

**Consolidation (Including Special Purpose Entities)
Education Session**

**Interpretation 46(R) Consolidation of Variable Interest Entities
(revised December 2003)—an interpretation of ARB No. 51**

**Presentation and discussion led by
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Financial Accounting Standards Board

Discussion of FIN 46(R) with IASB Monday, April 24, 2006

The views expressed in this presentation are my own and do not represent positions of the Financial Accounting Standards Board. Positions of the FASB Board are arrived at only after extensive due process and deliberations.



The Objectives of FIN 46(R)

- Identify situations where determining if one entity has a controlling financial interest in another entity should use as its primary indicator ***something other than voting interests.***
- Identify the primary indicator if it is **NOT** voting interest.
- Set forth the condition [rule] when one entity should consolidate another entity when the primary indicator is **NOT** voting interest.



Situations Where Voting Interest Is **NOT** the Primary Indicator

- Decisions about an entity's activities that have a significant effect on the success of the entity are **NOT** made by the holders of voting interests.
 - Significant activities are predetermined.
 - No voting interests exist.
- The holders of voting interests have not provided sufficient capital to permit the entity to finance its activities without additional financial support.
 - Too little investment by voting interest holders to consider their power to be substantive.
 - Capital at risk is not in equity form.
- FIN 46(R) calls these situations ***Variable Interest Entities (VIEs)***. See paragraph 5 of FIN 46(R).



How to Evaluate VIEs for Consolidation

- If voting interests are not the primary indicator, who is most likely to be “controlling” the VIE?
 - The person(s) whose involvement with the VIE will result in the person(s) being better-off or worse-off seems like a logical answer.
 - This is a form of considering “Risks and Rewards.”
 - FIN 46(R) calls this type of involvement a ***Variable Interest***. See paragraph 2c and its references.



More on Variable Interests

- The terms “Expected Losses and Expected Residual Returns” are used in FIN 46(R) to identify what is meant by **Variable Interest** (Risks and Rewards). FASB constituents are **NOT** familiar with these terms or the idea of thinking about entities in that way.
 - If an investment is made in an entity for a return of 10%, expected losses are returns less than 10% (even if they are still positive); expected residual returns are returns more than 10%.
 - Expected losses/residual returns \neq the most likely net income of a VIE. How do we communicate with the term “Expected” when it means different things to different persons.
- Expected losses/residual returns are also used in the evaluation of whether an entity is a VIE as a way to evaluate the sufficiency of equity capital.



Even More on Variable Interests

- Unfortunately FIN 46(R) uses a number of similar **but** different terms in discussing Expected Losses/Residual Returns.
 - variability
 - variability based on the design of the entity
 - variability in cash flows
 - variability in fair value
 - Notice the terms that are not used: net income or profit/loss.
- Also FIN 46(R) focuses on an **Economic** rather than an **Accounting** analysis of the assets, liabilities, derivatives, contracts, etc., of the entity to determine what creates variability (expected losses/residual returns) and what absorbs that variability. The **Absorbers** are Variable Interest!
- Appendix B and FSP FIN 46(R)-6 attempts to clarify this issue.



The Consolidation [Rule] When Using Variable Interests for Consolidation

- Consolidation is required when one entity has variable interests (or a combination of interests) that will absorb a **Majority** of expected losses, receives a majority of expected residual returns or both.
 - Absorbing losses is the most important condition.
- FIN 46(R) calls the entity that consolidates the VIE the VIE's **Primary Beneficiary**.
- The ED to FIN 46 proposed a lower condition and FIN 46 include a decision-maker bias (the fees were considered a variable interest).
 - FIN 46(R) removed the decision-maker bias and introduced the notion of kick-out rights to separate some fees from variable interests.



Things in FIN 46(R) That Surprise FASB Constituents

- VIEs cover more than SPEs (whatever that means)!
 - Some suppliers, customers, things called Joint Ventures can be VIEs.
- There is not a “mechanical” approach to evaluating an arrangement to see if it is a VIE, or if the reporting entity is a Primary Beneficiary.
- An evaluation without calculation of expected losses/residual returns is many times appropriate.
- A natural person is **NOT** considered an entity.
- Arrangements within an entity (silos) are rarely treated as a VIE.
- An abuse Preventer is included in paragraph 5 that uses the relationship of voting interest to allocation of benefits to identify VIEs.



An Approach to Use in Working with FIN 46(R)

- Is the potential VIE an Entity, or a Silo to be treated like an Entity?
- Does the potential VIE need additional capital or financial support to operate? Look for guarantees, unusual contract terms and expensive debt.
 - If the answer to the above two questions is YES, you have a VIE.
- Why was the entity created and what is it designed to do? What type of ***Variability*** was it designed to create?



An Approach to Use in Working with FIN 46(R) con't

- Assets and operations usually create variability and liabilities and equity are usually variable interests (they absorb/receive the variability). How do contracts and other arrangements and derivatives (things that can be assets or liabilities) work in the design?
 - This exercise should help focus on what Expected Losses/Residual Returns (variability) to focus on.
- Is there a ***Related Party Group*** that is involved with the VIE? FIN 46(R) treats de Facto Agents as part of the Group. It is a bigger Group than SFAS 57 defines as related parties. [Should this be a consideration when using Voting Interest?]



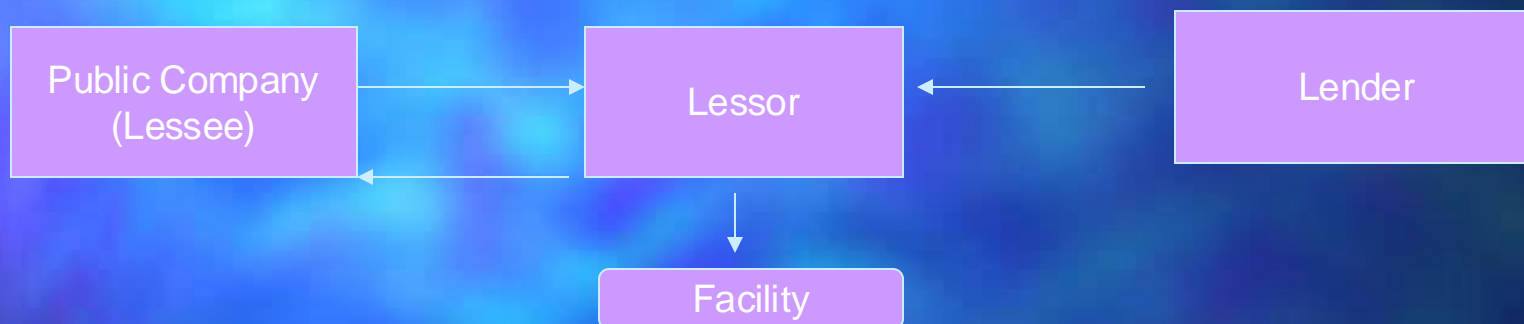
An Approach to Use in Working with FIN 46(R) (con't)

- If the Related Party Group is the VIE's Primary Beneficiary, who in the Group is most closely associated with the VIE. Consider Implicit Variable Interests (see FSP FIN 46(R)-5),
 - The “most closely associated” part of the Group is the VIE's Primary Beneficiary.



Examples

Example A — A Public Company that uses an entity to act as the lessor in a Synthetic Lease



- Public Company enters into an Operating lease with the Lessor. The Operating lease includes a Residual Value Guarantee that protects the Lender and an agreement that the Lessor will sell the facility to the Public Company at a fixed price at the end of the lease period or remit any proceeds from a sale of the facility to another party over the fixed price to the Public Company.
 - The Lender loans the Lessor funds at a rate based on the credit standing of the Public Company.



Examples (con't)

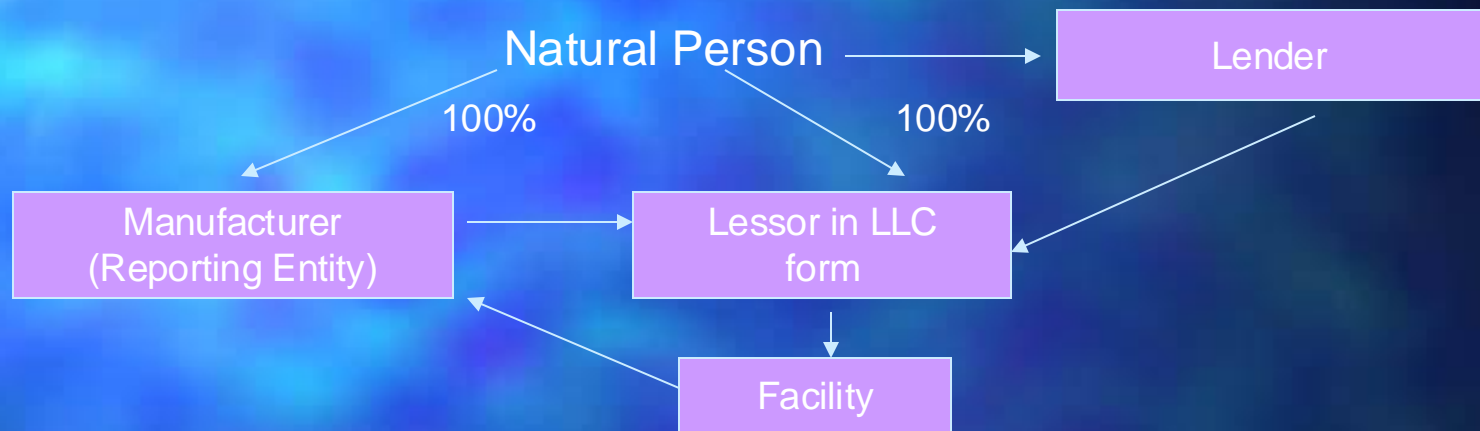
Example A

1. The Lessor is a partnership, LLP or LLC. It could have been created by the Public Company, the Lender or a lease broker. It's "owner" could be anyone.
2. The Lessor can borrow from the Lender only with the support of its arrangement with the Public Company.
3. The VIE is designed to create variability in the fair value of the facility. GAAP net income is meaningless — it's predetermined by the arrangements.
4. The Public Company has all of the expected loss/residual return related to the facility's fair value variability through its operating lease and other arrangements with Lessor.



Examples (con't)

Example B — Nonpublic Entity and Lessor



- Natural person owns the Manufacturer and the Lessor that is an LLC.
- Manufacturer has an operating lease with the Lessor for its main facility.
- Natural person guarantees the debt of the Lessor.
- The Lender loans to the Lessor based on the value of the facility and the guarantee from the Natural Person.



Examples (con't)

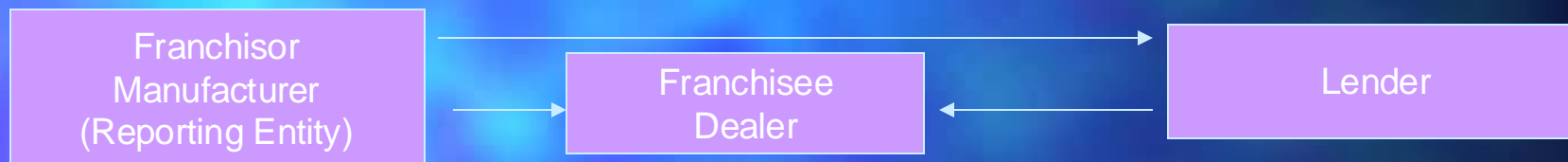
Example B

1. The Lessor is an LLC.
2. The Lessor can borrow from the Lender only with the support of the guarantee from the Natural Person.
3. The VIE is designed to create variability in the fair value of the facility. GAAP net income is meaningless.
4. The Manufacturer and Natural Person are part of a Related Party Group. The Manufacturer has an **implicit** variable interest in the Lessor because of the operating lease and the expectation that the Natural Person will use the Manufacturer to support the Lender so that the debt guarantee would never be triggered.



Examples (con't)

Example C — A Franchisor/Manufacturer and a Franchisee/Dealer



- Reporting Entity enter into a Franchise/Dealership agreement with an independently owned LLC. The owner of the LLC provides sweat equity. To obtain capital to operate (including to acquire the Franchise/Dealership), the Reporting Entity guarantees the debt of the Franchisee/Dealer.
- The Lender loans to the Franchisee/Dealer at a rate based on the credit standing of the Reporting Entity.



Examples (con't)

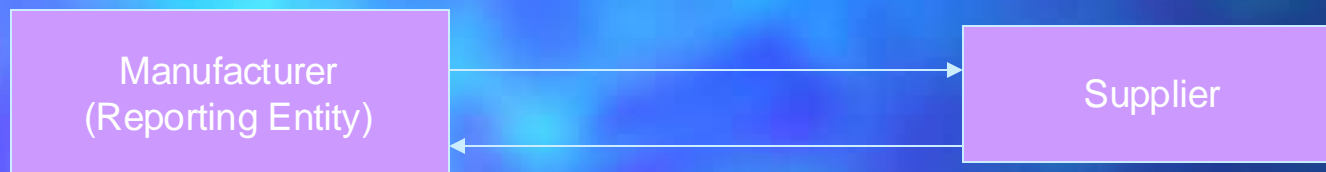
Example C

1. The Franchisee/Dealer is a LLC.
2. The Franchisee/Dealer can borrow from the Lender only with the guarantee of the Reporting Entity.
3. The VIE is designed to create the variability of cash flow/fair value caused by operating a retail outlet.
4. The Reporting Entity has substantially all of the expected loss/Residual return related to the retail operations based on the Franchise/Dealership's fees and sales of product and the debt guarantee.
5. This example does **NOT** mean that All Franchisees and Dealers are VIEs.



Examples (con't)

Example D— Manufacturer and Supplier



- Manufacturer has an agreement to buy a substantial portion of the Supplier's output. The Manufacturer has also loaned the Supplier substantially all of the Supplier's capital in the form of subordinate debt. The debt has a number of debt covenants that effectively makes the debt due on demand.



Examples (con't)

Example D

1. The Supplier is in corporate form.
2. The owner of the Supplier's equity provided minimal capital. The Supplier could not obtain capital from Banks or other traditional lenders.
3. The VIE was designed to create the variability of cash flow/fair value caused by the Supplier's operations.
4. The Manufacturer has substantially all of the expected losses/residual returns from the Supplier's operations based on its Purchase Agreement and the subordinated debt.



Examples (con't)

Example E — Home Builder and Land Supplier



- Home Builder does not want to be exposed to the risk of land development activities or owning undeveloped land. However, the Home Builder wants access to land on which to build homes. Home Builder obtains a purchase option on substantially all of the lots in a Development and pays the Land Developer a nonrefundable option fee equal to 5% of purchase price of each lot. The owner of the Land Developer finances the acquisition of the property used in the Development based on pledging the property and the nonrefundable option fee it has collected from the Home Builder. The owner of the Land Developer provides sweat equity.



Examples (con't)

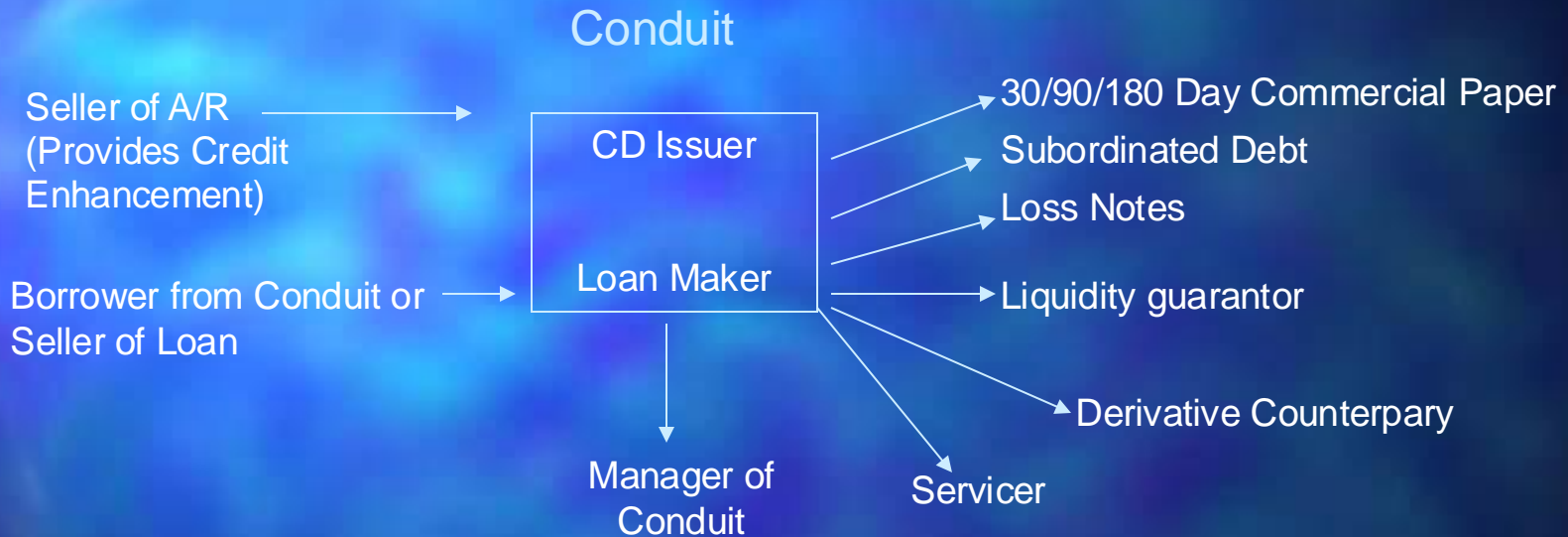
Example E

1. The Land Developer is in corporate form.
2. The Land Developer could obtain the financing to obtain the property used in the Development only by pledging the nonrefundable option fee.
3. The VIE is designed to create variability in the fair value of the lots.
4. The Builder has substantially all of the expected losses/residual return related to the lots based on its purchase option and option fee.
5. It sometimes is hard to determine who initiated this type of arrangement. The Builder, Land Developer or the Lender could be the creator.



Examples (con't)

Example F — Bank Sponsored Commercial Paper/Loan Conduit



- Bank sponsor a Conduit whose purpose is to buy accounts receivables from mid-sized companies (with credit enhancement from the selling companies) with proceeds from issuing various term CD paper (also various forms of interest rates) and various term/subordination/interest rate debt.
- Another type of conduit raises funds by issuing various term/subordination/interest rate debt and uses those funds to make loans or to buy loans.



Examples (con't)

Example F

- Conduits usually have liquidity guarantors, derivative counterparties, servicers and managers. Some Conduits also issue Notes that agree to absorb certain levels of credit losses. [These notes were created to make the Conduit have no Primary Beneficiary.]
- The Manager, liquidity guarantor and holders of the CD paper, subordinated debt and Loss Notes have an agreement on what types of A/R or loans will be acquired.
 1. The Conduit is designed to create various types of cash flow, credit and fair value variability.
 2. The Conduit does not have any voting interests because its activities have been predetermined.
 3. The A/R and loans are clear creators of variability and the CD, subordinate debt, Loss Notes and liquidity guarantees are clear variable interests.
 4. The role of the derivatives and contracts with the servicer and manager are potential variable interests. This is where the design of the entity needs to be examined to classify the derivatives and contracts (see FSP FIN 46(R)-6).

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It is in this type of situation where calculations of expected losses/residual return will be Necessary. This example also is much like CDO arrangements. [Is the Conduit/CDO a way for the Bank or Investment Company to run some of their operations off-book and to turn interest rate spread income into fee income?]



Examples (con't)

Example G — QSPEs or Pass-Through Arrangements

- FIN 46(R) does not apply to QSPE's based on the notion that a Q is designed not to be controlled by any other entity. The Q's Activities are suppose to be very limited—principally to collect and distribute the funds collected.
- IAS 39 Pass-Through Arrangements are subject to SIC 12. But what does that mean?
 - These arrangements demonstrate the tension when one accounting standard looks to the Power element of control and another accounting standard looks to the Benefit element of control.



Addition Issues In FIN 46(R)

- When should an entity be evaluated to determine if it is a VIE?
- When or what should require a reconsideration of whether an entity is a VIE?
- Can losses result in an entity switching from being a Voting Interest entity to a VIE?
- When should an involvement by a Reporting Entity be evaluated to determine if it is a VIE's Primary Beneficiary?
- When or what should require a reconsideration of that evaluation?
- How should the VIE be consolidated by the Primary Beneficiary? What is the day 2 accounting? Should the other variable interests be displayed based on their form or are they noncontrolling equity?
- What if information is not available for previously created VIEs or entities?