

Technical Line

Technical guidance on standards
and practice issues

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

Appendix C: Frequently asked questions on Statement 167

Contents

Overview	1
Appendix C – FAQs	C-1
Amendments.....	C-1
Fees paid to decision makers or service providers.....	C-1
VIE determination	C-3
Primary beneficiary determination	C-7
Related party provisions.....	C-16
Reconsideration events	C-16
Other	C-17
Separate presentation	C-17
Consideration of substantive terms, transactions and arrangements	C-18
Transition.....	C-20
Recognition	C-20
Measurement (carrying amounts)	C-21
Measurement – consolidation practicability exception.....	C-24
Retrospective application	C-24

Overview

On 12 June 2009, the Financial Accounting Standards Board (FASB) issued Statement 167,¹ which amends certain of the key provisions of FIN 46(R).² Statement 167 responds to certain concerns about the application of FIN 46(R), such as the complexity involved with determining the primary beneficiary, and concern over the lack of transparency of enterprises' involvement with off balance sheet structures. Statement 167, among other things, requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE and amends certain guidance for determining whether an entity is a VIE. In addition, Statement 167 amends the criteria for determining whether fees paid to a decision maker and other service providers are variable interests and requires enhanced disclosures about an enterprise's involvement with a VIE. Statement 167 is effective for enterprises in fiscal years beginning after 15 November 2009.

The attached Appendix serves as a supplement to our previously issued interpretative guidance in the Technical Line, *FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)* (No. 2009-15) and should be read in connection with that publication. The Appendix provides implementation guidance in the form of frequently asked questions (FAQs) and reflects our current understanding of Statement 167's provisions. It is important to note that on 11 November 2009, the FASB voted to expose for comment an amendment that would defer the application of Statement 167 to a limited number of entities (principally mutual funds, private equity and hedge funds) and provide additional

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

² FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51

guidance on fees paid to decision makers and service providers.³ Based upon the FASB's recent actions, we encourage readers to closely monitor the FASB's activities for additional developments with respect to Statement 167.

Further, we anticipate issuing additional interpretative guidance in the future in response to implementation issues as they arise. We encourage affected enterprises to read these FAQs carefully and consider the potential effects that the amendments to FIN 46(R) could have on their consolidation analysis.

³ Refer to our Hot Topic dated 11 November 2009, FASB proposes to defer Statement 167 for asset management funds(HT No. 2009-46)

Appendix C – FAQs

Amendments

Fees paid to decision makers or service providers

On 11 November 2009, the FASB discussed its project to address concerns with the application of Statement 167 to reporting enterprises in the asset management industry. As written, Statement 167 may result in asset managers consolidating many hedge funds, private equity funds and other investment funds that they manage due to Statement 167's provisions with respect to fees paid to decision makers. At the meeting, the FASB voted to expose for comment an amendment that would defer the application of Statement 167 for a limited number of entities (principally mutual funds, private equity and hedge funds) until the completion of the joint FASB/IASB project on consolidation accounting. The FASB intends for the deferral to apply only in instances in which certain conditions are met (Refer to our Hot Topic dated 11 November 2009, *FASB proposes to defer Statement 167 for asset management funds* (HT 2009-46), for additional information.

In addition, the FASB voted to amend certain of Statement 167's provisions for assessing whether fees paid to a decision maker or service provider are variable interests. These amendments would apply to entities that would not be subject to the proposed deferral. As a result, preparers of financial statements should closely monitor FASB activities for additional developments with respect to the deferral and potential amendments to provisions regarding fees paid to decision makers or service providers.

#1 Evaluation of "same level of seniority as other operating liabilities of the entity"

Question:

In paragraph B22(b), what is the meaning of the "same level of seniority as other operating liabilities of the entity"?

Response:

Fees paid to an entity's decision maker(s) or service provider(s) are not variable interests in an entity if, among other things, "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." We believe that this provision is referring to the priority of the decision maker's or service provider's claim on the entity's assets after the fee is calculated and is payable. Therefore, we do not believe that the mere fact that a performance fee is determined based on a defined performance metric violates this provision. However, if the performance fee, once calculated, is contractually subordinate in payment priority to other liabilities (e.g., trade payables) of the entity, the fee would constitute a variable interest. The enterprise must carefully evaluate the individual facts and circumstances when evaluating the seniority of a fee payable.

To illustrate, assume that a servicer in a collateralized loan obligation (CLO) arrangement receives both a fixed fee and a performance fee for the services that it provides. While the fixed fee is *pari passu* to senior debt and other operating payables with respect to priority of claim, the performance fee ranks subordinate to the senior debt and other operating payables. In this instance, the enterprise must evaluate whether the fixed fee represents "substantially all" the fees that will be received in the fee arrangement. If not, the servicing fee would be deemed a variable interest pursuant to paragraph B22(b).

To further illustrate, assume that a decision maker of an operating entity receives a performance fee that is calculated as a percentage of operating income (prior to consideration of the performance fee). In arriving at operating income, the entity deducts all operating expenses including salaries, utility expenses and repairs and maintenance. While the performance fee is calculated after all operating expenses have been deducted from sales, the calculated performance fee ranks *pari passu* with other operating payables in the entity with respect to priority of claim. As a result, the performance fee does not violate the provision of paragraph B22(b).

#2 Estimating an entity's "anticipated economic performance"

Question:

How should an enterprise estimate an entity's "anticipated economic performance"? What are the most appropriate performance metrics to consider when measuring anticipated economic performance (sales, operating margin, net income or some other metric)?

Response:

In making the determination of whether fees paid to an entity's decision maker(s) or service provider(s) represent a variable interest, paragraphs B22(e) and (f) require an evaluation of an entity's "anticipated economic performance." However, Statement 167 does not provide examples or detailed implementation guidance regarding this concept. In evaluating anticipated economic performance, we believe that it is important to consider the purpose and design of the entity. In addition, because these provisions refer to *anticipated* economic performance, we believe that an entity's anticipated economic performance likely will be measured by considering probabilistic (i.e., probability-weighted) outcomes over the life of the entity. That is, anticipated economic performance should reflect expectations rather than emphasize current performance or economic conditions. For example, when considering the anticipated economic performance of a CLO, one might consider the historical returns for similar CLOs over the life of the enterprise or over the anticipated life cycle of the CLO. Thus, we believe that short-term market conditions may not be relevant when considering an entity with a long-term performance horizon if those conditions are not consistent with the long-term outlook and purpose and design of the entity at inception or upon an enterprise's involvement with the entity.

We believe that a determination of the metrics to be used to measure anticipated economic performance will require a careful consideration of entity's purpose and design. We also believe that performance metrics that are closely monitored by an entity's investors often will provide insight into metrics to be considered for this purpose. Therefore, we believe that the metrics used to measure economic performance will likely vary by entity. In addition, we believe that it may be relevant for an enterprise to consider multiple metrics in this evaluation.

To illustrate, oftentimes a servicer receives a fee that is a fixed percentage of the unpaid principal balance on the underlying assets. However, for many securitization trusts, we would expect investors to look to the return of the trust or their beneficial interests to evaluate the trust's economic performance, which is a different metric than that used to calculate the fees due to the servicer. As such, the fee is only indirectly related to performance (i.e., the fee is related to the unpaid principal balance on the underlying assets and not to the total return of the trust or of the beneficial interests). Therefore, it may be appropriate for a servicer to consider this indirect relationship of its fees to the entity's performance as a factor when evaluating whether its fee is insignificant in relation to the "anticipated economic performance" of the entity. That is, because the fee is not calculated based on economic performance of the entity, it may be less likely that the fee will be considered significant compared to the anticipated performance of the entity.

#3 Consideration of a decision maker that does not hold a variable interest

Question:

Assume that the power to direct the activities of the entity that most significantly impact the entity's economic performance ("power") is held by a decision maker through its fee arrangement. Also, assume that the fees do not constitute a variable interest under paragraph B22. Is the decision maker required to evaluate whether the power held through its fee arrangement may cause it to be the primary beneficiary?

Response:

No. If a decision maker concludes that its fee arrangement does not constitute a variable interest in an entity after evaluating the provisions of paragraph B22 and considering any other interests in the entity, we believe that the decision maker is not required to evaluate the provisions of Statement 167 further to account for its interest. This includes determining whether the decision maker is the primary beneficiary of the entity and whether the decision maker is subject to the disclosure provisions of Statement 167.

In the Basis for Conclusions to Statement 167, the FASB indicated the following:

The Board also concluded that the revised guidance for determining whether decision maker fees and service provider fees represent a variable interest in a variable interest entity in paragraphs B22 and B23 of Interpretation 46(R), as amended by this Statement, is sufficient for determining whether an enterprise is acting in a fiduciary role in a variable interest entity, particularly because the Board removed the consideration of kick-out rights and cancellation provisions from those paragraphs. In other words, the Board expects that the fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a variable interest entity because those fees would typically meet the conditions in paragraph B22 of Interpretation 46(R), as amended by this Statement. If an enterprise's fee did not meet those conditions, the Board reasoned that an enterprise is not solely acting in a fiduciary role. If the enterprise has (a) the power to direct the activities that most significantly impact the economic performance of the entity and (b) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the variable interest entity, that enterprise would be the primary beneficiary of the entity. The Board observed that the conditions in paragraph B22 would allow an enterprise to hold another variable interest in the entity that would absorb an insignificant amount of the entity's expected losses or receive an insignificant amount of the entity's expected returns. **The Board concluded that an enterprise holding such an interest would still be acting in a fiduciary role as long as the other conditions in paragraph B22 were met and that enterprise would not be the primary beneficiary of the entity. [emphasis added]**

Based on the above, we believe that it is clear that fees paid to a decision maker that meet the criteria in paragraph B22 to not be considered a variable interest indicate that the decision maker is acting as a fiduciary rather than as a principal to the arrangement. Thus, a fiduciary (or agent) who acts on behalf of principal investors would not be the primary beneficiary. We also note that paragraph 5(b)(1) indicates that a decision maker does not prevent the equity holders from having the power unless the fees paid to the decision maker represent a variable interest based on paragraphs B22 and B23.

Statement 167 also indicates that "[a]n enterprise shall consolidate a variable interest entity when **that enterprise has a variable interest that provides the enterprise with a controlling financial interest** [emphasis added] on the basis of the provisions in paragraphs 14A-14G." Therefore, we do not believe that the "power" criterion would be met through an interest that has been deemed not to be a variable interest. It is possible that a decision maker's fees may not be considered a variable interest but the decision maker has another variable interest (e.g., a small equity interest). In that circumstance, the power held through the fee arrangement should not be considered in the evaluation of whether the enterprise is the primary beneficiary of the VIE. Of course, if the other variable interest were significant, the requirements of paragraph B22 would not be satisfied and the decision-maker would be the primary beneficiary.

VIE determination**#4 Holders of the equity investment at risk must make substantive decisions****Question:**

What types of decisions should the holders of the equity investment at risk have the ability to make through their voting rights to satisfy paragraph 5(b)(1)?

Response:

For an entity to be a voting interest entity, the holders of the equity investment at risk, as a group, must have the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance ("power"). We believe the power held by the holders of the equity investment at risk, as a group, cannot be limited to administrative functions. Rather, those powers must enable the equity holders to make substantive decisions.

Decisions are substantive when they most significantly affect the economic performance of the entity (e.g., revenues, expenses, gains and losses or financial position of the entity). Examples of substantive decisions that affect economic performance may include the ability to purchase or sell significant assets, enter into new lines of business, incur significant additional indebtedness, etc. We believe that the assessment of power in evaluating whether an entity is a VIE generally should be consistent with the assessment of power when determining the primary beneficiary of a VIE. That is, we believe that the identified activities that most significantly impact an entity's economic performance would be the same for the purposes of the VIE determination (paragraph 5(b)(1)) and the determination of the primary beneficiary.

Additionally, when considering all facts and circumstances, enterprises should consider the extent to which the holders of an entity's at-risk equity investment absorb expected losses and receive expected residual returns of the entity. Generally, the ability to make decisions that have a significant impact on the success of the entity becomes increasingly important to the at-risk equity group as the amount of their investment increases. The greater the amount of the at-risk equity investment as compared to the expected losses of the entity, the less likely it is that the holders of the investment would be willing to give up the ability to make decisions consistent with their interests or permit others to make decisions counter to their interests.

Determining whether, as a group, the holders of the equity investment at risk have the power will be based on the applicable facts and circumstances and will require the use of professional judgment.

#5 Participation in decision making by holders of interests that are not equity investments at risk**Question:**

Is an entity a VIE pursuant to 5(b)(1) if a holder of a variable interest that is not an equity investment at risk substantively participates in decision-making?

Response:

Yes. The requirement for the equity investors, as a group, to have the ability to make decisions would not be met if a party (including its related parties and de facto agents) other than a holder of an equity investment at risk has participating rights (as defined by paragraph 14C). In situations in which a single party other than at-risk equity holders has the right to make or participate in decisions, emphasis should be placed on the ability of the participating party to block the actions through which at-risk equity holders may exercise power. Paragraph 5(b)(1) may not be violated, however, if the participating rights are held collectively by multiple, unrelated parties that are not at-risk equity holders. Refer to FAQ #7 for further discussion of participating rights.

A holder of an interest that is not an equity investment at risk may hold protective rights (such as a lender through debt covenants) without paragraph 5(b)(1) being violated.

The following examples illustrate the consideration of participating rights:

Example 1

Facts

Assume that three unrelated enterprises (Enterprises A, B, and C) form an LLC. Enterprise A has a 60% equity ownership in the venture, and Enterprises B and C each hold a 20% equity ownership. However, Enterprises B and C can both put their equity interests to Enterprise A at the end of five years for an amount equal to their original equity investment. Enterprise A makes all decisions. However, Enterprise B has the ability to block Enterprise A's decisions.

Analysis

In this fact pattern, Enterprises B and C are not holders of an equity investment at risk because their ability to put their interests to Enterprise A at the end of five years protects them from having to significantly participate in the losses of the LLC. Enterprise A cannot unilaterally make decisions about the entity's activities because Enterprise B has participating rights. Because Enterprise B (holder of an equity investment that is not at risk) has the unilateral ability to exercise the participating rights, the entity is a VIE.

Example 2

Facts

Assume the same facts as Example 1. However, in order to block Enterprise A's decisions, Enterprises B and C must both agree to do so.

Analysis

Because two parties must agree to exercise the participating rights, the entity is not a VIE pursuant to paragraph 5(b)(1).

#6 Effect of decision makers or service providers when evaluating paragraph 5(b)(1)

Question:

If a decision maker or service provider holds a variable interest in an entity separate from an equity investment at risk, do the holders of the equity investment at risk have the power to direct the activities of the entity that most significantly impact the entity's economic performance ("power")? What if the holders of the equity investment at risk have kick-out rights or other rights that allow them to make decisions affecting the entity?

Response:

Determining whether an entity is a VIE because it has a decision maker or service provider through an interest separate from an equity investment at risk should be based on the applicable facts and circumstances.

In particular, it is important to determine whether the decision maker or service provider has a variable interest based upon an evaluation of the criteria in paragraph B22. This analysis focuses on whether the decision maker or service provider is acting in a fiduciary capacity (i.e., as an agent of the equity holders) or as a principal to the transaction. Paragraph 5(b)(1) indicates if an interest other than an equity investment at risk provides the holder of that interest with decision-making ability, but the interest does not represent a variable interest (e.g., the decision maker's or service provider's fee does not constitute a variable interest based on the guidance in paragraph B22), then the criterion in 5(b)(1) is not violated. The FASB believed that such a decision maker or service provider could never be the primary beneficiary of a VIE as it does not hold a variable interest.

Often in the circumstances in which it is determined that a decision maker has a variable interest, the entity will be a VIE as a result of the decision maker receiving power or participating rights through their fee arrangements (rather than through an

equity investment at risk). In making this determination, the nature of the rights held by the holders of the equity investment at risk (i.e., kick-out rights or liquidation rights) should be considered when a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those rights. Refer to FAQ #7 for further discussion on kick-out rights and liquidation rights.

#7 Consideration of kick-out rights and participating rights

Question:

How should an enterprise consider kick-out rights and participating rights when evaluating the provisions of paragraph 5(b)(1)?

Response:

When evaluating paragraph 5(b)(1), kick-out rights⁴ and participating 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.

Under EITFs 96-16 and 04-5, kick-out rights and participating 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 has acknowledged the inconsistency between Statement 167 and the guidance in EITFs 96-16 and 04-5. In arriving at its conclusion, the FASB was concerned with potential structuring opportunities and ultimately reasoned that kick-out rights are rarely exercised in practice. Therefore, these rights should not be considered in determining whether an entity is a VIE, and if so, which enterprise, if any, is the primary beneficiary, unless held by one party. 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 VIE determination 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.

While Statement 167 defines kick-out rights, 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 are subject to conditions that make it unlikely they will be exercisable (e.g., conditions that narrowly limit the timing of the exercise)
- ▶ Financial penalties or operational barriers associated with replacing the decision maker 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

⁴ Consistent with the guidance in EITF 04-5, we believe that, for the purpose of applying the provisions of Statement 167, kick-out rights encompass liquidation rights. Refer to FAQ #22 for a further discussion on liquidation rights

#8 Performing the primary beneficiary assessment prior to the VIE determination

Question:

If an enterprise determines that it would not be the primary beneficiary of an entity whether or not the entity was a VIE, must the enterprise still make the VIE determination?

Response:

Yes. Statement 167 requires certain disclosures for an enterprise that holds a variable interest in a VIE but is not the VIE's primary beneficiary. Thus, the determination of whether or not an entity is a VIE is necessary for disclosure purposes. However, if the entity is not within the scope of Statement 167, no further analysis is required.

Primary beneficiary determination

#9 Consideration of both the power and benefits criterion

Question:

In determining which party is the primary beneficiary of a VIE, must the primary beneficiary meet both of the criterion in paragraph 14A (i.e., power and benefits)?

Response:

Yes. An enterprise has a controlling financial interest in a VIE only if it has both of the following characteristics:

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

While the primary beneficiary must have both power and benefits, the primary beneficiary need not have both the obligation to absorb losses and the right to receive benefits. Either the obligation to absorb losses or the right to receive benefits constitutes benefits. For example, if an enterprise has power and has provided a significant guarantee on assets or obligations of the VIE, it is the primary beneficiary even though it may not be entitled to receive any "upside." Similarly, if an enterprise has power and has the right to receive "upside" but has no obligation to absorb losses, it is the primary beneficiary.

#10 Concept of "could potentially be significant" in the determination of the primary beneficiary

Question:

How should an enterprise evaluate "could potentially be significant" in the determination of whether an enterprise has benefits in the primary beneficiary assessment?

Response:

We believe that the assessment of significance as part of the primary beneficiary determination contemplates possible outcomes. In other words, we believe that a consideration of the likelihood or probability of the outcome generally is not relevant for this assessment. The FASB's use of the phrase "could potentially be significant" implies that the threshold is not "what would happen," but "what could happen." Accordingly, an enterprise would meet the "benefits" criterion if it could absorb significant losses or benefits, even if the events that would lead to such losses or benefits are not expected.

#11 Multiple primary beneficiaries

Question:

Can a VIE have more than one primary beneficiary?

Response:

No. Paragraph 14A states that “[o]nly 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.” While more than one enterprise could meet the benefits criterion, only one enterprise can have the power.

Given that more than one enterprise may evaluate a VIE for consolidation, it is possible that different enterprises may make different judgments when identifying the primary beneficiary. The FASB has acknowledged that inconsistent application of Statement 167 among parties with interests in the same entity could result. However, as noted in the Basis for Conclusions to Statement 167, “the Board believes that if (a) the information used in the assessment is complete and accurate and (b) the analyses of the pertinent factors and characteristics of both the variable interests and the variable interest entity are performed using sound judgment, then the risk of inconsistency should be mitigated to an acceptable level.”

#12 Effect of the variable interest determination on the primary beneficiary analysis

Question:

Must the primary beneficiary of a VIE have a variable interest in the VIE?

Response:

Yes. Paragraph 14 indicates that “[a]n 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” [emphasis added]. Additionally, Statement 167’s Basis for Conclusions states that “...a party cannot be the primary beneficiary of an entity if that party does not hold a variable interest in the entity.” Therefore, if an enterprise concludes that it does not have a variable interest in an 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.

Additionally, we believe that for purposes of the primary beneficiary determination, an enterprise must receive power and benefits through a variable interest or a combination of variable interests. If for example, an enterprise has power, but its power does not come through a variable interest (e.g., a decision maker fee that does not meet the criteria in paragraphs B22 and B23 to be a variable interest), then the enterprise would conclude that it is not the primary beneficiary. Refer to FAQ #3 for further discussion.

#13 Entities with no substantive decision-making

Question:

Are there entities for which there is no substantive decision-making?

Response:

We believe that there are few structures that provide for no substantive decision-making. That is, we believe that virtually all entities have some level of decision-making and that few, if any, are on “auto-pilot.” However, entities with limited decision-making require additional scrutiny to determine which party has the power. In doing so, careful consideration is required regarding the purpose and design of the entity. In addition, the evaluation of power may require an analysis of the decisions made at inception of the entity, including a review of the entity’s governing documents, as the activities at formation may affect the determination of 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 was established and directed.

For entities with limited decision-making, the following considerations may be relevant:

- ▶ An enterprise’s ability to direct the activities of a VIE only when specific circumstances arise or events occur may constitute power if that ability relates to the activities that most significantly impact the economic performance of the VIE. Refer to FAQ #18 for an example of power when circumstances arise or events happen
- ▶ An enterprise does not actively have to exercise its power in order to have power to direct the activities of an entity
- ▶ Involvement in the design of 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
- ▶ The magnitude of the disproportionality, if any, between an enterprise’s obligation to absorb losses or its right to receive benefits compared to its stated power—the greater the enterprise’s obligation to absorb losses or receive benefits, the more likely that it would be incented to have the power over the enterprise. Accordingly, a conclusion that an entity with the obligation to absorb significant losses or the right to receive significant benefits does not have power should be evaluated carefully.

#14 Consideration of related parties in the primary beneficiary determination

Question:

How should related parties and de facto agents be considered in determining which party is the primary beneficiary?

Response:

In evaluating whether an enterprise is the primary beneficiary of a VIE, an enterprise first determines whether it has power and benefits. If the enterprise meets the requirements to be the primary beneficiary under the power and benefits criteria, the enterprise does not evaluate Statement 167’s related party provisions (i.e., paragraph 17) further.

However, if an enterprise concludes that no party alone has power and benefits, but, as a group, the enterprise and its related parties (including de facto agents) have those characteristics, an enterprise then considers Statement 167’s related party provisions in determining the primary beneficiary. In that circumstance, the member of the related party group that is most closely associated with the VIE is the primary beneficiary.

#15 Relationship of the assessment of power in the VIE determination vs. the primary beneficiary determination

Question:

Are the activities that most significantly impact the economic performance in the assessment of power in the VIE determination the same as those in the assessment of power in the primary beneficiary determination?

Response:

Yes. Statement 167 requires that, as a group, the holders of the equity investment at risk have the power to direct the activities of an entity that most significantly impact the entity's economic performance. Otherwise, the entity is a VIE. Likewise, when evaluating whether an enterprise is the primary beneficiary of a VIE, the enterprise also must have the power to direct the activities of an entity that most significantly impact the entity's economic performance. We believe that the identified activities that most significantly impact an entity's economic performance would be the same for the purposes of the VIE determination (paragraph 5(b)(1)) and the determination of the primary beneficiary.

#16 Reconsideration of which party has the power

Question:

As the party with the power to direct the activities of an entity that most significantly impacts the entity's economic performance changes, should an enterprise reconsider which party is the primary beneficiary of the VIE?

Response:

Yes. Statement 167 amended FIN 46(R) to eliminate the primary beneficiary reconsideration concept. Therefore, Statement 167 effectively requires a VIE's primary beneficiary to be evaluated continuously as facts and circumstances change. 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

Refer to FAQ #25 for further discussion of different parties having power over the entity's life cycle.

#17 Power under Statement 167 vs. control for voting interest entities

Question:

Does the power to direct the activities of an entity that most significantly impact the economic success of an entity under Statement 167 equate to "control" for voting interest entities?

Response:

No. While the concepts of power and control have their similarities, we do not believe that the two concepts are necessarily synonymous. Control for voting interest entities generally is based upon whether an enterprise owns more than 50% of the outstanding voting shares of an entity. For other entities such as partnerships, the general partner is presumed to control an entity unless certain rights (i.e., substantive kick-out or participating rights) are held by the limited partners. For voting interest entities, there is not a requirement to identify which decisions are most significant. Rather, there is a rebuttable presumption that the controlling party has the unilateral ability to make all significant decisions.

In determining whether an entity is a VIE, an enterprise must evaluate whether the equity holders, as a group, have the ability to make decisions that most significantly impact the entity's economic performance. Not all activities of an entity will have a significant impact on the economic performance of the entity. This concept requires an enterprise to identify the most significant decisions from the population of all decisions that may affect an entity. As such, we generally believe that power would be based upon the ability to make decisions on a subset of the total activities and decisions made within an entity. Additionally, we believe that the identified activities that most significantly impact an entity's economic performance would be the same for the purposes of the VIE determination (paragraph 5(b)(1)) and the determination of the primary beneficiary.

It is important to note that, for the purpose of determining the primary beneficiary of a VIE, it is possible that an enterprise may be the primary beneficiary of a VIE without having the power to direct *all* activities that most significantly impact economic performance. Paragraph 14E indicates if the power rests with multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then an enterprise should identify which party has the power over the activities that are most significant.

#18 Power when circumstances arise or events happen

Question:

Could you provide an example of power that is based upon the occurrence of circumstances or events?

Response:

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. To assess power, an enterprise must identify which activities most significantly impact the VIE's economic performance. Generally, some subset of the total activities and decisions made within an entity would be considered "significant."

Paragraph 14B indicates that "[a]n 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."

To illustrate, in many receivable securitization structures, the securitization's economic performance is most significantly impacted by the performance of its underlying assets. Generally, the investors are exposed to the credit risk associated with the possible default by the underlying borrowers with respect to principal and interest payments. Therefore, if the purpose and design indicates that the entity's most important activity is to manage the assets when they become delinquent, the enterprise may determine that the party with the ability to manage the entity's assets upon default is the primary beneficiary. The decision-making by the party that has power is subject to the event of default occurring. Notwithstanding the fact that defaults may not yet have occurred and this power has not been exercised, the party that has the current right to make these decisions has the power.

While the provisions of paragraph 14B are applicable to all arrangements, we believe that these provisions may be more relevant to entities in which decision-making is limited.

#19 Power when circumstances arise or events happen vs. protective rights

Question:

How should an enterprise distinguish between power exercisable upon future circumstances and protective rights?

Response:

In certain circumstances, an enterprise's ability to direct the activities of an entity when circumstances arise or events happen may constitute power. However, protective rights (as discussed further below) do not constitute power and do not preclude another enterprise from having power.

To illustrate, assume that a special servicer in a receivable securitization has the ability to manage the entity's assets at the point in time when the receivables become delinquent or are in default. The rights of the special servicer are current rights over decisions that are expected to occur and are necessary for the entity to carry out its purpose and design. Thus, these rights would be relevant in the assessment of which party has the power, and, in many cases, the special servicer will be the primary beneficiary. Alternatively, a lender to the servicing arrangement may have the right to remove the servicer upon the servicer's breach of contract and to take over the servicing responsibilities. This type of right generally would not be viewed as a current right as the servicer's breach of contract most likely would not have been contemplated in the purpose and design of the entity. The right may be included in the arrangement to provide the debt provider with a protective right in the event of an exceptional circumstance. Thus, this protective right should not be considered in the determination of the primary beneficiary of the securitization facility.

In some circumstances, it may be difficult to distinguish between power and protective rights. In these instances, we believe that it will be particularly important to consider the purpose and the design of the VIE. It may be helpful to distinguish between those decision-making rights that relate to activities that are expected to arise for the entity to carry out its purpose and design versus contingent rights that are triggered upon events that arise outside the purpose and design of the entity, or upon an exceptional circumstance. The latter type of contingent rights often may be thought of as protective rights and may result in an enterprise obtaining power should a future event occur, but would not necessarily represent current power.

#20 Consideration of the board of directors when assessing power

Question:

Can a board of directors be viewed as a single enterprise when evaluating whether one party has the unilateral ability to exercise kick-out rights?

Response:

No. We believe that a board of directors acts in fiduciary capacity on behalf of the shareholders (i.e., the board of directors is an extension of the shareholders). Any kick-out right held by a board of directors essentially represents a kick-out right that is held by the shareholders. Therefore, unless one shareholder (and its related parties and de facto agents) has unilateral control over the board of directors, we believe that the kick-out rights held by the board of directors should not be considered when assessing which party is the primary beneficiary. We understand that the FASB staff and SEC staff share this view.

#21 Consolidation through participating rights

Question:

If an enterprise only holds participating rights, can that enterprise be deemed the primary beneficiary of a VIE?

Response:

Generally, no. Participating rights are defined in footnote 15c of Statement 167 as “the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance.” We do not believe that an enterprise’s ability to block actions provides the enterprise with power over those same actions. Thus, an enterprise that only holds participating rights over the decisions that otherwise constitute power would not be the primary beneficiary of a VIE by virtue of the participating rights. However, to the extent that an enterprise has other rights, careful consideration will be required to evaluate the combination of those rights and the participating rights in the primary beneficiary analysis as the enterprise could be considered the primary beneficiary in those circumstances. For example, assume an enterprise identifies the population of decisions that most significantly impact the entity’s economic performance. Assume that the enterprise has participating rights with respect to each of those decisions, except for decisions related to financing and asset transfers for which the enterprise has the unilateral ability to direct. In this scenario, we believe that the enterprise likely would be deemed the primary beneficiary of the entity.

#22 Liquidation rights as kick-out rights

Question:

Should liquidation rights be considered the same as kick-out rights for purposes of evaluating the provisions of Statement 167?

Response:

Generally, yes. Statement 167 does not specifically address an enterprise’s ability to dissolve or liquidate an entity (“liquidation rights”). The guidance in EITF 04-5 for voting interest entities defines kick-out rights and states that “[t]he rights underlying the limited partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners are collectively referred to as kick-out rights.” Thus, we believe that, for the purpose of Statement 167, kick-out rights encompass liquidation rights. We understand that the FASB staff shares a similar view.

#23 Call options as kick-out rights

Question:

In a venture established by two equity investors, should a fixed-priced call option held by one investor to acquire the other investor’s equity interest be considered the same as a kick-out right for purposes of evaluating Statement 167?

Response:

Generally, no. Statement 167 does not specifically address call options. We generally do not believe that a fixed-price call option to acquire another party’s equity interest should be viewed as a kick-out right for purposes of applying Statement 167. That is, we generally believe that the exercise of a call option is an event that would require reconsideration of the primary beneficiary of a VIE. An option generally provides the holder with an economic benefit and not current power. Thus, consistent with this view, we generally do not believe that a call option that is currently exercisable, a contingent call option that is not currently exercisable or a forward contract should be included in the analysis of “power” until an event occurs whereby the enterprise has acquired the rights underlying the equity instrument pursuant to the call option

However, in certain circumstances, the terms and conditions of a fixed-price call option (e.g., option that is deep in the money with little economic outlay required to exercise) may require further consideration to determine whether the substance of the option conveys power to the option holder.

#24 Kick-out right holder as party with the power

Question:

If a single enterprise has the unilateral ability to exercise kick-out rights (or liquidation rights), is that enterprise the party with the power to direct the activities of the VIE that most significantly impact the entity's economic performance?

Response:

Although we believe that the party with unilateral kick-out rights will often be the party with power, this may not necessarily be the case. Paragraph 14C indicates that "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." Determining whether a single enterprise that has the unilateral ability to exercise kick-out rights (or liquidation rights) is the party with the power will require a careful evaluation of facts and circumstances. Considerations that may be relevant in making this determination include the following:

- ▶ Other rights held by the holder of the kick-out rights
- ▶ Whether the holder of the kick-out rights has the ability to appoint the replacement to the party removed (e.g., the majority holder of the controlling interest in a securitization trust)
- ▶ Whether the holder of the liquidation rights receives its relative share of the entity's assets upon liquidation or receives a cash payment

As noted in FAQ #21 in this section, we generally do not believe that participating rights, in and of themselves, constitute power.

#25 Different parties with power over the entity's life cycle

Question:

How should an enterprise evaluate which party is the primary beneficiary of a VIE when, by design, power shifts between parties over the various stages of the entity's life cycle?

Response:

To illustrate, assume that an entity is formed to develop and ultimately manufacture a highly speculative drug candidate. One investor has power over the research and development (R&D) activities. A second investor has power over the drug manufacturing should the R&D activities be successful and should the drug receive FDA approval.

In evaluating which party has the power, an enterprise should carefully consider the entity's purpose and design. In this fact pattern, the entity was designed to develop a drug candidate with the hope of ultimately manufacturing the drug for sale. In assessing which activities most significantly impact the entity's economic performance, it is determined that there are two primary activities - (1) R&D and (2) manufacturing. In this example, we believe that determining which party has the power at the inception of the entity requires a consideration of the probability that the parties involved will have power through the different stages of the entity. For an entity that has different stages, as in the example above, we believe that an enterprise should evaluate the probability of successfully moving from one stage to the next and the nature of the different stages. Additionally, we believe that an enterprise should consider which activities most significantly impact the economic performance of the entity over its remaining life as of the date of the assessment. In this example, we believe that the party with power over the R&D activities is the primary beneficiary at inception. This conclusion is based on the significant uncertainty of the drug ever reaching the manufacturing stage. If the R&D activities are unsuccessful, the manufacturing of

the drug will never occur. We believe that the party with the ability to direct the manufacturing decisions has a current right to obtain power that is contingently exercisable upon completion of the R&D phase. Therefore, as the entity evolves, we believe that the primary beneficiary of the entity may change as characteristics and assumptions with respect to the entity may change. For example, an enterprise may conclude that once FDA approval of the drug candidate is received, the party with power over the entity's manufacturing processes is the primary beneficiary.

For entities in which the power shifts between various stages of the entity's life cycle, the determination of the primary beneficiary will require a careful analysis of the facts and circumstances. We generally believe that the greater the certainty of the completion of a stage, the more likely that an enterprise would look through the stage to other stages of the entity's life cycle or the more likely that an enterprise would discount the importance of that stage in evaluating which party has the power. Also, the length of a particular stage may be a relevant consideration in the primary beneficiary determination. Additionally, an enterprise should carefully evaluate whether rights of certain parties to an arrangement constitute protective rights. However, protective rights do not constitute power.

#26 Evaluating disproportionate power and benefits

Question:

Can the fact that a party has disproportionately greater benefits compared to its stated power be determinative in the primary beneficiary assessment?

Response:

No. As noted in paragraph 14G, the FASB did not intend for the provision addressing disproportionate power and benefits to be 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. In other words, in such circumstances, an enterprise should reevaluate whether all elements of power has been appropriately identified.

#27 Effect of VIE determination "anti-abuse clause" (paragraph 5(c)) on the identification of the primary beneficiary

Question:

If an enterprise concludes that an entity is a VIE pursuant to the "anti-abuse clause" (paragraph 5(c)), does that conclusion affect the primary beneficiary determination?

Response:

To prevent an entity from avoiding consolidation of a VIE by structuring it with non-substantive voting rights, paragraph 5(c) provides that an entity is a VIE when (1) 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 (2) substantially all of the entity's activities either involve or are conducted on behalf of an investor (including the investor's related parties, except its de facto agents under paragraph 16(d)) that has disproportionately few voting rights.

We do not believe that the holders of the equity interests of an entity that meet the criterion of paragraph 5(c) should be presumed to have non-substantive voting rights. As such, determining the primary beneficiary of an entity that is a VIE pursuant to paragraph 5(c) will require a careful examination of all facts and circumstances. In particular, the provisions of paragraph 14G addressing "...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..." should be carefully considered. Additionally, the provisions of paragraph 2A addressing substantive terms, transactions and arrangements should be evaluated.

Under FIN 46(R), the primary beneficiary of an entity that was a VIE as a result of paragraph 5(c)'s provisions was often the party with disproportionately few voting rights. This outcome was due to FIN 46(R)'s quantitative approach for assessing which party was the primary beneficiary. Subsequent to the amendments, the primary beneficiary of a VIE is the party that has (1) the power to direct activities of a VIE that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. Therefore, the party with disproportionately few voting rights may or may not be the primary beneficiary.

Related party provisions

#28 Substantive sale, transfer, or encumbrance restriction that is one-sided

Question:

Would a restriction on the sale, transfer, or encumbrance of an interest that is one-sided constitute a de facto agency relationship?

Response:

Yes. A de facto agency relationship would exist if the substantive sales, transfer, or encumbrance restriction is one-sided (i.e., one party approves a sale, transfer, or encumbrance of another party's interest but is not restricted itself). For example, assume a VIE's variable interest holders consist of Investor A and Investor B. Further assume that Investor A has an agreement with Investor B pursuant to which Investor B is prohibited from selling, transferring, and encumbering its interest in the VIE without Investor A's prior approval. However, Investor A is not restricted by Investor B from selling, transferring, and encumbering its interest in the VIE. Since the restriction is one-sided, a de facto agency relationship exists.

However, a de facto agency relationship does not exist if both the enterprise and the party have an agreement that they cannot sell, transfer, or encumber their interests in an entity without the prior approval and the rights are based on mutually agreed terms entered into by willing, independent parties.

Reconsideration events

#29 Bankruptcy

Question:

Does filing for bankruptcy by an entity constitute a VIE reconsideration event?

Response:

Generally, when an entity files for bankruptcy, the equity holders of the entity as a group lose the power from voting rights or similar rights to direct the activities of the entity that most significantly impact the entity's economic performance. Therefore, subsequent to the amendments to FIN 46(R), we believe that when an entity files for bankruptcy, an enterprise should reconsider whether the entity is a VIE. In most instances, if an entity files for bankruptcy, it would be a VIE due to the lack of sufficient equity at risk, and the equity holders may lose power. In addition, it is typical that once an entity files for bankruptcy, the entity is under the control of the bankruptcy court. Therefore, if the enterprise previously consolidated the entity that filed for bankruptcy under either the voting interest or variable interest model, it is likely that the enterprise will deconsolidate the bankrupt entity as the enterprise will no longer have the power to direct the activities that most significantly impact the entity's economic performance.

#30 Loss of power or similar rights

Question:

Must there be an event for the holders of the equity investment at risk, as a group, to lose the power from voting or similar rights to direct the activities of the entity that most significantly impact the entity's economic performance?

Response:

Often, there is an event that occurs for the holders of the equity investment at risk, as a group, to lose the power to direct the activities of the entity that most significantly impact the entity's economic performance. However, depending on the facts and circumstances, a loss of power or similar rights could occur through a mechanism in an agreement that defines and describes which party has the power and, if so, when that power is obtained. For example, a loan agreement may state that the lender obtains certain rights to manage the activities of the borrower if the collateral's fair value falls below the loan's outstanding principal balance. Upon such an occurrence, if the lender is deemed to have obtained power to direct the activities of the borrower that most significantly impact the borrower's economic performance, then the equity holders no longer have power. However, if the loan agreement merely provides that the lender has the right to foreclose on the borrower upon an event of default, the equity holders' loss of power or similar rights may not occur until the lender exercises its rights to foreclose and actually takes control of the borrower.

Other

Separate presentation

#31 Availability of aggregation principle for separate presentation

Question:

Can an enterprise aggregate amounts in presenting the assets and liabilities of a consolidated VIE that otherwise are required to be presented separately on the statement of financial position?

Response:

For certain enterprises that may consolidate numerous VIEs with assets and liabilities that meet the criteria for separate presentation under paragraph 22A, the presentation of separate line items on an enterprise's statement of financial position related to each VIE may prove impractical. While not discussed with respect to separate presentation, Statement 167's disclosure requirements include an aggregation principle. 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 should 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 both quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the enterprise.

For example, consider a circumstance in which an enterprise is required to consolidate three VIEs (VIE 1, VIE 2 and VIE 3). Each of those VIEs has accounts receivable, investments and liabilities that meet the separate presentation requirement. The enterprise determines VIEs 1 and 2 are similar under the enterprise's established policy such that the separate assets and liabilities of VIEs 1 and 2 would be eligible for aggregation. In addition, the enterprise determines that separate presentation of those two VIE's assets and liabilities on a combined basis would provide information that is more useful to financial statement users. Accordingly, the enterprise will aggregate the receivables of VIEs 1 and 2, the investments of VIEs 1 and 2, and the liabilities of VIEs 1 and 2, respectively. The receivables, investments and liabilities of VIE 3 will be presented separately from those of the other VIEs.

#32 Separate presentation on a net or a single line item basis

Question:

Is it acceptable to present the net assets of a VIE as a single line item on the statement of financial position?

Assume Enterprise A is the primary beneficiary of VIE 1. Assume that VIE 1's assets and liabilities meet the criteria for separate presentation in the financial statements of Enterprise A. The balance sheet of VIE 1 is as follows:

Assets

Cash	\$100
Accounts receivable	200
PP&E - net	<u>300</u>
Total assets	<u>\$600</u>

Liabilities and equity

Accounts Payable	\$150
Long Term Debt	400
Equity	<u>50</u>
Total liabilities and equity	<u>\$600</u>

Can Enterprise A report VIE 1's assets and liabilities in its consolidated financial statements at its net asset value of \$50? Alternatively, can Enterprise A aggregate VIE 1's assets and liabilities separately and present its total assets at \$600 and its total liabilities at \$550?

Response:

No. 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. While we believe that aggregation of similar assets and liabilities of consolidated VIEs may be appropriate (as discussed in FAQ #1 in this section), we do not believe that a net presentation for a VIE's assets and liabilities as one line item would be acceptable. As such, Enterprise A should not present VIE 1's assets and liabilities as a single line item in its financial statements at \$50. In addition, we believe that presenting VIE 1's aggregate assets and aggregate liabilities as suggested above (\$600 and \$550, respectively) also is inconsistent with the separate presentation requirements in paragraph 22A.

As noted above, Statement 167 does not provide detailed implementation guidance with respect to separate presentation. As a result, enterprises may choose different approaches to satisfy the separate presentation requirements. Using the above example, Enterprise A may choose to present a separate line item for accounts receivable for VIE 1 or it may choose to include the receivables of VIE 1 within its consolidated accounts receivable amount and parenthetically disclose the accounts receivable for VIE 1. Other presentation alternatives may be acceptable.

Consideration of substantive terms, transactions and arrangements

#33 Evaluation of changes in terms, transactions and arrangements prior to the adoption of Statement 167

Question:

How should an enterprise evaluate changes in terms, transactions and arrangements for entities for which they are already involved that occur subsequent to the issuance, but prior to the effective date, of Statement 167?

Response:

For purposes of evaluating the provisions of paragraph 2A, only changes in terms, transactions and arrangements that have a substantive effect on the consolidation analysis (e.g., an entity's status as a VIE, the determination of the primary beneficiary of a VIE) are required to be considered.

In evaluating whether changes in terms, transactions and arrangements are substantive, and therefore should have an effect on the Statement 167 analysis, careful consideration should be given to changes that occur to existing arrangements prior to Statement 167's effective date. 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. Thus, we believe that, in certain circumstances, significant professional judgment will be required to determine whether changes to terms, transactions and arrangements are substantive and, therefore, are necessarily considered in applying the provisions of Statement 167.

In evaluating the substance of the changes, we believe that it is appropriate to consider, among other things, the entity's original purpose and design and the business rationale for the changes. In particular, the business purpose of the change to a transaction or arrangement should be analyzed when alternative arrangements or transactions typically are used with respect to involvement in an entity. For example, changes made to the structure of an arrangement to conform the arrangement to other similar arrangements that the enterprise is involved in may be relevant in concluding that a change is substantive. Alternatively, changes made to a particular arrangement that deviate from an enterprise's traditional involvement may call into question the substance of the particular change.

In many circumstances, the underlying economics that accompany a change will be an important consideration. We generally believe that substantive changes to terms, transactions and arrangements will have an economic consequence to the parties involved. For example, assume that party A has a variable interest and would have the power to direct the activities of a VIE that most significantly impact the entity's economic performance over a VIE under Statement 167. Assume that leading up to the adoption of Statement 167, the arrangements between the parties involved with the VIE are altered such that party B is provided with the unilateral ability to remove party A as the party with the power. Thus, under Statement 167, party A would no longer have power. Also, assume that party A received no substantive compensation as part of party B obtaining the kick-out rights. Under this scenario, the arrangements should be carefully analyzed to ensure that the change is substantive. The fact that party A received no compensation for giving up its rights to control the VIE may raise questions as to whether the changes to arrangements were substantive.

#34 Consideration of the substance of existing terms, transactions and arrangements upon the adoption of Statement 167

Question:

Is an enterprise required to evaluate the provisions of paragraph 2A for an entity that the enterprise previously has been involved with and for which there has not been any changes in the terms, transactions, or arrangements?

Response:

Yes. Under the transition provisions of Statement 167, an enterprise is required to evaluate the effects of Statement 167 on historical consolidation conclusions as if Statement 167's requirements have always been effective. Thus, an enterprise should consider the provisions of paragraph 2A on historical terms, transactions and arrangements in making this assessment.

Statement 167 does not provide detailed implementation guidance or examples of the evaluation that enterprises should make when determining whether terms, transactions, or arrangements are substantive. We believe that enterprises should consider, among other things, the entity's original purpose and design and the business rationale for existing structures. Under the provisions of Statement 167, we note that the form of a transaction is often an important consideration in arriving at an

accounting conclusion. While form is important in the accounting analysis, the form of a transaction and its related attributes often drive the economics attributable to an entity's variable interest holders. One such example is the importance of form in establishing the tax status and related attributes of an interest in an entity. As such, when evaluating the provisions of paragraph 2A, we believe that a comparison of the terms, transactions and arrangements to the enterprise's involvement in similar entities and a comparison to the typical involvement that other enterprises may have in similar entities may provide an indication as to the substance of an existing arrangement. For example, if a particular arrangement is consistent with an enterprise's typical involvement in and structure of an entity (or the traditional form of the arrangement for similar entities), it may provide an indication that the terms, transactions, or arrangements are substantive. Significant professional judgment will be required when evaluating whether terms, transactions and arrangements are substantive and would therefore be considered in applying the provisions of Statement 167.

Notwithstanding the requirements of paragraph 2A, we believe that the primary intent of the FASB in including paragraph 2A in the amendments to FIN 46(R) was its concern with respect to potential structuring opportunities that certain enterprises may have contemplated to avoid an anticipated accounting consequence upon adoption of Statement 167 (e.g., consolidation of a previously nonconsolidated entity). While Statement 167's amendments introduce an explicit requirement to consider the substance of terms, transactions and arrangements in evaluating consolidation conclusions, we believe that a consideration of substance was implicitly required in evaluating the business purpose of an enterprise's involvement with a particular entity and, ultimately, the accounting conclusions prior to Statement 167's amendments. As a result, we generally would not expect that the provisions of paragraph 2A would necessitate a change to a prior consolidation conclusion under Statement 167, as non-substantive terms, transactions, or arrangements, likely were not determinative in an enterprise's previous consolidation conclusion with respect to involvement in an entity.

Transition

Recognition

#35 Transition for an enterprise that is not the primary beneficiary on the adoption date but would have been in prior periods presented if Statement 167 had applied

Question:

Assume Company C, which has a calendar year-end, determines pursuant to Statement 167 that it would have been the primary beneficiary of a collateralized debt obligation (CDO) when the CDO was created on 31 July 2005. Company C sells its only variable interest in the CDO on 1 December 2009 and concludes that it would no longer be the CDO's primary beneficiary if Statement 167 were adopted. No other events triggering reconsideration have occurred.

Even though Company C is not the primary beneficiary of the CDO on the date of adoption, since it would have been the primary beneficiary of the CDO under Statement 167 during the years for which the financial statements are presented, does Company C have to apply the transition provisions of Statement 167 to the CDO?

Response:

No. Upon adoption of Statement 167 on 1 January 2010, Company C would not consolidate the CDO as it was not the primary beneficiary on 31 December 2009 under Statement 167 (it would have deconsolidated the CDO under Statement 167 at the time it sold its interest). However, if Company C were to elect to retrospectively apply the provisions of Statement 167, it would consolidate the CDO in the financial statements until the sale of its interest.

Measurement (carrying amounts)

#36 Effect of prior period VIE reconsideration events on initial measurement

Question:

How do VIE reconsideration events affect the initial measurement of a VIE upon adoption of Statement 167?

Response:

Consider the following example:

Under Statement 167, Company A would have been the primary beneficiary of a VIE from inception on 1 January 2005. On 31 July 2008, an event occurred that would have required a reconsideration of the status of the entity as a VIE. After reconsideration, the entity is a VIE and Company A remains the primary beneficiary.

In accordance with the transition provisions of Statement 167, the determinations of whether an entity is a VIE and which enterprise, if any, is a VIE's primary beneficiary is made as of (a) the date the enterprise became involved with the entity or (b) if a reconsideration has occurred that would change the determination of whether the entity is a VIE or the enterprise is the primary beneficiary, at the most recent reconsideration date.

Assuming that the entity is a VIE, and Company A is the primary beneficiary under Statement 167, Company A would not adjust the measurement of any of VIE's assets, liabilities or noncontrolling interests as a result of the reconsideration event (i.e., in this scenario, the reconsideration event does not affect the measurement of assets, liabilities and noncontrolling interests previously recognized).

Assume now that certain events occurred that would have required reconsideration of the entity's VIE status on 1 May 2006 and on 1 August 2008 under Statement 167. Pursuant to Statement 167, the VIE would have been deconsolidated as of 1 May 2006 and then consolidated as of 1 August 2008. In this scenario, the determination of the carrying amounts upon adoption of Statement 167 would be made starting with the reconsolidation on 1 August 2008. Company A initially measures the VIE's assets, liabilities and noncontrolling interests as of 1 August 2008 and rolls them forward to 1 January 2010 to determine the carrying amounts upon adoption of Statement 167. The fact that Company A was the primary beneficiary prior to 1 May 2006 does not affect the requirement for Company A to initially measure the VIE's assets, liabilities and noncontrolling interests as of 1 August 2008 for the purpose of determining the carrying amounts upon adoption of Statement 167.

#37 Determining fair value in arriving at carrying amounts upon transition

Question:

Should an enterprise use the concepts in Statement 141(R), Statement 141 or fair value (with no exceptions) for purposes of the initial measurement that is rolled forward to arrive at carrying amounts upon transition?

Response:

Statement 167 does not provide detailed implementation guidance on the determination of the initial measurement in computing carrying amounts upon adoption. We note that paragraphs 18-21 of 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 141(R) if the VIE is a business; or
- ▶ Pursuant to 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 (i.e., no gain or loss is recorded by the transferor)

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 could be prior to the effective date of Statement 141(R). We note that prior to the incorporation of Statement 141(R)'s provisions, FIN 46(R) required initial measurement of assets, liabilities and noncontrolling interests at fair value. As such, we believe an approach to initially measure assets, liabilities and noncontrolling interests at fair value prior to Statement 141(R)'s effective date would be appropriate.

In addition, Statement 167 clearly states that Statement 141(R) should be followed in circumstances in which the basis of initial measurement would be fair value. Therefore, as an alternative, we believe that applying the provisions of Statement 141(R) would be acceptable even if an enterprise would have first met the conditions to be the primary beneficiary under Statement 167 prior to the effective date of Statement 141(R). Given that the measurement approaches in both Statement 141(R) and FIN 46(R)'s original approach to initial measurement are based principally upon fair value, the differences in valuation approaches often will not be significant.

However, we believe the initial measurement of newly recognized assets, liabilities, and noncontrolling interests based upon Statement 141 would be inappropriate since neither FIN 46(R) nor Statement 167 permit the use of Statement 141 as a basis for initial measurement.

#38 Determining initial carrying amounts when involvement precedes the effective date of current accounting standards

Question:

Should Statement 160 (or other accounting standards that may not have been effective when an enterprise first became involved with an entity or no longer met the conditions to be the primary beneficiary) be applied in determining carrying amounts upon transition to Statement 167?

Response:

Statement 167 does not provide detailed implementation guidance on the determination of initial measurement and subsequent accounting in computing carrying amounts upon adoption. Given that an enterprise is required to calculate carrying amounts from the date the enterprise would have first been the primary beneficiary (or from the date the enterprise was no longer the primary beneficiary), initial and subsequent accounting for purposes of determining carrying amounts may occur for periods prior to the effective date of Statement 160. Additionally, certain other accounting standards may not have been effective at the date an enterprise first became involved with an entity or no longer met the conditions to be the primary beneficiary.

We do not believe it was the FASB's intent to require the adoption of accounting standards prior to their effective date in rolling forward the carrying amounts or initial measurement of deconsolidated VIEs. Refer to FAQ #37 for initial measurement for consolidated VIEs. Therefore, we believe that in the circumstances in which an enterprise is required to determine carrying amounts, it should apply new accounting standards in rolling forward carrying amounts from the date at which the new accounting standards would have been effective.

#39 Application of accounting standards that require an assessment of management's intent or application of judgment retrospectively

Question:

How should an enterprise apply accounting standards that require an assessment of management's intent or application of judgment retrospectively in the determination of carrying amounts?

Response:

Statement 167 requires an enterprise upon initial adoption to determine the carrying amounts of the assets, liabilities and noncontrolling interests of a newly consolidated entity, or the carrying amount of an investment in an entity that is no longer consolidated, as if it always had applied the provisions of Statement 167. This requires calculating the initial carrying amounts and subsequent changes in those carrying amounts as if Statement 167 had always been applied. Statement 167 does not provide detailed implementation guidance regarding the determination of subsequent accounting in computing carrying amounts upon adoption. Therefore, application of standards that require judgment or an assessment of management's intent will require careful consideration in rolling forward initial carrying amounts for the purpose of determining the cumulative effect adjustment.

For example, 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. Therefore, the enterprise calculates its initial investment at cost in accordance with the equity method of accounting on 1 January 2005. The enterprise is required to subsequently adjust the initial investment balance in accordance with the equity method of accounting to the date of adoption of Statement 167.

In subsequently adjusting the investment balance in accordance with the equity method of accounting to the date of adoption of Statement 167, an enterprise may encounter circumstances that require judgment. For example, in rolling forward the initial investment balance, the enterprise may be required to evaluate whether the equity-method investment is other-than-temporarily impaired.

An enterprise should carefully evaluate how accounting standards that require judgment or an assessment of management's intent should be applied in the determination of carrying amounts. Those judgments should be based on information that would have been available at the time judgments would have been required. For example, it would be inappropriate to recognize an impairment based solely on subsequent events that could not have been known on the impairment assessment date.

#40 Practicability exception not available for deconsolidation

Question:

Is there a practicability exception available in deconsolidating an entity upon adoption of Statement 167?

Response:

No. Statement 167 does not provide for a practicability exception when an enterprise determines it is required to deconsolidate an entity upon transition to Statement 167. If an enterprise determines it is required to deconsolidate an entity pursuant to Statement 167, the enterprise will measure any retained interest(s) as of the date at which the entity should be deconsolidated as if Statement 167 always had been applied. The interest(s) in the entity must then be rolled forward to the adoption date. Statement 167 does not provide a practicability exception because it is anticipated that an enterprise that was previously consolidating an entity prior to Statement 167 will have the ability to measure the carrying value (as defined by Statement 167) of any retained interest(s) and appropriately roll them forward to the adoption date.

Measurement – consolidation practicability exception

#41 Practicability exception for measurement available on an entity-by-entity basis

Question:

Is the practicability exception with respect to measurement of assets, liabilities and noncontrolling interests available on an entity-by-entity basis?

Response:

Yes. We believe the practicability exception with respect to measurement can be applied on an entity-by-entity basis. For example, assume upon adoption of Statement 167, Company A determines it is required to consolidate three VIEs (VIE 1, VIE 2 and VIE 3) it has not previously consolidated. Company A became involved with VIEs 1, 2 and 3 on 1 January 2006, 1 July 2007 and 15 May 2009, respectively. Company A further concludes that it can determine the carrying amounts for VIE 3 but it is not practicable to do so for VIEs 1 and 2. Under this scenario, Company A will initially measure the assets, liabilities and noncontrolling interests of VIE 3 as of 15 May 2009. Company A would then rollforward to the adoption date the carrying amounts of the assets, liabilities and noncontrolling interests of VIE 3. With respect to VIE 1 and VIE 2, Company A will initially measure the assets, liabilities and noncontrolling interests at fair value at the date of adoption (if the VIEs activities are primarily related to securitizations or other forms of asset-backed financings, refer to FAQ #42). Company A recognizes any differences between the net amounts added to the balance sheet upon initial consolidation and the amount of any previously recognized interests in the newly consolidated VIEs as a cumulative effect adjustment to retained earnings.

#42 Practicability exception for measurement when the activities of the entity are primarily related to securitizations or other forms of asset-backed financings

Question:

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, can an enterprise measure the assets and liabilities of the entity at their unpaid principal balances in all circumstances?

Response:

Before the enterprise can elect to measure the eligible assets, liabilities and noncontrolling interests at their unpaid principal balances, the enterprise needs to first establish that it is not practicable to measure the assets, liabilities and noncontrolling interests of the VIE at their carrying amounts.

It is important to note that 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. In addition, with respect to 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, the primary beneficiary is required to measure such items at fair value.

Retrospective application

#43 Retrospective application when an enterprise no longer consolidates a VIE at the date of adoption

Question:

If an enterprise elects to retrospectively apply Statement 167, should the restatement include all VIEs that the enterprise was the primary beneficiary of during the restated period, even if it was not the primary beneficiary of the VIE at the date of adoption?

Response:

Yes. We believe the restatement should include all VIEs of which the enterprise was the primary beneficiary during the restated period, even if it was not the primary beneficiary of the VIE at the date of adoption. For example, assume Company Y, a calendar year-end company, would have been the primary beneficiary of two VIEs when they were created in 2002 under Statement 167. Company Y determines at 1 January 2010 (the date of adoption) that it is still the primary beneficiary of VIE 1 under Statement 167 but because of the sale of all of its variable interests in VIE 2 on 31 May 2009, it would no longer be VIE 2's primary beneficiary under Statement 167. If Company Y elects to retrospectively apply Statement 167 in previously-issued financial statements with a cumulative effect adjustment at 1 January 2008, Company Y's financial statements should reflect the consolidation of VIE 1 for 2008 and 2009 and VIE 2 through 31 May 2009, the date at which Company Y is no longer the primary beneficiary.

#44 SEC registration requirements following the adoption of Statement 167**Question:**

How should an enterprise consider the SEC registration requirements upon adoption of Statement 167? Specifically, what are the considerations when filing a registration statement on Form S-3 that incorporates the most recent annual report on Form 10-K in addition to financial statements for a subsequent interim period that includes the adoption of Statement 167?

Response:

At the 22 September 2009 SEC Regulations Committee meeting, the SEC staff indicated that if a registrant has elected to adopt Statement 167 retrospectively and has filed interim financial statements for a period that includes the date of adoption, Item 11(b) of Form S-3 would require that registrant to recast its prior period annual financial statements that are incorporated by reference to reflect a material retrospective application of Statement 167. Conversely, if a registrant elects to adopt Statement 167 only on a prospective basis, or if the retrospective application of Statement 167 is not material, its Form S-3 registration statement may incorporate by reference its most recent Form 10-K, which would include its historical annual financial statements for periods prior to the adoption of Statement 167 (assuming that the prior financial statements do not require revision for other purposes). Similar considerations would apply when the financial statements are being incorporated by reference into a Form S-4.

However, we expect the SEC staff to be skeptical of a conclusion that a retrospective application of Statement 167 is not material. Given that retrospective application is not required and generally would require significant effort on the part of the enterprise, we would expect that the SEC staff would presume such a retroactive application is material or the registrant would not have elected to apply Statement 167 retrospectively.

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