



Financial Accounting Standards Board

ORIGINAL PRONOUNCEMENTS

AS AMENDED

Statement of Financial Accounting Standards No. 167

Amendments to FASB Interpretation No. 46(R)

Copyright © 2010 by Financial Accounting Foundation. All rights reserved. Content copyrighted by Financial Accounting Foundation may not be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the Financial Accounting Foundation.

Statement of Financial Accounting Standards No. 167 Amendments to FASB Interpretation No. 46(R)

STATUS

Issued: June 2009

Effective Date: As of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter

Affects: Amends FIN 46(R), paragraphs 1, 4(g), 5(b), 6, 7, 14, 16, 17, 22, B1, B9, B11, B13 through B15, B22, and B23, and footnotes a, 3, 7, and 11
Adds FIN 46(R), paragraphs 1A, 2A, 14A through 14G, 22C through 22E, 23A, and C'1 through C'109
Deletes FIN 46(R), paragraphs 15 and B18 through B21 and footnotes 16a, 16b, 17, and 25 through 27
Replaces FIN 46(R), paragraphs 22A, 22B, 23, and 24 through 26
Supersedes FSP FAS 140-4/FIN 46(R)-8
Supersedes FSP FIN 46(R)-3
Amends FSP FIN 46(R)-5, paragraphs 2 and 6 and footnote 1
Amends FSP FIN 46(R)-6, paragraph A1

Affected by: Paragraph D1 (FIN 46(R), footnote 8) effectively amended by Accounting Standards Update 2010-08, paragraph A19(d)

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues

Interpreted by: No EITF Issues

Related Issues: EITF Issues No. 84-4, 84-15, 86-21, 88-22, 88-25, 89-20, 91-10, 94-1, 95-6, 96-16, 97-1, 97-2, 97-10, 97-14, 98-2, 98-13, 99-13, 99-16, 99-20, and 00-4

SUMMARY

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

The Board's objective in issuing this Statement is to improve financial reporting by enterprises involved with variable interest entities. The Board undertook this project to address (1) the effects on certain provisions of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as a result of the elimination of the qualifying special-purpose entity concept in FASB Statement No. 166, *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 in a variable interest entity.

This Statement shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

What Is the Scope of This Statement?

This Statement retains the scope of Interpretation 46(R) with the addition of entities previously considered qualifying special-purpose entities, as the concept of these entities was eliminated in Statement 166.

How Will This Statement Change Current Practice?

This Statement amends Interpretation 46(R) to require an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This analysis identifies the primary beneficiary of a variable interest entity as the enterprise that has both of the following characteristics:

- a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Additionally, an enterprise is required to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

This Statement amends Interpretation 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Before this Statement, Interpretation 46(R) required reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occurred.

This Statement amends Interpretation 46(R) to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

This Statement amends certain guidance in Interpretation 46(R) for determining whether an entity is a variable interest entity. It is possible that application of this revised guidance will change an enterprise's assessment of which entities with which it is involved are variable interest entities.

This Statement amends Interpretation 46(R) to add an additional reconsideration event for determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

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 Statement eliminates that exception.

This Statement amends Interpretation 46(R) to require enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise's involvement in a variable interest entity. The enhanced disclosures are required for any enterprise that holds a variable interest in a variable interest entity. This Statement nullifies FASB Staff Position FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. However, the content of the enhanced disclosures required by this Statement is generally consistent with that previously required by the FSP.

How Will This Statement Improve Financial Reporting?

This Statement amends Interpretation 46(R) to replace the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. An approach that is expected to be primarily qualitative will be more effective for identifying which enterprise has a controlling financial interest in a variable interest entity.

This Statement requires an additional reconsideration event when determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance. It also requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity. These requirements will provide more relevant and timely information to users of financial statements.

This Statement amends Interpretation 46(R) to require additional disclosures about an enterprise's involvement in variable interest entities, which will enhance the information provided to users of financial statements.

What Is the Effect of This 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. The IASB issued two related Exposure Drafts, *Consolidation* and *Derecognition*, in December 2008 and March 2009, respectively. The IASB project on consolidation is a broader reconsideration of all consolidation guidance (not just the guidance for variable interest entities).

Although this Statement was not developed as part of a joint project with the IASB, the FASB and IASB continue to work together to issue guidance that yields similar consolidation and disclosure results for special-purpose entities. The ultimate goal of both Boards is to provide timely, transparent information about interests in special-purpose entities. However, the timeline and anticipated effective date of the IASB project is different from the effective date of this Statement.

This Statement addresses the potential impacts on the provisions and application of Interpretation 46(R) as a result of the elimination of the qualifying special-purpose entity concept in Statement 166. Ultimately, the two Boards will seek to issue a converged standard that addresses consolidation of all entities.

Statement of Financial Accounting Standards No. 167

Amendments to FASB Interpretation No. 46(R)

CONTENTS

	Paragraph Numbers
Objective.....	1
Standards of Financial Accounting and Reporting:	
Scope.....	2
Amendments to Interpretation 46(R).....	3
Effective Date and Transition.....	4-10
Appendix A: Background Information and Basis for Conclusions.....	A1-A109
Appendix B: Amendments to Existing FASB Pronouncements.....	B1-B3
Appendix C: Amendments to Other Authoritative Literature.....	C1-C30
Appendix D: Interpretation 46(R), As Amended by This Statement.....	D1

OBJECTIVE

1. The objective of this Statement is to amend certain requirements of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

2. This Statement carries forward the scope of Interpretation 46(R), with the addition of entities previously considered qualifying special-purpose entities, as the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets*.

Amendments to Interpretation 46(R)

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

a. Paragraph 1:

This Interpretation, which replaces FASB Interpretation No. 46, *Consolidation of Variable In-*

terest 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, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:~~

- a. The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance
- 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 in the 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 the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

- c. Paragraph 2A and its related heading are added as follows:

Consideration of Substantive Terms, Transactions, and Arrangements

For purposes of applying this Interpretation, only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered. Any term, transaction, or arrangement that does not have a substantive effect on (a) an entity's status as a variable interest entity, (b) an enterprise's power over a variable interest entity, or (c) an enterprise's obligation to absorb losses or its right to receive benefits of the entity shall be disregarded when applying the provisions of this Interpretation. Judgment, based on consideration of all the facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from nonsubstantive terms, transactions, and arrangements.

- d. Footnotes a and 3 to paragraph 4:

³AICPA 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 com-

pany. 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 FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*.

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)(4).

- e. Paragraph 4(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 1044 of Statement 167 provides transition guidance for an enterprise that subsequently obtains the information necessary to apply this Interpretation to an entity subject to this exception.

- f. Paragraph 5(b) and its related footnotes:

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 power, direct or indirect ability through voting rights or similar rights, to directmake decisions about an entity's the activities of anthat have a significant effect on the success of the entity that most significantly impact the entity's economic performance. The investors do not have that abilitypower 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 Kick-out rights^{8a} or participating rights^{8a} held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs B22 and B23 of this Interpretation.

- (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

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 ~~these~~ the characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having ~~these~~ the necessary characteristics, 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.

^{8a}See footnotes 15b and 15c for the definitions of kick-out rights and participating rights.

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.

- g. Footnote 11 to paragraph 5(c):

This 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)(†).

- h. 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.~~

- i. 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.
- e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

~~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.~~

j. Paragraph 14:

~~An enterprise shall consolidate a variable interest entity if when that enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest on the basis of the provisions in paragraphs 14A–14G. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that 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.~~

k. Paragraphs 14A–14G are added as follows:

14A. An enterprise with a variable interest in a variable interest entity shall assess whether the enterprise has a controlling financial interest in the entity and, thus, is the entity's primary beneficiary. This shall include an assessment of the characteristics of the enterprise's variable interest or interests and other involvements (including involvement 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 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 the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The quantitative approach prescribed in paragraph 8 of this Interpretation is not required and shall not be the sole determinant as to whether an enterprise has these obligations or rights.

Only one enterprise, if any, is expected to be identified as the primary beneficiary of a variable interest entity. Although more than one enterprise could have the characteristic in paragraph 14A(b), only one enterprise, if any, will have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

14B. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. An enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic

performance of the entity. An enterprise does not have to exercise its power in order to have power to direct the activities of an entity.

14C. An enterprise's determination of whether it has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance shall not be affected by the existence of kick-out rights^{15b} or participating rights^{15c} unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. They include, for example:

- a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. For example:
 - (1) A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
 - (2) Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.
- b. The ability to remove the enterprise that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that enterprise.
- c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might

restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

14D. If an enterprise determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and if decisions about those activities require the consent of each of the parties sharing power. If an enterprise concludes that power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 14A(a).

14E. If the activities that impact the entity's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then an enterprise shall identify which party has the power to direct the activities that most significantly impact the entity's economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 14A(a).

14F. Although an enterprise may be significantly involved with the design of an entity, that involvement does not, in isolation, establish that enterprise as the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with that power. For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the entity operates as designed, the sponsor may have established arrangements that result in the sponsor being the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity.

14G. Consideration should be given to situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of an enterprise's economic interest may be indicative of the amount of power that enterprise holds.

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

^{15b}Kick-out rights are the ability to remove the enterprise with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. This requirement is limited to this particular analysis and is not applicable to transactions accounted for under other authoritative guidance, such as EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights."

^{15c}Participating rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. This requirement is limited to this particular analysis and is not applicable to transactions accounted for under other authoritative guidance such as 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."

1. 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 pri-~~

~~mary 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.~~

m. Paragraph 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. However, a de facto agency relationship does not exist if both the enterprise and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

n. Paragraph 17:

In situations in which an enterprise concludes that neither it nor one of its related parties has the characteristics in paragraphs 14A(a) and 14A(b) but, as a group, the enterprise and its related parties~~If two or more related parties (including the de facto agents described in paragraph 16) have those characteristics, 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~~variability~~ associated with the anticipated economic performance of the variable interest entity
- d. The design of the variable interest entity.

o. Paragraph 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. If an enterprise is required to deconsolidate a variable interest entity, the enterprise shall follow the guidance for deconsolidating subsidiaries in FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*.

p. Paragraph 22A and its related heading:

Disclosures for Public Enterprises Presentation

22A. A public enterprise^{16a}, including a public enterprise that is a sponsor that has a variable interest in a variable interest entity, shall provide disclosures as required in Appendix C of FSP FAS 140-4 and FIN 46(R)-8. A reporting enterprise shall present separately on the face of the statement of financial position (a) assets of a consolidated variable interest entity that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

^{16a} See footnote 3.

q. Paragraph 22B:

A public enterprise^{16b} shall provide disclosures as required in Appendix D of FSP FAS 140-4 and FIN 46(R)-8 if that enterprise is a (a) nontransferor sponsor of a qualifying SPE that holds a variable interest in a qualifying SPE or (b) nontransferor servicer of a qualifying SPE that holds a significant variable interest in the qualifying SPE. The principal objectives of the

disclosures required by paragraphs 22C–26 are to provide financial statement users with an understanding of the following:

- a. The significant judgments and assumptions made by an enterprise in determining whether it 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 and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- c. The nature of, and changes in, the risks associated with an enterprise's involvement with the variable interest entity
- d. How an enterprise's involvement with the variable interest entity affects the enterprise's financial position, financial performance, and cash flows.

An enterprise shall consider those overall objectives in providing the disclosures required by this Interpretation. To achieve those objectives, an enterprise may need to supplement the disclosures required by paragraphs 22C–26, depending on the facts and circumstances surrounding the variable interest entity and the enterprise's interest in that entity.

^{16b}See footnote*.

- r. Paragraphs 22C–22E are added as follows:

22C. Disclosures about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not provide more useful 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 has a variable interest
- b. Variable interest entities that are consolidated.

In determining whether to aggregate variable interest entities, the reporting 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. The disclosures shall be presented in a manner that clearly explains to financial statement users the nature and extent of an enterprise's involvement with variable interest entities.

22D. An enterprise shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the requirements of this Interpretation. An enterprise also shall determine how it aggregates information to display its overall involvements with variable interest entities with different risk characteristics. The entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial position. For example, an enterprise shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an enterprise shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks.

22E. In addition to disclosures required by other standards, an enterprise that is a primary beneficiary of a variable interest entity^{16c} or an enterprise that holds a variable interest in a variable interest entity but is not the entity's primary beneficiary shall disclose:

- a. Its methodology for determining whether the enterprise is the primary beneficiary of a variable interest entity, including, but not limited to, significant judgments and assumptions made. For example, one way to meet this disclosure requirement would be to provide information about the types of involvements an enterprise considers significant, supplemented with information about how the significant involvements were considered in determining whether the enterprise is the primary beneficiary.
- b. If facts and circumstances change such that the conclusion to consolidate a variable interest entity has changed 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 (explicitly or implicitly) during the periods presented to the variable interest entity that it was not previously contractually required to provide or whether the enterprise intends to provide that support, including:

- (1) The type and amount of support, including situations in which the enterprise assisted the variable interest entity in obtaining another type of support
- (2) The primary reasons for providing the support.

d. Qualitative and quantitative information about the enterprise's involvement (giving consideration to both explicit arrangements and implicit variable interests^{16d}) with the variable interest entity, including, but not limited to, the nature, purpose, size, and activities of the variable interest entity, and how the entity is financed.

^{16c}A 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 22E and 23A are not required.

^{16d}FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, provides guidance on how to determine whether an enterprise has an implicit variable interest in a variable interest entity.

s. Paragraph 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 any gain or loss recognized on the initial consolidation of the variable interest entity. 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 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
- b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations
- e. 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.

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, the disclosures in paragraphs 23 and 27 are not required.

t. Paragraph 23A is added as follows:

23A. In addition to disclosures required by other pronouncements, the primary beneficiary of a variable interest entity^{17a} shall disclose the following:

- a. The carrying amounts and classification of the variable interest entity's assets and liabilities in the statement of financial position that are consolidated in accordance with this Interpretation, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the variable interest entity's assets can be used only to settle obligations of the variable interest entity, the enterprise shall disclose qualitative information about the nature of the restrictions on those assets.
- b. 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.
- c. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the variable interest entity, including events or circumstances that could expose the enterprise to a loss.

^{17a}See footnote 16c.

u. Paragraphs 24–26:

24. An enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary shall disclose: In addition to

disclosures required by other pronouncements, an enterprise that holds a variable interest in a variable interest entity, but is not the variable interest entity's primary beneficiary, shall disclose:

- a. The nature of its involvement with the variable interest entity and when that involvement began
- b. The nature, purpose, size, and activities of the variable interest entity
- c. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity:
 - a. The carrying amounts and classification of the assets and liabilities in the enterprise's statement of financial position that relate to the enterprise's variable interest in the variable interest entity.
 - b. 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.
- d. A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the enterprise's maximum exposure to loss, as required by (b) above. An enterprise shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the variable interest entity, including events or circumstances that could expose the enterprise to a loss.
- e. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the enterprise's variable interest in the variable interest entity is encouraged.
- e. If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a variable

interest entity that most significantly impact the entity's economic performance is shared in accordance with the guidance in paragraph 14D.

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. 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 22B 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: 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.

- a. The number of entities to which this Interpretation is not being applied and the reason that the information required to apply this Interpretation is not available
- b. The nature, purpose, size (if available), and activities of the entity or entities and the nature of the enterprise's involvement with the entity or entities
- c. The reporting enterprise's maximum exposure to loss because of its involvement with the entity or entities
- d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting enterprise and the entity or entities 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.

v. 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 holders of the equity investment at risk do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support or because they lack (a) the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, or (c) the right to receive the expected residual returns of 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

~~in a variable interest entity and explains in general how they may affect the determination of the primary beneficiary.~~

w. 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.

x. Paragraph B11:

If the variable interest 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).

y. Paragraphs B13–B15:

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.

- z. Paragraphs B18–B23 and related headings and footnotes:

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:

- 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.

Fees Paid to Decision Makers or Service ProvidersOther Service Contracts

B22. Fees paid to an entity's decision maker(s) or service provider(s)Service contracts with hired service providers other than the entity's decision maker are not variable interests if all of thethree 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.decision maker or service provider and its related parties,^{26a} if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.
- d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.
- e. The total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
- f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

B23. Fees paid to decision makers or service providers that do not meet all of the conditions in B22 areService 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.

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

²⁶Refer to footnote 25.

^{26a}The term *related parties* refers to all parties identified in paragraph 16. However, for purposes of this condition, related parties do not include employees of the decision maker or service provider, unless the employees are used in an effort to circumvent the provisions of this Interpretation.

- aa. Paragraph B26 and its related footnote:

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.

²⁷This 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).

- bb. Appendix C' is added as follows:

Appendix C'

IMPLEMENTATION GUIDANCE

C1. The following example fact patterns and related evaluations are provided solely to illustrate the application of the guidance in paragraphs 14–14G of this Interpretation. 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, on the basis of the guidance in paragraphs 12 and 13 of this Interpretation. In some examples, certain fees are described as representing, or not representing, a variable interest on the basis of paragraphs B22 and B23 of this Interpretation. However, the examples were not meant to illustrate the application of the guidance in paragraphs B22 and B23, and additional facts would be necessary to determine which condition(s) resulted in the fee representing a variable interest. Finally, determining the primary beneficiary in accordance with the guidance in this Interpretation requires judgment and is on the basis of individual facts and circumstances of the variable interest entity and the enterprise with the variable interest or interests.

Example 1

Facts and Circumstances

C2. An entity is created and financed with \$94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and \$6 of equity. All of the bonds are held by third-party investors. The equity is held by a third party, who is also the special servicer. 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 a 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 bondholders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

C3. 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.

C4. If there is a shortfall in contractual payments from the borrowers or if the 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.

C5. The Transferor retains the primary 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 special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

C6. The special servicer is involved in the creation of the entity and required at the creation date that certain loans, which it deemed to be of high risk, be removed from the initial pool of loans that were going to be purchased by the entity from the Transferor. The special servicer also reviewed the entity's governing documents to ensure that the special servicer would be allowed to act quickly and effectively in situations in which a loan becomes delinquent. The special servicer concluded the entity's governing documents allowed the special servicer to adequately monitor and direct the performance of the underlying loans.

C7. For its services as primary servicer, the Transferor earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The special servicer also earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. No party has the ability to remove the primary servicer or the special servicer.

Evaluation

Design of the entity

C8. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to cre-

ate 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 provide liquidity to the Transferor to originate additional loans and to 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

C9. The special servicer and the bondholders are the variable interest holders in the variable interest entity. The fees paid to the Transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation. The fees paid to the special servicer represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C10. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact the performance of the underlying assets. The 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 special servicer, 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. However, an enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. An enterprise does not have to exercise its power in order to have power to direct the activities of an entity. The special servicer's involvement in the design of the entity does not, in isolation, result in the special servicer being the primary beneficiary of the entity. However, in this situation, that involvement indicated that the special servicer had the opportunity and the incentive to establish arrangements that result in the special servicer being the variable interest holder with the power to direct the activities that most significantly impact the entity's economic performance.

C11. The bondholders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity's economic performance.

C12. The activities that the primary servicer has the power to direct are administrative in nature and do not most significantly impact the entity's economic performance. In addition, the primary servicer, and its related parties, do not hold a variable interest in the entity. Thus, the primary servicer cannot be the primary beneficiary of the entity.

C13. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

C14. The special servicer, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the entity. The

special servicer concluded that the benefits could not potentially be significant to the entity. The special servicer, as the equity tranche holder, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the variable interest entity. As equity tranche holder, the special servicer 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.

C15. On the basis of the specific facts and circumstances presented above and the analysis performed, the special servicer 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. As the equity tranche holder, it has the obligation to absorb losses of the variable interest entity and the right to receive benefits from the variable interest entity, either of which could potentially be significant to the variable interest entity.

Example 2

Facts and Circumstances

C16. An entity is created and financed with \$90 of AAA-rated fixed-rate debt securities, \$6 of 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.

C17. 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 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.

C18. 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.

C19. 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.

C20. The third-party equity investor has rights that are limited to administrative matters.

Evaluation

Design of the entity

C21. 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 provide investors with the ability to invest in a pool of asset-backed securities, to earn a positive spread between the interest that the entity earns on its portfolio and the interest paid to the debt investors, and to 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 se-

curities in the portfolio and to the interest rate risk associated with the management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the 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

C22. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C23. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of the entity's portfolio of assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact the performance of the portfolio of assets. The Manager has the ability to 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.

C24. The debt holders of the entity do not have voting rights or other rights that provide them with the power to direct activities that most significantly impact the entity's economic performance. 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.

C25. The third-party equity investor has the power to direct certain activities. However, the activities that the third-party equity investor has the power to direct are administrative and do not most significantly impact the entity's economic performance.

C26. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Manager, as the 35 percent equity tranche holder, has the obligation to absorb losses and the right to receive benefits. 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 benefits of the entity. Through the equity interest and performance-based fee, the Manager has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

C27. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance (and no single enterprise has the unilateral ability to exercise kick-out rights).
- b. Through its equity interest and performance-based fee, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 3

Facts and Circumstances

C28. 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.

C29. 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.

C30. 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.

C31. 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—This 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.

C32. For its services, the Sponsor receives a fixed fee, calculated as an annual percentage of the aggregate equity outstanding, and a performance-based fee, calculated as a percentage of the entity’s profit above a targeted return.

C33. 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

C34. 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 provide investors with the ability to invest in a pool of high-quality debt, to maximize the spread it earns on its asset portfolio over its weighted-average cost of funding, and to generate management fees for the Sponsor.
- b. 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.

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

C35. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C36. An enterprise must identify which activities most significantly impact the entity’s economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the performance of the entity’s portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the entity’s economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The Sponsor manages the entity’s investment, funding, and defeasance activities. 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 indicated that the Sponsor had the opportunity and the incentive to establish arrangements that result in the Sponsor being the variable interest holder with the power to direct the activities that most significantly impact the entity’s economic performance.

C37. The debt security holders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity’s economic performance. Although the equity holders have voting rights, they are limited to voting on amendments to the constitutional documents of the entity, and those rights do not

provide the equity holders with the power to direct the activities that most significantly impact the entity's economic performance.

C38. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Sponsor, through its performance-based fee arrangement, receives benefits that could potentially be significant to the variable interest entity. As the entity is designed to earn a spread 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.

C39. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its performance-based fee arrangement and implicit financial responsibility to ensure that the variable interest entity operates as designed, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 4

Facts and Circumstances

C40. 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.

C41. The Sponsor of the entity provides credit enhancement in the form of a letter of credit equal to 5 percent of the entity's assets and it provides 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.

C42. A credit default of the entity's assets resulting in deficient cash flows is absorbed as follows:

- a. First by the subordinated note holders
- b. Second by the Sponsor's letter of credit
- c. Third by the short-term debt holders.

The Sponsor's liquidity facility does not advance against defaulted assets.

C43. The entity is exposed to liquidity risk because the average life of the assets is greater than that of its liabilities. The entity enters into a liquidity facility with the Sponsor to mitigate liquidity risk.

C44. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal 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.

C45. The Sponsor of the entity performs various functions to manage the operations of the entity. Specifically, the Sponsor:

- a. Establishes the terms of the entity
- b. Approves the sellers permitted to sell to the entity
- c. Approves the assets to be purchased by the entity
- d. Makes decisions regarding the funding of the entity including determining the tenor and other features of the short-term debt issued
- e. 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.

C46. For providing credit and liquidity facilities and management services, the Sponsor receives a fixed fee calculated as an annual percentage of the asset value.

C47. The short-term debt holders and subordinated note holders have no voting rights.

Evaluation

Design of the entity

C48. 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 provide investors with the ability to invest in a pool of highly rated medium-term assets, to provide the multiple sellers to the entity with access to lower-cost funding, to earn a positive spread between the interest that the entity earns on its asset

portfolio and its weighted-average cost of funding, and to generate fees for the Sponsor.

- b. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal 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

C49. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C50. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the performance of the entity's portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the entity's economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The Sponsor 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 about 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. 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 and the incentive to establish arrangements that result in the Sponsor being the variable interest holder with the power to direct the activities that most significantly impact the entity's economic performance.

C51. 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 the activities that most significantly impact the entity's economic performance.

C52. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity 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.

C53. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- 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.

Example 5

Facts and Circumstances

C54. 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.

C55. 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.

C56. 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.

C57. 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 that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

C58. 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.

C59. 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 managing default. 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

C60. 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 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, to provide the Transferor to the entity with access to liquidity for its originated loans and an ongoing servicing fee, and to 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 risk 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

C61. The debt securities holders and the Guarantor are the variable interest holders in the variable interest entity. The fees paid to the Transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C62. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact 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.

C63. 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 activities related to such risk.

C64. 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 the activities that most significantly impact the entity's economic performance. In addition, the primary servicer and

its related parties do not hold a variable interest in the entity. Thus, the primary servicer cannot be the primary beneficiary of the entity. Furthermore, the security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the entity's economic performance.

C65. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity 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.

C66. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- 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.

Example 6

Facts and Circumstances

C67. 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 activi-

ties 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.

C68. 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.

C69. The primary servicing responsibilities are retained by the Transferor. No party has the ability to remove the Transferor as servicer.

C70. 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 all of the following:

- 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)
- 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 managing default, 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

C71. 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 provide investors with the ability to invest in a pool of residential mortgage loans and to provide the Transferor to the entity with access to liquidity for its originated loans 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

C72. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C73. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it

has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact 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. The default management activities are performed only after default of the underlying assets or when default is reasonably foreseeable. However, an enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. A reporting entity does not have to exercise its power in order to have power to direct the activities of an entity.

C74. 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.

C75. The senior security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the entity's economic performance.

C76. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Transferor, through its residual tranche ownership, has the obligation to absorb losses and the right to receive benefits, either of which 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. The Transferor concluded that those benefits could not potentially be significant to the entity.

C77. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its residual tranche ownership, it has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the variable interest entity.

Example 7

Facts and Circumstances

C78. 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.

C79. 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.

C80. 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 the power to direct any activities of the variable interest entity. The entity was formed so that the lessee would have rights to use the property under an operating lease and would retain substantially all of the risks and rewards from appreciation or depreciation in value of the leased property.

C81. 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

C82. 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

C83. The debt investors, the equity investors, and the lessee are the variable interest holders in the variable interest entity.

C84. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the variable interest entity is significantly impacted 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, and the lessee directs the remarketing of the 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 how it remarkets the property.

C85. The debt holders do not have the power to direct activities that most significantly 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 activities that most significantly impact the entity's economic performance.

C86. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The lessee has both the obligation

to absorb losses that could potentially be significant to the variable interest entity and the right to receive benefits that could potentially be significant to the variable interest entity through the residual value guarantee and the purchase option, respectively.

C87. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its residual value guarantee and purchase option, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 8

Facts and Circumstances

C88. Company A and Company B form an entity to manufacture, distribute, and sell a beverage. The entity is funded with \$95 million of 20-year fixed-rate debt and \$5 million of equity. The debt is widely dispersed among third-party investors. The equity is held by Company A and Company B. Company A and Company B are not related parties. Company A, a beverage manufacturer and distributor, is responsible for manufacturing the beverage. Company B, also a beverage manufacturer and distributor, is responsible for distributing and selling the beverage. Company A and Company B each have 50 percent of the voting rights and each represents 50 percent of the board of directors. Decisions about the manufacturing, distributing, and selling of the beverage require the consent of both Company A and Company B. All other decisions about the entity 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.

Evaluation

Purpose and design of the entity

C89. 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 that the primary purpose for which the variable interest entity was created was to provide Company A with access to Company B's distribution and sales network and for Company B to gain access to Company A's manufacturing process and technology.

Determination of the primary beneficiary

C90. Company A and Company B (through their equity investment) and the debt investors are the variable interest holders in the variable interest entity.

C91. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the manufacturing of the beverage and by the selling and distributing of the beverage. Thus, the activities that significantly impact the entity's economic performance are the activities that significantly impact the manufacturing of the beverage and the selling and distributing of the beverage.

C92. If an enterprise determines that power is, in fact, shared among multiple parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, and if decisions about those activities require the consent of each of the parties sharing power.

C93. Company A and Company B share the power to direct the activities that will most sig-

nificantly impact the economic performance of the entity through their ability to make decisions about the manufacturing, distributing, and selling of the beverage and because of the fact that those decisions require each party's consent.

C94. The debt holders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity's economic performance.

C95. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. Company A and Company B both have the obligation to absorb losses and the right to receive benefits that could potentially be significant to the variable interest entity through their equity interests.

C96. On the basis of the specific facts and circumstances presented above and the analysis performed, the entity does not have a primary beneficiary because the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance, is, in fact, shared among multiple parties (Company A and Company B) such that no one party has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

Example 8A

C97. Assume that decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Company A and Company B. Each enterprise would be required to identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the variable interest entity. Because decisions about these activities do not require the consent of both Company A and Company B, power would not be considered shared,

and either Company A or Company B would be the primary beneficiary of the entity, on the basis of which party has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

Example 8B

C98. Assume that Company A and Company B each manufacture, distribute, and sell the beverage in different locations, but decisions about these activities do not require the consent of both Company A and Company B. That is, each company is responsible for the same activities. Because decisions about these activities do not require the consent of both Company A and Company B, power would not be considered shared.

C99. If an enterprise concludes that power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. If no party directs the majority of those activities, the variable interest entity does not have a primary beneficiary.

C100. If Company A or Company B has power over the majority of those activities, then that party would be the primary beneficiary of the entity.

Example 8C

C101. Assume that Company A and Company B are each responsible for manufacturing the beverage, but Company B is also responsible for all of the distributing and selling of the beverage, and decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Company A and Company B. Each enterprise would be required to identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary ben-

eficiary of the variable interest entity. That is, power would not be considered shared, and either Company A or Company B would be the primary beneficiary of the entity. However, if an enterprise concludes that power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. If no party directs the majority of those activities, the variable interest entity does not have a primary beneficiary.

C102. Company B may conclude that its power over some of the manufacturing of the beverage, combined with its power over all of the distributing and selling of the beverage, results in its being the party with the power to direct the activities that most significantly impact the entity's economic performance. However, if Company B were to conclude that the distributing and selling of the beverage did not significantly impact the economic performance of the entity, then the primary beneficiary of the entity would be the party, if any, with the power over the majority of the manufacturing of the beverage.

Example 9

Facts and Circumstances

C103. An entity is created by a furniture manufacturer and a financial investor to manufacture and 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. The debt agreement includes a clause such that if there is a materially adverse change that materially impairs the ability of the entity and the furniture manufacturer to pay the debt, then the financial investor can take possession of all the assets of the entity. An independent third party must objectively determine whether a materially adverse change has occurred on the basis of the terms of the debt agreement (an example of a materially adverse change under the debt agreement is the bankruptcy of the entity).

Evaluation

Purpose and design of the entity

C104. 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

C105. The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the variable interest entity.

C106. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The eco-

nomical performance of the entity is most significantly impacted by the operations of the entity because the operating cash flows of the entity are used to repay the financial investor. Thus, the activities that most significantly impact the entity's economic performance are the operating activities of the entity. The furniture manufacturer has the ability to establish the sales and marketing strategy of the entity and manage the day-to-day activities of the entity.

C107. The debt holder has the power to take possession of all of the assets of the entity if there is a materially adverse change under the debt agreement. However, the debt holder's rights under the materially adverse change clause represent protective rights. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. The debt holder's rights protect the interests of the debt holder; however, the entity's economic performance is most significantly impacted by the activities over which the furniture manufacturer has power. The debt holder's protective rights do not prevent the furniture manufacturer from having the power to direct the activities of the entity that most significantly impact the entity's economic performance.

C108. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits that could potentially be significant to the variable interest entity. The furniture manufacturer has the obligation to absorb losses that could potentially be significant through its equity interest and debt guarantee and the right to receive benefits that could potentially be significant through its equity interest.

C109. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its equity interest and debt guarantee, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

EFFECTIVE DATE AND TRANSITION

4. This Statement shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. For public enterprises, in periods after initial adoption, comparative disclosures for those disclosures that were not previously required by FASB Staff Position FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*, are required only for periods after the effective date. Comparative information for disclosures previously required by FSP FAS 140-4 and FIN 46(R)-8 that are also required by this Statement shall be presented. For nonpublic enterprises, in periods after initial adoption, comparative disclosures for those disclosures that were not previously required by Interpretation 46(R) are required only for periods after the effective date. Comparative information for disclosures previously required by Interpretation 46(R) that are also required by this Statement shall be presented.

5. If an enterprise is required to consolidate an entity as a result of the initial application of this Statement, the consolidating enterprise shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity (as defined in paragraph 2(a) of Interpretation 46(R), as amended by this Statement) at their carrying amounts at the date the requirements of this Statement first apply. In this context, *carrying amounts* refers to the amounts at

which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if this Statement had been effective when the enterprise first met the conditions to be the primary beneficiary (as defined in paragraph 2(d) of Interpretation 46(R), as amended by this Statement). If determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the variable interest entity shall be measured at fair value at the date this Statement first applies. However, if determining the carrying amounts is not practicable, and if the activities of the entity are primarily related to securitizations or other forms of asset-backed financings and the assets of the entity can be used only to settle obligations of the entity, then the assets and liabilities of the entity may be measured at their unpaid principal balances (as an alternative to a fair value measurement) at the date this Statement first applies. This measurement alternative does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or other-than-temporary impairment, as appropriate. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, shall be measured at fair value. Any difference between the net amount added to the balance sheet of the consolidating enterprise and the amount of any previously recognized interest in the newly consolidated entity shall be recognized as a cumulative effect adjustment to retained earnings. An enterprise shall describe the transition method(s) applied and shall disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.

6. An enterprise that is required to consolidate an entity as a result of the initial application of this Statement may elect the fair value option provided by FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, only if the enterprise elects the option for all financial assets and financial liabilities of that entity that are eligible for this option under Statement 159. This election shall be made on an entity-by-entity basis. Along with the disclosures required in Statement 159, the consolidating enterprise shall disclose management's reasons for electing the fair value option for a particular entity or group of entities. If the fair value option is elected for some entities and not others, the reasons for those different elections shall be disclosed. In addition, the consolidating enterprise shall disclose quantitative information by line item in the statement of financial

position indicating the related effect on the cumulative effect adjustment to retained earnings of electing the fair value option for an entity.

7. If an enterprise is required to deconsolidate an entity as a result of the initial application of this Statement, the deconsolidating enterprise shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of this Statement first apply. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the enterprise's financial statements if this Statement had been effective when the enterprise became involved with the entity or no longer met the conditions to be the primary beneficiary (as defined in Interpretation 46(R), as amended by this Statement). Any difference between the net amount removed from the balance sheet of the deconsolidating enterprise and the amount of any retained interest in the newly deconsolidated entity shall be recognized as a cumulative effect adjustment to retained earnings. The amount of any cumulative effect adjustment related to deconsolidation shall be disclosed separately from any cumulative effect adjustment related to consolidation of entities.

8. The determinations of (a) whether an entity is a variable interest entity and (b) which enterprise, if any, is a variable interest entity's primary beneficiary shall be made as of the date the enterprise became involved with the entity or if events requiring reconsideration of the entity's status or the status of its variable interest holders have occurred, as of the most recent date at which Interpretation 46(R), as amended by this Statement, would have required consideration. However, if at transition it is not practicable for an enterprise to obtain the information necessary to make the determinations as of the date the enterprise became involved with an entity or at the most recent reconsideration date, the enterprise

should make the determinations as of the date on which this Statement is first applied. If the variable interest entity and primary beneficiary determinations are made in accordance with this paragraph, then the primary beneficiary shall measure the assets, liabilities, and noncontrolling interests of the variable interest entity at fair value as of the date on which this Statement is first applied. However, if the activities of the entity are primarily related to securitizations or other forms of asset-backed financings and the assets of the entity can be used only to settle obligations of the entity, then the assets and liabilities of the entity may be measured at their unpaid principal balances (as an alternative to a fair value measurement) at the date this Statement first applies. This measurement alternative does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or other-than-temporary impairment, as appropriate. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, shall be measured at fair value.

9. This Statement may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

10. An enterprise that has not applied Interpretation 46(R), as amended by this Statement, to an entity because of the condition described in paragraph 4(g) of Interpretation 46(R), as amended by this Statement, and that subsequently obtains the information necessary to apply Interpretation 46(R), as amended by this Statement, to that entity shall apply the provisions of this Statement as of the date the information is acquired in accordance with paragraph 5 of this Statement.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz
Chairman

Thomas J. Linsmeier
Leslie F. Seidman

Marc A. Siegel
Lawrence W. Smith

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

	Paragraph Numbers
Introduction	A1
Background Information	A2–A4
Consideration of Substantive Terms, Transactions, and Arrangements	A5
Significant Variable Interests	A6–A9
Reconsideration Events	A10–A25
Primary Beneficiary Determination	A26–A38
The Obligation to Absorb Losses or the Right to Receive Benefits That Could Potentially Be Significant to the Variable Interest Entity	A39–A43
Kick-out, Participating, and Protective Rights	A44–A52
Shared Power	A53–A57
Involvement in the Design of a Variable Interest Entity	A58–A60
Determining Whether an Entity Is a Variable Interest Entity	A61–A65
Related Parties	A66–A71
Fees Paid to Decision Makers or Service Providers	A72–A77
Separate Presentation	A78–A81
Disclosures	A82–A93
Transition	A94–A101
Effective Date	A102–A104
Similarities and Differences with International Financial Reporting Standards	A105
Benefits and Costs	A106–A109

Appendix A

BACKGROUND INFORMATION AND
BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this 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

A2. In March 2008, the Board added a project to its agenda to amend and enhance certain guidance in

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. This project was undertaken to address the following:

- a. The potential effects on certain provisions of Interpretation 46(R) of the elimination of the qualifying special-purpose entity concept in FASB Statement No. 166, *Accounting for Transfers of Financial Assets*. As a result of the elimination of the qualifying special-purpose entity concept, many entities will become subject to the consolidation guidance in Interpretation 46(R).
- b. 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.

A3. 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 limited 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 limited reconsideration events listed in that paragraph
- c. The method for determining which enterprise, if any, is the primary beneficiary of a variable interest entity in paragraph 14 of the Interpretation
- d. The sufficiency of the disclosure requirements in paragraphs 23–26 of the Interpretation.

A4. To address these concerns, the Board issued the Exposure Draft, *Amendments to FASB Interpretation No. 46(R)*, in September 2008, that proposed amendments to the guidance related to items (a)–(d) in paragraph A3. Approximately 75 organizations and individuals from various constituent groups commented on the Exposure Draft. The Board also held two public roundtable meetings to listen to the views of, and obtain information from, interested constituents. Roundtable participants included a wide variety of constituents, including financial statement users, preparers, auditors, and others. In addition, the Board held 13 public Board meetings to deliberate the conclusions in this Statement.

Consideration of Substantive Terms, Transactions, and Arrangements

A5. In its redeliberations, the Board added guidance to emphasize that, for purposes of applying Interpretation 46(R), as amended by this Statement, only substantive terms, transactions, and arrangements should be considered. The Board deliberated whether this guidance was necessary and concluded that it was necessary to avoid situations in which the form of an entity may indicate that an entity is not a variable interest entity or an enterprise is not a primary beneficiary when the substance of the arrangement may indicate otherwise. The inclusion of that guidance is not meant to imply that nonsubstantive terms should be considered in other areas of generally accepted accounting principles (GAAP).

Significant Variable Interests

A6. Before being amended by this Statement, paragraph 6 of Interpretation 46(R) did not require an enterprise "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 . . . did not participate significantly in the design or redesign of the entity." Paragraph 24 of Interpretation 46(R) only required that disclosures be provided in situations in which an enterprise held a significant variable interest in a variable interest entity.

A7. In its initial deliberations, the Board concluded that for purposes of determining whether a variable interest is significant to an enterprise in paragraph 6 of the Interpretation, the interest would be significant if it is significant to either the variable interest entity or the enterprise.

A8. Some respondents to the Exposure Draft asked that significance be determined solely in relation to the variable interest entity for applying the guidance in paragraphs 6 and 24 of the Interpretation. Other respondents asked that significance be determined solely in relation to the reporting enterprise. Users were concerned with the overall concept of significance in paragraphs 6 and 24 of the Interpretation. Specifically, they expressed concern that practitioners may apply significance at a level in excess of material and, thus, would avoid determining whether the entity in which they have an interest is a variable interest entity. They also stated that many required disclosures were not provided under Interpretation 46(R) because preparers concluded that the risks that may initially have been material were deemed insignificant.

A9. In its redeliberations, the Board considered those concerns about the concept of significance in applying the provisions of paragraphs 6, 22E, and 24 of Interpretation 46(R), as amended by this Statement. The Board concluded that the significance threshold should be removed from the guidance in those paragraphs. The Board believes that because the provisions of Interpretation 46(R), as amended by this Statement, are not required to be applied to immaterial items, applying the provisions for determining whether an entity is a variable interest entity and providing the disclosures required by the amendments in this Statement should be based on a materiality assessment. The Board acknowledged that an

evaluation of materiality requires judgment but that materiality is the appropriate threshold because it is the same threshold used in applying all GAAP.

Reconsideration Events

A10. Before being amended by this Statement, 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 was primarily focused on the entity's design and capital structure and on transactions that changed the sufficiency of the entity's equity at risk. An enterprise was required to determine whether it was the primary beneficiary of a variable interest entity at the time it became 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 included a list of events that would require reconsideration, did not include losses in excess of expected losses as a reconsideration event. Furthermore, troubled debt restructurings, as defined in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, were explicitly exempt from Interpretation 46(R).

A11. Some constituents expressed significant concerns about the 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 agreed with those constituents and concluded that the application of the current guidance in the Interpretation often 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 power to direct the activities of a variable interest entity that most significantly impact the economic performance of the entity.

A12. As a result of the concerns noted in paragraph A11, the Board proposed in the Exposure Draft 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 of its primary beneficiary. Specifically, the Board proposed amending the guidance in paragraph 5 of Interpreta-

tion 46(R) for determining whether an entity is a variable interest entity so that the guidance would apply both to the design of the entity and to changes in facts and circumstances in the entity. The Board also proposed that paragraph 5 should be considered 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. Furthermore, the Board proposed that paragraph 14 of Interpretation 46(R) be amended to require enterprises to consider the guidance 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.

A13. In its initial 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). Specifically, 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.

A14. Although the Board acknowledged that the factors in paragraph A13 and those currently within the guidance of Interpretation 46(R) could be important to the analyses required by paragraphs 5 and 14, the Board decided that providing specific factors would unnecessarily limit an enterprise's analysis of whether an entity is a variable interest entity and whether an enterprise is a primary beneficiary.

A15. 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 the enterprise's status as the 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 and (b) requiring an annual assessment with interim assessments if specified triggering events occurred. The Board rejected those alternatives in favor of ongoing assessments because, in part, it was concerned that the rejected approaches could cause a delay in an entity's change in status or a change in the appropriate primary beneficiary.

A16. The Board acknowledged in the Exposure Draft that an entity previously considered to be a variable interest entity could 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, 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. However, the Board concluded that if after considering the provisions in paragraph 5 an entity is no longer a variable interest entity; it should be considered a voting interest entity.

A17. The Board also proposed eliminating the exception for troubled debt restructurings in Interpretation 46(R). The Board reasoned that in a troubled debt restructuring, the guidance in Interpretation 46(R) would typically identify an entity as a variable interest entity because 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. Furthermore, the Board noted that, as a result of unanticipated economic results, it may not be uncommon for the primary beneficiary of an entity involved in a troubled debt restructuring to change to a different enterprise when circumstances change.

A18. In reaching its initial 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 the 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. The Board decided that users would receive more timely information (including disclosures) about (a) the identification of an entity as a variable interest entity or voting interest entity and (b) the primary beneficiary of a variable interest entity.

A19. On the basis of the amendments to the guidance in paragraph 14 of Interpretation 46(R) for determining the primary beneficiary of a variable interest entity, the Board expected that the ongoing assessment of which enterprise, if any, is the primary beneficiary would require less effort and be less costly than the quantitative assessment of expected losses and residual returns previously required by the

Interpretation. Furthermore, the Board expected that the amendments to paragraph 14 would reduce the frequency in which the enterprise with the controlling financial interest changes.

A20. The Board acknowledged that the ongoing reassessments in accordance with paragraphs 5 and 14, as proposed in the Exposure Draft, would have required significant effort for reporting enterprises with involvements in numerous variable interest entities. However, the Board noted that enterprises currently must obtain data for interests in variable interest entities to account for such interests appropriately. The Board initially 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 that requirement. Finally, the Board noted that removing explicit reconsideration events was 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 consolidation.

A21. Several respondents to the Exposure Draft expressed concerns that the requirement to reassess continually an entity's status as a variable interest entity was not operational or practicable and that the costs of complying with that requirement would outweigh any perceived improvements in financial reporting. Other respondents, including users, expressed concerns about the potential inconsistencies and comparability issues in financial reporting that may result from ongoing reassessments of an entity's status as a variable interest entity or a voting interest entity. Specifically, these constituents were troubled by the possibility that an entity could be classified as a variable interest entity in one reporting period and a voting interest entity in the next reporting period (or vice versa) solely as a result of operating results temporarily changing the "sufficiency of the equity investment at risk" from period to period. Those constituents were concerned that subjecting reporting enterprises to different consolidation and disclosure requirements from period to period would not provide them with relevant and reliable information. However, users still expressed concern that if the Board retained the reconsideration events in paragraph 7, a reporting enterprise other than the equity investor or investors may gain control over an entity without triggering one of the reconsideration events and, consequently, the enterprise with power would avoid consolidation.

A22. In its redeliberations, the Board concluded that constituents' concerns about the reconsideration of an entity's status as a variable interest entity were valid, particularly the concern about the inconsistent reporting of an entity that could arise as a result of continuous reassessments of an entity's status as a variable interest entity. Specifically, the Board agreed with the concerns of users that the status of an entity as either a voting interest entity or a variable interest entity could continuously change from period to period solely as a result of operating results that made the equity at risk either sufficient or insufficient. The Board did not believe such continuous changes in an entity's status would provide users of financial statements with more relevant and reliable information about an enterprise's involvement with an entity. Consequently, the Board decided to retain the reconsideration guidance in paragraph 7 of Interpretation 46(R).

A23. The Board shared users' concern that the existing reconsideration guidance would not change an entity's status to a variable interest entity in situations in which the equity investor or investors lost power over an entity without triggering the specified events in paragraph 7 of the Interpretation. For example, if an entity previously considered to be a voting interest entity in accordance with the provisions of paragraph 5 of Interpretation 46(R) experienced severe losses such that the holder(s) of the equity investment as a group lost the power from the voting rights or similar rights of those interests and, thus, another party (for example, a guarantor or lender) obtained a controlling financial interest in the entity, the previous reconsideration events may not have required a reconsideration of an entity's status. The Board was troubled that, in this situation, the entity may not have been considered a variable interest entity and may not have been consolidated by the party with a controlling financial interest. Consequently, the Board added an additional criterion to the reconsideration events that requires enterprises with interests in an entity to reconsider an entity's status when changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

A24. A few respondents asked that the Board include in its amendments to Interpretation 46(R) an exemption from reconsidering an entity's status for troubled debt restructurings. Those respondents ex-

pressed concern about the operability and practicality of the guidance in the Exposure Draft, which proposed eliminating this exemption. Furthermore, those respondents were concerned that financial institutions that funded an entity at customary terms under the design of the entity would potentially be required to consolidate a significant number of entities. In its redeliberations, the Board rejected retaining the exemption previously provided for troubled debt restructuring. The Board concluded that the decision to rescind this exemption as provided in paragraph A17 was appropriate and, therefore, a troubled debt restructuring should be evaluated in the same manner as any other potential reconsideration event.

A25. Some respondents asked the Board to rescind its decision in the Exposure Draft to require ongoing assessments for determining whether an enterprise with a variable interest in a variable interest entity is the primary beneficiary of the entity and, instead, to retain the reconsideration events that were included in paragraph 15 of Interpretation 46(R). Those respondents suggested that requiring ongoing assessments of an enterprise's status as the primary beneficiary was neither operational nor practical and that the costs of complying with this requirement would outweigh the benefits to users. In its redeliberations, the Board rejected the request to retain the reconsideration guidance for determining whether an enterprise is a primary beneficiary and reaffirmed its decision to require ongoing assessments of an enterprise's status. The Board noted that several respondents expressed that ongoing reconsideration of an enterprise's status as a primary beneficiary was operational and agreed with the Board's decision in the Exposure Draft to require such ongoing reconsideration. The Board concluded that its basis for eliminating the specific reconsideration events and requiring ongoing assessments of an enterprise's status as the primary beneficiary of a variable interest entity was valid and provides users with more relevant and reliable information about enterprises that currently have or obtain the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Furthermore, the Board believes that an enterprise with a material interest in a variable interest entity should have the information to determine whether it is the primary beneficiary of that entity.

Primary Beneficiary Determination

A26. Interpretation 46(R), as amended by this Statement, requires an enterprise to consolidate a variable

interest entity if the enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest in the entity. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. An enterprise would 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 the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

A27. The Board believes that the approach in paragraph A26 is more effective for determining the primary beneficiary of a variable interest entity. The Board opposes an approach that would provide a list of specific qualitative criteria that would have to be considered or met. The Board believes that constituents will need to use judgment in applying the guidance in Interpretation 46(R), as amended by this Statement, to determine the appropriate primary beneficiary, if any, in a variable interest entity. The Board acknowledges that this 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, then the risk of inconsistency should be mitigated to an acceptable level.

A28. Before being amended by this Statement, Interpretation 46(R) required an enterprise to consolidate a variable interest entity if the enterprise had a variable interest or interests that would absorb the majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. An enterprise would calculate (using a quantitative analysis) the variable interest entity's expected losses and expected residual returns to determine which enterprise, if any, was required to consolidate the variable interest entity. A variable interest entity's expected losses and expected residual returns were 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.

A29. Some constituents expressed significant concerns about the application of that guidance in determining the primary beneficiary of a variable interest entity because they stated that the quantitative analysis previously required by Interpretation 46(R) was difficult to understand, apply, and audit. Those constituents maintained that the calculation often required a high degree of mathematical expertise and that entities often performed 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 were used to apply the expected losses calculation. This diversity led to inconsistent application and results for variable interest entities with similar characteristics and traits.

A30. Certain constituents were troubled that the quantitative analysis often seemed 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 sold interests to third parties that absorbed the majority of the expected losses (expected loss note holders). An expected loss note holder received a substantial return on its investment but typically had very limited power, if any, to direct the activities that most significantly impacted the economic performance of the variable interest entity. Additionally, the maximum exposure to economic losses that was absorbed by the expected loss note holders was typically limited to their investment in the notes, while other variable interest holders were often at risk of incurring significantly larger economic losses (either explicitly or implicitly). Although a quantitative analysis identified the expected loss note holder as the primary beneficiary, the Board believed that applying the analysis required by this Statement may not result in the same conclusions. The Board was troubled by those disparate outcomes.

A31. Users were particularly concerned that the quantitative analysis previously required by Interpretation 46(R) did not always capture situations in which enterprises involved with a variable interest entity provided the entity with financial support, including credit and liquidity support. Users stated that this support represented an implicit arrangement

(such as a guarantee). Users also 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 previously listed in that Interpretation occurred. Users asserted that a qualitative approach that analyzes the characteristics of an enterprise's variable interest(s) 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.

A32. The Board generally agreed with the concerns about the application of the quantitative analysis previously 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. In its initial deliberations, the Board considered several approaches to amending the guidance in Interpretation 46(R) for determining the primary beneficiary of a variable interest entity and for addressing constituent and Board concerns about that guidance. These approaches included the following:

- a. A qualitative analysis that would require a quantitative analysis on the basis of the expected losses calculation to be performed only if an enterprise believed it could be the primary beneficiary but could not determine its status qualitatively
- b. A qualitative analysis in which the expected losses calculation would be 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 enhanced disclosures.

A33. In the Exposure Draft, the Board decided on an approach that would have required an enterprise to initially perform a qualitative analysis (similar to the

analysis described in paragraph A26), with a quantitative analysis on the basis of the expected losses calculation when an enterprise could not determine whether it met the qualitative criteria. The majority of respondents stated that the Board should eliminate the quantitative analysis, stating that it was inconsistent with the approach described in paragraph A26. Those respondents asserted that a qualitative analysis alone should be sufficient to determine which enterprise, if any, is the primary beneficiary of a variable interest entity. In addition, the majority of respondents reiterated the concerns in paragraphs A29–A31. Some respondents expressed a concern that retaining the quantitative analysis would result in practitioners defaulting to the quantitative model to achieve a preferred accounting result. Some respondents stated that the quantitative analysis should be retained for situations in which the qualitative analysis does not produce a clear result. In addition, some respondents were concerned about situations in which an enterprise is exposed to the majority of the economic risks and rewards of a variable interest entity but concludes that it is not the primary beneficiary of the entity under a qualitative analysis. Those respondents suggested a risks-and-rewards-based “fall-back test” for situations in which power cannot be clearly assessed or an enterprise concludes it does not have power despite having the majority of the economic risks and rewards of a variable interest entity.

A34. In its redeliberations, the Board decided to remove the quantitative analysis from the determination of which enterprise is the primary beneficiary of a variable interest entity. The Board shared the concern of constituents that retaining the quantitative analysis would inevitably lead to the widespread use of a quantitative test that has been discredited as a means of identifying which party has a controlling financial interest in a variable interest entity. In addition, the Board decided that including a risks-and-rewards-based “fall-back test” could effectively override the consolidation principle in Interpretation 46(R), as amended by this Statement.

A35. The Board considered whether additional guidance was needed for determining whether a variable interest holder has power when the economics of the holder's interest(s) or other involvements is inconsistent with its stated power from such interest(s) or other involvements. The Board agreed that an increased level of skepticism is needed in situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb

losses or its right to receive benefits, is disproportionately greater than its stated power. In the Board's view, the level of skepticism about an enterprise's lack of power should increase as the disparity between an enterprise's economic interest and its power increases. Accordingly, Interpretation 46(R), as amended by this Statement, includes guidance that emphasizes that consideration should be given to these situations. The Board agreed that although this factor is not intended to be determinative in identifying a primary beneficiary, the level of an enterprise's economic interest may be indicative of the amount of power that enterprise holds.

A36. Some respondents to the Exposure Draft questioned why certain enterprises (for example, an enterprise that services the loans of a securitization entity when the loans are delinquent or in default) would have power over an entity if the enterprise only directs activities when certain events occur. Those respondents stated that if those events do not occur, then the enterprise has no ability to direct the activities of the entity.

A37. The Board concluded that power is specific to the ability to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. The Board acknowledges that the activities that most significantly impact the economic performance of a variable interest entity may differ by the type of entity being analyzed. The Board concluded that an enterprise will have to use judgment to determine which activities most significantly impact the economic performance of an entity and then determine if the enterprise has the power to direct such activities.

A38. For example, for an entity with a limited range of activities, such as certain securitization entities or other special-purpose entities, power is determined on the basis of who directs that limited range of activities. The Board reasoned that, in certain securitization entities, it is likely that the only activities that will significantly impact the economic performance of the entity include the management of troubled assets. In an operating entity, there would often be a wider range of activities that would need to be analyzed to determine which activities most significantly impact the economic performance of the entity. In addition, the Board reasoned that if the activities that most significantly impact the economic performance of a variable interest entity would only need to occur when certain circumstances arise or certain events happen, then the party that has the power to direct

those activities still has power over the entity. The Board concluded that an enterprise does not have to exercise its power to have power to direct the activities of an entity. The Board acknowledged that a party may have certain protective rights that apply only in exceptional circumstances, for example, certain rights typically held by senior lenders. Protective rights are discussed further in paragraph A52. The Board observed that distinguishing between protective rights and the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance will require judgment. The Board also observed that rights initially considered protective rights could result in an entity obtaining the power to direct the activities of an entity at a later date.

The Obligation to Absorb Losses or the Right to Receive Benefits That Could Potentially Be Significant to the Variable Interest Entity

A39. In its deliberations leading up to the Exposure Draft, the Board decided that the obligation to absorb losses or the right to receive benefits would have to potentially be significant to the variable interest entity to have the characteristic in paragraph 14A(b) of Interpretation 46(R). The Board reasoned that although an enterprise might not have obligations or rights that currently are significant, its interest may provide it with obligations or rights that may be significant to the variable interest entity in the future. The Board concluded that this guidance was imperative, because obligations or rights that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of a variable interest entity. The Board acknowledged that multiple enterprises may have obligations or rights that could "potentially be significant" but that only one enterprise could have the characteristic in paragraph 14A(a) of Interpretation 46(R); thus, this characteristic would not result in an enterprise identifying more than one party as the primary beneficiary.

A40. Some respondents to the Exposure Draft asked that the Board provide additional guidance on whether an enterprise's obligation to absorb losses or its right to receive benefits could potentially be significant to the variable interest entity. Those respondents commented that it was not clear whether a fixed fee paid to a service provider would represent an obligation to absorb losses or a right to receive benefits

that could potentially be significant. Those respondents also noted that, in some cases, fees paid to service providers do not represent a variable interest in the entity. Other respondents objected to the phrase “could potentially be significant.” Those respondents stated that giving no consideration to the likelihood of certain events occurring could result in a clearly minor variable interest being considered significant if the underlying assets in the variable interest entity become worthless. Some respondents cited the example of a holder of the most senior debt interest in an entity as a party that would not have the obligation to absorb losses or the right to receive benefits that could potentially be significant. Some respondents also questioned why they would be precluded from considering expected losses and expected residual returns, as defined in Interpretation 46(R), when considering whether an enterprise has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable interest entity.

A41. The Board considered those comments but decided not to provide additional guidance on whether an enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant to the variable interest entity. The Board emphasized that determining whether an enterprise has the obligation to absorb losses or the right to receive benefits that could potentially be significant to a variable interest entity would require judgment and consideration of all facts and circumstances about the terms and characteristics of the variable interest(s), the design and characteristics of the variable interest entity, and the other involvements of the enterprise with the variable interest entity. The Board added examples to Interpretation 46(R) to help illustrate the principles in paragraph 14. These examples are located in Appendix C’ of the Interpretation. However, the Board decided not to provide an analysis of how an enterprise concluded whether it had the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable interest entity. The Board believes that any such analysis would inevitably serve as the establishment of “bright lines” that would be used in practice as the sole factor when determining whether such obligations or rights could potentially be significant to a variable interest entity.

A42. The Board noted that this Statement retains the definition of a variable interest from Interpretation 46(R). As such, the Board observed that if an enterprise concludes that its involvement in a variable interest entity does not represent a variable interest,

further analysis of whether the enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant would not be required because a party cannot be the primary beneficiary of an entity if that party does not hold a variable interest in the entity. The Board also reasoned that a service provider’s right to receive a fixed fee, in and of itself, would not always represent an obligation or a benefit that could potentially be significant to the variable interest entity. For example, the Board observed that a servicer of an entity’s loans may be paid a fee that is a fixed percentage of the balance of the loans. In that case, the servicer may be able to conclude, on the basis of the magnitude of the fixed percentage, that the fee could not ever potentially be significant to the entity because the fee would remain a constant percentage of the entity’s assets.

A43. The Board rejected suggestions to provide more detailed definitions on how to determine benefits or losses as those terms are used in paragraph 14A(b) of Interpretation 46(R), as amended by this Statement. The Board observed that paragraph 14A(b) does not require an entity to determine which enterprise, if any, receives a majority of the benefits or losses of the entity, thus obviating the need for a detailed mathematical analysis. In addition, the Board observed that the results of the mathematical models that often were used to calculate expected losses and residual returns under Interpretation 46(R) are evidence that attempts to precisely quantify risks and rewards are less effective than a qualitative analysis of an enterprise’s obligation to absorb losses or its right to receive benefits of an entity. As a result, the Board concluded that a quantitative evaluation of expected losses and residual returns is not required, and shall not be the sole determinant in assessing whether an enterprise had the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable interest entity and, thus, added guidance reflecting this conclusion in paragraph 14A(b) of Interpretation 46(R), as amended by this Statement.

Kick-out, Participating, and Protective Rights

A44. In its initial deliberations, the Board discussed the role of kick-out rights in the analysis for determining a primary beneficiary. The Board decided that the analysis should not consider kick-out rights unless a single enterprise (including related parties and de facto agents) has the unilateral ability to exercise those kick-out rights. The Board acknowledged that excluding such kick-out rights is in conflict with

other GAAP, including other areas of Interpretation 46(R). However, the Board reasoned that while other GAAP would recognize the existence of substantive kick-out rights, they typically are not exercised and, thus, should not be considered until exercised unless one party has the unilateral ability to exercise those rights.

A45. The Board concluded that if kick-out rights were included in the primary beneficiary analysis, enterprises may have structuring opportunities to conclude that no single party with a variable interest in a variable interest entity had power over the entity. 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 Interpretation 46(R) and other GAAP (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 may effectively give the single enterprise overall power over the entity.

A46. Several respondents to the Exposure Draft asked the Board to rescind its decision to not consider kick-out rights for determining whether an enterprise has the power to direct the activities that most significantly impact the entity's economic performance unless a single enterprise has the unilateral ability to exercise those rights. They emphasized that paragraph B19 of Interpretation 46(R) already requires kick-out rights to be considered in determining whether fees paid to decision makers are variable interests and that specific guidance for determining whether kick-out rights are substantive is provided in paragraph B20. These respondents disagreed with the Board's decision to accept inconsistent guidance for kick-out rights that would exist within Interpretation 46(R) and within other GAAP, such as EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights."

A47. In its redeliberations, the Board considered these concerns but affirmed its decision that kick-out rights should be excluded from the determination of the primary beneficiary unless those rights are held by a single party. The Board was troubled by the fact that kick-out rights considered "substantive" for ac-

counting purposes are rarely exercised in practice. The Board decided that inconsistencies with other GAAP would be considered in the current project to reconsider consolidation accounting broadly. In addition, the Board concluded that the guidance for kick-out rights should be consistent within Interpretation 46(R); therefore, it removed the requirement in Interpretation 46(R) that a decision maker must be subject to substantive kick-out rights for its fee not to be considered a variable interest. Similarly, the Board also removed the requirement that a service contract should be subject to cancellation provisions for a service provider's fee not to be considered a variable interest. This conclusion was made in conjunction with amending the guidance for determining whether fees paid to a decision maker and other service providers represent variable interests, which is further addressed in paragraphs A72–A77.

A48. The Board also concluded that the guidance in paragraph B20 on whether kick-out rights are substantive should also be removed from Interpretation 46(R). Although paragraph 14C of Interpretation 46(R), as amended by this Statement, requires that kick-out rights must be substantive to impact the primary beneficiary determination, the Board did not want the factors previously listed in paragraph B20 of Interpretation 46(R) to be considered all-inclusive when determining the substance of kick-out rights. In addition, situations in which a decision maker or service provider can contractually be removed solely for performance-related issues represent a kick-out right that should be analyzed in accordance with the provisions of this Statement.

A49. Several respondents asked the Board to clarify whether and how participating and protective rights, which are 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," should be considered and evaluated in determining whether an enterprise is the primary beneficiary of a variable interest entity. Certain of those respondents stated that, absent further clarification, they would assume that substantive participating rights held by multiple parties would indicate that no one party had the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Other constituents stated that participating rights are similar in nature to kick-out rights and that both rights should have a similar impact on the determination of the primary beneficiary. Those constituents stated that the

ability of one party to block the actions of an enterprise that would otherwise be the primary beneficiary of an entity would impose the same constraint on that enterprise's power over an entity as the ability of one party to kick out that enterprise.

A50. The Board considered those requests in its deliberations and agreed to provide further clarification of the role of participating and protective rights in determining the primary beneficiary of a variable interest entity. The Board decided that participating rights can provide a constraint on an enterprise's decision-making ability in a manner similar to kick-out rights and, thus, should be subject to the same restrictions as kick-out rights. That is, the Board decided that the determination of the primary beneficiary should not be affected by participating rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such participating rights and the rights are substantive. The Board observed that a single enterprise's unilateral ability to exercise participating rights, in connection with other rights, may indicate that enterprise is the party with the power to direct the activities of an entity that most significantly impact the entity's economic performance. The Board acknowledged that this decision is not consistent with how participating rights are evaluated in Issues 96-16 and 04-5, but the Board decided that inconsistency would be considered in the current project that is re-considering consolidation accounting more broadly.

A51. The Board also decided to define participating rights as the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Although the Board agreed that a participating right is the ability of one party to block certain actions, the Board concluded that this ability should impact the determination of the primary beneficiary only if those actions are related to the activities that most significantly impact the economic performance of an entity. Because those activities could vary significantly between entities, the Board decided not to provide an illustrative list of those activities (such as the list that is included in Issue 96-16).

A52. The Board also agreed to add language to clarify how protective rights should be considered by an enterprise when evaluating whether it is the primary beneficiary of a variable interest entity. The Board decided that protective rights held by other parties do not prevent an enterprise from having the

power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. The Board also included examples of protective rights in paragraph 14C of Interpretation 46(R), as amended by this Statement, but emphasized that these examples are not meant to be all-inclusive. In the Board's view, those examples would be useful to illustrate the concept of protective rights because there are certain rights that are common to many entities that would generally be considered protective rights.

Shared Power

A53. In its initial deliberations, the Board acknowledged that, in certain circumstances, an enterprise may conclude that power is shared among multiple parties. The Board decided that if an enterprise can demonstrate that the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance is, in fact, shared among multiple parties such that no one party has the power to direct those activities, then no primary beneficiary exists. That is, the Board decided that shared power exists when no one party alone has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

A54. Respondents to the Exposure Draft asked the Board to clarify the concept of shared power and provide further guidance for determining whether shared power exists. Some respondents noted that there might be multiple parties that are responsible for directing discrete activities of an entity, and those respondents indicated that the Exposure Draft was not clear on how to determine whether power would be considered shared in those situations. Some respondents expressed concern that shared power would be interpreted broadly, which would result in very few enterprises concluding that they are the primary beneficiary of a variable interest entity. Other respondents observed that situations exist in practice in which multiple parties are directing the same activities for an entity and that those activities as a whole most significantly impact the economic performance of the entity. Those constituents cited the example of a securitization entity, in which multiple parties are servicing the loans of the entity.

A55. The Board agreed to clarify further the concept of shared power. In Interpretation 46(R), as amended by this Statement, power is considered shared if two or more unrelated parties together have the power to

direct the activities of a variable interest entity that most significantly impact the entity's economic performance and if decisions about those activities require the consent of each of the parties sharing power. To the Board, it was important that decisions require the consent of each party sharing power because this would be most indicative of a group of parties that had agreed to share the power to direct the activities of a variable interest entity. The Board believes that situations in which decisions can be made without the consent of each party directing certain activities of the entity simply indicate that different parties have power over different activities, but those situations do not represent shared power over the entity. The Board wanted to emphasize that the mere existence of consent requirements should not lead to a conclusion that power over an entity is shared. The Board believes that the governance provisions of an entity would need to be analyzed closely to understand whether the consent requirements are substantive (for example, the consequences if consent was not given).

A56. The Board acknowledged that situations could exist in practice in which multiple parties are directing the activities that significantly impact the economic performance of an entity, but those parties do not need to consent to the decisions relating to those activities. The Board noted that such situations would not meet the definition of shared power in Interpretation 46(R), as amended by this Statement. In the Board's view, if those parties are directing different activities, then the consolidation principle in Interpretation 46(R), as amended by this Statement, requires those parties to decide if they have the power to direct the activities that have the *most* significant impact on the economic performance of the entity (that is, the application of the principle in Interpretation 46(R), as amended by this Statement, would result in one of those parties having the characteristic in paragraph 14A(a) of Interpretation 46(R), as amended by this Statement). The Board acknowledged this could result in an enterprise consolidating an entity when it does not have the power to direct all of the entity's activities. However, the Board reasoned that as the number of activities of an entity increases, it will be more likely that one decision maker (or governing body) will exist or that decisions about those activities would require the consent of the enterprises involved with the entity.

A57. For situations in which power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple

parties, and the nature of the activities that each party is directing is the same, the party with power over the majority of the activities shall be considered to have the characteristic in paragraph 14A(a) of Interpretation 46(R), as amended by this Statement. The Board observed that the majority concept was consistent with guidance on interests in specified assets that was already included in Interpretation 46(R). In addition, the Board believes this guidance is necessary to avoid anomalous results when multiple parties have the power to direct the same activities of an entity. The Board acknowledged that determining which party has power over the majority of the activities would require judgment and an evaluation of all facts and circumstances but that the focus of this analysis would be to determine which party directs activities that will have the most significant impact on the entity's economic performance. In addition, the Board observed that this guidance would be applicable only when it is concluded that there is not one party with power over the entity (for example, the sponsor of the entity). The Board also observed that, in practice, there could be situations in which the parties involved with an entity have power over different activities and portions of the same activities. The Board reasoned that, in those situations, an enterprise's power over certain activities, along with its power over portions of other activities, might identify that enterprise as the party with the power to direct activities that most significantly impact the economic performance of the entity. The Board noted that an analysis of those fact patterns would require significant judgment, and Example 8 in Appendix C' of Interpretation 46(R), as amended by this Statement, serves to further illustrate these concepts.

Involvement in the Design of a Variable Interest Entity

A58. The Board stated in the basis for conclusions of the Exposure Draft that although a party may be significantly involved with the creation of an entity, that involvement does not, in isolation, establish that party as the party with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the party had the opportunity and the incentive to establish arrangements that result in the party being the variable interest holder with such power. The Board noted that an example of this concept could be a sponsor's explicit or implicit financial

responsibility to ensure that an entity operates as designed. In that situation, the Board concluded that a sponsor may have an implicit agreement to fund an entity's losses to protect the sponsor's reputation.

A59. Some respondents to the Exposure Draft suggested that the Board provide further guidance on how an entity's involvement in formation activities that restrict the substantive decision making of an entity should be considered in assessing which party has the power to direct the activities of the entity. Those respondents stated that if an enterprise established the decisions that were encompassed in the governing documents of the entity, then that party should be considered the primary beneficiary of the entity. Several constituents also noted that the fact that an enterprise sponsors a variable interest entity also should be considered in determining which party is the primary beneficiary of the entity.

A60. The Board elevated the guidance in the Exposure Draft about this issue to paragraph 14F of Interpretation 46(R) to emphasize the need for enterprises to assess their involvement in the design of an entity when determining whether or not they are the primary beneficiary of an entity. The Board observed that further emphasizing this involvement, or making involvement in the design determinative in identifying the primary beneficiary, could lead to difficulties in analyzing situations in which there are many parties involved in the design of the entity. In addition, excessive emphasis on the involvement in the design of an entity could prevent identifying the party that does have the power to direct the activities of a variable interest entity. The Board reasoned that if one party does indeed establish the decisions that are encompassed in the governing documents of an entity, then the guidance in Interpretation 46(R), as amended by this Statement, would require increased scrutiny of whether that party has power over an entity as a result of its explicit or implicit financial responsibility to ensure that an entity operates as designed. In addition, the Board observed that in situations in which a sponsoring enterprise does establish the decisions that are encompassed in the governing documents of the entity, the provisions of Interpretation 46(R), as amended by this Statement, would require that enterprise to closely scrutinize its relationships with other parties involved with the entity to determine whether those parties are related parties or de facto agents of the sponsoring enterprise.

Determining Whether an Entity Is a Variable Interest Entity

A61. Respondents to the Exposure Draft asked the Board to amend the guidance in paragraph 5(b)(1) of Interpretation 46(R) so that guidance is consistent with the guidance in paragraph 14A(a). Before the amendments made by this Statement, paragraph 5(b)(1) stated that an entity was a variable interest entity if, as a group, the holders of the equity investment at risk lacked "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." Respondents noted that the guidance in the Exposure Draft suggested that constituents perform a different assessment when considering the decision-making ability of at-risk equity holders as opposed to an enterprise's consideration of its "power to direct activities" as required by paragraph 14A(a).

A62. Respondents to the Exposure Draft also stated that, in practice, kick-out rights and participating rights are considered when determining whether the at-risk equity holders have the characteristic in paragraph 5(b)(1) of Interpretation 46(R) before that paragraph was amended by this Statement. Some respondents stated that, in practice, if kick-out rights or participating rights are held through interests other than equity interests, then the entity fails the 5(b)(1) characteristic and is considered a variable interest entity. Similarly, if the decision-making power is held through interests other than equity interests, the existence of kick-out rights held by the equity investors as a whole may result in the entity not being considered a variable interest entity under the 5(b)(1) characteristic (absent the entity failing one of the other characteristics in paragraph 5). Respondents questioned why kick-out rights and participating rights should be evaluated differently when determining if an entity is a variable interest entity as opposed to when it is evaluated to determine if a variable interest holder has a controlling financial interest under paragraph 14.

A63. In its redeliberations, the Board decided to make paragraph 5(b)(1) consistent with paragraph 14. The Board observed that if an entity was considered to be a variable interest entity for the sole reason that kick-out rights or participating rights were held by a group of nonequity holders, the primary beneficiary analysis under paragraph 14 would disregard those same rights unless the rights were

held by one party. The Board noted that, in that example, those rights would have no impact on the consolidation conclusion that would be reached under Interpretation 46(R), as amended by this Statement; however, it would require all enterprises with a variable interest in the entity to make the disclosures required by Interpretation 46(R), as amended by this Statement. The Board acknowledged that other GAAP, such as Issue 04-5, could result in these entities not being consolidated by the equity holder; however, the Board decided to address that inconsistency through the current project on consolidation of all entities. The Board also noted that in situations in which a nonequity holder was the decision maker of an entity but the equity holders as a group possessed kick-out rights, then a conclusion may have been reached that the entity was not a variable interest entity under paragraph 5(b)(1). The Board was troubled by these outcomes and decided that kick-out rights and participating rights should be evaluated in the same manner in paragraphs 5(b)(1) and 14.

A64. The Board also decided to amend paragraph 5(b)(1) to state that a decision maker should not prevent the equity holders from having the characteristic in paragraph 5(b)(1), unless the fees paid to the decision maker represent a variable interest on the basis of paragraphs B22 and B23 of Interpretation 46(R), as amended by this Statement. The Board reasoned such a decision maker would never be the primary beneficiary of the variable interest entity because it does not hold a variable interest. In addition, such an interest would typically indicate that the decision maker was acting as a fiduciary (see paragraph A76), and the Board observed that fact alone should not lead to a conclusion that an entity is a variable interest entity. The Board observed that this guidance was intended to prevent many traditional voting interest entities and certain investment funds from becoming variable interest entities solely as a result of the changes to paragraph 5(b)(1).

A65. As part of its decision to amend paragraph 5(b)(1), the Board also decided that this Statement should nullify the guidance in 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)*. The Board observed that FSP FIN 46(R)-3 provides interpretive guidance on the application of paragraph 5(b)(1). Constituents indicated that, in practice, the primary purpose of that

FSP is to indicate how paragraph 5(b)(1) of Interpretation 46(R) should be applied to a franchise arrangement. Constituents also noted that the FSP indicates that a franchisor's rights in a franchise arrangement, particularly when the franchisor is not providing financial support to the franchisee, are generally considered protective rights. The Board believes this same objective is achieved by including the typical rights of a franchisor as an example of a protective right in Interpretation 46(R), as amended by this Statement. For franchise arrangements that are consistent with those described in FSP FIN 46(R)-3, the Board does not expect or intend for the nullification of that FSP to result in a significant change in practice to franchisors' evaluations of the characteristic in paragraph 5(b)(1).

Related Parties

A66. In the Exposure Draft, the Board decided to retain the guidance in paragraphs 16 and 17 of Interpretation 46(R) while adding a factor for parties within a related-party group to consider when determining whether the party is most closely associated with a variable interest entity and, thus, is the entity's primary beneficiary. The factor was provided in paragraph 17(e) and would have required parties to consider "the extent to which a party meets criteria (a) and (b) in paragraph 14A," which was the guidance in the Exposure Draft for determining a primary beneficiary of a variable interest entity. In its initial deliberations, the Board did not provide guidance as to which factor, if any, in paragraph 17 should be weighted more heavily than another.

A67. A few respondents asked the Board to remove factor (c) of paragraph 17 of Interpretation 46(R), which required a party within a related-party group to consider its exposure to the expected losses of the variable interest entity, because they stated that the Board should remove the quantitative analysis from Interpretation 46(R). Other respondents asked the Board to require parties within a related-party group to initially consider the extent to which each party has the characteristics in paragraph 14A(a) and (b) of Interpretation 46(R), as amended by this Statement, before considering the other factors in paragraph 17 for determining which party is most closely associated with the variable interest entity.

A68. The Board considered these suggestions in its redeliberations and agreed that, because the quantitative analysis previously required in Interpretation 46(R) for determining a primary beneficiary has

been eliminated, the language in criterion (c) of paragraph 17 of Interpretation 46(R) should not require a calculation of expected losses. However, the Board decided that the evaluation of which party within a related-party group is most closely associated with a variable interest entity should include an evaluation of each party's exposure to the variability associated with the anticipated economic performance of the entity. Therefore, the Board concluded that a party's exposure to the variability associated with the anticipated economic performance of the variable interest entity should be considered when determining which party is most closely associated with the variable interest entity. The Board also agreed that each party within a related-party group should initially consider the consolidation guidance in paragraph 14 of Interpretation 46(R), as amended by this Statement, before considering the other factors. Consequently, the Board clarified that paragraph 17 should be applied only in situations in which an enterprise concludes that neither it nor one of its related parties meets the criteria in paragraph 14A(a) and (b) but, as a group, the enterprise and its related parties (including de facto agents as described in paragraph 16) meet those criteria. In those situations, the Board concluded that the party within the related-party group that is most closely associated with the variable interest entity is the primary beneficiary of the entity. That is, a primary beneficiary must be identified in those situations.

A69. Some respondents expressed concern that the guidance in paragraph 16(d)(1) of Interpretation 46(R) identifies "a party that has an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the enterprise" as a de facto agent of an enterprise even in situations in which the transfer restrictions are mutually agreed upon by willing, independent parties to preserve the strategic intent of a variable interest entity. Those respondents were troubled that many enterprises with substantive mutual transfer restrictions would be required to consolidate variable interest entities even in situations in which power is, in fact, shared in accordance with paragraph 14D of Interpretation 46(R), as amended by this Statement.

A70. In its redeliberations, the Board considered respondents' concern about mutual transfer restrictions and agreed that a de facto agency relationship does not exist in situations in which both the enterprise and a party or parties have the right of prior approval and the rights are based on mutually agreed-upon terms by willing, independent parties and the rights

are substantive. The Board emphasized that a conclusion that a related party relationship does not exist under paragraph 16 does not obviate the need for each enterprise or party with a variable interest to determine whether it is the primary beneficiary of a variable interest entity in accordance with the requirements in paragraph 14 of Interpretation 46(R), as amended by this Statement.

A71. The Board also reaffirmed that in situations in which a related-party group is considered the primary beneficiary of a variable interest entity, the parties within the related-party group cannot conclude that power is shared. In other words, the parties within the related-party group are required to identify one party within the related-party group as the primary beneficiary of the entity. The Board reasoned that when a related-party group exists, an analysis of the substance of consent requirements would be tainted by the overall related-party relationship. The Board clarified this concept by noting in paragraph 14D that only unrelated parties can conclude that power is shared.

Fees Paid to Decision Makers or Service Providers

A72. In its initial deliberations, the Board did not propose any amendments to the guidance in paragraphs B18–B21 for determining whether fees paid to a decision maker represent a variable interest or in paragraphs B22 and B23 for determining whether service contracts with hired service providers (other than an entity's decision maker) represent a variable interest. The Board acknowledged in its initial deliberations the inconsistency between the guidance for kick-out rights when determining whether an enterprise is a primary beneficiary and whether fees paid to a decision maker represent a variable interest in a variable interest entity. This inconsistency was eliminated in Interpretation 46(R), as amended by this Statement, as discussed in paragraph A47.

A73. In addition to the concerns about the inconsistent application of kick-out rights, some respondents questioned whether separate guidance was needed for determining whether a decision maker's fee represents a variable interest and whether a service contract represents a variable interest. Other respondents asked the Board to provide additional guidance for determining whether an enterprise acts solely as a fiduciary or agent as opposed to a principal. Those respondents cited the example of a trustee of an irrevocable trust who may have a variable interest in an

entity solely because it is not subject to substantive kick-out rights. In addition, representatives from the money management industry indicated that the fee paid to an investment manager often is considered a variable interest under Interpretation 46(R) because the fund shareholders do not hold substantive kick-out rights over the investment manager.

A74. In its redeliberations, the Board considered those concerns and agreed that the guidance for determining whether decision-making fees or service contracts represent variable interests should be similar in Interpretation 46(R). Consequently, the Board consolidated, with certain changes, the guidance in paragraphs B19, B21, and B22 (absent the kick-out rights and cancellation provisions requirements of paragraphs B19(d) and B22(c)) of Interpretation 46(R) under the heading “Fees Paid to Decision Makers or Service Providers.”

A75. The Board also decided to amend the guidance on the evaluation of a decision maker’s or service provider’s fees in paragraph B22 of Interpretation 46(R) to replace the terms *trivial* and *not large* with the term *insignificant*. Some respondents expressed concern that the phrase *more than trivial* has been applied in practice as *anything more than zero*, and that no evaluation of the facts and circumstances related to the interest or the enterprise’s involvement with the entity is considered when making this determination. In addition, constituents noted that the multiple terms used to refer to the size of an entity’s interest add complexity to this evaluation. The Board decided that the term *insignificant* should be used consistently in paragraph B22 to allow for a consistent evaluation of an enterprise’s interest within that paragraph. In addition, the Board believes that determining whether an item is *trivial* or *insignificant* requires judgment and consideration of all facts and circumstances.

A76. The Board also concluded that the revised guidance for determining whether decision maker fees and service provider fees represent a variable interest in a variable interest entity in paragraphs B22 and B23 of Interpretation 46(R), as amended by this Statement, is sufficient for determining whether an enterprise is acting in a fiduciary role in a variable interest entity, particularly because the Board removed the consideration of kick-out rights and cancellation provisions from those paragraphs. In other words, the Board expects that the fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a variable interest en-

tity because those fees would typically meet the conditions in paragraph B22 of Interpretation 46(R), as amended by this Statement. If an enterprise’s fee did not meet those conditions, the Board reasoned that an enterprise is not solely acting in a fiduciary role. If the enterprise has (a) the power to direct the activities that most significantly impact the economic performance of the entity and (b) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the variable interest entity, that enterprise would be the primary beneficiary of the entity. The Board observed that the conditions in paragraph B22 would allow an enterprise to hold another variable interest in the entity that would absorb an insignificant amount of the entity’s expected losses or receive an insignificant amount of the entity’s expected returns. The Board concluded that an enterprise holding such an interest would still be acting in a fiduciary role as long as the other conditions in paragraph B22 were met and that enterprise would not be the primary beneficiary of the entity.

A77. The Board agreed with the recommendation from certain respondents to the Exposure Draft that employees that are considered related parties in accordance with paragraph 16 of Interpretation 46(R), as amended by this Statement, should not generally be considered related parties for determining whether a decision maker or service provider holds other interests in a variable interest entity. The Board amended the guidance in footnote 26a of Interpretation 46(R) to reflect this recommendation. The Board was concerned about certain situations, such as those involving an investment manager of a mutual fund whose fees otherwise meet the criteria in paragraph B22 of Interpretation 46(R), as amended by this Statement, but has employees that invest in the fund. The Board believes that the manager of such an entity whose fees otherwise meet the criteria in paragraph B22 of Interpretation 46(R), as amended by this Statement, but has employees that invest in the entity should not be deemed to hold a variable interest in the entity unless the employees are used in a manner to circumvent the provisions of Interpretation 46(R).

Separate Presentation

A78. In its initial deliberations, the Board considered a linked presentation model in which certain assets would be classified separately on an enterprise’s statement of financial position. Any liabilities that are funded solely from the cash flows from those assets

would be reflected as a deduction from the related assets on the statement of financial position with a subtotal for a net amount.

A79. The Board initially considered a linked presentation model in its short-term project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. 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 about the presentation of financial and nonfinancial assets with related liabilities. The Board decided that extending the scope of linked presentation to a much broader population of assets and liabilities, including those that are nonfinancial, would be a significant change that would be more appropriate to develop as part of the joint projects with the IASB on derecognition and financial statement presentation. Furthermore, the Board decided that it would need to address significant issues about 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. Some Board members stated that the subsequent measurement attribute within a linked presentation model 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.

A80. In the Exposure Draft, the Board requested that constituents comment as to whether elements of consolidated variable interest entities should be required to be classified separately from other elements in the enterprise's financial statements. A significant number of respondents requested that separate classification of elements of consolidated variable interest entities be permitted but not required. Other respondents requested that separate classification of consolidated elements of a variable interest entity be required in situations in which (a) the assets of the consolidated variable interest entity could be used only to settle obligations of the consolidated entity and (b) the obligations of the variable interest entity could be settled only by the assets of the consolidated entity. These respondents stated that separate presentation, combined with enhanced disclosures, would provide transparent and useful information about an enterprise's involvement and associated risks in a variable interest entity.

A81. In its redeliberations, the Board considered the feedback from constituents about separate classification. The Board concluded that separate presentation should be required by enterprises consolidating a variable interest entity for (a) assets of a consolidated variable interest entity that could be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary. The Board considered, but rejected, a single line-item display of those assets and liabilities. The Board decided that requiring separate presentation of elements of consolidated variable interest entities should be limited to the situations described in (a) and (b) above to avoid potential inconsistency and comparability issues in a consolidating enterprise's financial statements. The Board also affirmed its initial decision to not pursue a linked presentation model for presenting entities consolidated as a result of Interpretation 46(R), as amended by this Statement.

Disclosures

A82. In developing the incremental disclosures included in the Exposure Draft, the Board noted that existing GAAP already requires numerous disclosures about 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*). 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.

A83. Users were concerned that the current disclosures about an enterprise's involvement(s) with a variable interest entity and the associated risks often are insufficient and not timely, regardless of whether the variable interest entity is consolidated by the enterprise. Financial statement users also asked that the

Board require enhanced disclosures, because additional information about an enterprise's involvement with a variable interest entity is urgently needed to improve transparency in financial reporting. These users suggested many of the incremental disclosure requirements that exist in the amendments to Interpretation 46(R) made by this Statement.

A84. The Board agreed with users' concerns and views and decided that the disclosures required by Interpretation 46(R), as amended by this Statement, would provide increased transparency of an enterprise's involvement with a variable interest entity. The Board decided to first develop overall objectives for the disclosures and to enhance the existing required disclosures because it is not possible to develop specific disclosures that would anticipate all existing and future transactions.

A85. On December 11, 2008, the Board issued FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*, to expedite the implementation of disclosure requirements related to Statement 140 and Interpretation 46(R). That FSP became effective for the first reporting period (interim or annual) ending after December 15, 2008, and will be superseded when this Statement and Statement 166 become effective.

A86. In developing the disclosures in the FSP, 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). 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 determined that the principal objectives of the disclosures required by paragraphs 22B–26 of Interpretation 46(R), as amended by the FSP, 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 or disclose information about its involvement in a variable interest entity
- b. The nature of restrictions on the consolidated variable interest entity's assets and on the settle-

ment of its liabilities reported by the enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities

- 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.

A87. Some constituents objected to the fact that the FSP requires the primary beneficiary to provide a significant number of disclosures for a consolidated variable interest entity that are not required for a consolidated voting interest entity. Other constituents indicated that there are important differences between consolidated variable interest entities and consolidated voting interest entities. The Board concluded that the assets in variable interest entities typically have different characteristics from those of voting interest entities. For example, assets of variable interest entities often can be used solely to settle specific obligations of the variable interest entity. As a result, the FSP requires more robust disclosures for a primary beneficiary of a variable interest entity than for voting interest entities.

A88. Constituents also expressed concern about the requirement in the FSP to consider implicit arrangements in providing the quantitative and qualitative information about an enterprise's involvement with a variable interest entity. Constituents suggested that the Board either delete the requirement or clarify whether the term *implicit arrangements* is consistent with the description of implicit variable interests in FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*. Users have consistently told the Board that disclosure of any implicit or explicit arrangement is important for understanding when an enterprise may provide financial or other support to the variable interest entity. As a result, the Board decided to clarify that the term *implicit arrangements* is consistent with the definition of *implicit variable interests* in FSP FIN 46(R)-5.

A89. Some constituents questioned the requirement that an enterprise disclose its methodology for identifying the primary beneficiary of a variable interest entity. The constituents indicated that because of the various entities, factors, and assumptions, it would be difficult to provide this disclosure. Other constituents agreed that it is important for a reporting enterprise to

disclose significant judgments and assumptions made in applying Interpretation 46(R), but they questioned the requirement for an enterprise to disclose whether it could reasonably have made a different judgment or assumption that would have resulted in a different conclusion.

A90. The Board concluded that the FSP should require certain disclosures for all enterprises that have a variable interest in a variable interest entity primarily to respond to the requests of users for information about the methodology, significant factors considered, and assumptions made in determining whether the enterprise is, or is not, the primary beneficiary of a variable interest entity. The Board reasoned that disclosure of the methodology for determining whether the enterprise is, or is not, the primary beneficiary is consistent with the requirement in ARB 51 to disclose the consolidation policy that is being followed. As a result of the various entities, judgments, and assumptions involved, the Board decided to provide additional guidance as to how an entity may disclose its methodology. The Board decided to remove the disclosure that would have required an enterprise to indicate whether it could reasonably have made a different judgment or assumption that would have resulted in a different conclusion. The Board reasoned that disclosure of the methodology should allow users to better understand the significant judgments and assumptions made by management that would provide increased transparency about an enterprise's consolidation policy for variable interest entities.

A91. The Board decided to enhance the aggregation principle for the Interpretation 46(R)-related disclosure requirements on the basis of feedback from users who indicated that in some cases, the application of the aggregation principle in Interpretation 46(R) did not result in meaningful information. The Board decided to remove the reference to materiality in amending the aggregation principle in Interpretation 46(R), reasoning that this Statement includes a clause that states that "the provisions of this Statement need not be applied to immaterial items." Furthermore, the Board concluded that disclosures should be reported separately for variable interest entities that are not consolidated and those that are consolidated.

A92. 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 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 Statements.

A93. In its redeliberations, the Board concluded that the disclosures in Interpretation 46(R) should be consistent with those in the FSP. However, as discussed in paragraph A9, the Board removed the term *significant* from the disclosure requirements in paragraphs 22E and 24 of Interpretation 46(R), as amended by this Statement. The Board also decided to require that an enterprise disclose the significant factors considered and judgments used in determining that the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance is shared in accordance with the guidance in paragraph 14D.

Transition

A94. In its initial deliberations, the Board concluded that if an enterprise is required to consolidate an entity upon implementing the guidance in the Exposure Draft, the enterprise would recognize and measure all assets and liabilities in accordance with paragraphs 18–21 of Interpretation 46(R), as amended, as of the date the requirements of this Statement are applicable. Generally, this guidance requires that assets and liabilities be measured at fair value.

A95. Some users supported the transition guidance in the Exposure Draft and asserted that requiring fair value measurement at consolidation further promotes fair value accounting. Several respondents, including other users, objected to the transition provisions in the Exposure Draft. Those respondents objected to the transition provisions in the Exposure Draft primarily due to the potential lack of comparability in future financial statements and the mixed-attribute accounting model inherent with requiring fair value measurement upon consolidation but not for subsequent accounting. Some respondents suggested that if an entity is consolidated by a particular enterprise under the amended guidance, that consolidation indicates that the entity should have been consolidated as of the date the enterprise became involved with the entity or at its latest reconsideration event and, thus, the elements of the entity should be reflected at their respective carrying values (as if they always had

been consolidated). Those respondents asked that the Board provide the same transition provisions as in Interpretation 46(R).

A96. Interpretation 46(R) requires assets, liabilities, and noncontrolling interests of a consolidated entity to be measured at their carrying amounts. Carrying amounts refer to the amounts that the elements would have been carried at in an enterprise's financial statements if the guidance had been effective when an enterprise first met the conditions to be the primary beneficiary. If it is not practicable for an enterprise to determine the carrying value of the elements, the enterprise must measure the assets, liabilities, and noncontrolling interests of the variable interest entity at fair value at the date the guidance first applies. The Interpretation 46(R) transition guidance also allows an enterprise to restate previously issued financial statements for one or more years. Some respondents asserted that they were not aware of any significant practice issues for either preparers or users under the transition method in Interpretation 46(R). However, some respondents asked that the Board provide guidance for situations in which an enterprise is required to deconsolidate a variable interest entity.

A97. In its redeliberations, the Board concluded that the transition requirements in this Statement should be the same as those that were provided in Interpretation 46(R), with certain additional guidance. The Board added transition guidance for situations in which an enterprise must deconsolidate a variable interest entity. This guidance is similar to the transition guidance for situations in which an enterprise must consolidate a variable interest entity. Specifically, any retained interest in the deconsolidated subsidiary should be measured at the amount the interest would have been carried in the enterprise's financial statements if this Statement had been effective when the enterprise became involved with the entity or no longer met the conditions to be its primary beneficiary.

A98. The Board also added an additional measurement alternative for enterprises that conclude that determining carrying amounts is not practicable. The Board decided that if the activities of the entity are primarily related to securitizations or other forms of asset-backed financings and the assets of the entity can be used only to settle obligations of the entity, then the assets and liabilities of the entity may be measured at their unpaid principal balances (as an alternative to a fair value measurement) at the date this Statement first applies. This measurement alternative

does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or an other-than-temporary impairment, as appropriate. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance and any items that are required to be carried at fair value under other applicable standards should be measured at fair value.

A99. The Board added this additional transition measurement alternative because of concerns that several potential primary beneficiaries of former qualifying special-purpose entities would need to utilize the practicability exception at transition because of excessive costs required to obtain the necessary information about the securitization trusts. These constituents stated that a fair value measurement upon consolidation with no ongoing fair value measurement requirement would not reflect their exposure to the activities of the consolidated variable interest entity and would provide information that would not be significantly more relevant than a measurement based on the unpaid principal balance of the assets and liabilities of the entity. The Board believed that this additional transition measurement alternative was an acceptable solution, primarily considering the desire for timely implementation of this Statement, and its view that unpaid principal balance in these circumstances still provides useful information to financial statement users.

A100. The Board intends for the additional transition measurement alternative to be available in situations in which an enterprise would need to incur an excessive amount of cost and effort to determine the carrying amounts of a consolidated entity's assets, liabilities, and noncontrolling interests.

A101. Some respondents suggested that the Board clarify whether the fair value option in accordance with FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, would be allowed for an entity consolidated as a result of this Statement at its effective date. The Board concluded that the fair value option provided by Statement 159 should be allowed only as of the date that the amendments to Interpretation 46(R) become effective if the consolidating enterprise elects the option for all financial assets and financial liabilities of the variable interest entity that are eligible for this option under Statement 159. The Board specified that the election could be made on an entity-by-entity basis but not on an instrument-by-instrument basis. The Board acknowledges that Statement 159 allows for

an instrument-by-instrument election, but the Board observed that the amendments to Interpretation 46(R) were not contemplated during the deliberations of Statement 159. The Board was concerned that allowing the fair value option on an instrument-by-instrument basis at transition may result in enterprises electing the option to achieve accounting results that are inconsistent with the objectives of Statement 159. The Board also decided to include specific disclosure requirements for enterprises that choose to elect the fair value option for some variable interest entities at transition. The Board noted that, subsequent to transition, an enterprise would be subject to the ongoing disclosure requirements in Statement 159.

Effective Date

A102. In its initial deliberations, the Board concluded that the requirements of this Statement should be effective as soon as reasonably possible to address the following:

- a. An urgent need to improve transparency of many variable interest entities that are not recognized in an enterprise's financial statements. The Board has received urgent requests from financial statement users, the Securities and Exchange Commission, the U.S. Senate Banking Subcommittee on Securities, Insurance, and Investments, The President's Working Group on Financial Markets, the Financial Crisis Advisory Group (FCAG), and other constituents, that improvements to the derecognition and consolidation accounting are needed to help restore confidence in the financial markets. In particular, the FCAG, which was convened by the IASB and the FASB, told the Board that immediate improvements are needed to derecognition and consolidation standards followed by a joint effort with the IASB to issue converged standards on derecognition and consolidation. The FCAG told the Board that improvements to the derecognition and consolidation standards will be a significant, lasting, and global improvement in financial reporting.
- b. Significant diversity in practice in the application of key provisions of Interpretation 46(R) and the financial reporting results of that application.
- c. User concerns about the insufficient information being provided by enterprises about their involvement in variable interest entities, as well as the extent and timeliness of information being provided through disclosures.

The Board decided that it was important to provide the same effective date for this Statement and Statement 166 because many transactions would be affected by both Statements.

A103. The Board recognizes that as a result of the removal of the qualifying special-purpose entity concept and the related amendments to the guidance in Interpretation 46(R), more entities may be required to be consolidated; thus, regulatory agencies will be required to analyze these changes to determine whether a change to regulatory capital guidelines is necessary. Furthermore, the Board acknowledges that preparers with involvement in numerous variable interest entities will be required to gather significant amounts of data that must be analyzed to initially apply the amendments to Interpretation 46(R) in this 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) should have much of the data necessary to apply the amendments in this Statement for variable interest entities that are not qualifying special-purpose entities, in part because enterprises needed this data to ensure that they were appropriately accounting for their particular variable interest or interests.

A104. The Board originally considered whether this Statement should be effective for fiscal years beginning after November 15, 2008. However, to have sufficient time to adequately discuss the amendments with preparers, regulators, auditors, and financial statement users, the Board did not issue this Statement until June 2009. The Board noted that preparers, regulators, auditors, and financial statement users need adequate time to consider and implement the amendments and discuss the impact on regulatory requirements, which are based, in part, on GAAP. In addition, financial statement users told the Board that they would prefer a single effective date. As a result, the Board decided that this Statement shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

Similarities and Differences with International Financial Reporting Standards

A105. 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 Statement was not developed as part of a joint project with the IASB, both organizations continue to work together to issue guidance that yields similar consolidation results for special-purpose entities. The ultimate goal is for both projects to provide timely, transparent information about interests in other entities; however, the timeline and anticipated effective date of the IASB project is different from the effective date of this Statement. In this Statement, the FASB improved 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 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. The Board believes that it has effectively met this request. 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 time frame to complete. Because Statement 166 eliminates the qualifying special-purpose entity concept, the Board decided that the timing of this Statement and Statement 166 should be the same.

Benefits and Costs

A106. 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 preparers. 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 measure objectively the costs to implement an accounting standard or to quantify the value of improved information in financial statements.

A107. In addition to the extensive due process discussed in paragraph A4, the Board's assessment of this Statement's benefits and costs is based on discussions with preparers, auditors, regulators, and users, and a review of published studies and other information related to Interpretation 46(R). After considering the incremental costs of (a) the amendments to the approach for determining which enterprise, if any, with a variable interest in a variable interest entity is the primary beneficiary and (b) the incremental disclosure requirements, the Board concluded that those costs do not outweigh the potential significant benefits of improved information about variable interest entities to users.

A108. The Board recognizes that this Statement may require significant effort for many entities to gather the necessary data for conformity and that the review and audit procedures to ensure compliance with the amendments to Interpretation 46(R) may require additional effort. Notwithstanding those additional costs, the Board developed the amendments to Interpretation 46(R) to provide users of financial statements with relevant information about an enterprise's involvement with a variable interest entity or entities. The amendments are expected to better reflect situations in which an enterprise has a controlling financial interest in a variable interest entity. Specifically, the Board has established the principle that if an enterprise has the power and responsibility that may be associated with the enterprise's variable interest or interests along with the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity, then that enterprise is the primary beneficiary of the entity. The amended disclosures are expected to enhance, among other things, a user's ability to understand and assess an enterprise's critical judgments in determining (a) whether it is the primary beneficiary and (b) the risks that it is exposed to through its interest or interests in the entity.

A109. 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 Statement would be done in a substantive manner that truly changes the enterprise's power and/or obligation to absorb losses or right to receive benefits.

Appendix B

AMENDMENTS TO EXISTING FASB PRONOUNCEMENTS

B1. This Statement supersedes the following FASB Staff Positions (FSPs):

- a. 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)*.
- b. FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*.

B2. FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, is amended as follows:

- a. Paragraph 2:

The identification of variable interests (implicit and explicit) may affect (a) the determination as to whether the potential VIE should be considered a VIE, (b) the calculation of expected losses and residual returns, and (c) the determination as to which party, if any, is the primary beneficiary of the VIE. Thus, identifying whether a reporting enterprise holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of Interpretation 46(R), as amended by FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R).

- b. Footnote 1 to paragraph 5:

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

- c. Paragraph 6:

The FASB staff believes the reporting enterprise should consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists should be based on all facts and circumstances in determining whether the reporting enterprise may absorb variability of the VIE or potential VIE. A reporting enterprise that holds an implicit variable interest in a VIE and is a related party³ to other variable interest holders should apply the guidance in paragraph 17 of Interpretation 46(R), as amended by Statement 167, to determine whether it is the primary beneficiary of the VIE. That is, if the aggregate variable interests held by the enterprise (both implicit and explicit variable interests) and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment, and shall be based on an analysis of all relevant facts and circumstances. Paragraph 17 of Interpretation 46(R), as amended by Statement 167, provides factors to consider in making that determination. A reporting enterprise that is not the primary beneficiary but holds an significant implicit variable interest in a VIE should disclose the information in paragraphs 22E and 24 of Interpretation 46(R), as amended by Statement 167.

B3. FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, is amended as follows:

- a. 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 shall be made in accordance with the guidance in paragraphs 14–14G of Interpretation 46(R), as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*.

Appendix C

AMENDMENTS TO OTHER AUTHORITATIVE LITERATURE

C1. 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*.

C2. 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 167, addresses consolidation by business enterprises of variable interest entities, which may include structures used to facilitate ADC loans. ~~Interpretation 46 and~~ That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim pe-

riods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C3. 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 167, addresses consolidation by business enterprises of variable interest entities, which include grantor trusts if they meet certain conditions. ~~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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C4. 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 167, 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~~ That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C5. EITF Issue No. 88-22, “Securitization of Credit Card and Other Receivable Portfolios,” is amended as follows:

- a. The sixth to last paragraph of the STATUS section:

Interpretation 46 and Interpretation 46(R), as amended by Statement 167, 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) and 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 third to last paragraph of the STATUS section:

Statement 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167

shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C6. 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 167, 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 That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C7. 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 167, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose

entities used in leasing transactions. ~~Interpretation 46 and That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C8. 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 167, 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 That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C9. 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 167, addresses consolidation by business enterprises of variable interest entities, which may include some limited partnerships. Interpretation 46 and That 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 in a variable interest entity. Paragraphs 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C10. 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 167, addresses consolidation of variable interest entities.

C11. 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 167, addresses consolidation of variable interest entities.

C12. 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods

thereafter. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 167, addresses consolidation of variable interest entities.

C13. 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 167, addresses consolidation of variable interest entities.

C14. 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. Interpretation 46(R), as amended by Statement 167, addresses consolidation of variable interest entities.

C15. 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 167, 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 That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C16. 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 167, addresses consolidation by business enterprises of variable interest entities, which include many types of trusts. Interpretation 46 and That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C17. 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 167, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose corporations and joint ventures. Interpretation 46 and That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

- C18. 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 167, 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 That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C19. 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 167, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in leasing transactions. Interpretation 46 and That 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 re-

sidual returns or both. Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C20. 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 167, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in research and development arrangements. Interpretation 46 and That 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 in a variable interest entity. Paragraphs 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C21. 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 also are included in FASB Statement No. 166, *Accounting for Transfers of Financial Assets*.]

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 167, 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 That~~ 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C22. 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 Noncontrolling Interest in That Subsidiary,” is amended as follows:

a. Paragraph 10:

~~Interpretation 46 and~~ Interpretation 46(R), as amended by Statement 167, addresses consolidation by business enterprises of variable inter-

est 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 That~~ 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 14–14G of Interpretation 46(R), as amended by Statement 167, 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 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

C23. AICPA Audit and Accounting Guide, *Agricultural Producers and Agricultural Cooperatives*, is amended as follows:

a. Paragraph 12.27:

FIN 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, establishes requirements applicable to accounting for investments in agricultural cooperatives and other entities.² Agricultural producers involved in cash or crop-sharing agreements³ whereby the landowner controls both the producer and the entity operating the land, may also be subject to provisions of FIN 46(R). FIN 46(R) addresses consolidation by business enterprises of variable interest entities; A variable interest entity is an entity in which have one or more of the following characteristics: (†) the 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 the

equity holders, and, as a group, the holders of the equity investment at risk lack (a)(2) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, ~~the equity investors do not have the characteristics of a controlling financial interest,~~ or (d)(3) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. An entity subject to consolidation according to the provisions of this interpretation is referred to as a variable interest entity (VIE). FIN 46(R) governs how entities should assess interests in other entities in determining whether to consolidate that entity. FIN 46(R) requires an assessment of every relationship between an enterprise and another legal entity. Legal entities include grantor trusts, limited liability corporations, partnerships, corporations, and other trusts. Broadly stated, an entity that must determine consolidation in accordance with FIN 46(R) is known as a VIE and an entity that is required to consolidate a VIE is known as a primary beneficiary. There are many possible relationships an enterprise may have with other legal entities that are VIEs. For example, a company may participate in joint ventures with outside investors that may be VIEs. Swap agreements and derivative instruments between entities, even if used for hedging purposes, need to be evaluated. Management needs to evaluate equity method investments, leases, trust accounts, and loans as potential relationships with a VIE that may trigger consolidation.

b. Paragraph 12.28:

FIN 46(R), as amended by Statement 167, 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 14–14G of FIN 46(R), as amended by Statement 167, 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

⁴For additional assistance, refer to Practice Alert 05-1, *Auditing Procedures With Respect to Variable Interest Entities* (AICPA, Technical Practice Aids, PA sec. 16,280).

C24. AICPA Audit and Accounting Guide, *Airlines*, is amended as follows:

a. Paragraph 6.60:

A number of airlines have structures that need to be evaluated under FIN 46(R), *Consolidation of Variable Interest Entities* (revised December 2003), as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, to determine if they are variable interest entities (VIEs) and, if so, whether the airline is the primary beneficiary of the VIEs and needs to consolidate them. Examples of such structures include capacity purchase agreements, aircraft leases, enhanced equipment trust certificates (EETC), and airport fuel facilities. The lessors in airport facility leases that involve special facility revenue bond financings (discussed in the "Airport Financings" section of this chapter) are normally governmental entities. Governmental entities are scoped out of FIN 46(R), as amended by Statement 167. An airline should determine whether it is the primary beneficiary of a VIE at the time it becomes involved with the entity and should reconsider its conclusions regarding VIEs upon the occurrence of certain events listed in paragraphs 7 and 15 of FIN 46(R), as amended by Statement 167. Also, if, as a result of the airline's bankruptcy, agreements governing the relationship between the airline and VIE are modified, the airline needs to reevaluate its VIE decisions. Airlines need to prepare and maintain qualitative and, if necessary, quantitative evidence to support and provide rationale for their conclusions related to VIEs. The previous examples are not intended to be all inclusive, and the airline needs to evaluate all interests in entities for which ~~one or more of the following conditions exist:~~ (a) the 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 the equity holders, and, as a group, the holders of the equity investment at risk lack (a) the power through voting rights or similar rights to direct the activities of an entity

that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, ~~(b) the equity investors do not have the characteristics of a controlling financial interest, or~~ ~~(d)(e) the equity investors have voting rights that are not proportionate to their economic interests, and substantially all of the activities of the entity involve or are conducted on behalf of an investor with a disproportionately few voting rights.~~

b. Paragraph 6.62:

A traditional form of aircraft financing is lease financing, in which leasing trusts are established specifically to purchase, finance, and lease aircraft to the airlines. These leasing entities are potential VIEs. The typical leasing arrangements generally take the following forms: U.S. tax leases (leveraged leases from the lessor's perspective), single investor leases, multiple investor leases, or synthetic leases. The airline would need to evaluate its lease arrangements to determine if a variable interest exists. However, operating leases that do not include a residual value guarantee (or similar arrangement) or fixed price purchase option, and whose terms are consistent with prevailing market terms at the inception of the lease, are not considered variable interests in the lessor. 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 are variable interests in the lessor entity if they meet the conditions described in paragraph 12 of FIN 46(R), as amended by Statement 167. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 13 of FIN 46(R), as amended by Statement 167. If a variable interest exists, the airline needs to determine if the lessor entity is a VIE based on the criteria in paragraph 5 of FIN 46(R), as amended by Statement 167. If the airline concludes that the entity is a VIE, which is generally the case with these arrangements, the next step is to determine whether the airline has a controlling financial interest in the VIE absorbs a majority of the VIE's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests and is, therefore, the primary beneficiary of the entity. Paragraphs 14–14G of FIN 46(R), as amended by

Statement 167, provide guidance on determining whether an enterprise has a controlling financial interest in a VIE. FIN 46(R), as amended by Statement 167, requires an enterprise that holds a significant variable interest or interests in a VIE, but is not the primary beneficiary, is required to provide certain disclosures.

C25. AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, is amended as follows:

a. Footnote †† to paragraph 7.46:

~~In April 2008, FASB began redeliberations of its previously issued exposure draft *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. In September 2008, an exposure draft was released of the proposed statement, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. The proposed statement would remove (1) the concept of a qualifying special-purpose entity (SPE) from FASB Statement No. 140, and (2) the exceptions from applying FIN 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, to qualifying SPEs. The proposed statement also would amend FASB statement No. 140 to revise and clarify the derecognition requirements for transfers of financial assets and the initial measurement of beneficial interests that are received as proceeds by a transferor in connection with transfers of financial assets. The proposed statement also would enhance the disclosure requirements to provide users of financial statements with greater transparency about transfers of financial assets and a transferor's continuing involvement with such transferred financial assets. This proposed statement is being exposed concurrently with the proposed FASB Statement, *Amendments to FASB Interpretation No. 46(R)*, which would amend the consolidation and related disclosure requirements for enterprises that hold an interest in a variable interest entity. Most securitization entities that previously met the requirements of a qualifying SPE under FASB Statement No. 140 that are variable interest entities would now be required to be evaluated under the revised guidance in the proposed statement, including entities that transfer financial assets, hold a variable interest in such an entity, or both. Readers should be alert for further developments.~~

b. Paragraph 7.55 and its related footnote 13:

In addition, certain securities that arise from asset securitizations may raise issues about whether the underlying legal entity should be consolidated by the broker-dealer. FASB Statement No. 140, as amended, provides guidance on the securitization of financial assets held by broker-dealers and for other transfers of financial assets involving SPEs. In a typical asset securitization transaction, a company transfers assets to a special-purpose vehicle (SPV) or variable interest entity (VIE) in exchange for cash or securities issued by the SPV or VIE. Many securitization vehicles meet the FASB Statement No. 140 definition of a qualifying SPE. Qualifying SPEs are not consolidated under guidance in FASB Statement No. 140. Also, FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*, addresses whether in certain circumstances an SPE would fail to meet the conditions of a qualifying SPE under the current requirements of FASB Statement No. 140. These securitization vehicles that do not qualify as qualifying SPEs need to be evaluated under FIN 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, to determine whether the broker-dealer is the primary beneficiary of the VIE and therefore should consolidate the VIE or whether the broker-dealer holds a significant variable interest in the VIE and should make the appropriate disclosures.^{†‡}

^{†‡}See also footnote †† in paragraph 7.46.

c. Paragraph 7.56:

FIN 46(R), an interpretation of ARB No. 51, addresses consolidation by business enterprises of VIEs with certain characteristics, as described in the interpretation. A VIE is an entity in which VIEs refer to entities subject to consolidation according to the provisions of the interpretation. FIN 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 the equity investment at risk is not sufficient to permit the entity sufficient equity at risk for the entity to fi-

nance its activities without additional subordinated financial support from other parties and, as a group, the holders of the equity investment at risk lack, (a) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, or (d) the equity investors have voting rights that are not proportionate to their economic interests, and substantially all of the activities of the entity involve or are conducted on behalf of an investor with disproportionately few voting rights. Paragraphs 22B3–26 of the interpretation include disclosure requirements. FASB has issued several FSPs related to FIN 46(R) that may be of interest to broker-dealers and their auditors.^{##} The latest staff position interpretation is FSP FIN 46(R)-7, *Application of FASB Interpretation No. 46(R) to Investment Companies*.

C26. AICPA Audit and Accounting Guide, *Construction Contractors*, is amended as follows:

a. Paragraph 3.17:

Accordingly, a controlling venturer should account for an ownership interest in excess of 50 percent in a corporate venture under principles of accounting applicable to investments in subsidiaries, in accordance with Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended.* Exceptions to consolidation should be based on the examples in ARB No. 51. FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, addresses consolidation by business enterprises of variable interest entities. A variable interest entity is an entity in which have one or more of the following characteristics: (†) the 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 the equity holders, and, as a group, the equity investment at risk lack (a) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to

receive the expected residual returns of the entity ~~(2) the equity investors do not have the characteristics of a controlling financial interest, or (d)(3) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.~~ An entity subject to consolidation according to the provisions of this interpretation is referred to as a variable interest entity (VIE). FASB Interpretation No. 46(R) provides guidance on how entities should assess interests in certain other entities (VIEs) in determining whether to consolidate that entity. FASB Interpretation No. 46(R) may impact the way construction contractors account for and report their investments in construction joint ventures. ~~The interpretation—FASB Interpretation No. 46(R), as amended by FASB Statement No. 167, also requires disclosures about VIEs that the company is not required to consolidate but in which it has a significant variable interest. The FASB has issued and proposed several staff positions (FSPs) related to FASB Interpretation No. 46(R) that may be of interest to construction contractors and their auditors.^{† 6} Minority shareholders in a corporate venture should account for their investment using the principles applicable to investments in common stock in APB Opinion No. 18, or in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as appropriate.*~~

b. 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. 167, 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 14–14G of FASB Interpretation No. 46(R), as amended by Statement 167, 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 non-controlling investor in a general partnership should be guided by the provisions of APB Opinion No. 18.

c. Paragraph 4.02:

The division believes that consolidated or combined financial statements for the members of a group of affiliated entities that constitute an economic unit generally present more meaningful information than the separate statements of the members of the economic unit. The separate statements of the members of the group usually cannot stand on their own because they may not reflect appropriate contract revenue, costs, or overhead allocations and because transactions may be unduly influenced by controlling related parties. Under generally accepted accounting principles, there is a presumption that entities with parent-subsidiary relationships should present consolidated financial statements. Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, specifies the basis of presentation.* FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, as amended by FASB Statement No. 167, addresses consolidation by business enterprises of variable interest entities.[‡] A variable interest entity is an entity in which

have one or more of the following characteristics: ~~(1) the 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 the equity holders, and, as a group, the holders of the equity investment at risk lack (a) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity~~ ~~(2) the equity investors do not have the characteristics of a controlling financial interest, or~~ ~~(d)~~ ~~(3) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. An entity subject to consolidation according to the provisions of this interpretation is referred to as a variable interest entity (VIE). FASB Interpretation No. 46(R) provides guidance on how entities should assess interests in certain other entities (VIEs) in determining whether to consolidate that entity. The owners of closely held construction contractors may establish separate legal entities to acquire equipment or real estate that are then leased to the contractor. Interpretation No. 46(R) may impact the way construction contractors account for and report such related party equipment and real estate rental companies which often qualify as VIEs.¹ The interpretation also requires disclosures about VIEs that the company is not required to consolidate but in which it has a significant variable interest. The FASB has issued and proposed several staff positions (FSP) related to FASB Interpretation No. 46(R) that may be of interest to construction contractors and their auditors.² Other recommended financial statement presentations for affiliated companies are presented in this chapter.³~~

C27. 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:

[Paragraph 21 includes amendments that also are included in FASB Statement No. 166, *Accounting for Transfers of Financial Assets*.]

FIN No. 46(R),^{12 13} as amended by FASB Statement No. 167, *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) 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.~~

b. Paragraph 17.10:

Under paragraph 5 of FIN 46(R), as amended by Statement 167, An entity is a variable interest entity if its equity investment at risk ~~(a)~~ is insufficient to support its activities, and, as a group, the holders of the equity investment at risk lack (a) the power through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, or (d) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. ~~or (b) does not provide its holders with all the characteristics of a controlling financial interest.~~ The trust's common equity investment is not at risk because the investment was financed by the trust through the purchase of the debentures. If the preferred stock is not classified as equity for generally accepted

accounting principles (GAAP) reporting purposes, then the trust has no equity investment at risk and is a variable interest entity under paragraph 5(a) of FIN 46(R), as amended by Statement 167. Even if the preferred stock were classified as equity, the trust typically would be a variable interest entity under paragraph 5(b)(1) of FIN 46(R), as amended by Statement 167, because the holders of the equity investment at risk lack one of the characteristics described in (a)–(d) in the first sentence of this paragraph. of a controlling financial interest; that is, decision-making ability through voting or similar rights. Under FIN 46(R), as amended by Statement 167, a variable interest entity is consolidated by an enterprise that has its primary beneficiary, which is the a variable interest holder (or a combination of variable interests) that provides the enterprise with a controlling financial interest in the entity. Paragraphs 14–14G of FIN 46(R), as amended by Statement 167, provide guidance for determining whether an enterprise has a controlling financial interest, with the obligation to absorb a majority of the entity's economic risks (expected losses) or the right to receive a majority of the entity's economic rewards (expected residual returns). In the typical trust preferred arrangement, the bank holds no variable interest in the trust, and therefore, cannot be the trust's primary beneficiary.⁴ If the bank or holding company does not consolidate the trust, the bank or holding company should report its debt issued to the trust and an equity method investment in the common stock of the trust.

C28. AICPA Audit and Accounting Guide, *Health Care Organizations*, is amended as follows:

a. Paragraph 11.14:

FASB Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities*, clarifies the application of ARB No. 51 to certain entities. Under paragraph 5 of FIN 46(R), as amended by FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), a variable interest entity exists when 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, and, as a group, the holders of the equity investment at risk lack (a) the power through voting rights or

similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, or (d) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. An entity subject to consolidation according to the provisions of FIN 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 FIN 46(R) if, by design, the conditions in paragraph 5 of that interpretation exist. Paragraphs 14–14G of FIN 46(R), as amended by Statement 167, provides guidance for consolidation based on variable interests. FIN 46(R), as amended by Statement 167, also requires certain disclosures. Not-for-profit organizations are not subject to FIN 46(R), as amended by Statement 167, except that they may be related parties for purposes of applying paragraphs 16–17 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 FIN 46(R), as amended by Statement 167, that not-for-profit entity is subject to that interpretation.

C29. 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 FIN 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*, which replaced FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin (ARB) No. 51. FIN 46. 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 FASB Statement No. 167, 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 14–14G of FIN 46(R), as amended by Statement 167, 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 is entitled to receive a majority of the entity’s residual returns, or both. Those interpretations FIN 46(R), as amended by Statement 167, 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 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 167, 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 14–14G of FIN 46(R), as amended by Statement 167, 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 FIN 46(R) interpretations 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. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, states that the effective date for applying the provisions of FIN 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, or FIN 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 (FSP) SOP 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. 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*, as amended by Statement 167 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 167, 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 an 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), as amended by Statement 167, 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~~ FIN 46(R) 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. 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 Positions (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.

C30. AICPA Audit and Accounting Guide, *Property and Liability Insurance Companies*, is amended as follows:

a. Paragraph 5.80:

~~For insurance companies issuing GAAP statements, FIN 46(R) (revised December 2003), *Consolidation of Variable Interest Entities*, as amended by FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, ~~an interpretation of ARB No. 51, *Consolidated Financial Statements*, and was issued to clarify controlling financial interests defined for consolidation purposes.~~ the application of ARB No. 51, *Consolidated Financial Statements*, to variable interest entities. A VIE is an entity in which the equity investment at risk is insufficient to support its activities, and, as a group, the holders of the equity investment at risk lack (a) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity’s economic performance, (b) the obligation to absorb the expected losses of the entity, (c) the right to receive the expected residual returns of the entity, or (d) the equity investors have voting~~

~~rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. This interpretation excludes entities subject to the reporting requirements of FASB Statement No. 140. However, insurance companies may participate in variable interest entities through investing in structured investments, such as asset-backed securities, synthetic asset-backed securities and catastrophe bonds, certain structured reinsurance transactions, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, synthetic leases, collateralized bond obligation issuances, or limited partnerships.~~²⁰

Appendix D

INTERPRETATION 46(R), AS AMENDED BY THIS STATEMENT

D1. This appendix contains the amendments to FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. This appendix does not contain the appendixes of Interpretation 46(R) that have not been amended by Statement 167. [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, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:~~

- a. The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance
- 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 in the 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 the activities of a variable interest entity that most significantly impact the entity’s economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

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.

Consideration of Substantive Terms, Transactions, and Arrangements

2A. For purposes of applying this Interpretation, only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered. Any term, transaction, or arrangement that does not have a substantive effect on (a) an entity’s status as a variable interest entity, (b) an enterprise’s power over a variable interest entity, or (c) an enterprise’s obligation to absorb losses or its right to receive benefits of the entity shall be disregarded when applying the provisions of this Interpretation. Judgment, based on consideration of all the facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from nonsubstantive terms, transactions, and arrangements.

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 Post-employment Benefits*.
- c. [This criterion has been deleted. See Status page.]
- d. [This criterion has been deleted. See Status page.]
- 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 ~~104~~ of ~~Statement 167~~ 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 under joint control of the reporting enterprise and one or more independent parties or a franchisee.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 FSP SOP 07-1-1, *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.

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.

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)(†).

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

- (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 according to the provisions of this Interpretation if, by design,⁵ 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 power, direct or indirect ability through voting rights or similar rights, to direct make decisions about an entity's the activities of an that have a significant effect on the success of the entity that most significantly impact the entity's economic performance. The investors do not have that ability power 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 Kick-out rights^{8a} or participating rights^{8a} held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and

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 these characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having these necessary characteristics, the entity is a variable interest entity.

⁸Enterprises that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder 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 Noncontrolling 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.

^{8a}See footnotes 15b and 15c for the definitions of kick-out rights and participating rights.

de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs B22 and B23 of this Interpretation.

- (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.
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.~~
 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.

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)(4).

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.

e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

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.

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 entity 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

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*.

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 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 if when that enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest on the basis of the provisions in paragraphs 14A–14G. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that 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.

14A. An enterprise with a variable interest in a variable interest entity shall assess whether the enterprise has a controlling financial interest in the entity and, thus, is the entity's primary beneficiary. This shall include an assessment of the characteristics of the enterprise's variable interest or interests and other involvements (including involvement 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 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 the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from

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.

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

the entity that could potentially be significant to the variable interest entity. The quantitative approach prescribed in paragraph 8 of this Interpretation is not required and shall not be the sole determinant as to whether an enterprise has these obligations or rights.

Only one enterprise, if any, is expected to be identified as the primary beneficiary of a variable interest entity. Although more than one enterprise could have the characteristic in paragraph 14A(b), only one enterprise, if any, will have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

14B. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. An enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. An enterprise does not have to exercise its power in order to have power to direct the activities of an entity.

14C. An enterprise's determination of whether it has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance shall not be affected by the existence of kick-out rights^{15b} or participating rights^{15c} unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights are designed to protect the interests of the party hold-

ing those rights without giving that party a controlling financial interest in the entity to which they relate. They include, for example:

- a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. For example:
 - (1) A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
 - (2) Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.
- b. The ability to remove the enterprise that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that enterprise.
- c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

14D. If an enterprise determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and if decisions about those activities require the consent of each of the parties sharing power. If an enterprise concludes that power is not shared but the activities that most significantly

^{15b} Kick-out rights are the ability to remove the enterprise with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. This requirement is limited to this particular analysis and is not applicable to transactions accounted for under other authoritative guidance, such as EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights."

^{15c} Participating rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. This requirement is limited to this particular analysis and is not applicable to transactions accounted for under other authoritative guidance such as 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."

impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 14A(a).

14E. If the activities that impact the entity's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then an enterprise shall identify which party has the power to direct the activities that most significantly impact the entity's economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 14A(a).

14F. Although an enterprise may be significantly involved with the design of an entity, that involvement does not, in isolation, establish that enterprise as the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with that power. For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the entity operates as designed, the sponsor may have established arrangements that result in the sponsor being the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity.

14G. Consideration should be given to situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of an enterprise's economic interest may be indicative of the amount of power that enterprise holds.

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 docu-

ments 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. However, a de facto agency relationship does not exist if both the enterprise and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

17. In situations in which an enterprise concludes that neither it nor one of its related parties has the characteristics in paragraphs 14A(a) and 14A(b) but, as a group, the enterprise and its related parties ~~if two or more related parties~~ (including the de facto agents described in paragraph 16) have those characteristics, 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 variability~~ associated with the anticipated economic performance of the variable interest entity
- d. The design of the variable interest entity.

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 enter-

prise 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 FASB Statement No. 141 (revised 2007), *Business Combinations*.

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.

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,

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.

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. If an enterprise is required to deconsolidate a variable interest entity, the enterprise shall follow the guidance for deconsolidating subsidiaries in FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*.

Disclosures for Public Enterprises Presentation

22A. A public enterprise^{16a}, including a public enterprise that is a sponsor that has a variable interest in a variable interest entity, shall provide disclosures as required in Appendix C of FSP FAS 140-4 and FIN 46(R)-8. A reporting enterprise shall present separately on the face of the statement of financial position (a) assets of a consolidated variable interest entity that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

DISCLOSURE

22B. A public enterprise^{16b} shall provide disclosures as required in Appendix D of FSP FAS 140-4 and FIN 46(R)-8 if that enterprise is a (a) nontransferor sponsor of a qualifying SPE that holds a variable interest in a qualifying SPE or (b) nontransferor ser-

vicee of a qualifying SPE that holds a significant variable interest in the qualifying SPE. The principal objectives of the disclosures required by paragraphs 22C–26 are to provide financial statement users with an understanding of the following:

- a. The significant judgments and assumptions made by an enterprise in determining whether it 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 and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- c. The nature of, and changes in, the risks associated with an enterprise's involvement with the variable interest entity
- d. How an enterprise's involvement with the variable interest entity affects the enterprise's financial position, financial performance, and cash flows.

An enterprise shall consider those overall objectives in providing the disclosures required by this Interpretation. To achieve those objectives, an enterprise may need to supplement the disclosures required by paragraphs 22C–26, depending on the facts and circumstances surrounding the variable interest entity and the enterprise's interest in that entity.

22C. Disclosures about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not provide more useful 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 has a variable interest
- b. Variable interest entities that are consolidated.

In determining whether to aggregate variable interest entities, the reporting 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. The disclosures

^{16a}See footnote *.

^{16b}See footnote *.

shall be presented in a manner that clearly explains to financial statement users the nature and extent of an enterprise's involvement with variable interest entities.

22D. An enterprise shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the requirements of this Interpretation. An enterprise also shall determine how it aggregates information to display its overall involvements with variable interest entities with different risk characteristics. The entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial position. For example, an enterprise shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an enterprise shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks.

22E. In addition to disclosures required by other standards, an enterprise that is a primary beneficiary of a variable interest entity^{16c} or an enterprise that holds a variable interest in a variable interest entity but is not the entity's primary beneficiary shall disclose:

- a. Its methodology for determining whether the enterprise is the primary beneficiary of a variable interest entity, including, but not limited to, significant judgments and assumptions made. For example, one way to meet this disclosure requirement would be to provide information about the types of involvements an enterprise considers significant, supplemented with information about how the significant involvements were considered in determining whether the enterprise is the primary beneficiary.
- b. If facts and circumstances change such that the conclusion to consolidate a variable interest entity has changed 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 (explicitly or implicitly) during the periods presented to the variable interest entity that it was not previously contractually required to provide or whether the enterprise intends to provide that support, including:
 - (1) The type and amount of support, including situations in which the enterprise assisted the variable interest entity in obtaining another type of support
 - (2) The primary reasons for providing the support.
- d. Qualitative and quantitative information about the enterprise's involvement (giving consideration to both explicit arrangements and implicit variable interests^{16d}) with the variable interest entity, including, but not limited to, the nature, purpose, size, and activities of the variable interest entity, and how the entity is financed.

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 any gain or loss recognized on the initial consolidation of the variable interest entity. 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 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
- b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations
- 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.

^{16c}A 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 22E and 23A are not required.

^{16d}FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, provides guidance on how to determine whether an enterprise has an implicit variable interest in a variable interest entity.

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, the disclosures in paragraphs 23 and 27 are not required.

23A. In addition to disclosures required by other pronouncements, the primary beneficiary of a variable interest entity^{17a} shall disclose the following:

- a. The carrying amounts and classification of the variable interest entity's assets and liabilities in the statement of financial position that are consolidated in accordance with this Interpretation, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the variable interest entity's assets can be used only to settle obligations of the variable interest entity, the enterprise shall disclose qualitative information about the nature of the restrictions on those assets.
- b. 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.
- c. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the variable interest entity, including events or circumstances that could expose the enterprise to a loss.

24. An enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary shall disclose: In addition to disclosures required by other pronouncements, an enterprise that holds a variable interest in a variable interest entity, but is not the variable interest entity's primary beneficiary, shall disclose:

- a. The nature of its involvement with the variable interest entity and when that involvement began
- b. The nature, purpose, size, and activities of the variable interest entity
- e. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity:
 - a. The carrying amounts and classification of the assets and liabilities in the enterprise's statement of financial position that relate to the enterprise's variable interest in the variable interest entity.
 - b. 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 en-

terprise'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.

- c. A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the enterprise's maximum exposure to loss, as required by (b) above. An enterprise shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the variable interest entity, including events or circumstances that could expose the enterprise to a loss.
- d. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the enterprise's variable interest in the variable interest entity is encouraged.
- e. If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance is shared in accordance with the guidance in paragraph 14D.

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. 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 22B 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

^{17a}See footnote 16c.

~~described in paragraph 4(g) shall disclose the following information: 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.~~
- ~~a. The number of entities to which this Interpretation is not being applied and the reason that the information required to apply this Interpretation is not available~~
- ~~b. The nature, purpose, size (if available), and activities of the entity or entities and the nature of the enterprise's involvement with the entity or entities~~
- ~~c. The reporting enterprise's maximum exposure to loss because of its involvement with the entity or entities~~
- ~~d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting enterprise and the entity or entities 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 (to Interpretation 46(R))

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 ef-

fective in determining whether a controlling financial interest exists because the holders of the equity investment at risk do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support or because they lack (a) the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, or (c) the right to receive the expected residual returns of the entity. ~~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 in a variable interest entity 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 variable interest 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:

- 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.

Fees Paid to Decision Makers or Service Providers~~Other Service Contracts~~

B22. Fees paid to an entity's decision maker(s) or service provider(s) ~~Service contracts with hired service providers other than the entity's decision maker~~ are not variable interests if all of the ~~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.

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

²⁶Refer to footnote 25.

- 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: decision maker or service provider and its related parties,^{26a} if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.~~
- d. ~~The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.~~
- e. ~~The total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.~~
- f. ~~The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.~~

B23. ~~Fees paid to decision makers or service providers that do not meet all of the conditions in B22 are 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.

^{26a}The term *related parties* refers to all parties identified in paragraph 16. However, for purposes of this condition, related parties do not include employees of the decision maker or service provider, unless the employees are used in an effort to circumvent the provisions of this Interpretation.

²⁷This 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).

Appendix C'**IMPLEMENTATION GUIDANCE**

C1. The following example fact patterns and related evaluations are provided solely to illustrate the application of the guidance in paragraphs 14–14G of this Interpretation. 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, on the basis of the guidance in paragraphs 12 and 13 of this Interpretation. In some examples, certain fees are described as representing, or not representing, a variable interest on the basis of paragraphs B22 and B23 of this Interpretation. However, the examples were not meant to illustrate the application of the guidance in paragraphs B22 and B23, and additional facts would be necessary to determine which condition(s) resulted in the fee representing a variable interest. Finally, determining the primary beneficiary in accordance with the guidance in this Interpretation requires judgment and is on the basis of individual facts and circumstances of the variable interest entity and the enterprise with the variable interest or interests.

Example 1***Facts and Circumstances***

C2. An entity is created and financed with \$94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and \$6 of equity. All of the bonds are held by third-party investors. The equity is held by a third party, who is also the special servicer. 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 a 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 bondholders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

C3. 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.

C4. If there is a shortfall in contractual payments from the borrowers or if the 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.

C5. The Transferor retains the primary 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 special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

C6. The special servicer is involved in the creation of the entity and required at the creation date that certain loans, which it deemed to be of high risk, be removed from the initial pool of loans that were going to be purchased by the entity from the Transferor. The special servicer also reviewed the entity's governing documents to ensure that the special servicer would be allowed to act quickly and effectively in situations in which a loan becomes delinquent. The special servicer concluded the entity's governing documents allowed the special servicer to adequately monitor and direct the performance of the underlying loans.

C7. For its services as primary servicer, the Transferor earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The special servicer also earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. No party has the ability to remove the primary servicer or the special servicer.

Evaluation

Design of the entity

C8. 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 provide liquidity to the Transferor to originate additional loans and to 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

C9. The special servicer and the bondholders are the variable interest holders in the variable interest entity. The fees paid to the Transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation. The fees paid to the special servicer represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C10. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact the performance of the underlying assets. The 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 special servicer, 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. However, an enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. An enterprise does not have to exercise its power in order to have power to direct the activities of an entity. The special servicer's involvement in the design of the entity does not, in isolation, result in the special servicer being the primary beneficiary of the entity. However, in this situation, that involvement indicated that the special servicer had the opportunity and the incentive to establish arrangements that result in the special servicer being the variable interest holder with the power to direct the activities that most significantly impact the entity's economic performance.

C11. The bondholders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity's economic performance.

C12. The activities that the primary servicer has the power to direct are administrative in nature and do not most significantly impact the entity's economic performance. In addition, the primary servicer, and its related parties, do not hold a variable interest in the entity. Thus, the primary servicer cannot be the primary beneficiary of the entity.

C13. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

C14. The special servicer, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the entity. The special servicer concluded that the benefits could not potentially be significant to the entity. The special servicer, as the equity tranche holder, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the variable interest entity. As equity tranche holder, the special

servicer 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.

C15. On the basis of the specific facts and circumstances presented above and the analysis performed, the special servicer 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. As the equity tranche holder, it has the obligation to absorb losses of the variable interest entity and the right to receive benefits from the variable interest entity, either of which could potentially be significant to the variable interest entity.

Example 2

Facts and Circumstances

C16. An entity is created and financed with \$90 of AAA-rated fixed-rate debt securities, \$6 of 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.

C17. 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 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.

C18. 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.

C19. 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.

C20. The third-party equity investor has rights that are limited to administrative matters.

Evaluation

Design of the entity

C21. 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 provide investors with the ability to invest in a pool of asset-backed securities, to earn a positive spread between the interest that the entity earns on its portfolio and the interest paid to the debt investors, and to 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 management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the 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

C22. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C23. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of the entity's portfolio of assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact the performance of the portfolio of assets. The Manager has the ability to 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.

C24. The debt holders of the entity do not have voting rights or other rights that provide them with the power to direct activities that most significantly impact the entity's economic performance. 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.

C25. The third-party equity investor has the power to direct certain activities. However, the activities that the third-party equity investor has the power to direct are administrative and do not most significantly impact the entity's economic performance.

C26. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Manager, as the 35 percent equity tranche holder, has the obligation to

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

C27. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance (and no single enterprise has the unilateral ability to exercise kick-out rights).
- b. Through its equity interest and performance-based fee, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 3

Facts and Circumstances

C28. 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.

C29. 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.

C30. 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.

C31. 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—This 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.

C32. For its services, the Sponsor receives a fixed fee, calculated as an annual percentage of the aggregate equity outstanding, and a performance-based fee, calculated as a percentage of the entity's profit above a targeted return.

C33. 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

C34. 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 provide investors with the ability to invest in a pool of high-quality debt, to maximize the spread it earns on its asset portfolio over its weighted-average cost of funding, and to generate management fees for the Sponsor.
- b. 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.
- 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

C35. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C36. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the performance of the entity's portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the entity's economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The Sponsor manages the entity's investment, funding, and defeasance activities. 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 indicated that the Sponsor had the opportunity and the incentive to establish arrangements that result in the Sponsor being the variable interest holder with the power to direct the activities that most significantly impact the entity's economic performance.

C37. The debt security holders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity's economic performance. Although the equity holders have voting rights, they are limited to voting on amendments to the constitutional documents of the entity, and those rights do not provide the equity holders with the power to direct the activities that most significantly impact the entity's economic performance.

C38. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Sponsor, through its performance-based fee arrangement, receives benefits that could potentially be significant to the variable interest entity. As the entity is designed to earn a spread 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.

C39. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.

- b. Through its performance-based fee arrangement and implicit financial responsibility to ensure that the variable interest entity operates as designed, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 4

Facts and Circumstances

C40. 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.

C41. The Sponsor of the entity provides credit enhancement in the form of a letter of credit equal to 5 percent of the entity's assets and it provides 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.

C42. A credit default of the entity's assets resulting in deficient cash flows is absorbed as follows:

- a. First by the subordinated note holders
- b. Second by the Sponsor's letter of credit
- c. Third by the short-term debt holders.

The Sponsor's liquidity facility does not advance against defaulted assets.

C43. The entity is exposed to liquidity risk because the average life of the assets is greater than that of its liabilities. The entity enters into a liquidity facility with the Sponsor to mitigate liquidity risk.

C44. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal 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.

C45. The Sponsor of the entity performs various functions to manage the operations of the entity. Specifically, the Sponsor:

- a. Establishes the terms of the entity
- b. Approves the sellers permitted to sell to the entity
- c. Approves the assets to be purchased by the entity
- d. Makes decisions regarding the funding of the entity including determining the tenor and other features of the short-term debt issued
- e. 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.

C46. For providing credit and liquidity facilities and management services, the Sponsor receives a fixed fee calculated as an annual percentage of the asset value.

C47. The short-term debt holders and subordinated note holders have no voting rights.

Evaluation

Design of the entity

C48. 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 provide investors with the ability to invest in a pool of highly rated medium-term assets, to provide the multiple sellers to the entity with access to lower-cost funding, to earn a positive spread between the interest that the entity earns on its asset portfolio and its weighted-average cost of funding, and to generate fees for the Sponsor.

- b. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal 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

C49. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C50. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the performance of the entity's portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the entity's economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The Sponsor 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 about 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. 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 and the incentive to establish arrangements that result in the Sponsor being the variable interest holder with the power to direct the activities that most significantly impact the entity's economic performance.

C51. 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 the activities that most significantly impact the entity's economic performance.

C52. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity 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.

C53. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- 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.

Example 5

Facts and Circumstances

C54. 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.

C55. 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.

C56. 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.

C57. 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 that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

C58. 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.

C59. 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 managing default. 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

C60. 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 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, to provide the Transferor to the entity with access to liquidity for its originated loans and an ongoing servicing fee, and to 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 risk 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

C61. The debt securities holders and the Guarantor are the variable interest holders in the variable inter-

est entity. The fees paid to the Transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C62. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact 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.

C63. 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 activities related to such risk.

C64. 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 the activities that most significantly impact the entity's economic performance. In addition, the primary servicer and its related parties do not hold a variable interest in the entity. Thus, the primary servicer cannot be the primary beneficiary of the entity. Furthermore, the security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the entity's economic performance.

C65. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity 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.

C66. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- 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.

Example 6

Facts and Circumstances

C67. 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.

C68. 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.

C69. The primary servicing responsibilities are retained by the Transferor. No party has the ability to remove the Transferor as servicer.

C70. 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, ad-

ministering 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 all of the following:

- 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)
- 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 managing default, 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

C71. 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 provide investors with the ability to invest in a pool of residential mortgage loans and to provide the Transferor to the entity with access to liquidity for its originated loans 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

C72. 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 on the basis of a consideration of the conditions in paragraphs B22 and B23 of this Interpretation.

C73. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the entity's economic performance are the activities that most significantly impact 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. The default management activities are performed only after default of the underlying assets or when default is reasonably foreseeable. However, an enterprise's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. A reporting entity does not have to exercise its power in order to have power to direct the activities of an entity.

C74. 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.

C75. The senior security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the entity's economic performance.

C76. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance,

then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. The Transferor, through its residual tranche ownership, has the obligation to absorb losses and the right to receive benefits, either of which 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. The Transferor concluded that those benefits could not potentially be significant to the entity.

C77. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its residual tranche ownership, it has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the variable interest entity.

Example 7

Facts and circumstances

C78. 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.

C79. 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.

C80. 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 the power to direct any activities of the variable interest entity. The entity was formed so that the lessee would have rights to use the property under an operating lease and would retain substantially all of the risks and rewards from appreciation or depreciation in value of the leased property.

C81. 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

C82. 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

C83. The debt investors, the equity investors, and the lessee are the variable interest holders in the variable interest entity.

C84. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the variable interest entity is significantly impacted 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, and the lessee directs the remarketing of the 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 how it remarkets the property.

C85. The debt holders do not have the power to direct activities that most significantly 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 activities that most significantly impact the entity's economic performance.

C86. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits

from the entity that could potentially be significant to the variable interest entity. The lessee has both the obligation to absorb losses that could potentially be significant to the variable interest entity and the right to receive benefits that could potentially be significant to the variable interest entity through the residual value guarantee and the purchase option, respectively.

C87. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its residual value guarantee and purchase option, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

Example 8

Facts and Circumstances

C88. Company A and Company B form an entity to manufacture, distribute, and sell a beverage. The entity is funded with \$95 million of 20-year fixed-rate debt and \$5 million of equity. The debt is widely dispersed among third-party investors. The equity is held by Company A and Company B. Company A and Company B are not related parties. Company A, a beverage manufacturer and distributor, is responsible for manufacturing the beverage. Company B, also a beverage manufacturer and distributor, is responsible for distributing and selling the beverage. Company A and Company B each have 50 percent of the voting rights and each represents 50 percent of the board of directors. Decisions about the manufacturing, distributing, and selling of the beverage require the consent of both Company A and Company B. All other decisions about the entity 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.

Evaluation

Purpose and design of the entity

C89. 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 that the primary purpose for which the variable interest entity was created was to provide Company A with access to Company B's distribution and sales network and for Company B to gain access to Company A's manufacturing process and technology.

Determination of the primary beneficiary

C90. Company A and Company B (through their equity investment) and the debt investors are the variable interest holders in the variable interest entity.

C91. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is significantly impacted by the manufacturing of the beverage and by the selling and distributing of the beverage. Thus, the activities that significantly impact the entity's economic performance are the activities that significantly impact the manufacturing of the beverage and the selling and distributing of the beverage.

C92. If an enterprise determines that power is, in fact, shared among multiple parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, and if decisions about those activities require the consent of each of the parties sharing power.

C93. Company A and Company B share the power to direct the activities that will most significantly impact the economic performance of the entity through their ability to make decisions about the manufacturing, distributing, and selling of the beverage and because of the fact that those decisions require each party's consent.

C94. The debt holders of the entity have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the entity's economic performance.

C95. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. Company A and Company B both have the obligation to absorb losses and the right to receive benefits that could potentially be significant to the variable interest entity through their equity interests.

C96. On the basis of the specific facts and circumstances presented above and the analysis performed, the entity does not have a primary beneficiary because the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance, is, in fact, shared among multiple parties (Company A and Company B) such that no one party has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

Example 8A

C97. Assume that decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Company A and Company B. Each enterprise would be required to identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the variable interest entity. Because decisions about these activities do not require the consent of both Company A and Company B, power would not be considered shared, and either Company A or Company B would be the primary beneficiary of the entity, on the basis of which party has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

Example 8B

C98. Assume that Company A and Company B each manufacture, distribute, and sell the beverage in different locations, but decisions about these activities

do not require the consent of both Company A and Company B. That is, each company is responsible for the same activities. Because decisions about these activities do not require the consent of both Company A and Company B, power would not be considered shared.

C99. If an enterprise concludes that power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. If no party directs the majority of those activities, the variable interest entity does not have a primary beneficiary.

C100. If Company A or Company B has power over the majority of those activities, then that party would be the primary beneficiary of the entity.

Example 8C

C101. Assume that Company A and Company B are each responsible for manufacturing the beverage, but Company B is also responsible for all of the distributing and selling of the beverage, and decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Company A and Company B. Each enterprise would be required to identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the variable interest entity. That is, power would not be considered shared, and either Company A or Company B would be the primary beneficiary of the entity. However, if an enterprise concludes that power is not shared but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. If no party directs the majority of those activities, the variable interest entity does not have a primary beneficiary.

C102. Company B may conclude that its power over some of the manufacturing of the beverage, combined with its power over all of the distributing and selling of the beverage, results in its being the party with the power to direct the activities that most significantly impact the entity's economic performance. However, if Company B were to conclude that the distributing and selling of the beverage did not significantly impact the economic performance of the entity, then the primary beneficiary of the entity would be the party, if any, with the power over the majority of the manufacturing of the beverage.

Example 9

Facts and Circumstances

C103. An entity is created by a furniture manufacturer and a financial investor to manufacture and 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. The debt agreement includes a clause such that if there is a materially adverse change that materially impairs the ability of the entity and the furniture manufacturer to pay the debt, then the financial investor can take possession of all the assets of the entity. An independent third party must objectively determine whether a materially adverse change has occurred on the basis of the terms

of the debt agreement (an example of a materially adverse change under the debt agreement is the bankruptcy of the entity).

Evaluation

Purpose and design of the entity

C104. 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

C105. The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the variable interest entity.

C106. An enterprise must identify which activities most significantly impact the entity's economic performance and determine whether it has the power to direct those activities. The economic performance of the entity is most significantly impacted by the operations of the entity because the operating cash flows of the entity are used to repay the financial investor. Thus, the activities that most significantly impact the entity's economic performance are the operating activities of the entity. The furniture manufacturer has the ability to establish the sales and marketing strategy of the entity and manage the day-to-day activities of the entity.

C107. The debt holder has the power to take possession of all of the assets of the entity if there is a materially adverse change under the debt agreement. However, the debt holder's rights under the materially adverse change clause represent protective rights. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. The debt holder's rights protect the interests of the debt holder; however, the entity's economic performance is most significantly impacted by the activities over which the furniture manufacturer has power. The debt holder's protective rights do not prevent the furniture manufacturer from having the power to direct the activities of the entity that most significantly impact the entity's economic performance.

C108. If an enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance, then that enterprise also is required to determine

whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits that could potentially be significant to the variable interest entity. The furniture manufacturer has the obligation to absorb losses that could potentially be significant through its equity interest and debt guarantee and the right to receive benefits that could potentially be significant through its equity interest.

C109. On the basis of 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 the activities of the variable interest entity that most significantly impact the entity's economic performance.
- b. Through its equity interest and debt guarantee, it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity and the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

