

Technical Line

Technical guidance on standards
and practice issues

FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)

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Overview

On 12 June 2009, the Financial Accounting Standards Board (FASB) issued Statement 167.¹ Statement 167 (1) addresses the effects of eliminating the qualifying special-purpose entity (QSPE) concept from Statement 140,² and (2) responds to concerns about the application of certain key provisions of FIN 46(R),³ including concerns over the transparency of enterprises' involvement with variable interest entities (VIEs). Statement 167 is effective as of the beginning of an enterprise's first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. That is, Statement 167 is effective for calendar year-end enterprises beginning on 1 January 2010.

Notice to readers

On 1 July 2009, the FASB instituted a major change in the way accounting standards are organized. On that date, the FASB *Accounting Standards Codification* (ASC) became the single source of authoritative nongovernmental US GAAP, with the exception of guidance issued by the SEC. However, the recent guidance issued by the FASB in the form of Statement 166 (which amended Statement 140) and Statement 167 has not yet been codified as of the date of this publication. As a result, the use of the new codification references is limited to guidance issued prior to Statement 166.

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¹ FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*

² FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB ASC Topic 860, *Transfers and Servicing*)

³ FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (generally contained within the Variable Interest Entities paragraphs of FASB ASC Topic 810-10, *Consolidation-Overall*)

It is important to note that the amendments to FIN 46(R) are applicable to all enterprises and to all entities with which those enterprises are involved, regardless of when that involvement arose. Therefore, upon adoption of Statement 167, all enterprises must reconsider their consolidation conclusions for all entities with which they are involved.

While the objectives of the project to amend FIN 46(R) initially were focused on the scope exception for QSPEs, improving disclosures and establishing a qualitative basis for determining a primary beneficiary of a VIE, Statement 167's final amendments to FIN 46(R) were more pervasive. Subsequent to the comment period on the Exposure Draft, the FASB engaged in extensive redeliberations that resulted in modifications to some of their initial decisions and an expansion of the scope of the amendments to the FIN 46(R) model.

Statement 167, among other things:

- ▶ Requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE
- ▶ Amends FIN 46(R)'s consideration of related party relationships in the determination of the primary beneficiary of a VIE by providing, among other things, an exception with respect to de facto agency relationships in certain circumstances
- ▶ Amends certain guidance in FIN 46(R) for determining whether an entity is a VIE, which may change an enterprise's assessment of whether an entity with which it is involved is a VIE or not
- ▶ Amends the criteria for determining whether fees paid to a decision maker and other service contracts are variable interests
- ▶ Requires continuous assessments of whether an enterprise is the primary beneficiary of a VIE
- ▶ Requires enhanced disclosures about an enterprise's involvement with a VIE. In general, the disclosure requirements are consistent with the provisions of FSP FAS 140-4 and FIN 46(R)-8,⁴ which is nullified by Statement 167 upon its adoption

These changes and others are discussed in further detail in the Amendments section below.

In conjunction with Statement 167, the FASB issued Statement 166.⁵ The Statement 140 amendments, among other things, eliminate the concept of QSPEs. Thus, Statement 167 eliminates the FIN 46(R) scope exception for QSPEs. This will result in more QSPEs being evaluated for consolidation. See our Technical Line, *FASB Statement No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (No. 2009-14), for more information on the amendments to Statement 140.

Background

The first step in applying consolidation accounting is to determine whether an enterprise has a variable interest in an entity. If so, the enterprise should determine whether the entity is a VIE pursuant to the provisions of FIN 46(R). If an entity is a VIE, the enterprise must determine whether it should consolidate the entity based on its variable interests under FIN 46(R). FIN 46(R) does not apply to an enterprise that does not have a variable interest in an entity. Thus, if the enterprise's interest is not a variable interest, the enterprise should account for its interest in accordance with other literature. Additionally, only if the entity is determined not to be a VIE (i.e., a voting interest entity), would ARB 51,⁶ as amended, EITF 04-5,⁷ or other consolidation literature be considered.

⁴ FASB Staff Position (FSP) No. FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (generally contained within the Disclosure sections of FASB ASC Topic 860, *Transfers and Servicing*, and FASB ASC Topic 810-10, *Consolidation-Overall*)

⁵ FASB Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*

⁶ ARB No. 51, *Consolidated Financial Statements* (generally contained within the General paragraphs of FASB ASC Topic 810-10, *Consolidation-Overall*)

⁷ 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"* (FASB ASC Topic 810-20, *Consolidation-Control of Partnerships and Similar Entities*)

FIN 46(R) provides guidance on determining whether an enterprise should consolidate certain entities in which the equity investors do not have the characteristics of a controlling financial interest (i.e., they lack certain decision-making ability) or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. These entities are known as VIEs.

FIN 46(R) requires an enterprise holding a variable interest in an entity (i.e., an interest that absorbs the variability of changes in the fair value of the entity's net assets) to determine whether the entity is a VIE and, if so, to determine whether the enterprise is the primary beneficiary of the VIE. In general, prior to the effective date of Statement 167, a VIE's primary beneficiary absorbs the majority of the VIE's variability, as determined through quantitative analyses.

Subsequent to the issuance of FIN 46(R), some have expressed concerns that the determination of the primary beneficiary of a VIE is overly complex and, by emphasizing a quantitative analysis, requires a high degree of mathematical expertise to apply. Others have raised concerns that there is significant diversity in practice in the approaches and methodologies used to calculate a VIE's variability. Additionally, some believe that the use of quantitative analyses can at times require an enterprise to consolidate an entity over which it has little or no characteristics of substantive control.

In addition, users also have expressed concern over the lack of transparency (either through nonconsolidation or through lack of disclosure) of enterprises' involvement with off-balance-sheet structures. That lack of transparency limits their ability to understand the nature of an enterprise's involvement with a VIE and the related risks and benefits of that involvement. In an interim step to address users' concerns regarding the lack of sufficiency and timeliness of information regarding an enterprise's involvement with a VIE, the FASB issued FSP FAS 140-4 and FIN 46(R)-8, which was effective for calendar year-end public enterprises as of 31 December 2008.

In March 2008, the FASB added a project to its agenda to amend and enhance certain guidance in FIN 46(R). The proposed amendments to FIN 46(R) were exposed on 15 September 2008, and the comment period ended 14 November 2008. Approximately 75 organizations and individuals from various constituent groups responded to the Exposure Draft. The FASB also held two public roundtable meetings to listen to the views of, and obtain information from, interested constituents. The FASB redeliberated several of the proposed amendments based on constituents' responses. During the redeliberations, the FASB altered the direction of certain proposed amendments and made amendments to other portions of FIN 46(R) that were not originally contemplated in the Exposure Draft. The section that follows describes Statement 167's final amendments to FIN 46(R).

Amendments

QSPE scope exception

The adoption of Statement 166 will eliminate the concept of a QSPE from Statement 140. As a result of the Statement 140 amendments, FIN 46(R) was amended by Statement 167 to eliminate its scope exception for QSPEs. Thus, all QSPEs should be evaluated for consolidation regardless of when the transactions were entered into. As most QSPEs meet the definition of a VIE, many QSPEs will be subject to the consolidation provisions of Statement 167 on its effective date. See our Technical Line, *FASB Statement No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (No. 2009-14), for more information on the amendments to Statement 140.

Fees paid to decision makers or service providers

Excerpt from FIN 46(R), as amended by Statement 167

Fees Paid to Decision Makers or Service Providers

B22. Fees paid to an entity's decision maker(s) or service provider(s) are not variable interests if all of the 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 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 variable interests.

^{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.

FIN 46(R) defines variable interests as "...contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets..." In applying the provisions of FIN 46(R), an enterprise⁸ first must determine whether it has a variable interest in the entity being evaluated for consolidation. An enterprise should consider the purpose of the entity and the risks that the entity was designed to create and pass along to its interest holders in making that determination. FIN 46(R) provides specific guidance in its Appendix B for evaluating whether fees paid to a decision maker or service provider are variable interests. Statement 167 amends this guidance.

The most significant change is that a decision maker or service provider no longer need be subject to removal through substantive kick-out rights to conclude that it does not hold a variable interest. Additionally, Statement 167 replaces the quantitative thresholds of "trivial" and "not large" with the term "insignificant" for purposes of assessing the magnitude of a decision maker's or service provider's fees or the amount of variability that could be absorbed by the fees or its other variable interests. This change was made to provide a consistent threshold throughout the analysis of decision maker's or service provider's fees. The other amendments primarily consolidate the criteria included in paragraphs B18-23 in FIN 46(R) into two paragraphs as reproduced above.

⁸ When we use the term "enterprise" in this publication, we refer to the enterprise that is evaluating its potential variable interest in a VIE for purposes of determining whether it must consolidate that VIE. When we use the term "entity," we refer to the potential VIE. That is, the purpose of FIN 46(R) is to determine whether the enterprise is the primary beneficiary that must consolidate an entity that is a VIE.

The FASB has indicated that the amendment to remove the kick-out rights criterion was to promote consistency between the determination of whether an enterprise has a variable interest in a VIE and whether an enterprise is the primary beneficiary of a VIE. As described in detail under the heading “Primary beneficiary determination” below, the FASB concluded that kick-out rights should not be considered in the primary beneficiary determination unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such rights.

The conditions in paragraph B22(a)-(f) focus on the nature of the services and the amount of the fees. Specific items to note are:

- ▶ Criteria (a) and (d) may require a decision maker or service provider to analyze similar arrangements among parties outside of the relationship being analyzed to assess whether it meets these criteria
- ▶ Criteria (c), (e) and (f) may require a quantitative assessment, in certain circumstances, and will require an assessment of what meets the definition of “insignificant.” While fee percentages (e.g., 2% of assets under management, 20% of profits) often are stated in contractual arrangements, a decision maker or service provider may be required to perform a quantitative analysis, in certain cases, to determine the magnitude and variability of fees that may be earned. It is important to note that with criteria (e) and (f), the fees and economic performance being evaluated are what is *anticipated*. This may require an enterprise to consider probabilistic outcomes over time. It should be noted that the FASB has provided no “bright-lines” for the quantitative thresholds contained in these criteria
- ▶ Criterion (c) requires an enterprise to evaluate its other interests in the entity. These interests could include implicit variable interests. An implicit variable interest is defined in FSP FIN 46(R)-5⁹ as “an implied pecuniary interest in a entity that changes with changes in the fair value of the entity’s net assets exclusive of variable interests...Paragraph B10 of Interpretation 46(R) provides one example of an implicit variable interest; that is, an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses.” Refer to FAQ 12-17 in our Financial Reporting Developments publication, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51*, for further discussion of implicit variable interests

The FASB concluded that the revised guidance for determining whether fees paid to a decision maker or service provider represent a variable interest in a VIE is sufficient for determining whether an enterprise is acting in a fiduciary role in a VIE. The FASB expects that an enterprise that acts solely as a fiduciary or agent should typically not have a variable interest in a VIE as its fees and variable interests, if any, would typically meet the criteria in paragraph B22(a)-(f). If an enterprise’s fees or other variable interests do not meet these criteria, the FASB believes that an enterprise is not acting solely in a fiduciary role.

To illustrate, investment managers in the asset management industry (e.g., mutual fund managers) typically have decision-making ability over the financial assets in the entities that they manage. Oftentimes in these arrangements, investment managers do not hold an ownership interest or other interests outside of their management contract. Investment managers typically receive a fee that is calculated as a percentage of the fair value of the assets that they manage (e.g., 75 basis points). In these cases, investment managers likely will conclude that their management contract satisfies the criteria in B22 and, therefore, does not constitute a variable interest in the entities that they manage.

Alternatively, a general partner in partnership arrangements may receive a “carried interest” that allows the general partner to participate significantly in the profits of the partnership (e.g., 20%). In these situations, a general partner likely will conclude that their equity interest does provide them with a variable interest.

⁹ FSP No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)* (generally contained within the Variable Interest Entities paragraphs of FASB ASC Topic 810-10, *Consolidation-Overall*)

If an enterprise concludes that it does not have a variable interest in an entity after evaluating the provisions of paragraph B22(a)-(f) and considering any other interests in the entity, we believe that the enterprise is not required to evaluate the provisions of Statement 167 further to account for its interest. This includes determining whether the enterprise is the primary beneficiary of the entity and whether the enterprise is subject to the disclosure provisions of Statement 167. If an enterprise does have a variable interest in an entity, the next step is to evaluate whether the entity is a VIE.

Decision maker and service provider arrangements may not include provisions whereby the decision maker or service provider can be removed. As such, those arrangements are considered variable interests under the current FIN 46(R) model. In addition, some enterprises in practice may have considered whether such arrangements, in combination with other variable interests, would have caused the enterprise to be the primary beneficiary of the VIE through absorption of a majority of the expected losses and expected residual returns. If the arrangement could not have caused the enterprise to be the primary beneficiary, those enterprises may not have performed a formal evaluation of whether the arrangement was a variable interest. In these circumstances, the enterprise may not have evaluated all of the conditions included in B18 through B23 of FIN 46(R) to determine whether the arrangement is a variable interest. Additionally, some may find that interpretations of the quantitative thresholds of “trivial” and “not large” are different than “insignificant.” As noted in certain comment letters on the Exposure Draft, some practitioners had interpreted “more than trivial” as “anything more than zero.” Therefore, as a result of the discussed changes to these provisions, previous consolidation conclusions should be revisited.

A decision maker’s or service provider’s evaluation of whether an arrangement is a variable interest under the provisions of paragraph B22(a)-(f) will require a careful examination of the facts and circumstances and the use of professional judgment. As discussed below, decision makers that hold a variable interest may be the primary beneficiary under Statement 167’s new qualitative criteria.

VIE determination

Excerpt from FIN 46(R), as amended by Statement 167 (amendments shown)

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.

- 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 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 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.

⁵ The 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.

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

⁷ ~~The objective of this provision is to identify as variable interest entities those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest. If interests other than the equity investment at risk provide the holders of that investment with 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.~~

⁸ Enterprises 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.

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

¹⁰ For 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.

¹¹ 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 involved 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).

Statement 167 amends certain of the guidance for determining whether an entity is a variable interest entity. Specifically, paragraph 5(b)(1) of FIN 46(R), which indicates that an entity is a VIE if its equity investors, as a group, lack certain characteristics normally associated with equity ownership, has been amended as illustrated above. These amendments may change an enterprise's assessment of which entities with which it is involved are VIEs.

In order not to be a VIE, the holders of the equity investment at risk, as a group, must have certain characteristics. One of those characteristics is that they have the power, through voting rights or similar rights held through their equity interests, to direct the activities of an entity that most significantly impact the entity's economic performance. The equity investors, as a group, may not have this ability if a decision maker is not a holder of a substantive equity investment at risk. Additionally, a party other than a holder of an equity investment at risk that has substantive participating rights in the entity's decision-making may violate this provision. Determining whether an entity is a VIE because it has a decision maker or other party with substantive participating rights that does not have an equity investment at risk should be based on the applicable facts and circumstances.

Other interests held by holders of an equity investment at risk may not be considered in determining whether those equity holders have the power to direct the activities that most significantly impact the entity's economic performance. The FASB believes that paragraph 5(b) describes the characteristics of a controlling financial interest. If the rights and obligations provided by the total equity investment at risk lack any of those characteristics, then the ownership of a majority of the voting equity investment (i.e., application of the voting interests model) would not provide an appropriate basis for determining which party should consolidate the entity. In their view, paragraph 5(b) would not be effective in identifying a VIE if the equity holders treated the rights and obligations provided by their other interests in the entity as if those rights and obligations were derived from the equity investment.

To illustrate, assume a partnership is created to develop commercial real estate. None of the partnership interests have voting rights, but one partner, a real estate developer, makes all significant decisions for the partnership under the terms of a service agreement entered into at the inception of the entity. The developer is required to have a substantive equity investment at risk as long as it provides services pursuant to the service agreement. In this example, the entity would be a VIE because the decision making for the entity is not embodied in the equity interests; rather, decision making authority is granted through the service agreement, violating the paragraph 5(b)(1) criterion.

Under current and historical practice (both pre-Statement 167), if the holders of the entity's at-risk equity investment possess substantive kick-out rights or liquidation rights (collectively kick-out rights) providing them with the ability to remove a decision maker that does not have a substantive equity investment in the entity through which it makes decisions, the criterion of 5(b)(1) is not violated. That is, the ultimate controlling authority over the decision maker's actions reside with the at-risk equity holders by virtue of their kick-out rights. Enterprises have generally looked to the criteria in EITF 04-5 to assess whether those rights are substantive. Under EITF 04-5, one of the criteria that must be met for kick-out rights to be considered substantive is that the kick-out rights can be exercised by a simple majority of the voting interests held by parties other than the decision maker (including the decision maker's related parties and de facto agents).

After the adoption of Statement 167, kick-out rights should not be considered in determining whether the at-risk equity investors lack the power to direct the activities of an entity that most significantly impact the entity's economic performance unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those rights. This is consistent with Statement 167's amendments to the primary beneficiary determination, which are discussed in detail below. This provision may result in entities becoming VIEs upon the adoption of Statement 167 in certain circumstances. For example, if decision making ability is held by a non-equity holder, an enterprise may have previously concluded that the entity was not a VIE by giving consideration to substantive kick-out rights held by the equity holders as a group (as opposed to a single equity holder). This is often a consideration for partnerships or LLCs in which the general partner or managing member does not have a substantive equity investment at risk but can be removed by a majority of the LP or member interests. Thus, the FIN 46(R) amendments may result in more partnerships and LLCs becoming VIEs. Under Statement 167's provisions, limited partnerships that are VIEs will likely be consolidated by the general partner.

Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights do not prevent the equity holders from having the characteristic in criterion 5(b)(1) unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such rights. However, few structures provide for non-equity interests to hold kick-out rights or participating rights.

If an interest other than the equity investment at risk provides the holder of that interest with decision-making ability, but the interest does not represent a variable interest based on the guidance in paragraphs B22 and B23 (discussed above), that interest does not make the entity a VIE. The FASB reasoned that such a decision maker would never be the primary beneficiary of the VIE because it would not hold a variable interest. Additionally, such an interest would typically indicate that the decision maker was acting as a fiduciary, and the FASB observed that this fact alone should not lead to a conclusion that entity is a VIE. The FASB observed that this guidance was intended to prevent many traditional voting interest entities and certain investment funds from becoming VIEs solely as a result of the changes to paragraph 5(b)(1). For example, if an investment manager (e.g., mutual fund manager) that is considered to have power over the entity concludes that it does not have a variable interest in the entity after evaluating paragraphs B22 and B23, the investment manager's power does not make the entity a VIE under paragraph 5(b)(1).

Statement 167 nullifies FSP FIN 46(R)-3.¹⁰ FSP FIN 46(R)-3 provides interpretive guidance on the application of paragraph 5(b)(1), including its application to franchise arrangements. Under FSP FIN 46(R)-3, the rights of a franchisor in a franchise arrangement generally are considered protective rights. By including the rights of a franchisor as an example of a protective right in Statement 167 (see discussion of protective rights below), the FASB believes that the same objectives are achieved. Therefore, the FASB does not expect or intend that the nullification of FSP FIN 46(R)-3 will result in a significant change in practice to franchisors' evaluations of the criteria in paragraph 5(b)(1).

¹⁰ FSP No. 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)* (generally contained within the Variable Interest Entities paragraphs of FASB ASC Topic 810-10, *Consolidation-Overall*, and FASB ASC Topic 952-810, *Franchisors-Consolidation*)

Primary beneficiary determination

Power and benefits

Excerpt from FIN 46(R), as amended by Statement 167

14. An enterprise shall consolidate a variable interest entity 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.
- 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:
- The power to direct the activities of variable interest entity that most significantly impact the entity's economic performance
 - 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.

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

Statement 167 revises paragraph 14 of FIN 46(R) to require that an enterprise perform a qualitative analysis, rather than a quantitative analysis, to determine if it has a controlling financial interest and is therefore the primary beneficiary of a VIE. The qualitative analysis considers the purpose and design of the VIE as well as the risks that the VIE was designed to create and pass through to its variable interest holders. An enterprise is required to consolidate a VIE if it has both (a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance ("power") and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE ("benefits"). Currently under FIN 46(R), an enterprise is required to consolidate a VIE if the enterprise has a variable interest (or interests) that absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns or both. In most cases, an enterprise would perform a quantitative analysis of the expected losses and residual returns by calculating the variability in the fair value of the entity's net assets exclusive of its variable interests.

The FASB believes that a qualitative approach focusing on power and benefits is more effective for determining the primary beneficiary of a VIE. The FASB opposed an approach that would provide a list of specific qualitative criteria that would have to be met in order to determine the primary beneficiary. An evaluation under this principles-based approach will require the use of significant judgment.

Power

In evaluating the power criterion, an enterprise should first consider the purpose and design of the VIE and the risks that the VIE was designed to create and pass to its variable interest holders. In evaluating purpose and design, an enterprise should consider the nature of the entity's activities, including the terms of the contracts the entity has entered into, the nature of variable interests issued, and how the entity's interests were marketed to potential investors. The entity's governing documents, marketing materials and contractual arrangements should be closely reviewed. The risks that the VIE was designed to create and pass to its variable interest holders may include, but are not limited to:

- ▶ Credit risk
- ▶ Interest rate risk (including prepayment risk)
- ▶ Foreign currency exchange risk
- ▶ Commodity price risk
- ▶ Equity price risk
- ▶ Operations risk

Prior to the adoption of Statement 167, many enterprises may not have considered where power rests within the VIEs that they were involved with. Rather, these enterprises may have focused strictly on an evaluation of variability through a quantitative analysis. We believe that it will be critical for an enterprise to establish a disciplined approach in evaluating the power criterion. To assess power, an enterprise must identify which activities most significantly impact the VIE's economic performance. Those activities may differ by the type of entity being analyzed. Generally, some subset of the total activities and decisions made within an entity would be considered "significant." After the activities that are considered to have the most significant impact on the VIE's economic performance have been identified, an enterprise should evaluate whether it has power to direct those activities. Power may be exercised through the board of directors, management, a contract, or other arrangements.

An enterprise's ability to direct the activities of a VIE when circumstances arise or events occur constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. An enterprise does not actively have to exercise its power in order to have power to direct the activities of an entity. We believe that virtually all entities have some level of decision-making and that few are on "auto-pilot." As more fully discussed below, involvement in the design on an entity may indicate that an enterprise had the opportunity and incentive to establish arrangements that result in the enterprise being the party with the power. However, that involvement in isolation does not establish that enterprise as the enterprise with the power. For entities with a limited range of activities, such as certain securitization entities or other special-purpose entities, we believe that power should be determined based on how that limited range of activities is directed.

In some limited circumstances, an enterprise may conclude that no one party has the power over a VIE. To illustrate one such scenario in which no party has the power, assume that three unrelated parties form a venture (which is a VIE) to manufacture, distribute and sell beverages. Each party has one-third of the voting rights and each has one seat on the board of directors. The board of directors hires a management team to carry out the day-to-day operations of the venture. All significant decision-making matters are taken to the board of directors for approval. Decisions are made by the board of directors based on majority vote. Under this fact pattern, the VIE does not have a primary beneficiary as no one party has the power to direct the activities that most significantly impact the economic performance of the entity. Refer to the "Shared power" heading below for a discussion on when power within an entity may be shared.

Power-Example 1 (Securitization)

Assume a VIE that is financed with debt and equity uses the proceeds from its financing to purchase commercial mortgage loans from a Transferor. The primary purposes for which the entity was created were to (1) provide liquidity to the Transferor and (2) provide investors with the ability to invest in a pool of commercial mortgage loans. 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 first dollar risk of loss.

The Transferor retains primary servicing responsibilities, which 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 to the Special Servicer (the equity holder).

The Special Servicer, as the equity holder, also has the approval rights for budgets, leases and property managers of foreclosed properties. 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. Therefore, the Special Servicer's ability to manage the entity's assets that are delinquent or in default provides the Special Servicer with the power.

Power-Example 2 (Asset management)

Assume a VIE that is financed with debt and equity uses the proceeds from its financing to purchase a portfolio of asset-backed securities with varying tenors and interest rates. The equity tranche is held 35% by the manager of the entity (Manager) and 65% by a third-party investor. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of asset-backed securities, (2) earn a positive spread between the interest that the entity earns on its portfolio and the interest paid to debt investors and (3) generate management fees for the Manager. The entity was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the active management of the portfolio. The equity tranche was designed to absorb first dollar risk of loss and receive any residual returns from a favorable change in interest rates or credit risk.

The assets of the entity are managed with 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. The third-party equity investor has rights that are limited to administrative matters.

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. Therefore, the Manager's ability to manage the entity's assets within the parameters of the trust documents provides the Manager with the power.

Power-Example 3 (Lease)

Assume a VIE that is financed with 5-year fixed-rate debt and equity uses the proceeds from its financing to purchase property to be leased to a lessee with an AA rating. 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. However, the lessee is considered the owner of the property for tax purposes and, thus, receives tax depreciation benefits. Additionally, 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 the 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. The lessee is entitled to the excess of the sales proceeds over the option price.

The primary purpose for which the VIE was created was to provide the lessee with the use of the property for five years with substantially all of the rights and obligations of ownership, including tax benefits. 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 the equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt. The residual value guarantee transfers substantially all of the risk associated with the underlying property to the lessee and the fixed-price purchase option effectively transfers substantially all of the rewards from the underlying property to the lessee. 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.

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 VIE. The economic performance of the VIE 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. Therefore, the lessee has the power.

Refer to Statement 167 for additional examples.

Benefits

In evaluating whether an enterprise has satisfied the benefits criterion, the use of professional judgment will be required to determine whether the benefits could potentially be significant to the VIE. An enterprise should consider all facts and circumstances regarding the terms and characteristics of the variable interest(s), the design and characteristics of the VIE and the other involvements of the enterprise with the VIE. Benefits can be current benefits or future benefits. The FASB decided not to provide additional guidance or "bright lines." The FASB noted that if an enterprise concludes that it does not have a variable interest in an entity, then it would not meet this criterion. We believe that if an interest meets the definition of a variable interest,¹¹ it would often represent an obligation or benefit that could potentially be significant to the VIE. Additionally, we believe that if an enterprise has a variable interest in a VIE, the presumption should be that the enterprise has satisfied the benefits criterion as we believe that it will be uncommon that an enterprise would conclude that it has a variable interest but does not have benefits.

Refer to the paragraph B22 discussion above for guidance in assessing whether fees paid to a decision maker or a service provider represent a variable interest.

¹¹ Statement 167 defines variable interests as "...contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets..." In applying the provisions of Statement 167, an enterprise first must determine whether it has a variable interest in the entity being evaluated for consolidation. An enterprise should consider the purpose of the entity and the risks that the entity was designed to create and pass along to its interest holders in making that determination.

Kick-out rights, participating rights and protective rights**Excerpt from FIN 46(R), as amended by Statement 167**

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 issue 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 protect the brand of the franchisor.

^{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."

Kick-out rights and participating rights

In determining whether an enterprise has the power, an enterprise should not consider kick-out rights or participating rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such rights. In those circumstances, a single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise such rights may be the enterprise with the power. The FASB's conclusion regarding the consideration of kick-out rights in the determination of a primary beneficiary is consistent with the Exposure Draft. During the comment process, many constituents expressed concern regarding the inconsistency between how kick-out rights are considered in determining the primary beneficiary of a VIE and how they are considered when evaluating a voting interest entity for consolidation. When evaluating the consolidation of voting interest entities under EITF 04-5, kick-out rights are considered in the circumstances in which those rights can be exercised by a simple majority of the equity holders (as opposed to one party) and are otherwise substantive.

The FASB acknowledged these inconsistencies between Statement 167 and the conclusions reached in EITF 04-5. In arriving at its conclusion, the FASB reasoned that kick-out rights are rarely exercised in practice and, thus, should not be considered until exercised unless one party has the unilateral ability to exercise such rights. The FASB was concerned that if consideration of kick-out rights in the determination of the primary beneficiary was consistent with the consideration of those rights for voting interest entities, there would have been obvious structuring opportunities. The FASB was concerned that these structuring opportunities would allow enterprises to avoid consolidation by inserting kick-out rights such that no single party had power over an entity.

With respect to participating rights, the FASB affirmed that it believes that participating rights are substantively similar to kick-out rights and, thus, should be subject to the same restrictions as kick-out rights. That is, the FASB decided that the determination of the primary beneficiary should not be affected by participating rights unless a single party (including its related parties and de facto agents) has the unilateral ability to exercise such participating rights and the rights are substantive.

It is also noteworthy that in affirming its preliminary conclusions with respect to kick-out rights, the FASB acknowledged that it established an inconsistency with respect to how kick-out and participating rights are considered under a VIE and voting interest model. The FASB indicated that it may address these inconsistencies at a later date by reconsidering the conclusions reached in EITF Nos. 96-16¹² and 04-5 in their current project to reconsider consolidation accounting more broadly.

While kick-out rights are defined by Statement 167, we believe that enterprises should consider the provisions of EITF 04-5 when evaluating whether kick-out rights held by a single enterprise are substantive. The following barriers to exercise may indicate that the kick-out rights held by a single enterprise are not substantive:

- ▶ 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
- ▶ Financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive for removal
- ▶ The absence of an adequate number of qualified replacement decision makers or inadequate compensation to attract a qualified replacement
- ▶ The absence of an explicit, reasonable mechanism in the arrangement by which the party that possesses the kick-out rights can exercise them

¹² 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" (generally contained within the General paragraphs of FASB ASC Topic 810-10, *Consolidation-Overall*)

In addition, the economic terms could make it unlikely that the kick-out rights would be exercised and thus the presumption of control would not be overcome. For example, a partnership that is a VIE has within its partnership agreement a provision that the general partner can be removed by one limited partner, but is still entitled to its economic interest (i.e., 1% from its legal ownership and its 20% carried interest, which is earned after the limited partners receive a preferred return) over the remaining life of the partnership. We believe that the kick-out rights would not be substantive in this example because the limited partner is unlikely to remove the general partner when it must continue to pay that general partner for services for which the replacement general partner also will be compensated.

Other partnership agreements may provide that the general partner is to be paid an amount equal to the fair value of its interest on the termination date. All of the related facts and circumstances should be evaluated to determine whether such a provision acts as a financial barrier. For example, a partnership that is invested in one real estate property may have insufficient liquidity to pay the general partner without selling the property, creating a significant disincentive for a limited partner to exercise the kick-out rights.

Statement 167 does not specifically address an enterprise's ability to dissolve, or liquidate, an entity ("liquidation rights"). Consistent with the guidance in EITF 04-5, we believe that, for the purpose of Statement 167, kick-out rights encompass liquidation rights. However, it is important to distinguish liquidation rights from withdrawal rights. Withdrawal rights must be carefully analyzed, and the specific facts and circumstances must be considered. In certain limited circumstances withdrawal rights may be considered to be substantive kick-out rights. For example, if a limited partnership were economically compelled to dissolve, or liquidate, upon the withdrawal of one limited partner, that withdrawal right may be considered a substantive kick-out right if there were no barriers to exercise (as discussed above), and the right was otherwise considered substantive. However, withdrawal rights that do not explicitly require the dissolution or liquidation of the entire limited partnership generally would not be considered a substantive kick-out right.

Statement 167 defines participating rights as the ability to block the actions of the enterprise with the power. Although the FASB agreed that a participating right is the ability of one party to block certain actions, the FASB believes that this ability should effect 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. Examples of participating rights would be the rights to block decisions that would convey power. Determining what would constitute participating rights will likely vary by entity. Selecting, terminating and setting the compensation of management or establishing operating budgets as discussed in EITFs 96-16 and 04-5 may or may not represent participating rights. Power and, more specifically, the activities that most significantly impact the economic performance of the entity, will likely be different for different entities.

Protective rights

Protective rights held by other parties do not preclude an enterprise from having the power. Statement 167's notion of protective rights is similar to that in EITFs 96-16 and 04-5. However, neither Statement 167's nor EITFs 96-16 and 04-5's lists of protective rights should be viewed as all-inclusive, and determining whether a right is participating or protective is a matter of professional judgment.

Shared power**Excerpt from FIN 46(R), as amended by Statement 167**

- 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).

If an enterprise determines that power is shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then no party is the primary beneficiary. Power is shared if each of the unrelated parties sharing power are required to consent to the decisions relating to the activities that most significantly impact the VIE's performance. The governance provisions of an entity should be evaluated to ensure that the consent provisions are substantive.¹³ To illustrate the concept of shared power, assume two unrelated parties form a venture (which is a VIE) to manufacture, distribute and sell beverages. Assume that one party is responsible for manufacturing the beverage and the other party is responsible for distributing and selling the beverage. Both parties have 50% of the voting rights and each represents 50% of the board of directors. The manufacturer is required to consent to the decisions of the distributor/seller, and the distributor/seller is required to consent to the decisions of the manufacturer. Both parties through their voting interests and board representation jointly decide all other matters related to the entity. In this example, the VIE does not have a primary beneficiary because the power is shared between both parties. However, if the two parties are related parties or de facto agents, one of the parties must be identified as the primary beneficiary (because together they have power). Statement 167's related party provisions would be used to determine which party is the primary beneficiary of the entity (see discussion of the related party provisions below).

If an enterprise concludes that power is not shared but the activities that most significantly impact the VIE's economic performance are directed by multiple parties, and each party is directing the *same* activities, the party, if any, with the power over the majority of the activities is the primary beneficiary of the VIE (provided they have benefits). If no party has the power over the majority of the activities, then no party would be the primary beneficiary under Statement 167's power and benefits provisions. Assume two parties form a venture (which is a VIE) to manufacture, distribute and sell beverages with each holding an equity interest. Assume that each party manufactures, distributes and sells the beverages in different locations. Power is not shared as each party is not required to consent to the other's decisions. As each party is directing the same activities, the party with the power over the majority of the activities is the primary beneficiary of the VIE. Determining which of these roles require decisions over the majority of the activities could prove difficult and will require a careful assessment of the facts and circumstances. In this example, because there are only two decision makers, we believe that one must have the power over a majority of the activities and, therefore, one party must be identified as the primary beneficiary. If there had been three or more decision makers, it is possible that no one party would have power over a majority of the activities (e.g., if each party had power over 33% of the decisions).

¹³ For example, an enterprise should consider what occurs in the event that consent is not given (e.g., remedies) and how those provisions may effect the determination of whether consent is truly substantive.

If power is not shared but the activities that most significantly impact the VIE's economic performance are directed by multiple parties, and each party is performing *different* activities, then an enterprise must identify which party has the power to direct the activities that most significantly impact the entity's economic performance. That is, one party has the power. To determine which party is the primary beneficiary in these circumstances will require an enterprise to evaluate the purpose and design of the entity and to consider the factors that may provide insight into which entity has the power. Assume two parties form a venture (which is a VIE) to manufacture, distribute and sell beverages with each holding an equity interest. Assume that one party is the manufacturer and the other party is responsible for distribution and sales. In this instance, either the manufacturer or the distributor/seller is the primary beneficiary. Determining which of these roles require decisions that most significantly impact the entity's performance could prove difficult and will require a careful assessment of the facts and circumstances.

Involvement with the design of the VIE

Excerpt from FIN 46(R), as amended by Statement 167

14F. Although a party 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.

The FASB included paragraph 14F 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. However, an enterprise's involvement with the design of a VIE does not, in and of itself, establish the enterprise as the party with the power, even if that involvement was significant. Rather, 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 the power. 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, a sponsor may have an implicit agreement to fund an entity's losses to protect the sponsor's reputation. In circumstances in which an enterprise established the decisions that were encompassed in the governing documents of the entity, there should be increased scrutiny as to whether that enterprise has the power, particularly if the sponsor has a potentially significant explicit or implicit variable interest. When there are many parties involved with the design of an entity, this provision of Statement 167 may be less relevant.

Disproportionate power and benefits

Excerpt from FIN 46(R), as amended by Statement 167

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 the enterprise holds.

We believe that the greater an enterprise's exposure to benefits, the more incentivized the enterprise would be to obtain power over an entity. In other words, most enterprises would not be willing to accept a high level of economic risk in an entity without having elements of power. However, this provision of Statement 167 is not determinative. Rather, in circumstances in which an enterprise has a disproportionately greater obligation to absorb losses or right to receive benefits compared to its stated power, an enterprise should approach the evaluation of the primary beneficiary with greater skepticism. This may require an enterprise to consider whether it has clearly identified the characteristics of power with respect to the entity. In the circumstances in which, after careful consideration of the disproportionality, an enterprise concludes that it has appropriately determined which party has the power, we believe that the enterprise should clearly document its judgments with respect to its determination of power and its consideration of the disproportionality in power and benefits.

Quantitative analysis

Currently, FIN 46(R) requires an enterprise to determine if it has a controlling financial interest in a VIE through an analysis that generally is quantitative. Statement 167 eliminates the quantitative analysis from the primary beneficiary determination. The Exposure Draft included the quantitative analysis as a "fall back test" if an enterprise was unable to determine whether it met the qualitative assessment criteria. Several respondents noted in the comment process that the retention of the quantitative analysis may result in some defaulting to the quantitative model to obtain a desired accounting result. The FASB shared these concerns that the quantitative test could potentially override the consolidation principle being established with the amendments to FIN 46(R) and, therefore, eliminated the fall back test in the final standard.

It should be noted that Statement 167 does not necessarily eliminate the need to perform a quantitative analysis in applying other provisions within Statement 167. For example:

- ▶ A quantitative analysis is often necessary to determine whether the total equity investment at risk is sufficient to permit an entity to finance its activities without additional subordinated financial support and thus, whether or not an entity is a VIE
- ▶ A quantitative analysis may be necessary to determine 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 either involve or are conducted on behalf of the investor that has disproportionately few voting rights and thus, whether or not an entity is a VIE
- ▶ Determining whether a decision maker or service provider has a variable interest may require an enterprise to perform a quantitative analysis
- ▶ Within Statement 167's related party provisions, there are elements of a quantitative analysis that might be required to perform the "most closely associated" test

Effects of eliminating the quantitative analysis

Statement 167's requirement to qualitatively determine the primary beneficiary may affect structures on which a quantitative analysis provided the basis for the evaluation of whether the entity should be consolidated. As an example, some sponsors do not consolidate their asset-backed commercial paper conduits because the conduit issued to independent investors expected loss notes (ELNs) that absorb a majority of the conduit's expected losses. Because ELN holders typically have little decision-making ability over the conduit's significant activities, these investors would not be the primary beneficiary. Instead, under Statement 167, the sponsor may be required to consolidate the conduit based on its decision-making ability and economic interests in the conduit.

Related party provisions

De facto agents

Excerpt from FIN 46(R), as amended by Statement 167 (amendments shown)

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.

Currently under FIN 46(R), a party that has an agreement that it cannot sell, transfer, or encumber its interests in a VIE without the prior approval of an enterprise is a de facto agent of that enterprise if that right could constrain the party's ability to manage the economics of its interest in a VIE. Under FIN 46(R), de facto agents are considered along with related parties when evaluating FIN 46(R)'s related party provisions. Historically, many enterprises have found themselves evaluating the related party provisions of FIN 46(R) as sale, transfer, or encumbrance restrictions are present in many arrangements.

Statement 167's amendments provide for an exception to this de facto agency provision. Under Statement 167, a de facto agency relationship does not exist if both the enterprise and the other party have the right of prior approval and those rights are based on mutually agreed terms entered into by willing, independent parties. During the comment process, some respondents expressed concerns over the broad applicability of the de facto agency provisions and that a de facto agent relationship currently exists in circumstances where the transfer restrictions are the result of negotiations between willing and independent parties. Respondents also noted that these provisions are often important to preserve the strategic intent of the entity. The FASB decided to amend the de facto agency provisions to address the concerns raised by these respondents who were troubled that many enterprises with substantive mutual transfer restrictions would be required to consolidate VIEs even in situations in which power is in fact shared pursuant to paragraph 14D of Statement 167.

Notwithstanding the above amendment, substantive transfer restrictions will continue to arise in practice. A substantive transfer restriction might exist when the restriction is one-sided (i.e., one party approves transfers but is not restricted itself). However, the existence of a substantive transfer restriction does not obviate the need for each party subject to such a restriction to determine if it is the primary beneficiary of a VIE pursuant to the power and benefits principle. That is, if the enterprise meets the requirements to be the primary beneficiary under the power and benefits criteria, then it is not necessary to assess the enterprise's related parties or de facto agents as the enterprise must consolidate the VIE.

The amendments to the de facto agency provisions, coupled with the changes discussed in the following section, will represent a significant change to the current practice of determining the primary beneficiary through an evaluation of FIN 46(R)'s related party provisions as fewer enterprises will be required to do so under Statement 167. Thus, it is possible that an enterprise that is the primary beneficiary of a VIE under FIN 46 (R) may conclude that it is no longer the primary beneficiary under the power and benefits provisions upon adoption. This particularly may be true for enterprises with involvement in joint ventures and other business ventures in which transfer restrictions are prevalent.

Primary beneficiary determination – related party group

Excerpt from FIN 46(R), as amended by Statement 167 (amendments shown)

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.

Currently under FIN 46(R), if two or more related parties (including de facto agents) hold variable interests in a VIE, and the aggregate variable interests held by the related party group would, if held by a single party, identify the group as the primary beneficiary, then the party within the related party group that is "most closely associated" with the VIE is the primary beneficiary. These related party provisions are currently considered in lieu of determining the primary beneficiary solely based upon the quantitative analysis.

Statement 167 amends FIN 46(R) so that the power and benefits provisions are considered prior to the related party provisions. Accordingly, only if an enterprise concludes that neither it nor one of its related parties individually meets the power and benefits criteria, but, as a group, the enterprise and its related parties have those characteristics, does an enterprise consider the related party provisions in paragraph 17.

Furthermore, in situations in which no one member, but rather the related party group is considered the primary beneficiary of a VIE, 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 determination of which party from a related party group is most closely associated with a VIE is generally qualitative and is dependent upon the facts and circumstances. The assessment also requires the use of professional judgment. Statement 167 lists factors to consider in making the determination but does not identify any single factor as determinative.

We believe that in certain circumstances, Statement 167's requirement to consider the power and benefits principle prior to the related party provisions will have a significant effect on the primary beneficiary determination of a VIE. As an example, enterprises that have been identified as the primary beneficiary under the "most closely associated" test but do not have

power likely will deconsolidate these VIEs under Statement 167 if (1) another enterprise in the related party group is the enterprise with the power, or (2) the parties are not related or de facto agents because of the amendments to the de facto agency provisions discussed above.

To illustrate, assume two parties form a venture (which is a VIE) to manufacture, distribute and sell beverages. Assume that one party is responsible for manufacturing the beverage and the other party is responsible for distributing and selling the beverage. Both parties have 50% of the voting rights and each represents 50% of the board of directors. The manufacturer is required to consent to the decisions of the distributor/seller, and the distributor/seller is required to consent to the decisions of the manufacturer. Both parties through their voting interests and board representation jointly decide all other matters related to the entity. Assume under the current provisions of FIN 46(R) that the parties are de facto agents as neither party can sell, transfer, or encumber its interests in the venture without the prior approval of the other party. Therefore, the party that is most closely associated to the venture is the primary beneficiary. Under FIN 46(R), as amended by Statement 167, assume a de facto agency relationship does not exist as both parties have a right of prior approval and the rights were based on mutually agreed terms by willing, independent parties. The parties are not related under the other provisions of Statement 167. Therefore under Statement 167, the VIE does not have a primary beneficiary because power is shared between both parties. Thus, the party that consolidated the VIE prior to Statement 167 would deconsolidate the VIE upon its adoption.

Statement 167 also amends paragraph 17(c) of the “most closely associated” test to require that an enterprise consider exposure to variability associated with the anticipated economic performance of the VIE rather than “expected losses.” While paragraph 17(c) no longer requires a calculation of expected losses, the FASB decided that the evaluation of which party within a related party group is most closely associated with a VIE should include an evaluation of each party’s exposure to variability associated with the anticipated economic performance of the VIE. While a detailed calculation of expected losses will not be required, paragraph 17(c) does require an analysis of variability associated with anticipated economic performance and, therefore, may require some quantitative analysis in its application.

Reconsideration events

Primary beneficiary

FIN 46(R) currently requires an enterprise to reconsider the primary beneficiary determination upon certain events. In particular, the primary beneficiary of a VIE may be required to be reevaluated in the event of a change in an entity’s design or capital structure and for transactions that impact the entity’s equity at risk.

Statement 167 eliminates the primary beneficiary reconsideration concept and effectively requires a VIE’s primary beneficiary to be evaluated continuously as facts and circumstances change. These ongoing assessments should not be limited to the end of each reporting period but, rather, should occur when circumstances warrant a change in an enterprise’s status as primary beneficiary. The FASB believes that the ongoing qualitative assessment of which enterprise, if any, is the primary beneficiary will require less effort and be less costly than the quantitative assessment of expected losses and residual returns previously required within FIN 46(R). Further, the FASB expects that the amendments to paragraph 14 to determine the primary beneficiary qualitatively will reduce the frequency in which the enterprise with the controlling financial interest changes. Intuitively, for the primary beneficiary to change, there must be a change in either the power or benefits. In practice, we believe that most changes to power will be evident to the party that ceases to be the primary beneficiary as a result of losing power or becomes the primary beneficiary as a result of obtaining power. Some examples of circumstances that may cause a change in the primary beneficiary include, but are not limited to, the following:

- ▶ acquisition or sale of interests that constitute a change of control
- ▶ lapse of certain rights such as participating or substantive kick-out rights (e.g., a lapse in participating rights held by one party to determine the operating budget of a VIE after the first two years of a VIE’s existence)
- ▶ termination of contractual arrangements that conveyed power

The FASB believes that eliminating the specific reconsideration guidance and requiring ongoing assessments will provide users with more relevant and timely information about the nature of an enterprise's interest(s) in a VIE and the associated risks and obligations of that interest. The amendment to require the continuous assessment of a primary beneficiary is more consistent with the application of ARB 51, which does not incorporate a reconsideration concept in its requirements, and implicitly requires continuous consideration of whether or not consolidation is required. Given that the primary beneficiary analysis is required to be performed continuously under Statement 167, enterprises may need to establish new processes to capture shifts in power, changes in variable interests, or changes to the status of de facto agent and related party relationships, in addition to those events that would qualify as a reconsideration of an entity's status as a VIE discussed below.

VIE

Excerpt from FIN 46(R), as amended by Statement 167 (amendments shown)

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:
- 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
 - The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity
 - 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
 - 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
 - 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~~

Currently, FIN 46(R) requires an enterprise to reevaluate the status of an entity as a VIE upon certain events. The Exposure Draft proposed to eliminate this reconsideration concept. However, many respondents to the Exposure Draft expressed concerns that a requirement to continually reassess an entity's status as a VIE was not operational or practicable. Additionally, constituents were troubled by the potential that an entity could be classified as a VIE in one reporting period and a voting interest entity in the next reporting period (or vice versa) solely as a result of the effect of operating results on the adequacy of equity investment at risk.

The FASB acknowledged these concerns and ultimately decided that reconsideration of an entity as a VIE should be based upon the occurrence of certain events. However, the FASB also shared the concern expressed by users that the existing reconsideration guidance would not change an entity's status to a VIE in situations in which the equity investor(s) lost power over an entity without triggering the specified VIE reconsideration events. For example, if an entity that was previously considered a voting interest entity experienced severe losses such that another party (e.g., a guarantor or lender) obtained a controlling financial interest in the entity, the specified reconsideration events may not have required a reconsideration of an entity's status. The FASB was troubled that, in this situation, the entity may not have been considered a VIE and may not have been consolidated by the party with a controlling financial interest. Consequently, paragraph 7.e as illustrated above was added as a VIE reconsideration event under Statement 167.

In addition, Statement 167 removes the current exemption for troubled debt restructurings, which could lead to more consolidation of borrowers by lenders in loan workouts that provide the lender with the power over the VIE's activities. Additionally, this amendment could expand the disclosure requirements for lenders that have variable interests in entities that become VIEs as a result of troubled debt restructurings. In removing the exception, the FASB concluded that the guidance in FIN 46(R) would typically identify the borrower as a VIE since economic events indicate 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. The FASB believed removing the exemption for troubled debt restructuring will provide more relevant and reliable information to users of financial statements.

Disclosures

In response to financial statement users' concerns over the transparency of entities' involvement with VIEs, Statement 167 adds disclosure requirements to FIN 46(R). Specifically, Statement 167 will require expanded disclosures in the following areas:

- ▶ The significant judgments and assumptions considered by the enterprise in determining whether it must consolidate a VIE or disclose information about its involvement with a VIE
- ▶ The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by the enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- ▶ The nature of, and changes in, the risks associated with an enterprise's involvement with a VIE
- ▶ How an enterprise's involvement with a VIE affects its financial position, financial performance and cash flows

In general, Statement 167 retains the disclosure requirements applicable to FIN 46(R) within FSP FAS 140-4 and FIN 46(R)-8 (the FSP) with only minor editorial changes (see our Hot Topic publication, *FASB issues FSP on disclosures about transfers of financial assets and interests in variable interest entities* (HT No. 2008-40), for further details on the FSP). Additionally, Statement 167 requires disclosures in situations in which an enterprise determines that it shares the power over a VIE. The FSP was effective for public enterprises for the first reporting period (interim or annual) ending after 15 December 2008, and will be superseded once Statement 167 is effective. As nonpublic enterprises were not required to apply the FSP, the adoption of Statement 167 will significantly expand the disclosure requirements for those enterprises. Refer to Appendix B for a complete listing of the Statement 167's disclosure requirements.

While some constituents objected to the fact that the FSP requires the primary beneficiary to provide a significant number of disclosures for consolidated VIEs that are not required for a consolidated voting interest entity, other respondents indicated that there are important differences between consolidated VIEs and consolidated voting interest entities. The FASB believes that the characteristics of assets in VIEs are different than those of assets of voting interest entities. For example, assets of VIEs often can be used solely to settle specific obligations of the VIEs. As a result, the FASB decided that the FSP should require more robust disclosures for a primary beneficiary of a VIE than for voting interest entities. However, the FASB provided some relief for primary beneficiaries of a VIE for which the primary beneficiary also holds a majority voting interest 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. See footnote 16c in Appendix B for additional details.

Other

Separate presentation

Excerpt from FIN 46(R), as amended by Statement 167

Presentation

22A. 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.

Statement 167 amends FIN 46(R) to require that a reporting enterprise separately present on the face of the balance sheet certain assets and liabilities of a consolidated VIE as noted above. For example, if cash and loans receivable of a consolidated VIE can be used only to settle the loans payable of the same consolidated VIE, separate classification would be required.

While not addressed in the Exposure Draft, the FASB requested that constituents comment as to whether separate presentation of elements of consolidated VIEs should be permitted or required. A significant number of respondents requested that separate classification of elements of consolidated VIEs be *permitted* on the face of the balance sheet. Ultimately, the FASB concluded that separate presentation should be *required* by enterprises consolidating a VIE. In arriving at its conclusion, the FASB considered but rejected a single line-item display of assets and liabilities or net assets and liabilities of VIEs. In other words, qualifying assets and liabilities of VIEs should be presented separately on the balance sheet for each major class of assets and liabilities (e.g., cash, accounts receivable, property, plant and equipment).

While Statement 167 requires separate presentation, it does not provide examples or detailed implementation guidance with respect to how enterprises would satisfy the separate presentation requirements. We believe that enterprises will have to carefully consider the new presentation requirements and evaluate whether financial reporting systems will require modification to track and capture the assets and liabilities of consolidated VIEs that meet the criteria for separate presentation.

For certain enterprises that may consolidate numerous VIEs with assets and liabilities that meet the criteria for separate presentation, the presentation of separate line items on an enterprise's statement of financial position for each VIE may prove challenging. While not discussed with respect to separate presentation, Statement 167's disclosure requirements include an aggregation provision. Specifically, Statement 167 permits aggregation of disclosures for similar entities in situations in which separate reporting would not provide information that is more useful to financial statement users. In circumstances in which an enterprise consolidates numerous VIEs, we believe that the aggregation principle for disclosure could be considered when applying the separate presentation requirement. Enterprises should establish (and disclose) a policy for how similar entities are aggregated. That policy should contemplate quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the enterprise.

Deconsolidation guidance

Excerpt from FIN 46(R), as amended by Statement 167

22. 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*.

Statement 167 clarifies that if an enterprise is required to deconsolidate a VIE, the enterprise should follow the deconsolidation provisions of ARB 51, as amended by Statement 160.¹⁴ Generally, we believe that an enterprise currently should follow the deconsolidation provisions of Statement 160 under FIN 46(R). Thus, this amendment should not result in a change in practice.

¹⁴ FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (generally contained within the General sections of FASB ASC 810-10, *Consolidation-Overall*)

However, consistent with the views expressed in a 1997 SEC staff speech,¹⁵ we believe that the derecognition provisions of Statement 166 should apply to situations in which an entity sells the equity securities of its consolidated subsidiary if all of the assets in the consolidated subsidiary are financial assets.

Additionally, we note that as of the date of this publication, the FASB had undertaken a project to reconsider the scope of Statement 160's deconsolidation provisions. Readers should monitor that project closely as decisions reached by the FASB may affect the scope of Statement 167's deconsolidation provisions.

Significant variable interests

Currently, FIN 46(R) does not require an enterprise to determine whether an entity with which it is involved is a VIE if it is apparent that the enterprise's interest would not be a significant variable interest and the enterprise (and its related parties and de facto agents) did not participate significantly in the design (or redesign) of the entity. Also, prior to the adoption of Statement 167, FIN 46(R) only requires that disclosures be provided in situations in which an enterprise held a significant variable interest in a VIE. Statement 167 removes both exceptions. The FASB concluded that the significance threshold should be removed from FIN 46(R) because the provisions of FIN 46(R) are not required to be applied to immaterial items. That is, whether or not an enterprise must determine if an entity is a VIE or provide the disclosures required by Statement 167 should be based on a materiality assessment. The FASB acknowledged that an evaluation of materiality requires judgment, but that materiality, rather than significance, is the appropriate threshold, as it is the same threshold used in applying all generally accepted accounting principles.

Consideration of substantive terms, transactions and arrangements

Excerpt from FIN 46(R), as amended by Statement 167

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.

Statement 167 added language to FIN 46(R) stating that only substantive terms, transactions and arrangements, whether contractual or noncontractual, should be considered in applying FIN 46(R), as amended. The FASB concluded that this guidance is necessary to avoid situations in which the form of an entity may indicate that an entity is not a VIE or an enterprise is not a primary beneficiary when the substance of the arrangement may indicate otherwise. However, the inclusion of this provision in FIN 46(R), as amended by Statement 167, is not meant to imply that nonsubstantive terms should be considered in other areas of accounting.

The FASB included this provision in response to concerns regarding the potential for certain enterprises to engage in restructuring in and around their involvement with a VIE in an effort to maintain their consolidation conclusions under the current FIN 46(R) model that would otherwise have changed upon adoption of Statement 167. In addition, it is important to note that while the FASB had originally contemplated including the language in the body of Statement 167 (without amending FIN 46(R)), the FASB ultimately decided to include these provisions within FIN 46 (R), as amended by Statement 167, to emphasize the consideration of this provision for all new and existing involvement in entities.

Statement 167 does not provide detailed implementation guidance or examples of the considerations that enterprises should evaluate when determining whether terms, transactions and arrangements are substantive. We believe that, in certain circumstances, significant professional judgment will be required to determine whether terms, transactions and arrangements

¹⁵ Remarks made by Armando Pimentel at the December 1997 AICPA Twenty-Fifth Annual National Conference on Current SEC Developments

are substantive and would therefore be considered in applying the provisions of FIN 46(R), as amended by Statement 167. In some instances, enterprises previously may not have evaluated whether terms, transactions or arrangements are substantive as there was no explicit requirement under FIN 46(R) to do so. In considering whether terms, transactions and arrangements are substantive, we believe that it is appropriate to consider among other things, the purpose and design of the entity and the business purposes for the particular arrangements or transactions when alternative arrangements or transactions are typically used with respect to involvement in an entity.

Given the nature of the considerations in paragraph 2A, we believe that it is likely that these provisions will be broadly applied by the SEC staff. As such, we believe that it will be important for an enterprise to contemporaneously document the economic substance of the terms, transactions and arrangements that it enters into, with particular emphasis on changes to the terms, transactions and arrangements that occur for existing involvement in entities prior to the effective date of Statement 167.

Effective date

Excerpt from Statement 167

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 Interest 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.

Statement 167 is effective as of the beginning of an enterprise's first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter, with earlier application prohibited. That is, Statement 167 is effective for calendar year-end companies beginning on 1 January 2010.

In periods after the initial adoption, comparative information for disclosures previously required for nonpublic enterprises (FIN 46(R)) or for public enterprises (FIN 46(R) or the FSP) is required. In periods after initial adoption, comparative disclosures for those disclosures that were not previously required for nonpublic enterprises or public enterprises only are required for periods subsequent to the effective date.

Transition

Excerpt from Statement 167

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 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 consolidation 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 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 consolidated 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, 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.

It is important to note that the amendments to FIN 46(R) are applicable to all enterprises and to all entities with which those enterprises are involved, regardless of when that involvement arose. Therefore, upon adoption of Statement 167, all enterprises must reconsider their consolidation conclusions for all entities with which they are involved.

We encourage enterprises to begin evaluating Statement 167's transition provisions as soon as practicable as we expect that many enterprises will find that assessment of all entities with which the enterprise is involved and the application of the transition provisions will require significant time and effort.

Recognition

Upon transition, an enterprise may be required to consolidate entities that it does not consolidate prior to the adoption of Statement 167. Conversely, an enterprise may be required to deconsolidate entities that it consolidated prior to the adoption of Statement 167. In evaluating the effects of Statement 167, an enterprise should assume that Statement 167's requirements have always been effective. The determination of whether an entity is a VIE and which enterprise, if any, is the VIE's primary beneficiary should be made as of the date the enterprise first became involved with the entity. That conclusion should then be reevaluated when events requiring reconsideration of the entity's status as a VIE (as described in paragraph 7 of FIN 46(R), as amended by Statement 167) or when a change in the primary beneficiary would have occurred under Statement 167. If the enterprise would be a VIE's primary beneficiary at the adoption date if Statement 167's provisions had always been applied, then the VIE should be consolidated by the enterprise on the adoption date. Alternatively, if the enterprise would not be an entity's primary beneficiary at the adoption date if Statement 167's had always been applied, the entity should not be consolidated by the enterprise on the adoption date.

Measurement – consolidation (carrying amounts)

If an enterprise is required to consolidate a VIE upon the implementation of Statement 167, the enterprise initially will measure and recognize all assets, liabilities and noncontrolling interests of the VIE at their carrying amounts at the date of adoption. Carrying amounts are the amounts at which the assets, liabilities and noncontrolling interests would have been carried in the consolidated financial statements if Statement 167 was effective when the enterprise would have first met the conditions to be the primary beneficiary under Statement 167. Any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interest in the newly consolidated VIE should be recognized as a cumulative effect adjustment to retained earnings.

The provisions of paragraphs 18-21 of FIN 46(R), as amended by Statement 167, require that an enterprise initially measure the assets, liabilities and noncontrolling interests of a VIE:

- ▶ At the amounts at which they were carried in the accounts of the enterprise that controls the VIE if the primary beneficiary of a VIE and the VIE are under common control;
- ▶ Pursuant to Statement No. 141(R)¹⁶ if the VIE is a business; or
- ▶ Pursuant to Statement 141(R) (except for the recognition of goodwill) for a VIE that is not a business. However, assets and liabilities transferred shortly before or after the date the enterprise became the primary beneficiary are measured at the same amounts at which those assets and liabilities would have been measured had the transfer not occurred (no gain or loss is recorded by the transferor)

With respect to the determination of initial measurement in computing carrying amounts upon adoption, Statement 167 does not provide detailed implementation guidance. Given that an enterprise is required to calculate carrying amounts from the date the enterprise would have first met the conditions to be the primary beneficiary under Statement 167, the initial measurement date

¹⁶ FASB Statement No. 141(R), *Business Combinations* (FASB ASC Topic 805, *Business Combinations*)

could be prior to the effective date of Statement 141(R). Therefore, questions have arisen as to whether Statement 141(R) would be an appropriate basis for computing carrying amounts in these circumstances. As an alternative, some may believe that initial measurement should be based on fair value (FIN 46(R)'s original approach to initial measurement) or Statement 141¹⁷ in these instances. Given that the measurement approaches in both Statements 141 and 141(R) contain elements of fair value, the differences in valuation under the different accounting models may not be significant.

The provisions of paragraph 22 of FIN 46(R), as amended by Statement 167, require that accounting subsequent to initial measurement follow the provisions of Statement 160 (i.e., the same accounting for a consolidated voting interest entity). Subsequent accounting may include, but would not be limited to, the elimination of intercompany transactions and balances, asset valuations (including analysis of asset impairments) and depreciation and amortization. Again, with respect to the determination of subsequent accounting in computing carrying amounts upon adoption, Statement 167 does not provide detailed implementation guidance. Given that an enterprise is required to calculate carrying amounts from the date the enterprise would have first met the conditions to be the primary beneficiary under Statement 167, subsequent accounting for purposes of determining carrying amounts may occur for dates prior to the effective date of Statement 160. Therefore, questions have arisen as to whether Statement 160 would be an appropriate basis for computing carrying amounts in these circumstances. As an alternative, some may believe that in these instances subsequent accounting should be based on ARB 51 prior to Statement 160's amendments until Statement 160 would have been adopted by the entity.

As noted in the previous paragraphs, certain accounting standards may not have been effective at the date an enterprise first became involved with an entity. As a result, an enterprise should carefully consider how to address the adoption of new accounting standards in determining carrying amounts. In addition, an enterprise should carefully determine how accounting standards that require an assessment of management's intent should be applied in the determination of carrying amounts. Standards that require an assessment of management's intent may include Statement 115¹⁸ or Statement 133.¹⁹ We anticipate issuing additional guidance with respect to these and other transition matters in a future Technical Line or update to our Financial Reporting Developments publication series.

Example (Measurement – consolidation (carrying amounts))

Assume an enterprise determines upon the adoption of Statement 167 that it is the primary beneficiary of a VIE that was not previously consolidated. The enterprise determines it first met the conditions to be the primary beneficiary under Statement 167 on 1 January 2005. The enterprise also determines that the entity would have remained a VIE and that it would have remained the primary beneficiary under Statement 167 through the date of adoption. Therefore, the enterprise initially calculates the values of all assets, liabilities and noncontrolling interests of the VIE at the date the enterprise first met the conditions to be the primary beneficiary under Statement 167. The enterprise then subsequently adjusts those assets, liabilities and noncontrolling interests as if the entity was a consolidated subsidiary from 1 January 2005 to the date of adoption. The resulting amounts are recognized in consolidation at the date of adoption.

Assume now that VIE reconsideration events occurred on 1 May 2006 and on 1 August 2008. The VIE would have been deconsolidated as of 1 May 2006 as power and benefits were lost and then consolidated as of 1 August 2008 as power and benefits were re-gained. In this scenario, the determination of the carrying amounts upon adoption of Statement 167 would be made starting with 1 August 2008.

¹⁷ FASB Statement No. 141, *Business Combinations*

¹⁸ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC Topic 320, *Investments-Debt and Equity Securities*)

¹⁹ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB ASC Topic 815, *Derivatives and Hedging*)

Measurement – deconsolidation (carrying amounts)

If an enterprise is required to deconsolidate an entity upon the adoption of Statement 167, the deconsolidating enterprise should initially measure any retained interest in the deconsolidated entity at its carrying amount upon adoption. Carrying amount refers to the amount at which any retained interest would have been carried in the enterprise's financial statements if Statement 167 had been effective when the enterprise became involved with the entity or no longer met the conditions to be the primary beneficiary (as defined by Statement 167). As noted above, an enterprise should carefully consider how to address the adoption of new accounting standards in subsequent accounting periods after the initial measurement of the interest.

Any difference between the net amount removed from the balance sheet of the deconsolidating enterprise and the amount of any retained interest in the deconsolidated entity should be recognized as a cumulative effect adjustment to retained earnings. The amount of any cumulative effect adjustment related to deconsolidation should be separately disclosed from cumulative effect adjustments related to consolidation.

Example (Measurement – deconsolidation (carrying amounts))

Assume an enterprise determines upon the adoption of Statement 167 that it is not the primary beneficiary of an entity that was previously consolidated. The enterprise became involved with the entity on 1 January 2005. In considering Statement 167, the entity concludes that it would have accounted for its initial investment under the equity method in accordance with APB 18.²⁰ Therefore, the enterprise calculates its initial investment at cost in accordance with APB 18 on 1 January 2005. The enterprise then subsequently adjusts the investment balance in accordance with APB 18 to the date of adoption of Statement 167. The amount resulting from these calculations through the adoption date is recognized on the enterprise's balance sheet at the date of adoption.

Recognition – consolidation practicability exception

Situations may arise in which it is not practicable for an enterprise to determine whether an entity would have been a VIE or whether the enterprise would have been the primary beneficiary had Statement 167's provisions always been effective. That is, it may not be practicable for an enterprise to determine whether an entity is a VIE or whether the enterprise is the primary beneficiary from the date the enterprise first became involved with an entity, or if a reconsideration has occurred, at the most recent reconsideration date. In these instances, the enterprise should make the determination of whether it should consolidate an entity as of the effective date of the Statement 167. That is, an enterprise that takes the practicability exception performs the VIE and primary beneficiary analysis as of different date (the adoption date). Refer to the "Practicability" heading below for considerations for determining what is "not practicable" for purposes of evaluating this provision.

If the VIE and primary beneficiary determinations are made as of the effective date of Statement 167 in accordance with the paragraph above, then the primary beneficiary should measure the assets, liabilities and noncontrolling interests of the VIE at fair value on the adoption date. However, the exceptions described in the following measurement sections for securitization vehicles, transfers between entities under common control and transfers shortly before, in connection with, or shortly after becoming the VIE's primary beneficiary, would apply.

Measurement – consolidation practicability exception

If the practicability exception described in the preceding section that relates to the timing of the consolidation assessment does not apply, Statement 167 requires that the assets and liabilities of a consolidated VIE be measured at their carrying amounts, as described previously. If determining the carrying amounts is not practicable, the assets, liabilities and noncontrolling interests of the VIE should be measured at fair value at the date of adoption. However, if a VIE's primary

²⁰ APB No. 18, *The Equity Method of Accounting for Investments in Common Stock* (FASB ASC Topic 323, *Investments-Equity Method and Joint Ventures*)

beneficiary changes between entities that are under common control, we believe that the new primary beneficiary should initially measure the assets, liabilities and noncontrolling interests of the VIE at carryover basis.²¹ In addition, we believe that when an enterprise transfers assets and liabilities to a VIE shortly before, in connection with, or shortly after becoming the VIE's primary beneficiary, the primary beneficiary should initially measure those assets and liabilities transferred to the VIE at the same amounts at which the assets and liabilities would have been measured had they not been transferred.

However, Statement 167 provides a measurement alternative if the activities of the VIE are primarily related to securitizations or other forms of asset-backed financings and the assets of the VIE can be used only to settle obligations of the VIE. If determining carrying value is not practicable (or the recognition practicability exception described in the previous section is applied), the enterprise upon adoption may choose to measure the assets and liabilities of the VIE at their unpaid principal balance. The primary beneficiary must also consider the need to recognize accrued interest, allowances for credit losses, or other-than-temporary impairments, as appropriate under this measurement alternative. However, 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. The FASB 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 carrying amounts of a consolidated entity's assets, liabilities and noncontrolling interests.

Any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interest in the newly consolidated entity should be recognized as a cumulative effect adjustment to retained earnings.

Refer to the heading "Practicability" below for considerations for determining what is "not practicable" for purposes of evaluating this provision.

Practicability

Statement 167 provides for practicability exceptions in applying its consolidation transition provisions with respect to both (a) recognition and (b) initial measurement (see sections above). However, Statement 167 does not define "not practicable." Therefore, we believe that the discussion contained within Statement 154²² regarding impracticability may provide for useful considerations in evaluating Statement 167's provisions.

Additionally, we believe the following factors should be considered in assessing whether it is impracticable to apply Statement 167's transition provisions:

- ▶ Whether data was collected in prior periods in a way that allows retrospective application. If not, whether it is impracticable to recreate the data in a manner that supports retrospective application
- ▶ Whether applying the provisions of Statement 167 requires the use of hindsight on the part of management, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognized, measured, or disclosed (e.g., an estimate of fair value based on inputs that are not derived from observable market sources and were not used for other accounting measurements at that time)
- ▶ Whether in light of the expected costs and perceived benefits, retrospective application would involve undue cost and effort

Given the challenges that some may face in applying Statement 167's transition provisions, we believe that the use of Statement 167's practicability exceptions may not be uncommon. If an entity concludes that applying Statement 167's provisions are impracticable, we would expect that this conclusion be supported by a thoroughly documented analysis.

²¹ Carryover basis is the amount at which the assets, liabilities, and noncontrolling interests were carried in the accounts of the enterprise that formerly controlled the VIE (i.e., carryover basis should be used with no adjustment to current fair values and no gain or loss should be recognized).

²² FASB Statement No. 154, *Accounting Changes and Error Corrections* (FASB ASC Topic 250, *Accounting Changes and Error Corrections*)

Fair value option

An enterprise that is required to consolidate a VIE as result of Statement 167 may elect the “fair value option” pursuant to Statement 159,²³ but only as of the date that Statement 167 becomes effective (i.e., adoption date). An enterprise may elect the fair value option for items of a VIE that are eligible for this option so long as the election is applied to all eligible items within the VIE. While Statement 159 allows entities to elect the fair value option for individual qualifying financial instruments without regard to consistency, the FASB 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. However, enterprises may elect the fair value option on an entity-by-entity basis. Subsequent to transition, an enterprise should follow the provisions of Statement 159 for newly consolidated VIEs.

An enterprise electing the fair value option should disclose its rationale for electing the option for certain entities. If the fair value option is elected for some entities and not others, the reasons for those elections must be disclosed. Additionally, the consolidating enterprise must disclose quantitative information by line item in the statement of financial position indicating the related effect on the cumulative effect adjustment of electing the fair value option for an entity. Thus, an enterprise must compare the amounts of the line items for which the fair value option was elected to the carrying amounts of the same line items (assuming determining carrying amounts is practical). Subsequent to transition, an enterprise will continue to be subject to the ongoing disclosure requirements of Statement 159.

Retrospective application

Excerpt from Statement 167

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.

Statement 167 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. If an entity restates its financial statements, we believe the restatement should include the effects of all entities for which the enterprise had involvement during the restated period. Additionally, we believe that by restating and promoting comparability between periods that an enterprise should consider the appropriateness of providing the disclosures required by Statement 154.

IFRS convergence

In December 2008, the IASB issued ED 10²⁴ with the objective of publishing a single IFRS on consolidation to replace the consolidation requirements in IAS 27²⁵ and SIC-12.²⁶

The main objectives of the IASB’s project are: i) to improve the definition of control and related application guidance so that a control based model can be applied to all entities, including special purpose entities or “structured entities” (the new term introduced in ED 10), and ii) to enhance the disclosure requirements for consolidated and unconsolidated entities.

Under ED 10, a reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity. A reporting entity has the power to direct the activities of another entity if it can determine that entity’s strategic operating and financing policies. A reporting entity is required to assess control continuously, and the consolidation analysis under ED 10 is qualitative, based on all relevant facts and circumstances.

²³ FASB Statement No. 159, *The Fair Value Option of Financial Assets and Financial Liabilities* (generally included within the Fair Value Option paragraphs of FASB ASC Topic 825-10, *Financial Instruments-Overall*)

²⁴ Exposure Draft 10, *Consolidated Financial Statements*

²⁵ IAS 27, *Consolidated and Separate Financial Statements*

²⁶ SIC-12, *Consolidation – Special Purpose Entities*

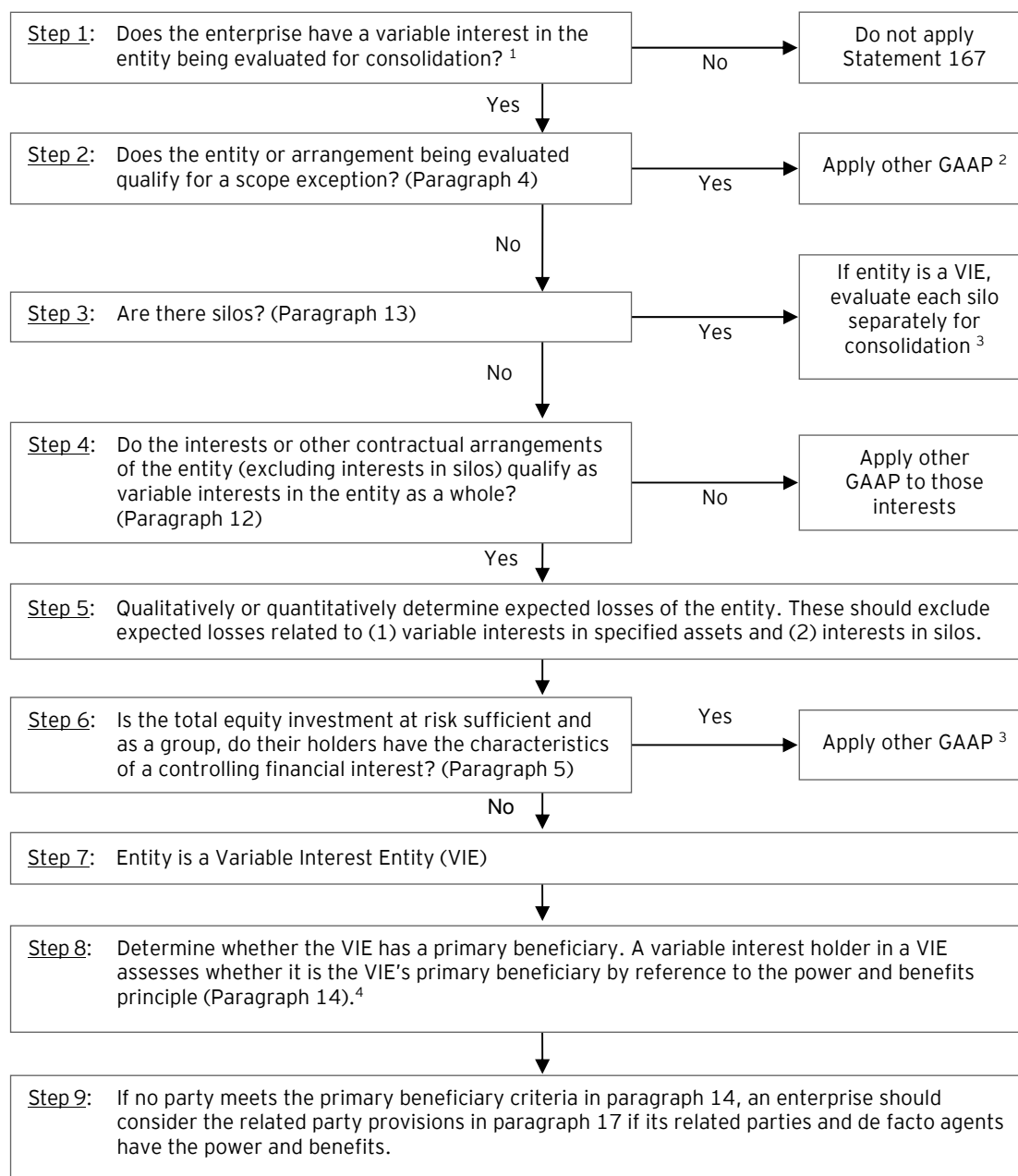
ED 10 would be applied prospectively for annual periods beginning on or after the final IFRS is issued. Earlier application is expected to be permitted. It is expected that the IASB will allow a minimum of one year between the issuance of a final standard and its implementation date.

Although both Statement 167 and the IASB's proposal are based on the notion of "power and benefits," there are significant differences between Statement 167 and the IASB's proposal. One significant difference is that ED 10 is a broader reconsideration of all consolidation guidance (not just the guidance for VIEs), while Statement 167 will continue to apply solely to VIEs. Another critical difference is that unlike US GAAP, ED 10 does not contain a scope exception for investment companies. Other potential differences may include, but are not limited to, the consideration of de facto control and consideration of options and potential voting rights pursuant to ED 10. De facto control and these rights are not elements of the US GAAP consolidation model.

Although Statement 167 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's project is different from the effective date of Statement 167. Ultimately, the two Boards plan to issue a converged standard that address consolidation of all entities.

Refer to our Hot Topic publication, *IASB issues Exposure Draft on Consolidated Financial Statements* (HT No. 2009-04), for further discussion of ED 10. In June 2009, the IASB held roundtable discussions in North America, Asia and Europe to gain feedback on its proposals on consolidation and derecognition of financial instruments from various constituent groups. At the time of this publication, the IASB has indicated that it plans to issue a final standard in the second half of 2009. Readers are encouraged to keep abreast of developments in the IASB project.

Appendix A – Step-by-step guide to applying Statement 167



Note: All paragraph references are to FIN 46(R), as amended by Statement 167

1. Consider the risks the entity was designed to create and distribute and whether the instrument absorbs that variability.

2. Including other GAAP consolidation guidance.

3. A silo is not to be treated as a separate entity for purposes of applying Statement 167 unless the host entity is a VIE.

4. The primary beneficiary should consolidate the VIE. Other holders of variable interests should make the disclosures required by paragraphs 22B-26 of FIN 46(R), as amended by Statement 167.

Appendix B – Statement 167 disclosure provisions

Excerpt from FIN 46(R), as amended by Statement 167

Disclosure

22B. 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 to the enterprise. The disclosures shall be presented in a manner that clearly explains to financial statements 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 shall also 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 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 that is not a business shall disclose the amount of any gain or loss recognized on the initial consolidation of the variable interest entity.
- 23A. In addition to the 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 interest 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. 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 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.
 - 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 explicit arrangement and implicit variable interests, that could require 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 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. 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:
- 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 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.

^{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} See footnote 16c.

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