

**Board Meeting Handout**  
**Insurance Contracts**  
**February 19, 2014**

**Purpose of This Meeting**

1. The objective of the February meeting is to discuss the overall direction of the insurance contracts project, including the following:
  - a. Whether the overall scope of the insurance contracts project should continue to include all entities that issue insurance contracts or only insurance entities
  - b. Alternative approaches regarding the direction of the insurance contracts project (including whether to continue with a comprehensive project on the accounting for insurance contracts and redeliberate the issues related to the guidance in the proposed Update or whether targeted improvements to Topic 944, Financial Services—Insurance, should be considered) and the proposed redeliberation or deliberation topics for each alternative.
2. The staff is not asking the Board to reach decisions on the more granular issues associated with scope or on any specific aspects of the guidance in the proposed FASB Accounting Standards Update, *Insurance Contracts (Topic 834)* . Rather, the Board will be asked to provide direction to the staff on the direction the Board would like to take in redeliberations. The Board will be asked to reach decisions about insurance accounting and reporting issues at future Board meetings.

**Overall Scope**

3. Existing U.S. generally accepted accounting principles (GAAP) on insurance apply only to insurance entities and not to contracts issued by noninsurance entities, even though noninsurance entities may issue contracts that have identical or similar economic characteristics to contracts issued by insurance entities. The guidance in the proposed Update would apply to all entities that issue insurance

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The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

contracts as defined in that Update (including entities other than insurance companies) or that hold reinsurance contracts, unless those contracts are specifically excluded from the scope of the proposed Update.

4. As discussed in the comment letter and other feedback summary, stakeholders generally agreed with the objectives and the scope of the guidance in the proposed Update. However, many stakeholders (mainly noninsurance entities) had concerns about accounting for certain types of contracts that would now meet the definition of an insurance contract. The comment letter respondents who agreed noted that the guidance would resolve the diversity in practice in accounting for similar contracts issued by different types of reporting entities, while some comment letter respondents who disagreed noted that the scope of insurance contract accounting should be limited to entities subject to insurance regulation, which would be consistent with existing U.S. GAAP.
5. Additionally, many preparers and auditors/accounting firms supported convergence of U.S. GAAP with International Financial Reporting Standards (IFRS). However, many users noted that convergence of U.S. GAAP and IFRS is secondary to improving existing U.S. GAAP. While most of those stakeholders did not identify scope as an essential area to converge the guidance in the proposed Update with IFRS, the FASB staff notes that the responses may reflect the types of respondents who provided feedback on convergence (most of the preparers who commented were insurance entity respondents).
6. The overall scope of the guidance in the proposed Update is converged with the 2013 International Accounting Standards Board (IASB) Exposure Draft, *Insurance Contracts*, because they both would affect any reporting entity that issues insurance contracts, not only reporting entities that are regulated as insurance entities. The detailed scope of the proposed FASB Update and the IASB Exposure Draft also is largely converged with a few exceptions.

**Question for the Board**

Should the overall scope of the insurance contracts project continue to include all entities that issue insurance contracts or only insurance entities?

**Direction of the Insurance Contracts Project**

7. Given the feedback received on the guidance in the proposed Update, the FASB staff has identified the following four alternative approaches to the overall direction of the insurance contracts project for the Board to consider:
- a. Alternative A—Continue with a comprehensive project on the accounting for insurance contracts and consider the issues identified by the staff when redeliberating the guidance in the proposed Update.
  - b. Alternative B—Continue with a project on the accounting for long-duration insurance contracts, consider the issues identified by the staff related only to the building block approach during redeliberations, and assess whether a second phase of the insurance contracts project should be added to consider targeted improvements to short-duration insurance contract guidance in Topic 944 at a later date.
  - c. Alternative C—Consider potential targeted improvements to Topic 944 identified by the staff.
  - d. Alternative D—Postpone redeliberations until the IASB has issued a final insurance contracts standard.

**Question for the Board**

For the overall direction of the insurance contracts project, does the Board wish to follow Alternative A, Alternative B, Alternative C, or Alternative D, or does the Board wish to pursue a different alternative approach?

## Board Meeting Handout

### Accounting for Financial Instruments: Impairment

February 19, 2014

#### Purpose of This Meeting

1. At its December 18, 2013 meeting, the Board decided to continue to refine the current expected credit loss (CECL) model in the proposed Accounting Standards Update, Financial Instruments—Credit Losses (Subtopic 825-15).
2. The purpose of this meeting is to discuss several specific topics within the proposed Update considering feedback received and research performed by the staff during redeliberations. At this meeting, the staff and Board will discuss the following topics:
  - (a) Nonaccrual
  - (b) Purchased credit-impaired (PCI) assets
  - (c) Troubled debt restructurings (TDRs).

#### Nonaccrual

3. The Board will discuss how nonaccrual guidance should be included in the final CECL model in light of feedback received from stakeholders.

#### *Alternatives for Consideration*

4. Based on the feedback received on the nonaccrual guidance included in the proposed Update, the staff believes the following alternatives exist:
  - (a) **Alternative A:** Make targeted amendments to the nonaccrual principle included in the proposed Update.
  - (b) **Alternative B:** Do not address as part of the credit losses project but consider whether further changes to current U.S. GAAP are needed through pre-agenda research.

- (c) **Alternative C:** Maintain current U.S. GAAP for the nonaccrual of interest income.

#### Question for the Board

Which alternative does the Board prefer regarding the development of a nonaccrual principle?

### Purchased Credit-Impaired (PCI) Assets

- 5. In light of feedback received, the Board will discuss the following issues and consider whether changes should be made to the PCI guidance in the proposed Update:
  - (a) **Issue 1:** Whether the proposed PCI approach should apply to all purchased assets measured at amortized cost and fair value with qualifying changes in fair value recognized in other comprehensive income (FV-OCI), regardless of the level of credit deterioration experienced since origination.
  - (b) **Issue 2:** Whether to provide application guidance on how to “push down” to the individual asset level the non-credit-related discount or premium resulting from acquiring a portfolio of PCI assets.

### *Alternatives for Consideration – Issue 1*

- 6. The staff believes the alternatives regarding Issue 1 include the following:
  - (a) **Alternative A:** Do not amend the proposed Update to more broadly apply the PCI approach to all purchased assets.
  - (b) **Alternative B:** Amend the proposed Update to require that the PCI approach apply to all purchased assets, regardless of the level of credit deterioration experienced since origination. Accordingly, upon acquisition of an asset, an entity would recognize at acquisition the

amortized cost of the purchased asset as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The asset would then be accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition. Under this alternative, an entity would need to determine the portion of the discount related to credit and non-credit factors.

- (c) **Alternative C:** Allow an entity to apply the PCI-approach for business combinations and asset acquisitions in which the acquired loans represent a significant percentage of the postacquisition portfolio. This alternative would apply to all asset acquisitions that represent a significant percentage of the postacquisition portfolio, regardless of whether the asset acquisition qualifies as a business combination. The proposed Update would not be amended to include a definition of *significant*.

#### Question for the Board

Which alternative does the Board prefer regarding whether the proposed PCI approach should apply to all purchased assets?

#### ***Alternatives for Consideration – Issue 2***

- 7. The staff believes the alternatives regarding Issue 2 include the following:
  - (a) **Alternative A:** Do not amend the proposed Update to include guidance on how to allocate the non-credit-related discount or premium to an individual asset.
  - (b) **Alternative B:** Amend the proposed Update to *explicitly* state that there could be multiple acceptable methods of allocating the non-credit-related discount or premium. Under this alternative, no specific allocation method would be prescribed.

- (c) **Alternative C:** Amend the proposed Update to indicate that an entity must allocate the non-credit-related discount or premium to the individual asset level using a fair value allocation method.

#### Question for the Board

Which alternative does the Board prefer regarding whether to provide application guidance on how to “push down” to the individual asset level the non-credit-related discount or premium resulting from acquiring a portfolio of PCI assets?

#### Troubled Debt Restructurings (TDRs)

- 8. In light of feedback received on the proposed update, the Board will discuss the following issues:
  - (a) **Issue 1:** Whether it believes the TDR classification is still relevant under the proposed Update and, if so, whether it intends to address accounting differences that currently exist in U.S. GAAP between a TDR and a non-TDR modification as part of this project.
  - (b) **Issue 2:** Whether (and how) an entity would be permitted under the proposed Update to *increase* the cost basis of an asset upon execution of a TDR if the present value of the modified cash flows exceeds an asset’s existing amortized cost.
  - (c) **Issue 3:** Whether expected prepayments could be considered in measuring the basis adjustment to record upon execution of a TDR.

### ***Alternatives for Consideration – Issue 1***

9. Following are the alternatives that the staff has developed for the Board’s consideration:
- (a) **Alternative 1A:** The TDR classification would remain relevant but the accounting and disclosure differences between TDRs and non-TDR modifications would not be addressed in the scope of this project.
  - (b) **Alternative 1B:** The TDR classification would remain relevant and the accounting and disclosure differences between TDRs and non-TDR modifications would be addressed in the scope of this project.
  - (c) **Alternative 2:** The TDR classification would no longer be relevant under the CECL model. Accordingly, the proposed Update would be amended to remove the requirement to recognize a cost-basis adjustment and to provide guidance on how to account for modifications.

#### **Question for the Board**

Does the Board believe that a TDR classification continues to be relevant? If so, does it intend to address as part of this project the accounting differences that currently exist in U.S. GAAP between a TDR and a non-TDR modification?

### ***Alternatives for Consideration – Issue 2***

10. The staff believes the following alternatives exist related to the cost basis adjustment for a TDR:
- (a) **Alternative 1:** Amend the proposed Update to prohibit an entity from increasing an asset’s cost basis upon the execution of a TDR. Amounts associated with the present value of the cash flows in excess of an asset’s original cost basis would not be recognized until the corresponding cash is collected.



- (b) **Alternative 2A:** Amend the proposed Update to clarify that certain circumstances may require an entity to increase an asset's cost basis upon the execution of a TDR and require that the corresponding amount be recognized as an increase to an entity's allowance for expected credit losses.
- (c) **Alternative 2B:** Amend the proposed Update to clarify that certain circumstances may require an entity to increase an asset's cost basis upon the execution of a TDR. Do not prescribe how an entity recognizes the corresponding amount in its financial statements but indicate that there could be multiple acceptable methods on how to recognize that amount (for example, as an increase to the entity's allowance for expected credit losses, as an income statement gain, or a combination thereof).

#### Question for the Board

Does the Board believe that an entity should be permitted to increase the cost basis of an asset upon execution of a TDR? If so, how should the corresponding entry be recognized in an entity's financial statements?

#### ***Alternatives for Consideration – Issue 3***

11. Following are the alternatives that the staff has developed for the Board's consideration:
  - (a) **Alternative 1:** Amend the proposed Update to specifically prohibit an entity from considering expectations about prepayments in determining the basis adjustment upon execution of a TDR.
  - (b) **Alternative 2;** Amend the proposed Update to specifically allow an entity to consider expectations about prepayments in determining the basis adjustment upon execution of a TDR. In the event that prepayment speeds are different from expected upon executing the TDR, amend the proposed Update to require that an entity adjust the asset's cost basis

using revised prepayment expectations to maintain the asset's original contractual yield.

- (c) **Alternative 3:** Amend the proposed Update to specifically allow an entity to consider expectations about prepayments in determining the basis adjustment upon execution of a TDR. If prepayment speeds are different from expected upon executing the TDR, amend the proposed Update to require that the entity prospectively reflect the adjusted yield.
- (d) **Alternative 4:** Require that TDRs always be considered in a discounted cash flows analysis consistent with current guidance in Subtopic 310-10 (formerly FAS 114).

**Question for the Board**

Does the Board believe that expected prepayments can be considered in measuring the basis adjustment to record upon execution of a TDR? If so, which alternative does the Board prefer?

**Board Meeting Handout**  
**Private Company Council**  
**Endorsement of PCC Decision and Removal of FSP Example**  
**February 19, 2014**

**Purpose of This Meeting**

1. The purpose of this meeting is for the Board to consider for endorsement a final proposal reached by the Private Company Council (PCC) at its January 28, 2014 meeting.

**Summary of the PCC Final Proposal**

***PCC Issue No. 13-02, “Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements”***

2. The PCC voted to finalize (subject to Board endorsement) an accounting alternative that would allow a private company lessee (the reporting entity) not to apply VIE guidance to a lessor entity when (a) the lessor entity and the private company (the reporting entity) are under common control, (b) the private company has a leasing arrangement with the lessor entity, (c) substantially all of the activity between the entities is related to the leasing activity between the lessor entity and the private company, and (d) any obligation of the lessor that is being guaranteed or collateralized by the private company could (have the ability to), at inception of the obligation, be sufficiently collateralized by the asset(s) leased to the private company. An example of leasing activity between the lessor and the private company lessee is issuance of a guarantee or providing collateral on the obligations related to the leased asset(s) of the lessor entity.

3. The accounting alternative, when elected, is an accounting policy election that should be applied by a private company lessee to all current and future lessor entities under common control that meet the criteria for applying this approach.

4. In applying this alternative, a private company would replace VIE disclosures about the lessor entity with (a) the amount and key terms of significant liabilities recognized by the lessor

entity that expose the private company lessee to providing significant financial support to the lessor entity and (b) a qualitative description of significant arrangements not recognized by the lessor entity that expose the private company lessee to providing financial support to the lessor entity. The disclosures under this alternative are required to be disclosed in combination with the disclosure guidance required by other Topics (for example, Topic 460, Guarantees; Topic 840, Leases; and Topic 850, Related Party Disclosures) about the lessor entity. The disclosures could be made by aggregating all disclosures in a single note or by including cross-references within the notes to the financial statements. In addition, entities that elect this alternative should continue to apply the guidance in other applicable Topics, including consolidation guidance other than VIE guidance in Topic 810, Consolidation; Topic 460; and Topic 840.

5. The accounting alternative, if elected, should be applied using a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the alternative. The alternative will be effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted, including application to any period for which the entity's annual or interim financial statements have not yet been made available for issuance.

***Question for the Board***

***Question 1:*** Does the Board wish to endorse the final proposal of the PCC on Issue 13-02?

**Removal of the FSP Example**

6. In the proposed Update issued on August 22, 2013, for PCC Issue No. 13-02, the Board exposed the removal of an example that is currently codified in Topic 810. The example is derived from FSP FIN 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. 46," in paragraphs 810-10-55-87 through 55-89, and is referred to as the FSP example.

7. In the FSP example, a reporting entity (lessee entity) leases a facility from a leasing entity (lessor entity) that is owned by one of the reporting entity's two owners and has the facility as its only asset. The operating lease, with market terms, is the only contractual relationship between the two entities. Furthermore, the lease contains no other explicit arrangements, such as a

guarantee of the residual value or a purchase option of the leased asset. U.S. GAAP requires the lessee entity in such circumstances to consider whether it holds an implicit variable interest in the lessor entity; for example, due to its relationship with the owner of both entities, the lessee entity may implicitly guarantee the lessor's debt. If a lessee entity holds an implicit variable interest in the lessor entity and determines that the lessor entity is a VIE, then the lessee entity must assess whether it holds a controlling financial interest in the lessor entity.

***Question for the Board***

***Question 2:*** Does the Board wish to reaffirm its decision to remove the FSP example?

**Board Meeting Handout  
Consolidation: Principal versus Agent Analysis  
February 19, 2014**

**Purpose of This Meeting**

1. At the February 19, 2014, Board meeting, the staff will ask the Board how to further integrate two of the principal versus agent factors included in the proposed FASB Accounting Standards Update, *Consolidation (Topic 810): Principal versus Agent Analysis*: fees paid to a decision maker as well as economic interests held by a decision maker, within the existing guidance in Topic 810, Consolidation, variable interest entities (VIE).

**Background**

2. The guidance in the proposed Update includes the following three factors to evaluate whether a decision maker is using its authority as a principal or an agent:
  - a. Rights held by other parties
  - b. Fees paid to a decision maker (that is, the compensation to which the decision maker is entitled in accordance with its compensation agreement(s))
  - c. Economic interests (that is, the decision maker's exposure to variability of returns from interests that it holds in the entity, which also includes a reference to decision-maker fees).
3. At the December 11, 2013, Board meeting, the Board agreed that the principal versus agent factors should be integrated within the existing guidance in Topic 810 rather than included as a separate principal versus agent analysis.
4. At the January 8, and January 29, 2014, Board meetings, rights held by other parties were discussed and evaluated. Therefore, at today's meeting, the staff intends on discussing the remaining two factors in the principal versus agent analysis.

5. The evaluation of fees paid to a decision maker<sup>1</sup> and economic interests significantly impact the determination of a controlling financial interest under the variable interest entity model within Topic 810.
6. For purposes of this meeting, assume that all fees paid to the decision maker fail to meet the conditions included in paragraph 810-10-55-37 and, therefore, represent a variable interest in a variable interest entity. Additionally, assume that the decision maker has the power to direct the activities that most significantly impact the economic performance of the variable interest entity.
7. If a reporting entity has a variable interest in a variable interest entity, Topic 810 requires that the reporting entity consider if it is the primary beneficiary of the variable interest entity. A reporting entity would be considered the primary beneficiary if the reporting entity has a variable interest that meets both of the following criteria, as required by paragraph 810-10-25-38A:
  - a. The power to direct the activities of a variable interest entity that most significantly impact the variable interest entity's economic performance (the "power criterion")
  - b. The obligation to absorb losses of the variable interest entity that could potentially be significant to the variable interest entity, or the right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity (the "potentially significant economics criterion").
8. Currently, fees paid to a decision maker and economic interests held by a decision maker are evaluated in the potentially significant economics criterion when evaluating if a reporting entity is a primary beneficiary. For example, see Case B: Asset-Backed Collateralized Debt Obligation from Topic 810.

#### **Additional Background—Proposed Update**

9. In the guidance in the proposed Update, the assessment of compensation requires a reporting entity to consider the nature and magnitude of the compensation that the

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<sup>1</sup> Fees paid to a decision maker also are evaluated when considering whether those fees represent a variable interest in paragraph 810-10-55-37; the staff will analyze that specific evaluation in a future memorandum.

decision maker receives relative to the entity's anticipated economic performance. The guidance in the proposed Update states that the greater the magnitude of, and variability associated with, the decision maker's compensation relative to the entity's economic anticipated performance, the more likely the decision maker is using its decision-making authority in a principal (and, thus, the primary beneficiary) capacity.

10. Additionally, a decision maker is required to consider whether both of the following conditions exist:
  - a. The compensation is commensurate with the services provided.
  - b. Its compensation agreement includes only terms, conditions, or amounts that are customarily in arrangements for similar services negotiated on an arm's-length basis.
11. Hereinafter, the staff will refer to those collective conditions as "at-market and commensurate fees." The guidance in the proposed Update states that if conditions (a) and (b) in the previous paragraph are not present, that would be a strong indicator that the decision maker is acting in a principal capacity. However, if the decision maker meets those conditions, then it is not determinative whether the decision maker is acting as an agent. A reporting entity (that is, the decision maker) would have to consider that compensation factor in conjunction with the remaining two factors (economic interests held and rights held by others).

### **Alternatives for Board Consideration and Staff Recommendations—Fees Paid to a Decision Maker**

#### **Question 1—How should at-market and commensurate fees paid to a decision maker be evaluated in the potentially significant economics criterion of the primary beneficiary determination?**

[For Question 1, presume that the decision maker and its related parties hold no other economic interests in the variable interest entity and compensation is in the form of cash and paid when fully earned. In addition, the staff will evaluate and analyze the related party guidance within the proposed Update and Topic 810 in a future memorandum.]



12. **Alternative A**—If fees paid to a decision maker are at-market and commensurate fees, then the at-market and commensurate fees should be excluded from consideration in the potentially significant economics criterion of the primary beneficiary determination.

[A decision maker that has at-market and commensurate fees would not meet the potentially significant economics criterion and would not be the primary beneficiary of the variable interest entity.]

13. **Alternative B**—Fees paid to a decision maker that are at-market and commensurate fees should be included in the consideration of the potentially significant economics criterion of the primary beneficiary determination. That would require a full evaluation of the potentially significant economics criterion of the primary beneficiary determination for the decision maker.

14. The staff recommends Alternative A.

#### Question 1 for the Board

Which alternative would the Board like to pursue when considering how at-market and commensurate fees should be evaluated in the potentially significant economics criterion of the primary beneficiary determination?

**Question 2—How should at-market and commensurate fees paid to a decision maker that are fully earned but subject to lock-up provisions or settled in the form of variable interests be evaluated in the potentially significant economics criterion of the primary beneficiary determination?**

[For Question 2, presume that the decision maker and its related parties hold no other economic interests in the variable interest entity. The staff will evaluate and analyze the related party guidance within the proposed Update and Topic 810 in a future memorandum.]

15. **Alternative A**—At-market and commensurate fees paid to a decision maker that are fully earned but subject to lock-up provisions or settled in the form of variable interests of the variable interest entity (that is, not cash) should be excluded from the evaluation of the potentially significant economics criterion of the primary beneficiary determination.

16. **Alternative B**—At-market and commensurate fees paid to a decision maker that are fully earned but subject to lock-up provisions or settled in the form of variable interests of the variable interest entity (that is, not cash) should be considered in the evaluation of the potentially significant economics criterion of the primary beneficiary determination.
17. **Alternative C**—The amount of at-market and commensurate fees paid to a decision maker that are fully earned but subject to lock-up provisions or settled in the form of variable interests of the variable interest entity (that is, not cash) should be considered in the evaluation of the potentially significant economics criterion of the primary beneficiary determination. That would allow the amount of fees that are not subject to lock-up provisions and that are settled in cash to be excluded from the evaluation of the potentially significant economics criterion of the primary beneficiary determination. Unless the entire arrangement is subject to lock-up provisions or is not settled in cash, then the entire arrangement would not be considered in the evaluation of the potentially significant economics criterion of the primary beneficiary determination.
18. The staff is split in its recommendations; some staff members support Alternative A and some support Alternative C.

#### Question 2 for the Board

Which alternative would the Board like to pursue when considering how to evaluate at-market and commensurate fees paid to a decision maker when subject to lock-up provisions or settled in the form of variable interests (that is, not cash) in the potentially significant economics criterion of the primary beneficiary determination?

#### **Question 3—How should at-market and commensurate fees paid to a decision maker<sup>2</sup> be evaluated in the primary beneficiary determination when a decision maker or its related parties have other economic interests?**

[The staff will evaluate and analyze the related party guidance within the proposed Update and Topic 810 in a future memorandum.]

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<sup>2</sup>If the Board chooses Alternative B or Alternative C for Question 2, Question 3 would not include fees that are subject to lock-up provisions or that are not settleable in cash.

19. **Alternative A**—Do not include at-market and commensurate fees paid to a decision maker in the potentially significant economics criterion of the primary beneficiary determination when the decision maker or its related parties have other economic interests.
20. **Alternative B**—At-market and commensurate fees paid to a decision maker should be included in the potentially significant economics criterion of the PB determination when the decision maker or its related parties have other economic interests.
21. The staff recommends Alternative A.

### Question 3 for the Board

Which alternative would the Board like to pursue when considering how to evaluate at-market and commensurate fees paid to a decision maker in the potentially significant economics criterion of the primary beneficiary determination when the decision maker or its related parties have other economic interests?

## Economic Interests

22. Currently, as noted in paragraph 7 of this handout, economic interests held by a decision maker are evaluated in the potentially significant economics criterion when evaluating if a decision maker (that is a reporting entity) is the primary beneficiary of a variable interest entity. For an example of this in current practice, see Case A: Commercial Mortgage-Backed Securitization from Topic 810.

## Additional Background

23. Under the guidance in the proposed Update, a decision maker that holds other economic interests in an entity would assess its exposure to variability of returns from those interests. When assessing that factor, a decision maker would consider the following:
  - a. Whether the magnitude of and variability associated with the decision maker's economic interests, considering its compensation and other interests in aggregate, is indicative of the decision maker being a principal. (This was considered explicitly in Questions 1–3 of this handout.)

- b. Whether the decision maker's exposure to variability of returns is more than that of the other investors. For example, a subordinated economic interest or forms of credit enhancement is more indicative of a principal relationship than a pro rata economic interest.
- c. Whether the decision maker is exposed to positive and negative returns (for example, an equity interest or a guarantee) makes it more likely to be a principal. For purposes of this paper, this exposure is referred to as "downside risk." Alternatively, an interest that only exposes the decision maker to positive returns (hereinafter referred to as "upside") would be less indicative of a principal relationship.
- d. The decision maker's maximum exposure to losses (again, downside risk) in the entity.

#### **Alternatives for Board Consideration and Staff Recommendations—Economic Interests**

##### **Question 1: Should the potentially significant economics criterion of the primary beneficiary determination be further defined?**

- 24. **Alternative A**—No. Retain existing terminology in U.S. generally accepted accounting principles (GAAP) such that the criterion requires the decision maker to have the obligation to absorb losses of the variable interest entity that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the variable interest entity.
- 25. **Alternative B**—Yes. Replace the "potentially significant" threshold within the criterion to require that variable interest holders, other than the decision maker and the related parties<sup>3</sup> of the decision maker, have the obligation to absorb losses of the variable interest entity that could be substantially all of the potential losses of the variable interest entity and the right to receive benefits from the variable interest entity that could be substantially all of the potential benefits from the variable interest entity. (If this criterion were met, the decision maker would not be the primary beneficiary.)

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<sup>3</sup> The term *related parties* in this handout refers to all parties identified in paragraph 810-10-25-43. Related parties will be address by the staff in a future memorandum.

26. **Alternative C**—Yes. Replace the “potentially significant” threshold within the criterion to require that the decision maker has the obligation to absorb losses of the variable interest entity that could be equal to or greater than 20 percent of the potential losses of the variable interest entity or the right to receive benefits from the variable interest entity that could be equal to or greater than 20 percent of the potential benefits of the variable interest entity. That is consistent with the threshold interpreted from the guidance in the proposed Update.
27. **Alternative D**—Yes. Replace the “potentially significant” threshold within the criterion to require that the decision maker has the obligation to absorb losses of the variable interest entity that could be greater than the majority of the potential losses of the variable interest entity or the right to receive benefits from the variable interest entity that could be greater than the majority of the potential benefits of the variable interest entity.
28. The staff is split in its recommendations; some staff members support Alternative A and some support Alternative B.

#### Question 1 for the Board

Which alternative would the Board like to pursue when considering how the potentially significant economics criterion of the primary beneficiary determination should be further defined?