



**Board Meeting Handout**  
**REDELIBERATION OF THE PROPOSED FASB STATEMENT, *ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS***

**Transfers of Portions of Financial Assets**

**January 28, 2009**

**PURPOSE**

The purpose of this meeting is to redeliberate whether the proposed Statement should limit when it is appropriate to derecognize a portion of a transferred financial asset. If the Board decides that the proposed Statement should limit when it is appropriate to derecognize a transferred portion of a financial asset, the staff will ask the Board to redeliberate the approach to defining the unit of account (participating interest) that is eligible for derecognition.

**ISSUE 1: WHETHER THE PROPOSED STATEMENT SHOULD LIMIT WHEN IT IS APPROPRIATE TO DERECOGNIZE A TRANSFER OF A PORTION OF A FINANCIAL ASSET**

*View A—The proposed Statement should limit when a transfer of a portion of a financial asset is eligible for derecognition.*

*View B—The proposed Statement should not limit when a transfer of a portion of financial asset is eligible for derecognition.*

**Staff Recommendation**

The staff recommends View A because it believes that the segregation of an entire financial asset in an entity that is not controlled by a transferor is a significant factor to be considered for derecognition. The staff also believes that limiting a portion of a financial asset that is eligible for derecognition to proportionate, pari passu portions will reduce concerns about the practice issues that have arisen in the application of the isolation criteria in paragraph 9(a) of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, particularly those transfers involving pools of financial assets. The staff also believes that View A will reduce structuring opportunities for transactions that must be evaluated under both Statement 140 and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. Without providing guidance on portions that are eligible for derecognition, the staff believes that more transfers will result in derecognition, which is currently the case under Statement 140. In addition, limiting portions that are eligible for derecognition is consistent with IAS 39, *Financial Instruments: Recognition and Measurement*, which provides unit of account guidance.

**ISSUE 2: IF THE BOARD CHOOSES VIEW A IN ISSUE 1, WHAT CRITERIA SHOULD BE USED TO DEFINE A PORTION OF A FINANCIAL ASSET ELIGIBLE FOR DERECOGNITION?**

**View A—Utilize the Participating Interest Definition in the Proposed Statement with Certain Modifications (See Issue 3 for Potential Modifications to Be Considered)**

Paragraph 8B of the proposed amendments to Statement 140 defines a participating interest as having the following characteristics:

1. It represents a proportionate ownership interest in an entire individual financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
2. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) in proportion to the share of ownership represented by each. Cash flows allocated to a servicer as compensation for servicing activities, if any, shall not be included in that determination. The transferor's ownership shares must remain pro rata over the life of the original financial asset. Participating interests may be further apportioned by the transferor as long as the resulting portions meet the definition of a participating interest.
3. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates included in the financial statements being presented or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder in its role as a participating interest holder.
4. No party has the right to pledge or exchange the entire financial asset.

**View B—Utilize IASB Definition of a Portion That Is Eligible for Derecognition**

Under paragraph 16 of IAS 39, the derecognition criterion can be applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions:

1. The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, the derecognition criteria is applied to the interest cash flows.

2. The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of all cash flows of a debt instrument, the derecognition criteria is applied to 90 percent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
3. The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of interest cash flows from a financial asset, the derecognition criteria is applied to 90 percent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

### **Staff Recommendation**

The staff recommends View A. The staff notes that the Board has previously considered and rejected View B because of concerns that the definition of a portion would result in subordination of cash flows in some cases. The staff believes that the IAS 39 unit of account guidance is currently being reviewed by the IASB and may change significantly because of practice issues.

### **ISSUE 3: IF THE BOARD CHOOSES VIEW A IN ISSUE 2, SHOULD THE PROPOSED DEFINITION OF A THE PARTICIPATING INTEREST BE MODIFIED?**

*Issue 3A (Comment Letter Summary, Paragraph 17):* Whether paragraph 8B(a) of the participating interest definition should explicitly prohibit transfers of equity instruments, derivative financial instruments, or hybrid financial instruments with an embedded derivative that is not clearly and closely related, as described in Statement 133.

**Staff Recommendation:** The staff recommends that paragraph 8B(a) of the proposed amendments to Statement 140 should not explicitly prohibit transfers of equity instruments, derivative financial instruments, or hybrid financial instruments with an embedded derivative that is not clearly and closely related, as described in Statement 133. The staff believes that the participating interest definition adequately captures when it is appropriate for these items to be considered for derecognition. As a result, paragraph 8B(a) will be modified to state the following: “It represents a proportionate ownership interest in an entire individual financial asset.”

*Issue 3B (Comment Letter Summary, Paragraphs 19-21):* Whether paragraph 8B(b) of the participating interest definition should be clarified to indicate that the determination of proportionate cash flows shall exclude cash flows allocated to a transferor as compensation for services performed, if any, provided that such cash flows (1) are not subordinate to the proportionate cash flows and (2) are not significantly above or below adequate compensation for the services rendered. In addition, all cash flows that represent the transferor’s share of the contractual interest retained as the transferor’s gain on sale due to changes in market interest rates shall be excluded from the determination of what is meant by proportionate cash flows.

**Staff Recommendation:** The staff believes this issue can be addressed by amending the language in the second sentence of paragraph 8B(b) to clarify which cash flows shall be excluded from the

determination of proportionate cash flows. The staff proposes the following changes (subject to drafting):

Cash flows allocated to a ~~servicer~~ transferor as compensation for ~~servicing activities~~ services performed, if any, shall not be included in that determination provided such cash flows are (1) not subordinate to the proportionate cash flows and (2) not significantly above or significantly below adequate compensation for the services rendered. In addition, all cash flows that represent the transferor's share of the contractual interest retained as the transferor's gain on sale because of changes in market interest rates shall be excluded from that determination....

**Issue 3C (Comment Letter Summary, Paragraph 22):** Whether third-party guarantees should affect the determination of whether a transferred portion meets the definition of a participating interest.

**Staff Recommendation:** The staff believes that third-party guarantees do not affect whether the participating interest definition is met. As a result, the staff recommends that the Board clarify that third party guarantees are considered a separate unit of account that should not be considered in the evaluation of whether the participating interest definition is met.

**Issue 3D (Comment Letter Summary, Paragraph 26):** Whether setoff rights should preclude meeting the definition of a participating interest.

**Staff Recommendation:** The staff does not believe that setoff rights should preclude meeting the definition of a participating interest, consistent with the basis for conclusions in the proposed Statement relating to setoff rights (paragraph A14) that states that “the Board ultimately decided that setoff rights would not be an impediment to meeting the isolation requirement.”

**Issue 3E (Comment Letter Summary, Paragraph 16):** Whether the term *individual financial asset* should be clarified.

**Staff Recommendation:** The staff believes that the term *individual financial asset* should be clarified to indicate the following (subject to drafting):

A financial instrument that is legally a single contract is considered an individual financial asset. For example, a loan transferred to a special-purpose entity prior to securitization shall be considered the unit of account. In contrast, a beneficial interest (in the loan) issued after the securitization process has been completed shall be considered the unit of account.

**Issue 3F (Comment Letter Summary, Paragraph 9):** Whether the participating interest definition should permit a transferor to retain a senior interest.

**Staff Recommendation:** The staff does not recommend that the participating interest definition permit a transferor to retain a senior interest since it would be inconsistent with the concept of the participating interest that requires the cash flows received from the asset be proportionate.

**Issue 3G (Comment Letter Summary, Paragraph 28):** Whether separate transfers of portions that do not individually meet the participating interest definition, but that result in the transferor transferring 100 percent of the interests in an individual financial asset, should be derecognized when all portions of the financial asset have been transferred and meet the criteria in paragraph 9 of the proposed amendments to Statement 140.

**Staff Recommendation:** The staff recommends clarifying in the implementation guidance that transfers of portions that do not individually qualify for sale accounting, but result in the transferor transferring 100 percent of the interests should be derecognized when the entire financial asset has been transferred.



**Board Meeting Handout**  
**REDELIBERATION OF THE PROPOSED FASB STATEMENT, *ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS***

**Transferee Ability to Pledge and Exchange Financial Assets Received**

**January 28, 2009**

**PURPOSE**

The purpose of this handout is to assist the Board in deciding on two issues: (1) whether the ability of a transferee to use the asset it receives should be a deciding factor for derecognition by a transferor and (2) whether to permit that ability to be restricted in a securitization or an asset-backed financing arrangement.

**ISSUE 1: SHOULD PARAGRAPHS 9(B) AND 9(C)(3) BE ELIMINATED?**

Alternative A would remove the ability of a transferee to use a transferred asset from the criteria for derecognition (Comment Letter Summary dated December 17, 2008, paragraphs 35-37). Removing that criterion is beneficial because it simplifies the derecognition test and addresses respondents' concerns about the operationality and subjectivity of paragraph 9(c)(3). The main drawback is that the removal of the criterion contradicts the Board's decision that the ability of a transferee to use the financial asset it receives is an important indication that a transferor has surrendered control over the transferred financial asset and that the criterion should continue to be a condition for sale accounting.

**Staff Recommendation**

The staff recommends that the Board reject Alternative A because the staff believes that the ability of a transferee to use the financial asset it receives is an important indicator that a transferor has surrendered control over the transferred financial asset to the transferee and should continue to be a condition for sale accounting

*Question 1: Does the Board agree with Alternative A or should the transferee's ability to use the financial asset it receives continue to be a condition for sale accounting?*

*If the Board rejects Alternative A, then the following additional alternatives should be considered.*

*If the Board agrees with Alternative A, the following alternatives are not applicable.*

**ISSUE 2: SHOULD A RESTRICTION ON THE TRANSFEREE BE PERMITTED IN A SECURITIZATION TRANSACTION?**

The proposed changes to paragraph 9(b) and 9(c)(3) have drawn concerns that (1) the proposed requirement to determine which party primarily benefits from the restriction placed on the transferee is not operational and (2) most, if not all, securitization transactions would fail to satisfy

derecognition requirements under the proposed amendments unless a look-through provision is permitted.

### **Staff Recommendation**

The staff recommends that look-through provisions should be provided for securitization transactions. The staff believes that a transferee's ability to pledge or exchange is not a determinative factor for derecognition in a securitization transaction when the transferee primarily serves as a conduit. In those transactions, the staff believes that the ability of an investor to pledge or exchange its interests in a securitization vehicle is a determinative factor when assessing whether the transferor has relinquished control. The staff supports the Board's decision to eliminate the concept of a qualifying special-purpose entity and also believes that the Board should not attempt to restrict the transferee entity's ability to pledge or exchange the assets it receives when determining if look-through provisions apply to securitization and asset-backed financing arrangements.

The staff believes that the proposed amendments to paragraphs 9(b) and 9(c)(3) are not operational and that the look-through provision is consistent with the Board's overall conclusion that transferee constraints in securitization transactions should not preclude sale accounting.

*Question 2: If the Board rejects Alternative A, should a look-through provision be provided for securitization transactions (Alternative B)? If not, what type of exception, if any, should apply to securitization transactions?*

### **ISSUE 3: SHOULD A RESTRICTION ON THE TRANSFEREE BE PERMITTED IN ALL TRANSFERS OF FINANCIAL ASSETS?**

The proposed amendments address restrictions on the ability of a transferee to pledge or exchange transferred assets as an example of effective control in paragraph 9(c)(3). The staff considered the following approaches for addressing respondents' concerns that a transfer with a restriction that benefits the transferee may preclude sale accounting:

1. **Alternative C:** Retain the proposed requirement without modification.
2. **Alternative D:** Base the proposed effective control example on whether the transferor primarily benefits from the constraint rather than from the transferee.
3. **Alternative E:** Retain the proposed example in effective control and replace the term *primarily* with *significantly*.
4. **Alternative F:** Retain the existing language in paragraph 9(b) with modification for the removal of the qualified special-purpose entity.

### **Staff Recommendation**

While the staff is aware of difficulties in applying the more than trivial benefit notion that exists today, the staff recommends Alternative F because (1) it minimizes the risk that new implementation issues would emerge, (2) practice issues with its terminology have been previously addressed, and (3) leaving the evaluation of transferee restrictions in paragraph 9(b) is a more straightforward way to address the transferee issue than moving the transferee evaluation into paragraph 9(c).

Alternative F would retain the existing requirement that a transferor cannot obtain a more than trivial benefit from restrictions on the transferee's ability to pledge or exchange the transferred assets and keep the transferee evaluation located in paragraph 9(b).

***Question 3: If the Board answered yes to question 1 (rejected Alternative A), which of the above alternatives (Alternatives C–F) does the Board prefer? If the Board supports none of those alternatives, please describe an alternative you would support.***

#### **ISSUE 4: WHICH TRANSFEREE ENTITIES SHOULD BE ELIGIBLE FOR A LOOK-THROUGH PROVISION?**

If the Board agrees in question 2 to adopt Alternative B, a look-through provision may be provided to any of the following entities:

1. Special-purpose entities
2. Special-purpose entities involved in securitization or asset-backed financing arrangements
3. Variable interest entities
4. Variable interest entities involved in securitization or asset-backed financing arrangements
5. Special-purpose entities that are variable interest entities
6. Special-purpose entities involved in securitization or asset-backed financing arrangements that are variable interest entities.

#### **Staff Recommendation**

The staff recommends that look-through provisions be limited to special-purpose entities involved in securitization or asset-backed financing arrangements. The staff notes that FASB Staff Position (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*, includes a specific set of disclosures for “securitization or asset-backed financing arrangements that qualify as sales.” The staff opposes introducing the term *variable interest entity* in the proposed amendments to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and believes that the difference between “special-purpose entities involved in securitization or asset-backed financing arrangements” and “special-purpose entities involved in securitization or asset-backed financing arrangements that are variable interest entities” is nominal.

***Question 4: Should look-through provisions be limited to special-purpose entities involved in securitization and asset-backed financing arrangements? If not, what type of transferee entity should be eligible for a look-through provision?***



## Board Meeting Handout

### Proposed FASB Statement, *Amendments to FASB Interpretation No. 46(R)* Redeliberation of Issues January 28, 2009

#### INTRODUCTION

1. At the December 17, 2008, Board meeting, the Board decided to redeliberate certain issues related to the proposed Statement. This handout outlines the following six issues to be redeliberated:
  - a. Issue 1: Reconsideration of an entity's status as a variable interest entity (paragraphs 2–12)
  - b. Issue 2: Deconsolidation guidance (paragraphs 13–17)
  - c. Issue 3: Significant variable interests (paragraphs 18–27)
  - d. Issue 4: Elimination of the quantitative assessment (paragraphs 28–41)
  - e. Issue 5: Transition guidance (paragraphs 42–48)
  - f. Issue 6: Separate classification of elements (paragraphs 49–58).

#### ISSUE 1: RECONSIDERATION OF AN ENTITY'S STATUS AS A VARIABLE INTEREST ENTITY

##### Background

2. In the proposed Statement, the Board decided to remove the reconsideration events for determining if an entity is a variable interest entity (VIE) in paragraph 7 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. The Board concluded that an enterprise with an interest in an entity should reconsider if the entity is a VIE based on changes in facts and circumstances, as reflected in paragraph 5 of the proposed amendments to Interpretation 46(R). In paragraph B7 of the proposed Statement, the Board concluded that paragraph 5 "...should be used both (a) when an enterprise becomes involved with an entity and (b) on an ongoing basis to determine whether an entity is a variable interest entity or voting interest entity."
3. The Board thought that eliminating the specific reconsideration guidance and requiring ongoing assessments would provide users with more relevant and timely

information related to an enterprise's interest or interests in a VIE and the risks and obligations associated with that interest.

### **Comment Letter Analysis**

4. Several respondents expressed concerns regarding the operationality and usefulness of the proposed Statement's requirements for the ongoing reassessment of an entity's status as a VIE. Preparers and auditors continued to stress that the operational challenges and costs required to comply with an ongoing reassessment requirement (which can include an expected losses calculation) generally outweigh any perceived benefits in financial reporting.

5. Other respondents were concerned with the usefulness and potential inconsistencies in financial reporting that would result from the constant reconsideration of an entity's status as a VIE. Specifically, these respondents were concerned that operating losses in excess of expected losses (expected losses determined at the inception of an entity) and operating gains in excess of expected residual returns would result in an entity being classified as a VIE or voting interest entity in one reporting period with subsequent operating outcomes resulting in a change in the entity's status in the next reporting period. That is, an entity could constantly move in and out of VIE status in different reporting periods and be subject to different accounting and disclosure requirements.

6. Although many users originally requested ongoing reconsideration of an entity's status based on changes in facts and circumstances, many users conveyed a different message to the staff after considering the impact of this guidance on an enterprise's financial statements. Specifically, these users cited the same concerns as other respondents regarding the usefulness and potential inconsistencies in financial reporting that could result from the constant reconsideration of an entity's status as a VIE. However, the users remained concerned that the party with a controlling financial interest in a VIE might change despite the fact that none of the specific "triggering events" in paragraph 7 of Interpretation 46(R) had occurred.

7. Many respondents requested that the Board retain the original reconsideration guidance from paragraph 7 of Interpretation 46(R). Certain respondents stated that the

criteria for an entity to be considered a VIE in paragraph 5 of Interpretation 46(R) was, and should continue to be, based on the design of the entity at its inception or the latest reconsideration event, and should not be affected by subsequent unanticipated operating results that were not accompanied by changes in the entity's design. These respondents noted that although changes in design may occur as a result of unanticipated operating results, the changes would normally be evidenced in the triggering events that are already captured in paragraph 7 of Interpretation 46(R).

8. Some respondents also noted that the requirement to continually assess an entity's status as a VIE would require excessive costs and may not be operational or practical. These constituents expressed an additional concern that providing the incremental disclosures as required in the proposed Statement for every lending arrangement in which the borrower may subsequently be deemed insufficiently capitalized and, thus, a VIE, would diminish the usefulness of the overall disclosures. Specifically, these constituents assert that this "over disclosure" would likely "mask" disclosures of substantive risks to an enterprise with an interest in an entity that is a VIE "by design."

9. Other respondents noted that continuous reassessment of an entity's VIE status would require the holder of the variable interest to obtain updated fair value information from many entities in which it holds a variable interest. These respondents noted that in many cases this information would not be available in a timely manner or at a reasonable cost.

10. Certain users and other constituents requested that a reconsideration event be added to the existing reconsideration events in paragraph 7 of Interpretation 46(R) to capture entities that subsequently would be VIEs as a result of excessive economic losses. These constituents expressed concern that, historically, many entities that were not deemed VIEs at their inception had become VIEs as a result of subsequent economic results; however, these entities weren't considered VIEs because no specific triggering event had occurred. Further, these constituents believe that not subsequently classifying these entities as VIEs resulted in non-consolidation by enterprises that had obtained a controlling financial interest subsequent to the inception of the entity through arrangements other than voting interests without a change in the entity's governing or

contractual arrangements (for example, enterprises that obtained controlling rights through predefined triggering events, such as a material adverse change clause in a lending arrangement). Finally, these constituents believe that because the analysis at the inception of an entity is based on an entity's design, favorable results would not typically change the entity's design and controlling party and, thus, the criterion should be limited to unfavorable events.

### **Alternatives for Board Consideration**

- *Alternative A—Retain the guidance in the proposed Statement: Ongoing assessment of whether or not an entity is a VIE based on changes in facts and circumstances.*
- *Alternative B—Retain the guidance in paragraph 7 Interpretation 46(R): Reassessment of whether or not an entity is a VIE only when certain triggering events occur.*
- *Alternative C—Retain the guidance in paragraph 7 of Interpretation 46(R) and add an additional criterion for entities that were not deemed VIEs at inception or at the latest reconsideration event. The following criterion would be added to paragraph 7:*

*An entity that previously was not subject to this Interpretation shall become subject to this Interpretation if the following event occurs:*

*The equity holders of the entity lose the direct or indirect ability through voting rights or similar rights to make decisions about the entity's activities that have a significant effect on the success of the entity.*

## **Staff Analysis and Recommendation**

11. The staff believes that the current “by design” concept within Interpretation 46(R) has merit because the design of the entity should enable constituents to assess the risks associated with the entity and the criteria within paragraph 5 of Interpretation 46(R) at the inception of an entity. However, the staff believes that the power to direct matters that most significantly impact the success of an entity may change from enterprises with substantive voting rights (as such rights become non-substantive) to enterprises with interests other than voting interests when the equity at risk becomes insufficient. The staff acknowledges that, often, these types of situations would be immediately preceded by changes in design (consistent with the reconsideration criterion in paragraph 7 of Interpretation 46(R)). However, the staff believes that continuing to rely solely on changes in design or capital structure will continue to provide users with, at best, untimely financial and risk information in certain situations. In addition, the staff believes that continuously reassessing an entity’s status as a VIE by considering all of the requirements in paragraph 5 of Interpretation 46(R) may not be practical.

12. The staff believes a criterion should be included that would capture situations in which power shifts away from voting interests without an accompanying change in the entity’s governing or contractual documents (or without the occurrence of one of the other triggering events in paragraph 7 of Interpretation 46(R)). The staff believes these situations are likely to occur when unfavorable economic events occur that were not anticipated at the inception of an entity or at the latest reconsideration event. Further, the staff believes that the guidance in the proposed criterion in *Alternative C* preserves the original intent of Interpretation 46(R); that is, capturing entities that are not controlled through voting rights or similar rights. Therefore, the staff recommends *Alternative C*.

## **Question for Board**

***Q1: Which alternative for reconsidering if an entity is a VIE should be required?***

## **ISSUE 2: DECONSOLIDATION GUIDANCE**

### **Background and Comment Letter Summary**

13. The issue of whether guidance should be provided for deconsolidation upon transition of the proposed Statement and for subsequent deconsolidations of VIEs was not deliberated prior to the issuance of the Exposure Draft. Certain respondents requested that specific deconsolidation guidance be provided to mitigate the risk that the application of deconsolidation accounting for VIEs is inconsistently applied in practice.

14. These respondents recommended that the deconsolidation guidance within FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, be the required accounting when a VIE is deconsolidated by an enterprise that previously held the controlling interest in the entity. Statement 160 provides examples of events that result in deconsolidation, and these examples do not include the situation in which deconsolidation is required by an enterprise when it ceases to have the controlling financial interest in a VIE. However, the deconsolidation of a VIE is not scoped out of Statement 160.

### **Staff Analysis and Recommendation**

15. The staff agrees with the concerns presented by respondents and believes that the proposed Statement should contain guidance for the deconsolidation of VIEs. The staff believes that the guidance for deconsolidation in Statement 160 is the appropriate guidance for the deconsolidation of a VIE subsequent to the effective date of the final Statement.

16. Consequently, the staff proposes that the Board provide explicit derecognition guidance within the proposed Statement through a reference to the deconsolidation requirements in ARB No. 51, *Consolidated Financial Statements*, as amended by Statement 160. This would be accomplished through the following amendment to the fourth sentence of paragraph 22 of Interpretation 46(R) (added text is underlined):

The consolidated enterprise shall follow the requirements for elimination of intercompany balances and transactions and other matters (including deconsolidation) described in paragraphs 6-15-39 of ARB 51 and existing practices for consolidated subsidiaries.

17. For transition, the staff proposes that any amount that would otherwise have been recognized as a gain or loss pursuant to the Statement 160 requirements be recognized as a cumulative-effect adjustment within retained earnings.

### **Questions for the Board**

*Q2: Does the Board agree with the staff's recommendation to provide explicit guidance for derecognition of VIEs for transition and deconsolidations subsequent to the effective date of the proposed Statement?*

*If so, does the Board agree with the specific derecognition guidance proposed by the staff?*

### **ISSUE 3: SIGNIFICANT VARIABLE INTERESTS**

#### **Background**

18. Paragraph 6 of Interpretation 46(R) states that “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 defacto agents (as described in paragraph 16 [of Interpretation 46(R)]) did not participate significantly in the design or redesign of the entity.” In addition, paragraph 24 of Interpretation 46(R) limits the Interpretation’s disclosure requirements for non-primary beneficiaries to enterprises that hold a significant variable interest.

19. The proposed Statement attempted to clarify the concept of a significant variable interest by amending paragraph 6 to include the following: “An enterprise has a significant variable interest if the interest is significant to either the variable interest entity or to the enterprise.”

#### **Comment Letter Analysis**

20. Respondents expressed mixed views on the proposed Statement’s clarification that a variable interest is significant if the interest is significant to either the VIE or to the enterprise.

#### **Respondents Who Supported Significance in Relation to the VIE (and Not the Reporting Enterprise)**

21. Some respondents believe significance should be determined solely in relation to the VIE (and not to the reporting enterprise). Those respondents stated that the original intent of the paragraph 6 “significance” language was to allow an enterprise to avoid applying the accounting and disclosure requirements of Interpretation 46(R) if it has no chance of consolidating an entity, even if it were determined to be a VIE.

## **Respondents Who Supported Significance in Relation to the Reporting Enterprise (and Not the VIE)**

22. Several respondents stated that significance should only be determined in relation to the reporting enterprise. While some of those respondents acknowledged that part of that assessment might include assessing the significance of the interest to the VIE, they believe that disclosures should not be required for a variable interest that is not significant to the reporting enterprise. Those respondents also reasoned that significance should be dependent upon whether the interest is significant to the reporting enterprise because they believe users are typically concerned only about items that are significant to the enterprise's financial statements, including related disclosures.

## **Comments from Users**

23. Financial statement users appeared skeptical that management of an enterprise with a variable interest in an entity could effectively decide whether their interest was significant or not for purposes of assessing (a) if an entity should be classified as a VIE and (b) if the disclosures required by the proposed Statement should be provided. Users also stated that "significant" implies something greater than "material" and expressed strong concerns that practitioners will apply "significance" at a level in excess of "material" and, thus, will avoid determining whether the entity in which they have an interest is a VIE. They believe that many required disclosures were not made under Interpretation 46(R) because preparers concluded that the risks were insignificant; recent market events have shown that in hindsight these risks were significant.

24. These comments are consistent with comments that users expressed in relation to FASB Staff Position (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*. The staff believes that users' commentary and the Board's reaction to such commentary regarding whether there should be a significance threshold related to continuing involvement disclosures under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is relevant to the consideration of a significance threshold in the proposed Statement. The

Board decided not to provide a significance threshold for continuing involvement in FSP FAS 140-4 and FIN46(R)-8.

### **Alternatives for Board Consideration**

- *Alternative A—Retain the guidance in the proposed Statement: A variable interest is significant if the interest is significant to either the VIE or to the enterprise.*
- *Alternative B—Remove the significance exception from the proposed Statement. The exception in paragraph 6 would be removed and the disclosure requirements would be for all variable interests (the “significant” qualifier would not be included). This alternative emphasizes that the proposed Statement “need not be applied to immaterial items.”*

### **Staff Analysis and Recommendation**

25. The staff notes that diversity in practice exists in determining what constitutes a significant variable interest. Although it is unclear to the staff whether or not there is general consensus among preparers as to whether “significant” is generally interpreted to mean more than, less than, or the equivalent to “material,” it appears to the staff that users’ resistance to a significance threshold in FSP FAS 140-4 and FIN 46(R)-8 would indicate they would not support a significance threshold in Interpretation 46(R).

26. The removal of the significance threshold would require preparers to determine (a) if a variable interest, or the result of consolidating a VIE, was material to their financial statements and (b) whether the information required by the disclosures in the proposed Statement was material for users to analyze the enterprise’s involvement in a VIE. As an evaluation of materiality requires judgment in determining what information would matter to an investor, the staff believes “material” is the appropriate threshold in performing the analysis required by paragraph 6 and within the disclosure requirements of the proposed amendments to Interpretation 46(R). Additionally, the concept of materiality existed within Interpretation 46(R) and has been retained in the proposed Statement (and the concept is still applicable in all other areas of financial reporting).

27. The staff believes the paragraph 6 significance language has effectively become another scope exception within Interpretation 46(R). The staff also believes that this scope exception has been misunderstood and misapplied in some situations. In addition, the staff believes that this scope exception has caused an unnecessary additional layer of complexity in financial reporting.

**Question for the Board**

*Q3: Does the Board agree with the staff's recommendation to remove the significance exception from the proposed Statement?*

## **ISSUE 4: ELIMINATION OF THE QUANTITATIVE ASSESSMENT**

### **Background**

28. In the proposed Statement, the Board concluded that a principles-based qualitative approach to determining which enterprise with a variable interest in a VIE was the primary beneficiary would be more effective than the quantitative model in Interpretation 46(R). Paragraphs 14A and 14B of the proposed amendments to Interpretation 46(R) provide a qualitative analysis designed to identify the enterprise with a controlling financial interest in a VIE. Under this qualitative analysis, the enterprise that has both the power to direct matters that most significantly impact the activities of a VIE and the right to receive benefits or the obligation to absorb losses that could potentially be significant to the VIE is the primary beneficiary of the VIE.

29. Paragraph 14 of Interpretation 46(R) requires an enterprise to consolidate a VIE if the enterprise has a variable interest or interests that will absorb the majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. That assessment is performed by calculating the VIE's expected losses and expected residual returns (the expected loss calculation or quantitative model) to determine which enterprise, if any, is required to consolidate the VIE. Application guidance for performing the expected loss calculation is in Appendix A of Interpretation 46(R). A VIE's expected losses and expected residual returns are determined by calculating the expected negative variability (for losses) and positive variability (for returns) in the fair value of its net assets, exclusive of variable interests.

30. After receiving extensive feedback from constituents, the Board concluded that the application of the current guidance in Interpretation 46(R) for determining the primary beneficiary has shown that the required quantitative analysis is difficult to understand (including its results of which enterprise is the primary beneficiary), apply, and audit. The Board acknowledged that the calculation often requires a high degree of mathematical expertise and that entities often perform a significant number of calculations for a single VIE, particularly structured financial vehicles, to determine the primary beneficiary. The Board also noted that, in practice, several different approaches and methodologies are

used to apply the expected loss calculation. The Board was concerned that such diversity would lead to inconsistent application and results for VIEs with similar characteristics and traits.

31. The Board also was troubled that the quantitative analysis often seems to identify a different primary beneficiary of a VIE from that identified by applying a qualitative analysis to the same entity. For example, to avoid consolidation of certain structured finance vehicles that are VIEs, sponsors of these certain structured finance vehicles sell interests to third parties that would absorb the majority of the expected losses (expected-loss-note holders). The expected-loss-note holder receives a substantial return on its investment but typically has very limited power, if any, to direct matters that most significantly impact the activities of the VIE.

32. Under the guidance in paragraph 14C of the proposed amendments to Interpretation 46(R), an enterprise is required to perform a quantitative analysis using the expected loss calculation only if the enterprise cannot determine whether it meets both of the criteria in paragraph 14A. The Board stressed that situations in which an enterprise performs the quantitative analysis should be uncommon, and concluded that disclosure substantiating the use of the quantitative analysis should be provided. The Board stated that a primary goal of paragraph 14 of the proposed amendments to Interpretation 46(R) was to provide a more principles-based approach to determining a primary beneficiary.

### **Comment Letter Summary**

33. The majority of respondents to this issue stated that the foundation for the quantitative analysis is to identify the party with the majority of exposure to variability in an entity's assets, which is distinctly different from a qualitative approach that seeks to identify the party with power and the rights to receive benefits or absorb losses that could be significant. These respondents believe that power and benefits or losses are often linked. However, the respondents asserted that, as a result of the inability of constituents to effectively perform the quantitative analysis under the expected loss model and the structuring opportunities associated with such an analysis, applying the quantitative analysis often identifies a different primary beneficiary than that identified through the

qualitative analysis. These respondents also asserted that the primary beneficiary historically identified under the quantitative analysis has not always been the enterprise with sufficient power to control the VIE.

34. Several respondents also questioned when the quantitative analysis would be performed under the proposed Statement. That is, they were confused about which circumstances or situations would warrant an enterprise to proceed to the quantitative analysis. The respondents pointed to the fact that in all of the examples provided by the staff in Appendix A of the proposed Statement, the consolidation conclusion was reached through the qualitative analysis. Therefore, they suggested removing the quantitative analysis unless the staff could provide (a) more effective guidance on when the quantitative analysis would ever be applied or (b) examples of where the analysis would be warranted.

35. Certain respondents did not believe the Board would achieve its goal of a more principles-based approach if the quantitative analysis in paragraph 14C was retained. They asserted that although the guidance in the proposed Statement is clear in respect to the qualitative analysis being the primary assessment for consolidation and that situations in which a quantitative assessment is performed should be rare, practitioners may inevitably default to the quantitative model to avoid having regulators scrutinize their judgment.

36. Other respondents suggested that the quantitative analysis be retained because (a) they were not convinced that the qualitative analysis within the proposed Statement would always identify a primary beneficiary or (b) it may be useful in situations in which the qualitative analysis does not produce a definitive conclusion on which enterprise is the primary beneficiary of a VIE.

#### **Alternatives for Board Consideration**

- *Alternative A—Retain the quantitative analysis in paragraph 14C.*
- *Alternative B—Eliminate the quantitative analysis in paragraph 14C.*

## **Staff Analysis and Recommendation**

37. The staff believes that for purposes of determining the controlling interest in a VIE, a qualitative analysis focusing on power and the right to receive benefits or the obligation to absorb losses that could be significant will be more effective than the quantitative analysis within paragraph 14C of the proposed guidance (the quantitative guidance is the same as the guidance for determining the primary beneficiary in Interpretation 46(R)). Further, the staff received no information in comment letters or through discussions with constituents that adequately refuted the concerns noted in the basis for conclusions to the proposed Statement regarding the general ineffectiveness of determining a primary beneficiary using the quantitative analysis required under Interpretation 46(R).

38. The staff believes that a common theme for certain constituents' desire to have the expected loss calculation retained is derived from their concerns that the proposed Statement will result in enterprises with interests in a VIE that expose the enterprise to the majority of the economic risks or benefits of an entity while not consolidating an entity in situations in which the enterprise does not have power over the entity. The staff understands this concern; however, it believes relying on the expected loss calculation to mitigate this concern simply allows for the continued use of a risks and rewards model that has proven to be generally unreliable in identifying the party with the controlling interest in a VIE. The staff believes that when inconsistency between an enterprise's power and its rights to receive benefits or obligation to absorb losses exists, an increased level of skepticism is warranted when determining whether an enterprise is the primary beneficiary of a VIE.

39. The staff considered and analyzed various structures (including those documented in Appendix A to the proposed Statement) to, among other things, ascertain if situations exist in which the quantitative analysis would be necessary. The staff could not develop or conclude that a situation or structure existed in which using the quantitative analysis would be necessary.

40. The staff also shares constituent concerns regarding the likelihood that practitioners will default to the quantitative analysis, regardless of the level of detail available to

perform a qualitative analysis. The staff believes that if the quantitative guidance is retained and the practice of defaulting to such a quantitative analysis becomes commonplace, practitioners will again default to creating vehicles such as expected loss note holders to absorb the majority of expected losses and, thus, avoid consolidation in situations in which the practitioner is the party with the power.

41. Based on the staff analysis in paragraphs 37–40 above, the staff recommends *Alternative B*.

**Question for the Board**

*Q4: Does the Board support retaining or eliminating the quantitative analysis in paragraph 14C?*

## ISSUE 5: TRANSITION GUIDANCE

### Background

42. The Board proposed prospective application with the following transition guidance in paragraph 6 of the proposed Statement:

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

43. Paragraph 20 of Interpretation 46(R) requires that the initial consolidation of a VIE that is a business be accounted for in accordance with the provisions of FASB Statement No. 141 (revised 2007), *Business Combinations*. If an enterprise becomes the primary beneficiary of an entity that is not a business, the entity shall recognize the assets (except goodwill) and liabilities of the VIE, according to paragraphs 12–33 of Statement 141(R). For both business and non-business entities, the required guidance under paragraphs 20 and 21 of Interpretation 46(R) for recognition of assets and liabilities is **fair value** under Statement 141(R). This guidance is retained in the proposed Statement.

44. The guidance for transition within paragraph 37 of Interpretation 46(R) for consolidation at the effective date was:

If initial application of the requirements of this Interpretation results in the initial consolidation of an entity..., the consolidating enterprise shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity at their carrying amounts at the date the requirements of this Interpretation 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 Interpretation had been effective when the enterprise first met the conditions to be the primary beneficiary. 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 Interpretation first applies. 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 of an accounting change.

### **Comment Letter Summary**

45. Several respondents objected to the transition provisions in the proposed Statement. They strongly urged the Board to use the same transition provisions provided when Interpretation 46(R) was issued. Respondents noted they were not aware of any significant practice issues for either preparers or users under the transition method of Interpretation 46(R).

46. The primary reason given by those who objected to the transition provisions was the potential lack of comparability in future financial results and the mixed attribute accounting model related to certain securitization structures that would most likely be consolidated under the guidance in the proposed Statement. Additionally, opponents of the transition guidance in the proposed Statement asserted that consolidating at transition is not analogous to a business combination. In other words, why should the adoption of the proposed Statement imply that there has been a change in control of the VIE? An entity obtaining control subsequent to transition appears more consistent with a business combination and, thus, these constituents agree that retaining the Statement 141(R) guidance for subsequent consolidations is appropriate. Financial statement users generally agreed with recognizing assets and liabilities of an entity consolidated at transition at their respective carrying values.

### **Alternatives for Board Consideration**

- *Alternative A—Retain the transition provision in the proposed Statement.*
- *Alternative B—Utilize a transition method similar to the transition provided when Interpretation 46(R) was issued, as documented in paragraph 44 of this handout.*
- *Alternative B’—Utilize a transition method similar to the transition provided when Interpretation 46(R) was issued; however, eliminate the practicability exception that allows entities to measure consolidated VIEs at fair value when determining the carrying amount is not practicable. In addition, eliminate the practicability exception for enterprises that cannot obtain the information necessary to make the VIE or primary beneficiary determinations as of the date the enterprise became involved with an entity or at the most recent reconsideration date.*

## **Staff Analysis and Recommendation**

47. The staff notes the transition in the proposed Statement simplifies implementation by providing the same transition method for all situations with no exceptions, and by providing a consistent measurement for consolidation at transition and on an ongoing basis. However, the staff also notes that the transition provisions could lead to financial results that are not comparable in future periods, particularly if the assets and liabilities of the VIE are not carried at fair value on an ongoing basis.

48. The transition provisions in Interpretation 46(R) when it was originally issued (*Alternative B*), for the most part, result in accounting that is consistent with a view that the VIE should always, or at the latest reconsideration event, have been consolidated by the primary beneficiary. The staff believes this is a particularly compelling argument for *Alternative B* because it is consistent with the Board's view that Interpretation 46(R) did not always identify the enterprise that held a controlling financial interest in a VIE. Therefore, the staff recommends *Alternative B*.

## **Question for the Board**

***Q5: Does the Board support the staff's recommendation for transition?***

## **ISSUE 6: SEPARATE CLASSIFICATION OF ELEMENTS**

### **Background**

49. During the Board's deliberations of the proposed Statement, it did not extensively deliberate the issue of classification of elements of consolidated VIEs, but, rather, posed a question to constituents in the Exposure Draft asking if separate classification should be permitted, required, or disallowed.

### **Comment Letter Summary**

50. The vast majority of respondents requested that separate classification of elements of consolidated VIEs be permitted, but not required. Some respondents pointed out that reporting enterprises are not precluded from separately reflecting the elements of consolidated subsidiaries in their financial statements (whether or not those consolidated subsidiaries are VIEs). In fact, when Interpretation 46(R) was originally issued, many reporting enterprises separately classified the assets and liabilities of consolidated VIEs. However, other respondents indicated that it was not clear whether separate presentation was permitted under U.S. generally accepted accounting principles.

51. Certain respondents asserted that consolidated assets of a VIE are distinctly different from those of voting interest entities because the assets of a VIE often cannot be used to settle the general obligations of the enterprise. Rather, assets of VIEs often can be used solely to settle the specific obligations of the VIE. Consequently, these respondents requested that the Board require separate classification of elements, and stated that combining the elements of a VIE with other elements of an enterprise would be misleading to financial statement users due to the restrictions on the VIE's assets.

52. The majority of users communicated that separate classification would be preferable because they believe that such classification, combined with the enhanced disclosures in the proposed Statement, would provide transparent and useful information regarding an enterprise's involvement and associated risks with VIEs.

53. Other respondents did not support separate classification of the elements of a VIE in the financial statements of the consolidating enterprise because they believe that consolidated VIEs are “controlled” by the enterprise and, thus, are no different than other subsidiaries consolidated under ARB 51.

#### **Alternatives for Board Consideration**

- *Alternative A—Require enterprises to separately classify the elements of their consolidated VIEs from other elements in their financial statements.*
- *Alternative B—Permit, but not require, separate classification of the elements of consolidated VIEs in the financial statement of the primary beneficiary.*
- *Alternative C—Prohibit separate classification of elements in the financial statements.*

#### **Staff Analysis and Recommendation**

54. The staff considered the potential effects on the financial reporting of separate classification of consolidated VIE elements, as well as the arguments made for and against “linked presentation,” which was preliminarily deemed to be outside of the scope of this project.

55. Requiring separate classification of consolidated VIE elements appears to meet the requests of users because relevant financial information related to consolidated VIEs is separately presented on the face of the financial statements, as opposed to within the footnotes. Some users believe it is necessary to separately present elements of consolidated VIEs, particularly in situations in which the consolidated VIE’s assets are restricted to solely fund the obligations of the VIE.

56. Permitting separate classification allows an enterprise to determine if the most appropriate presentation of its overall business is to bifurcate the elements of consolidated VIEs from the elements of the enterprise’s voting interest subsidiaries. The staff believes that permitting separate classification provides a reporting

enterprise with the opportunity to provide greater transparency of a consolidated VIE's financial information, which should facilitate analysis by users in situations in which the enterprise believes that the characteristics of the elements of the consolidated entity are different from those of other consolidated subsidiaries.

57. Some respondents do not support separate presentation of the elements of a consolidated VIE in the financial statements of the consolidating enterprise because they believe that consolidated VIEs are "controlled" by the enterprise and, thus, are no different than other subsidiaries consolidated under ARB 51. However, the staff believes that prohibiting reporting enterprises from presenting separate classification of elements effectively limits their ability to disaggregate information so that it is useful in predicting an entity's future cash flows, which is a stated objective of the FASB's and the IASB's joint project on financial statement presentation.

58. The staff believes that permitting separate classification is the most desirable alternative. Therefore, the staff recommends *Alternative B*.

### **Question to the Board**

***Q6: Does the Board agree with the staff recommendation to permit, but not require, separate classification of the elements of consolidated VIEs in the financial statements of a primary beneficiary?***