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Capital Markets  
Accounting Developments  
Advisory 2008 - 7  
June 13, 2008

**June 11, 2008 FASB Board Meeting on  
FAS 140 and FIN 46(R) Amendments**

**Overview**

On June 11, 2008, the Financial Accounting Standards Board ("FASB" or "the Board") held a Board meeting regarding FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("FAS 140"), and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* ("FIN 46R"), in connection with its projects to amend the standards. Refer to Capital Markets Accounting Developments Advisories ("CMADA") 2008-5 and 2008-6 for additional background on the Board's previous deliberations and decisions on these topics.

**Summary of Board Decisions related to FIN 46(R)**

The Board discussed (1) how to determine the primary beneficiary of a variable interest entity ("VIE") (the alternative views principally considered by the Board are described in the Appendix to this Advisory) and (2) whether to (a) include a "current control" notion in the qualitative assessment of "powers", (b) address the guidance in FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FIN 46(R)* regarding the purpose and design of an entity and the risks that an entity is designed to pass on to its interest holders, and (c) include examples in the Exposure Draft.

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The Board voted in favor of View A' as described below and in the Appendix to this Advisory (however, the Board suggested that certain slight modifications to the wording of View A' be made to address a potential conflict with FSP FIN 46R-6; those modifications are not reflected in the Appendix). Under View A', the primary beneficiary ("PB") would be determined initially through a qualitative analysis. An entity would be the PB of a VIE if it has (1) the power to direct matters that significantly impact the activities and success of the VIE and (2) the right to receive benefits that could potentially be significant and/or the obligation to absorb losses that could be significant. The qualitative analysis would not explicitly require an entity to determine the risks that the VIE was designed to create and pass through to its variable interest holder(s). View A' also considers the implicit and explicit responsibility of an enterprise to ensure that the VIE operates as designed.

If the qualitative assessment is not determinative, then the PB (if any) would be determined through a quantitative analysis using a calculation of the VIE's expected losses and expected residual returns as illustrated in Appendix A of FIN 46(R).

#### *Current Control Notion*

The Board decided to incorporate a "current control" notion into the determination of the PB. Consequently, the qualitative evaluation of the PB would not be affected by other interest holders' rights to potentially effect change (for example, by exercising kick-out rights) at a future date.

***FICG Observation:*** Under the "current control" notion, kick-out rights would not be considered in the initial consolidation analysis. Instead, this approach focuses on identifying and assessing the powers that each variable interest holder has at the date of the qualitative evaluation. If a kick-out right is subsequently exercised, then the primary beneficiary might change upon reconsideration.

The staff had recommended that (1) the "current control" notion should not be included and (2) that kick-out rights should continue to be considered, consistent with applicable current guidance.

Certain Board members expressed concern that permitting "contingent control" provisions like kick-out rights to affect the consolidation assessment might incent parties to include such arrangements solely to avoid consolidation. Other Board members stated that this issue should be analyzed more closely because, in their view, the implications of ignoring kick-out rights in the day one qualitative assessment had not been sufficiently considered. As such, these Board

members believed they were not adequately prepared to make a decision at the meeting.

In the end, the Board disagreed with the staff's recommendation, based on the members' overriding concern that entities might avoid consolidation by inserting kick-out right provisions in the transaction documents.

#### *Applicability of FSP FIN 46R-6*

The Board decided that the guidance in FSP FIN 46R-6 (regarding the purpose and design of a VIE and the risks it is designed and created to pass on to its interest holders) should continue to be applicable. However, the Board agreed that there was a need to revisit the guidance to clarify its intended interaction with the qualitative and quantitative analyses under View A'.

#### *Examples*

The Board agreed that examples illustrating the application of View A' should be included in a separate appendix in the Exposure Draft.

#### **Summary of Board Decisions related to FAS 140**

As a result of the Board's decision to eliminate QSPEs:

- transferees that are VIEs would now be subject to analysis under FIN 46R, and
- the current requirement that at least 10 percent of the fair value of a QSPE's beneficial interests must be held by parties not affiliated with the transferor (or deemed to be its agent) would be eliminated.

The Board discussed whether the amended standard should have a rule that sets a minimum amount of beneficial interests that must be held by parties other than the transferor and its consolidated affiliates for a transferor to account for a transfer as a sale. The Board decided that such a rule was not necessary.

***FICG Observation:*** Although this issue was discussed at a prior Board meeting, a formal decision was not made until this meeting. See CMADA 2008-6.

#### **Comment Period, Effective Date and Transition**

The Board discussed several issues regarding effective dates and the period for enacting the amendments:

- The Board agreed to a 60-day comment period.
- After extensive deliberation, the Board decided that:
  1. The amendments should be effective for fiscal years beginning after November 15, 2008, except for QSPEs existing as of the effective date.
  2. For existing QSPEs, the amendments would become effective for fiscal periods beginning after November 15, 2009. Additional disclosures would be required for these QSPEs during the delay period.
  3. All other proposed amendments (i.e., new disclosures, reconsideration under FIN 46R at each reporting period, and new derecognition and consolidation criteria) would become effective for fiscal years beginning after November 15, 2008. See CMADA 2008-5 and 2008-6 for additional information regarding these proposed changes.

***FICG Observation:*** The staff presented two alternatives with regard to the amendments' effective date: (a) a single effective date for both amendments or (b) different effective dates based on when the transfer was completed and/or when the VIE was created.

The staff proposed that the alternative calling for two different effective dates should apply to both existing VIEs and QSPEs. However, certain Board members expressed an interest in making the changes effective as soon as possible. The Board recognized that many of the proposed changes are significant, and concluded that a one-year deferral for existing QSPEs was appropriate. Because existing VIEs are already evaluated under FIN 46(R), the Board believes that applying the changes to existing VIEs that are not QSPEs will present fewer operational challenges. In contrast, applying the new rules to QSPEs may be a more difficult exercise, since these entities have not previously been considered under the analysis required by FIN 46(R).

It is unclear whether the effective date will be deferred for a QSPE which does not maintain its qualifying status under previous accounting standards, issues new beneficial interests that it was not committed to issue, or receives financial assets that it was not committed to receive.

The Board remains concerned with the project's timeline. Considering the 60-day comment period, the Board may not be in a position to redeliberate the

amendments until September. Issuing the final document in October will leave a minimal amount of time before the effective date.

The Board also discussed -- but rejected -- another option which called for certain significant disclosures and reconsideration provisions being "carved out" and issued in a FSP effective for fiscal years beginning after November 15, 2008. Under this approach, implementation of the enhanced disclosures and the new reconsideration requirements would be effective even if other portions of the project fall behind schedule.

### **Next Steps**

The Board instructed the staff to proceed with the drafting process, which the expected to take 8-10 business days to complete. If this timetable is met, an Exposure Draft of each amendment may be issued by the end of June.

### **Questions**

Questions regarding this Advisory, financial instruments, or credit in general may be directed to:

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## Appendix

The following are excerpts from the Board Meeting Handout prepared by the FASB staff<sup>1</sup>. Note that during the Board meeting, the Board suggested that certain slight modifications to the wording in View A' be made to address a potential conflict with FSP FIN 46R-6 that was discussed in the Board meeting. Those changes are not reflected below.

**View A**—*Initially require a qualitative assessment if an enterprise has a controlling financial interest, and if an enterprise cannot determine if it is or is not the primary beneficiary, it should perform a quantitative analysis.* The proposed language is included [below]. This view requires an enterprise to, along with analyzing the purpose and design of an entity, determine the risks that the variable interest entity creates and passes through to its interest holders as required by FASB Staff Position (FSP) FIN 46(R)–6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*. This view also is purposely silent on the magnitude of benefits and risks that must be present when determining if an enterprise is a primary beneficiary to avoid establishing a bright line for determining the amount of benefits and risks that are required for an enterprise to be the primary beneficiary. However, the staff acknowledges that no guidance on the level of significance necessary to be considered for this criterion may lead to diversity in application. Finally, this view requires both benefits and risks (along with the power to direct matters that significantly impact the activities and success of the entity) to exist for an enterprise to be the primary beneficiary.

**View A'**—Same as View A (proposed language [below]) except for the following:

1. The guidance would not explicitly require an entity to determine the risks that the variable interest creates and passes through to its interest holders as View A, Step 1 (see description [below]); this is partially because Step 1 of this view is purely qualitative.

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<sup>1</sup> The Board Meeting Handout includes the following statement: "The staff has prepared this summary to facilitate the audience's understanding of the issues to be addressed by the Board at its June 11, 2008 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."

2. The guidance would require that, along with the power to direct matters that significantly impact the activities and success of the variable interest entity, an enterprise determine if its right to receive benefits can potentially be significant **or** its obligation to losses can potentially be significant.

3. Specific guidance was added to address an enterprise's implicit or explicit financial responsibility to ensure that a variable interest entity operates as designed to be inserted, in part, to address concerns about an enterprise's reputation risk.

## **View A Guidance**

### **Objective**

**An entity (including any related parties or de facto agents) is the primary beneficiary of a variable interest entity (VIE) if the entity has a variable interest (or a combination of variable interests) in the VIE that provides the entity with a controlling financial interest.**

**The entity whose variable interest or interests provide the entity with (1) the power to direct the activities of the VIE and (2) the right to receive benefits from the VIE along with the obligation to absorb losses of the VIE is the primary beneficiary. Generally, the purpose and design of a VIE, including the risks the VIE creates and passes through to its interest holders, provide key indicators as to which entity, if any, is the primary beneficiary.**

**The determination of which entity, if any, is required to consolidate a VIE will be performed using a qualitative analysis (Step 1) and if, necessary, a quantitative analysis (Step 2) using a calculation of a VIE's expected losses and expected residual returns as illustrated in Appendix A of Interpretation 46(R). The qualitative analysis of an enterprise's right to receive benefits along with the obligation to potentially absorb the related risks as part of Step 1 is not to be performed using the quantitative analysis prescribed in Step 2. Only one entity, if any, is expected to be identified as the primary beneficiary of a VIE.**

## **Step 1—Qualitative Analysis**

Qualitatively determine if an entity has a controlling financial interest in a VIE. This qualitative determination shall include an assessment of the characteristics of the entity's interest(s) and the VIE's primary purpose, including the risks that the VIE was designed to create and pass through to its variable interest holders. Based on this qualitative analysis, an entity shall determine if it has:

1. The power to direct matters that significantly impact the activities and success of the VIE
2. The right to receive benefits from the VIE, along with the obligation to absorb losses of the VIE.

This assessment should enable an entity to determine if it is or is not the primary beneficiary in a VIE. If an entity believes that it may be the primary beneficiary but that the qualitative analysis is not determinative, it shall perform the quantitative analysis pursuant to Step 2 below.

## **Step 2 (If Necessary)—Quantitative Analysis**

An entity shall determine if, through its variable interest, the entity absorbs the majority of the VIE's expected losses, receives the majority of the VIE's residual returns, or both. However, the primary beneficiary identified under this quantitative analysis, if any, must have more than an insignificant ability to influence decisions or matters that could impact the success of the VIE to be its primary beneficiary. If one entity absorbs the majority of a VIE's expected losses and another absorbs the majority of the entity's expected residual returns, the entity absorbing the majority of a VIE's expected losses is considered the primary beneficiary.

### **View A' Guidance (marked for changes from View A)**

#### **Objective**

**An entity (including any related parties or de facto agents) is the primary beneficiary of a variable interest entity (VIE) if the entity has a variable interest (or a combination of variable**

interests) in the VIE that provides the entity with a controlling financial interest.

The entity whose variable interest or interests provide the entity with (1) the power to direct the activities of the VIE and (2) the right to receive benefits from the VIE that could potentially be significant and/or ~~along with~~ the obligation to ~~potentially~~ absorb losses of the VIE that could potentially be significant is the primary beneficiary. ~~Generally, T~~the purpose and design of a VIE, ~~including the risks the VIE creates and passes through to its interest holders,~~ should provide key indicators as to which entity, if any, is the primary beneficiary.

The determination of which entity, if any, is required to consolidate a VIE will be performed using a qualitative analysis (Step 1) and, if necessary, a quantitative analysis (Step 2) using a calculation of a VIE's expected losses and expected residual returns as illustrated in Appendix A of Interpretation 46(R). The qualitative analysis of an enterprise's right to receive benefits and/or ~~along with~~ the obligation to potentially absorb losses of the VIE as part of Step 1 is not to be performed using the quantitative analysis prescribed in Step 2. Only one entity, if any, is expected to be identified as the primary beneficiary of a VIE.

### Step 1—Qualitative Analysis

Qualitatively determine if an entity has a controlling financial interest in a VIE. This qualitative determination shall include an assessment of the characteristics of the entity's interest(s) and the VIE's primary purpose, ~~including the risks that the VIE was designed to create and pass through to its variable interest holders.~~ Based on this qualitative analysis, an entity shall determine if it has:

1. The power to direct matters that significantly impact the activities and success of the VIE
2. The right to receive rights benefits from the VIE that could potentially be significant and/or the obligation to absorb losses of the VIE that could potentially be significant. This criterion includes an entity's implicit or explicit financial responsibility to ensure that a VIE operates as designed.

This assessment should enable an entity to determine if it is or is not the primary beneficiary in a VIE. If an entity believes that it may be the primary beneficiary but that the qualitative analysis is not determinative, it shall perform the quantitative analysis pursuant to Step 2 below.

### **Step 2 (If Necessary)—Quantitative Analysis**

An entity shall determine if, through its variable interest, the entity absorbs the majority of the VIE's expected losses, receive the majority of the VIE's residual returns, or both. However, the primary beneficiary identified under this quantitative analysis, if any, must have more than an insignificant ability to influence decisions or matters that could impact the success of the VIE to be its primary beneficiary. If one entity absorbs the majority of a VIE's expected losses and another absorbs the majority of the entity's expected residual returns, the entity absorbing the majority of a VIE's expected losses is considered the primary beneficiary.

Note: Two additional views (Views B and C) were presented. Those are not included in this appendix as the Board principally discussed Views A and A'.