph 53 the existence of specialized industry practices for investment companies. In discussing the board’s decision to remove an exposure draft requirement to use the cost method for majority-owned subsidiaries that remain unconsolidated, it states:

. . . respondents said that the requirement would change practice because “significant influence” might remain even if control were lost and *because of specialized industry practices for investment companies*. The Board removed the requirement to use only the cost method, thereby leaving existing pronouncements in effect. The method to be used to account for those subsidiaries will be considered in the broad project described in paragraphs 19 and 20 [a project on the reporting entity, including consolidations and the equity method]. [emphasis added]

The guidance in paragraphs 7.04–.05 of this guide is consistent with long-standing industry practice. That practice results in investment company financial statements that focus on a net asset value that reflects the fair value of the underlying investments. The purpose and nature of investment companies makes fair value for their investments the most relevant measure to report to their investors, the principal users of their financial statements who typically evaluate the performance of the investment company based on changes in net asset value. Exchanges of open-end investment company shares are at, or based on, net asset value. Purchasers and sellers of other investment company (for example, closed-end investment companies) shares often consider the premium or discount based on net asset value that is present in the exchange price. Regulation S-X, rule 6-03(c)(1) also precludes consolidation by a registered investment company of any entity other than another investment company. Similarly, Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, does not apply to “investments in common stock held by investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly.” As discussed in paragraph 7.06, in 2003, FASB issued FASB Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities*, and FIN 46 (revised December 2003), *Consolidation of Variable Interest Entities*, an interpretations of ARB No. 51. Until the issuance of FIN 46(R), investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. ~~FIN 46 and~~ FIN 46(R), as amended by Statement 16X, which replaced FIN 46, changes the model for determining when to consolidate a variable interest entity (VIE) controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest. ~~is subject to a majority of the risk of loss from the VIE’s activities or entitled to receive a majority of the entity’s residual returns or both. These interpretations~~ FIN 46(R) also requires disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company. Paragraph 36 of FIN 46(R), states that the effective date for applying the ~~provisions of FIN 46 or the revised Interpretation~~ is deferred for investment companies that are not subject to Securities and Exchange Commission (SEC) Regulation S-X, Rule 6-03(c)(1) but are currently accounting for their investments in accordance with the specialized accounting guidance in this guide until the date that the investment company initially adopts AICPA Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and*

Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies (AICPA, *Technical Practice Aids*, ACC sec. 10,930). An enterprise that is required to discontinue application of the specialized accounting in the guide as a result of adoption of SOP 07-1 is subject to the provisions of the interpretation at that time. (See footnote * to the title to chapter 1 in this guide for further discussion about the proposed SOP.) SOP 07-1 nullifies the guidance in Emerging Issues Task Force Issue No. 85-12, “Retention of Specialized Accounting for Investments in Consolidation,” but only as it applies to investment companies. FASB recently issued FASB Staff Position (FSP) SOP 07-1-1, *Effective Date of AICPA Statement of Position SOP 07-1*, which delays the effective date of SOP 07-1. FSP SOP 07-1-1 amends paragraph 56 of SOP 07-1 to (1) to delay the effective date of the SOP and (2) prohibit adoption of the SOP for an entity that has not early adopted the SOP before issuance of the final FSP. An entity that early adopts SOP 07-1 before issuance of the final FSP would be permitted but not required to continue to apply the provisions of the SOP. An entity that did not early adopt SOP 07-1 would not be permitted to adopt the SOP. The effective date of FSP SOP 07-1-1 is December 15, 2007.

Appendix E

INTERPRETATION 46(R) MARKED TO SHOW CHANGES THAT WOULD BE MADE BY THIS PROPOSED STATEMENT

E1. This proposed Statement would amend FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. This appendix contains the following sections of Interpretation 46(R), as amended, marked to integrate changes from this proposed Statement: Introduction, Interpretation, Disclosure, and Appendix B: Variable Interests. This appendix does not contain a separate summary or the other appendixes within Interpretation 46(R).

E2. If this proposed Statement is adopted as exposed, Interpretation 46(R) would read as follows: [Added text is underlined and deleted text is ~~struck out~~.]

INTRODUCTION

1. This Interpretation, which replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors ~~do not have the characteristics of a controlling financial interest or~~ do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support or lack any one of the following three characteristics:

- a. The direct or indirect ability through voting rights or similar rights to make decisions about the entity's activities that have a significant effect on the success of the entity
- b. The obligation to absorb the expected losses of the entity
- c. The right to receive the expected residual returns of the entity.

Paragraph 1 of ARB 51 states that consolidated financial statements are “usually necessary for a fair presentation when one of the ~~companies~~ entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.” Paragraph 2 states that “the usual condition for a controlling financial interest is ownership of a majority voting interest. . . .” However, application of the majority voting interest requirement in ARB 51 to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests.

1A. The enterprise with a variable interest or interests that provide the enterprise with a controlling financial interest in a variable interest entity will have both of the following characteristics:

- a. The power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity's economic performance; and
- b. The right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity.

Determining whether an enterprise has a controlling financial interest based on the above characteristics typically will be achieved through a qualitative analysis of the enterprise's interest or interests and the characteristics of the variable interest entity, including the involvement of other variable interest holders. However, if an enterprise cannot determine whether it meets both of the criteria in paragraph 14A, the enterprise is then required to perform a quantitative analysis to determine whether it has the obligation to absorb the majority of a variable interest entity's expected losses, the right to receive a majority of its expected residual returns, or both. However, if an enterprise determines that power is, in fact, shared among multiple parties such that no one party meets the criteria of paragraph 14A, the enterprise is not the primary beneficiary.

INTERPRETATION

Definition of Terms

2. Certain terms are defined for use in this Interpretation as follows:
 - a. *Variable interest entity* refers to an entity subject to consolidation according to the provisions of this Interpretation.
 - b. *Expected losses* and *expected residual returns* refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. Paragraph 8 specifies which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity. *Expected variability* is the sum of the absolute values of the expected residual return and the expected loss. All three concepts are illustrated in Appendix A.
 - c. *Variable interests* in a variable interest entity are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the entity is a variable interest entity and to the extent that the investment is at risk as described in paragraph 5. 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 may affect the determination of the primary beneficiary of a variable interest entity.

- d. *Primary beneficiary* refers to an enterprise that consolidates a variable interest entity under the provisions of this Interpretation.
- e. *Subordinated financial support* refers to variable interests that will absorb some or all of an entity's expected losses.

Use of the Term *Entity*

3. For convenience, this Interpretation uses the term *entity* to refer to any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. Portions of entities or aggregations of assets within an entity shall not be treated as separate entities for purposes of applying this Interpretation unless the entire entity is a variable interest entity. Some examples are divisions, departments, branches, and pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity. Majority-owned subsidiaries are entities separate from their parents that are subject to this Interpretation and may be variable interest entities.

Scope

4. This Interpretation clarifies the application of ARB 51 and replaces Interpretation 46. 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*, 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. [Deleted by the proposed FASB Statement, *Accounting by Transfers of Financial Assets*]
- d. [Deleted by the proposed FASB Statement, *Accounting for Transfers of Financial Assets*]
- e. Investments accounted for at fair value in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, *Investment*

Companies, are not subject to consolidation according to the requirements of this Interpretation.^a

- 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 December 31, 2003, is not required to apply this Interpretation to that entity if the enterprise, after making an exhaustive effort, is unable to obtain the information¹ 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 necessary information. Paragraph 26 requires certain disclosures to be made about interests in entities subject to this provision. Paragraph 41 provides transition guidance for an enterprise that subsequently obtains the information necessary to apply this Interpretation to an entity subject to this exception.
- h. An entity that is deemed to be a business under the definition in FASB Statement No. 141 (revised 2007), *Business Combinations*, need not be evaluated by a reporting enterprise to determine if the entity is a variable interest entity under the requirements of this Interpretation unless one or more of the following conditions exist (however, for entities that are excluded by this provision of this Interpretation, other generally accepted accounting principles should be applied):²
 - (1) The reporting enterprise, its related parties,³ or both participated significantly in the design or redesign of the entity. However, this condition does not apply if the entity is an operating joint venture

^aAICPA Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, discusses the circumstances in which the specialized accounting in the Audit Guide shall not be retained by a noninvestment company parent or equity method investor of an investment company. In those cases, Interpretation 46(R) applies to the investments held by the investment company subsidiary or equity method investee for the purposes of the parent or equity method investor's financial statements. The effective date of SOP 07-1 has been deferred indefinitely by FASB Staff Position SOP 07-1, Effective Date of AICPA Statement of Position 07-1.

¹This inability to obtain the necessary information is expected to be infrequent, especially if the enterprise participated significantly in the design or redesign of the entity.

²~~An entity that previously was not evaluated to determine if it was a variable interest entity because of this provision need not be evaluated in future periods as long as the entity continues to meet the conditions in this paragraph.~~ The determination of whether the conditions in this paragraph exist shall be evaluated based on the current facts and circumstances of the entity.

³The term *related parties* as used in this list of conditions refers to all parties identified in paragraph 16, except for de facto agents under item 16(d)(1).

under joint control of the reporting enterprise and one or more independent parties or a franchisee.⁴

- (2) The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise and its related parties.
 - (3) The reporting enterprise and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the entity based on an analysis of the fair values of the interests in the entity.
 - (4) The activities of the entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.
- i. An enterprise shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity (1) is not a governmental organization and (2) is used by the business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation.

Variable Interest Entities

5. An entity shall be subject to consolidation during a reporting period (not limited to the end of a reporting period) according to the provisions of this Interpretation if, by design,⁵ or as a result of changes in facts and circumstances, the conditions in *a, b, or c* exist:

- a. The total equity investment⁶ 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. 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

⁴The term *franchisee* is defined in paragraph 26 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

⁵The phrase *by design* refers to entities that meet the conditions in this 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.~~

⁶Equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements.

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 9 and 10 discuss the amount of the total equity investment at risk that is necessary to permit an entity to finance its activities without additional subordinated financial support.

- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics⁷ ~~of a controlling financial interest~~:
 - (1) The direct or indirect ability through voting rights or similar rights to make decisions about an entity's activities that have a significant effect on the success of the entity. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).⁸
 - (2) The obligation to absorb the expected losses of the entity.⁹ 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. 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 the entity.¹⁰
- 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

⁷~~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 in criteria b(1)–b(3) of this paragraph a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the necessary characteristics in criteria b(1)–b(3) of this paragraph, the entity is a variable interest entity.~~

⁸Enterprises 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.

⁹Refer to paragraphs 8 and 12 and Appendix A for discussion of expected losses.

¹⁰For 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 in those instruments are exercised, the holders will become additional equity investors.

disproportionately few voting rights.¹¹ 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 to its equity investment at risk.

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 or receive portions of the entity's expected residual returns 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 involved¹² 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) did not participate significantly in the design or redesign of the entity. An enterprise has a significant variable interest if the interest is significant to either the variable interest entity or to the enterprise.

~~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 if one or more of the following occur:~~

- ~~a. The entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.~~
- ~~b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity.~~
- ~~c. The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.~~
- ~~d. The entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses.~~

~~A troubled debt restructuring, as defined in paragraph 2 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended, shall be accounted for in accordance with that Statement and is not an event that requires the reconsideration of whether the entity involved is a variable interest entity.~~

¹¹This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with nonsubstantive voting interests. 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).

¹²For purposes of this Interpretation, *involvement with an entity* refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests.

Expected Losses and Expected Residual Returns

8. A variable interest entity's expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests. A variable interest entity's expected residual returns are the expected positive variability in the fair value of its net assets exclusive of variable interests. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the entity.

9. An equity investment at risk of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including but not limited to the qualitative assessments described in paragraphs 9(a) and 9(b), will in some cases be conclusive in determining that the entity's equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the entity's equity at risk cannot be reached based solely on qualitative considerations, the quantitative analyses implied by paragraph 9(c) should be made. In instances in which neither a qualitative assessment nor a quantitative assessment, taken alone, is conclusive, the determination of whether the equity at risk is sufficient shall be based on a combination of qualitative and quantitative analyses.

- a. The entity has demonstrated that it can finance its activities without additional subordinated financial support.
- b. The entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.
- c. The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.

10. Some entities may require an equity investment at risk greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the entities' assets or liabilities. The presumption in paragraph 9 does not relieve an enterprise of its responsibility to determine whether a particular entity with which the enterprise is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

Development Stage Enterprises

~~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 stage¹³ is very important. A development stage entity¹³ is a variable interest entity if it meets one of the conditions in paragraph 5. A development stage entity does not meet the condition 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.~~

Variable Interests and Interests in Specified Assets of a Variable Interest Entity

12. A variable interest in specified assets of a variable interest entity (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets or if the holder has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).¹⁴ The expected losses and expected residual returns applicable to variable interests in specified assets of a variable interest entity shall be deemed to be expected losses and expected residual returns of the entity only if that variable interest is deemed to be a variable interest in the entity. Expected losses related to variable interests in specified assets are not considered part of the expected losses of the entity for purposes of determining the adequacy of the equity at risk in the entity or for identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the entity. For example, expected losses absorbed by a guarantor of the residual value of leased property are not considered expected losses of a variable interest entity if the fair value of the leased property is not a majority of the fair value of the entity's total assets.

13. An enterprise with a variable interest in specified assets of a variable interest entity shall treat a portion of the entity as a separate variable interest entity if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests.¹⁵ That requirement does not apply unless the entity has been determined to be a variable interest entity. If one enterprise is required to consolidate a discrete portion of a variable interest entity, other variable

¹³Guidelines for identifying a development stage enterprise appear in paragraphs 8 and 9 of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*.

¹⁴This exception is necessary to prevent an enterprise that would otherwise be the primary beneficiary of a variable interest entity from circumventing the requirement for consolidation simply by arranging for other parties with interests in certain assets to hold small or inconsequential interests in the entity as a whole.

¹⁵The portions of a variable interest entity referred to in this paragraph have sometimes been called silos.

interest holders shall not consider that portion to be part of the larger variable interest entity.

Consolidation Based on Variable Interests

14. An enterprise shall consolidate a variable interest entity during a reporting period (not limited to the end of a reporting period) if that enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest based on the provisions in paragraphs 14A–14C. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. Only one enterprise, if any, is expected to be identified as the primary beneficiary of a variable interest entity. ~~will absorb a majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, 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. 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.~~

Step 1—Qualitative Analysis

14A. An enterprise with a variable interest in a variable interest entity shall qualitatively assess whether the enterprise has a controlling financial interest in the entity and, thus, is the entity’s primary beneficiary. This qualitative assessment shall include an assessment of the characteristics of the enterprise’s variable interest or interests and other involvement (including those of related parties and de facto agents),^{15a} if any, in the variable interest entity, as well as the involvement of other variable interest holders. Additionally, the qualitative assessment shall consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders. An enterprise shall be deemed to have a controlling financial interest in a variable interest entity if it has both of the following characteristics:

- a. The power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity’s economic performance. An enterprise’s determination of whether it has the power to direct matters shall not be affected by the existence of substantive kick-out rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such substantive kick-out rights.^{15b} A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise substantive kick-

^{15a}See paragraph 16 for guidance on related parties and de facto agents.

^{15b}The requirement to generally exclude consideration of substantive kick-out rights is limited to this particular analysis and is not applicable to other areas within Interpretation 46(R) or transactions accounted for under other interpretative guidance.

out rights may be the party with the power to direct matters that most significantly impact the activities of the entity; and

- b. The right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity. For purposes of applying this criterion, determining benefits and losses shall not be performed using the quantitative analysis prescribed in Step 2 (paragraph 14C). This criterion includes an enterprise's implicit or explicit financial responsibility to ensure that a variable interest entity operates as designed.

14B. An enterprise that meets both of the criteria in paragraph 14A is the primary beneficiary of the variable interest entity. The qualitative assessment required by paragraph 14A should enable an enterprise to determine whether it is the primary beneficiary of a variable interest entity. If an enterprise cannot determine whether it meets both of the criteria in paragraph 14A, the enterprise shall then perform the quantitative analysis pursuant to Step 2 below. However, if an enterprise determines that power is, in fact, shared among multiple parties such that no one party meets the criteria of paragraph 14A, the enterprise is not the primary beneficiary.

Step 2 (If Necessary)—Quantitative Analysis

14C. An enterprise shall consolidate a variable interest entity if that enterprise has a controlling financial interest in the entity through a variable interest (or combination of variable interests) that requires the enterprise to absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, 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 and, thus, provide the enterprise with a controlling financial interest. 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 be deemed to hold the controlling financial interest and consolidate the variable interest entity.

~~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 contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties (a) the obligation to absorb the expected losses of the variable interest entity or (b) the right to receive the expected residual returns of the variable interest entity. 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 interests to unrelated parties or if the~~

~~variable interest entity issues new variable interests to parties other than the primary beneficiary or the primary beneficiary's related 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 that enterprise acquires additional variable interests in the variable interest entity. A troubled debt restructuring, as defined in paragraph 2 of Statement 15, as amended, shall be accounted for in accordance with that Statement and is not an event that requires the reconsideration of whether an enterprise is the primary beneficiary of the variable interest entity.~~

Related Parties

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 a 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 that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a variable interest entity through the sale, transfer, or encumbrance of those interests.

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, 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, including:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the variable interest entity to the various parties within the related party group

- c. A party's exposure to the expected losses of the variable interest entity
- d. The design of the variable interest entity
- e. The extent to which a party meets criteria a and b in paragraph 14A.

Initial Measurement

18. If the primary beneficiary of a variable interest entity and the variable interest entity are under common control, the primary beneficiary shall initially measure the assets, liabilities, and *noncontrolling interests*¹⁶ of the variable interest entity at the amounts at which they are carried in the accounts of the enterprise that controls the variable interest entity (or would be carried if the enterprise issued financial statements prepared in conformity with generally accepted accounting principles).

19. Paragraphs 20 and 21 provide guidance if the primary beneficiary and variable interest entity are not under common control.

20. The initial consolidation of a variable interest entity that is a *business*^{16a} is a business combination and shall be accounted for in accordance with the provisions of Statement 141(R).

21. If an entity becomes the primary beneficiary of a variable interest entity that is *not* a business:

- a. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and liabilities of the variable interest entity in accordance with paragraphs 12–33 of Statement 141(R). However, the primary beneficiary shall initially measure assets and liabilities that it has transferred to that variable interest entity at, after, or shortly before the date that the entity 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.
- b. The primary beneficiary shall recognize a gain or loss for the difference between (1) the fair value of any consideration paid, the fair value of any noncontrolling interests, and the reported amount of any previously held interests and (2) the net amount of the variable interest entity's identifiable assets and liabilities recognized and measured in accordance with Statement 141(R). No goodwill shall be recognized if the variable interest entity is not a business.

¹⁶The term *noncontrolling interest* is used in this Interpretation with the same meaning as in FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. That Statement defines a noncontrolling interest as “the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent.”

^{16a}Statement 141(R) provides guidance on determining whether an entity is a business.

Accounting after Initial Measurement

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 6–39 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. 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.

DISCLOSURE

22A. The principal objectives of the disclosures required by paragraphs 22B–26 are to provide users of financial statements with an understanding of:

- a. The judgments and assumptions made by the enterprise in determining whether the enterprise must consolidate a variable interest entity and/or disclose information about its involvement in a variable interest entity
- b. The nature of restrictions on a consolidated variable interest entity's assets reported in an enterprise's statement of financial position, including the carrying amounts of such assets
- c. The nature of, and changes in, the risks associated with the enterprise's involvement with the variable interest entity
- d. The current and potential financial effects from an enterprise's involvement with a variable interest entity on the enterprise's financial position, financial performance, and cash flows.

An enterprise shall consider these overall objectives in providing the disclosures required by this Interpretation. To achieve these objectives, an enterprise may need to supplement the disclosures required by paragraphs 22B–26, depending on the facts and circumstances surrounding the variable interest entity and the enterprise's interest in that entity. Accordingly, if the enterprise's economic relationship with the variable interest entity or exposure to risk is not addressed by any of the disclosures provided in paragraphs 22B–26, the enterprise shall provide further information, as needed.

22B. Disclosures about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not provide useful incremental information for

financial statement users. An enterprise shall disclose how similar entities are aggregated and shall distinguish between:

- a. Variable interest entities that are not consolidated because the enterprise is not the primary beneficiary but is either the sponsor or has a significant variable interest
- b. Variable interest entities that are consolidated.

In determining whether to aggregate variable interest entities, the enterprise should consider quantitative and qualitative information about the different risk and reward characteristics of each variable interest entity and the significance of each variable interest entity to the enterprise.

22C. An enterprise that is a primary beneficiary in a variable interest entity, holds a significant variable interest in a variable interest entity but is not the primary beneficiary, or is a sponsor that holds a variable interest in a variable interest entity (irrespective of the significance of the variable interest) shall disclose:

- a. Its methodology for determining whether the enterprise is (or is not) the primary beneficiary of a variable interest entity including, but not limited to:
 - (1) Significant factors considered.
 - (2) Significant assumptions and judgments made and whether a different assumption or judgment could have reasonably been made that would result in a different conclusion.
- b. If the consolidation determination is different for a variable interest entity in the current financial statements from the determination in the most recent financial statements (for example, the variable interest entity was previously consolidated and is not currently consolidated), the primary factors that caused the change, and the effect on the enterprise's financial statements.
- c. Whether the enterprise has provided financial or other support to the variable interest entity that it was not contractually required to provide during the periods presented, including:
 - (1) The type and amount of financial support, including situations where the enterprise assisted the variable interest entity in obtaining another type of support.
 - (2) The primary reasons for providing the noncontractual support.
- d. Qualitative and quantitative information about the enterprise's involvement (giving consideration to both explicit and implicit arrangements) with the variable interest entity, including:
 - (1) The nature, purpose, size, and activities of the variable interest entity, including how the entity is financed.
 - (2) Information to allow users to understand the significant risks of the variable interest entity, including those created and passed through to the variable interest holder's assets. Such risks may include concentrations of assets and/or activities, credit risk, interest rate risk (including prepayment risk), foreign currency exchange risk, commodity price risk, equity price risk, and operational risk. In

providing this information, the disclosures required by other standards shall be considered (for example, AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*).

- (3) Terms of arrangements that could require the enterprise to provide financial support (for example, liquidity commitments and obligations to purchase assets) to the variable interest entity, including events or circumstances that could expose the enterprise to a loss.

23. The primary beneficiary of a variable interest entity that is a business shall provide the disclosures required by Statement 141(R). The primary beneficiary of a variable interest entity that is not a business shall disclose the amount of gain or loss, if any, recognized on the initial consolidation of the variable interest entity. In addition to disclosures required by other standards, the primary beneficiary of a variable interest entity shall disclose the following ~~(unless the primary beneficiary also holds a majority voting interest):~~¹⁷

- a. ~~The nature, purpose, size, and activities of the variable interest entity~~The carrying amount and classification of the consolidated variable interest entity's assets and liabilities in the statement of financial position that are consolidated pursuant to this Interpretation
- b. ~~The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations~~If the variable interest entity's assets can only be used to settle obligations of the variable interest entity:
 - (1) The carrying amount and classification of the consolidated variable interest entity's assets and associated liabilities
 - (2) Qualitative information about the nature of the restrictions on those assets
- c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary.
- d. Quantitative and qualitative information about liquidity facilities, guarantees, and other commitments to the variable interest entity provided by third parties
- e. The fair value of the consolidated variable interest entity's financial assets and financial liabilities (separately from those disclosed pursuant to Statement 107).

24. In addition to disclosures required by other standards, an~~An~~ enterprise that holds a significant variable interest or is a sponsor that holds a variable interest in a variable

¹⁷A variable interest entity may issue voting equity interests, and the enterprise that holds a majority voting interest also may be the primary beneficiary of the entity. If so, and if the entity meets the definition of a business in Statement 141(R) and the entity's assets can be used for purposes other than the settlement of the entity's obligations, the disclosures in paragraphs 22C, 23, and 27 are not required.

interest entity (irrespective of the significance of the variable interest), but is not the entity's primary beneficiary shall disclose:

- a. ~~The nature of its involvement with the variable interest entity and when that involvement began~~The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity, including how the maximum exposure is determined and the significant sources of the enterprise's exposure to the variable interest entity. If the enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity cannot be quantified, that fact shall be disclosed.
- b. ~~The nature, purpose, size, and activities of the variable interest entity~~The enterprise's estimated exposure to loss or range of that loss if it believes that the amount of the maximum exposure to loss is not representative of its estimated exposure to loss. If this disclosure is made, the enterprise shall disclose the methodology used to determine the estimated loss exposure. This description shall include qualitative and quantitative information, such as:
 - (1) Significant factors considered, assumptions made, and primary risks of the variable interest entity
 - (2) Liquidity, guarantees, and other commitments to the variable interest entity by third parties.
- c. ~~The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.~~The carrying amount and classification in the enterprise's statement of financial position of the enterprise's variable interest in the variable interest entity.

~~25. Disclosures required by Statement 140 about a variable interest entity shall be included in the same note to the financial statements as the information required by this Interpretation. Information about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not add material information.~~

25A. The disclosures required by this Interpretation may be provided in more than one note to the financial statements, as long as the objectives in paragraph 22A are met. If the disclosures are provided in more than one note to the financial statements, the enterprise shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Interpretation for similar entities.

26. 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 this Interpretation is not being applied and the reason why the information required to apply this 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.

Appendix B

VARIABLE INTERESTS

Introduction

B1. This Interpretation provides guidance for identifying entities for which analysis of voting interests, and the holdings of those voting interests, is not effective in determining whether a controlling financial interest exists because the entity does not have adequate equity capital or the equity instruments do not have the normal characteristics of equity that provide its holders with a potential controlling financial interest. Those entities are called variable interest entities. This Interpretation also provides guidance for determining whether an enterprise shall consolidate a variable interest entity. An enterprise that consolidates a variable interest entity is called the primary beneficiary of that variable interest entity. ~~The guidance in this Interpretation identifies the primary beneficiary as a holder of variable interests in a variable interest entity that absorb or receive a majority of the entity's expected losses or expected residual returns. This appendix provides guidance for identifying variable interests, and explains in general how they may affect the determination of the primary beneficiary.~~

B2. The identification of variable interests requires an economic analysis of the rights and obligations of an entity's assets, liabilities, equity, and other contracts. Variable interests are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of an entity's net assets exclusive of variable interests. This Interpretation uses the terms *expected losses* and *expected residual returns* to describe the expected variability in the fair value of an entity's net assets exclusive of variable interests.

B3. For an entity that is not a variable interest entity (sometimes called a voting interest entity), all of the entity's assets, liabilities, and other contracts are deemed to create variability, and the equity investment is deemed to be sufficient to absorb the expected amount of that variability. In contrast, variable interest entities are designed so that some of the entity's assets, liabilities, and other contracts create variability and some of the entity's assets, liabilities, and other contracts (as well as its equity at risk) absorb or receive that variability.

B4. The identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual

arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity’s variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the entity.

B5. This appendix describes examples of variable interests in entities subject to this Interpretation. The appendix is not intended to provide a complete list of all possible variable interests. In addition, the descriptions are not intended to be exhaustive of the possible roles, and the possible variability, of the assets, liabilities, equity, and other contracts. Actual instruments may play different roles and be more or less variable than the examples discussed. Finally, this appendix does not analyze the relative significance of different variable interests, because the relative significance of a variable interest will be determined by the design of the variable interest entity. The identification and analysis of variable interests must be based on all of the facts and circumstances of each entity.

B6. This appendix also does not discuss whether the variable interest is a variable interest (a) in a specified asset of a variable interest entity or (b) in the entity as a whole. Guidance for making that determination is provided in paragraph 12. Paragraph 13 provides guidance for when a variable interest entity should be separated with each part evaluated to determine if it has a primary beneficiary.

Equity Investments, Beneficial Interests, and Debt Instruments

B7. Equity investments in a variable interest entity are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 5 of this Interpretation.) Some equity investments in a variable interest entity that are determined to be not at risk by the application of paragraph 5 also may be variable interests if they absorb or receive some of the entity’s variability. If an entity has a contract with one of its equity investors (including a financial instrument such as a loan receivable), a reporting enterprise applying this Interpretation to that entity should consider whether that contract causes the equity investor’s investment not to be at risk. If the contract with the equity investor represents the only asset of the entity, that equity investment is not at risk.

B8. Investments in subordinated beneficial interests or subordinated debt instruments issued by a variable interest entity are likely to be variable interests. The most subordinated interest in an entity will absorb all or part of the expected losses of the entity. For a voting interest entity the most subordinated interest is the entity’s equity; for a variable interest entity it could be debt, beneficial interests, equity, or some other interest. The return to the most subordinated interest usually is a high rate of return (in relation to the interest rate of an instrument with similar terms that would be considered to be “investment grade”) or some form of participation in residual returns.

B9. Any of a variable interest entity’s liabilities may be variable interests because a decrease in the fair value of an entity’s assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of

~~the entity's expected variability, and therefore, a holder of *only* the most senior interests of a variable interest entity likely would not be the primary beneficiary of that entity, unless the subordinated interests of the variable interest entity are not large enough to absorb the entity's expected losses (or unless there are provisions such as embedded derivatives that expose the senior interests to losses).~~ By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the entity's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.

Guarantees, Written Put Options, and Similar Obligations

B10. Guarantees of the value of the assets or liabilities of a variable interest entity, written put options on the assets of the entity, or similar obligations such as some liquidity commitments or agreements (explicit or implicit) to replace impaired assets held by the entity are variable interests if they protect holders of other interests from suffering losses. To the extent the counterparties of guarantees, written put options, or similar arrangements will be called on to perform in the event expected losses occur, those arrangements are variable interests, including fees or premiums to be paid to those counterparties. The size of the premium or fee required by the counterparty to such an arrangement is one indication of the amount of risk expected to be absorbed by that counterparty.

B11. If the entity is the writer of a guarantee, written put option, or similar arrangement, the items usually would create variability. Thus, those items usually will not be a variable interest of the entity (but may be a variable interest in the counterparty).

Forward Contracts

B12. Forward contracts to buy assets or to sell assets that are not owned by the entity at a fixed price will usually expose the entity to risks that will increase the entity's expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the entity are not variable interests in the entity.

B13. A forward contract to sell assets that are owned by the entity at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. Thus, most forward contracts to sell assets that are owned by the entity are variable interests with respect to the related assets. However, if the term of a forward contract is short or the volatility of the value of the asset is low or both, the holder of the forward contract is not likely to absorb a majority of the entity's expected losses or to receive a majority of the entity's expected residual returns. Because forward contracts to sell assets that are owned by the entity relate to specific assets of the entity, it will be necessary to apply the guidance in paragraph 12 to determine whether a forward contract to sell an asset owned by an entity is a variable interest in the entity as opposed to a variable interest in that specific asset.

Other Derivative Instruments

B14. Derivative instruments held or written by an entity should be analyzed in terms of their option-like, forward-like, or other variable characteristics. If the instrument creates variability, in the sense that it exposes the entity to risks that will increase expected variability, the instrument is not a variable interest. If the instrument absorbs or receives variability, in the sense that it reduces the exposure of the entity to risks that cause variability, the instrument is a variable interest. Rights and obligations under derivative instruments whose underlyings are market interest rates or currency exchange rates probably will not cause the holder to be a primary beneficiary unless the primary causes of variability in the entity's assets are the same or similar interest rates or currency exchange rates.

B15. Derivatives, including total return swaps and similar arrangements, can be used to transfer substantially all of the risk or return (or both) related to certain assets of an entity without actually transferring the assets. Derivative instruments with this characteristic should be evaluated carefully. If the arrangement effectively transfers significant risks to the counterparty, the counterparty is likely to be the entity's primary beneficiary.

B16. Some assets and liabilities of a variable interest entity have embedded derivatives. For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately.

Assets of the Entity

B17. Assets held by an entity almost always create variability and, thus, are not variable interests. However, as discussed separately in this appendix, assets of the entity that take the form of derivatives, guarantees, or other similar contracts may be variable interests.

Fees Paid to a Decision Maker

B18. A variable interest entity's expected losses and expected residual returns shall not include the expected variability in fees paid to the decision maker (if there is a decision maker) except as discussed in the last sentence in this paragraph. Those contractual rights to receive fees are considered variable interests that absorb rather than cause variability. However, a fee paid by a variable interest entity to a decision maker is not considered a variable interest in the entity if all of the characteristics of a hired service provider or an employee relationship identified in paragraph B19 are present in an arrangement.

B19. Fees paid to a decision maker shall not be considered variable interests if all of the following conditions exist:

- a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services. Paragraph B21 describes factors that may indicate that fees exceed the level of compensation that would be commensurate with the services provided.

- b. The fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of business, such as trade payables.
- c. Except for the fees described in conditions (a) and (b), the decision maker and the decision maker's related parties²⁵ do not hold interests in the variable interest entity that individually, or in the aggregate, would absorb more than a trivial amount of the entity's expected losses or receive more than a trivial amount of the entity's expected residual returns.
- d. The decision maker is subject to substantive kick-out rights, as that term is described in paragraph B20.

B20. The ability of an investor or another party to remove the decision maker (that is, kick-out rights) does not affect the status of a decision maker's fees in the application of paragraphs B18 and B19 unless the rights are substantive. The determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights must have both of the following characteristics:

- a. The decision maker can be removed by the vote of a simple majority of the voting interests held by parties other than the decision maker and the decision maker's related parties.²⁶
- b. The parties holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:
 - (1) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
 - (2) Financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive for removal
 - (3) The absence of an adequate number of qualified replacement decision makers or inadequate compensation to attract a qualified replacement
 - (4) The absence of an explicit, reasonable mechanism in the contractual arrangement, or in the applicable laws or regulations, by which the parties holding the rights can call for and conduct a vote to exercise those rights
 - (5) The inability of parties holding the rights to obtain the information necessary to exercise them.

B21. Determination of whether fees paid to a decision maker represent compensation for services provided commensurate with the level of effort required to provide those services will require judgment based on all relevant facts and circumstances. The following factors may indicate that the fees exceed the level of compensation that would be commensurate with the services provided:

²⁵The term *related parties* refers to all parties identified in paragraph 16.

²⁶Refer to footnote 25.

- a. The service arrangement includes terms, conditions, or amounts that are not customarily present in arrangements for similar services negotiated at arm's length.
- b. The total amount of the expected fees is large relative to the total amount of the variable interest entity's expected return to its variable interests.
- c. The expected variability in the fees is large relative to the total expected variability in the fair value of the variable interest entity's net assets exclusive of variable interests.

Other Service Contracts

B22. Service contracts with hired service providers other than the entity's decision maker are not variable interests if all three conditions below are met:

- a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- b. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
- c. The service contracts are subject to cancellation provisions that are customary for such contracts and there is an adequate number of qualified replacement service providers.

B23. Service contracts that do not have all of the features listed above may be variable interests. The counterparties to the contracts could absorb or receive some of the variability of the entity.

Operating Leases

B24. Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset's life that is covered by the lease. Most operating leases do not absorb variability in the fair value of an entity's net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraph 12 of this Interpretation. Alternatively, such arrangements may be variable interests in portions of a variable interest entity as described in paragraph 13 of this Interpretation. The guidance in paragraphs B8 and B9 related to debt instruments applies to creditors of lessor entities.

Variable Interests of One Variable Interest Entity in Another Variable Interest Entity

B25. One variable interest entity is the primary beneficiary of another variable interest entity if it meets the conditions in paragraph 14. A variable interest entity that is the primary beneficiary of a second variable interest entity will consolidate that second variable interest entity. If another enterprise consolidates the first variable interest entity, that enterprise's consolidated financial statements include the second variable interest entity because the second entity had already been consolidated by the first. For example, if Entity X (a variable interest entity) is the primary beneficiary of Entity Y (a variable interest entity), Entity X consolidates Entity Y. If Enterprise Z is the primary beneficiary of Entity X, Enterprise Z consolidates Entity X, and Enterprise Z's consolidated financial statements include Entity Y because Entity X has consolidated Entity Y.

B26. [An interest that continues to be held by a transferor] of financial assets to a variable interest entity is a variable interest in the transferee entity but it is not a variable interest in a second variable interest entity to which the transferee issues a beneficial interest. The following example illustrates this point:²⁷

- a. Enterprise A transfers financial assets to Entity 1 (a variable interest entity that holds no other assets), retains a subordinated beneficial interest, and reports the transfer as a sale under the provisions of Statement 140.
- b. Entity 1 issues all of its senior beneficial interests in the transferred assets to Entity 2 (a variable interest entity). Entity 2 issues various types of interests in return for cash and uses the cash to pay Entity 1. Entity 1 uses the cash received from Entity 2 to pay Enterprise A.
- c. Enterprise A's subordinated beneficial interest is a variable interest in Entity 1, but neither Entity 1 nor Enterprise A has a variable interest in Entity 2.

²⁷~~This analysis describes variable interests in all variable interest entities including qualifying special purpose entities. However, a special requirement applies to qualifying special purpose entities. Refer to paragraphs 4(c) and 4(d).~~