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The exposure drafts reflect the Board's response to the increased scrutiny by SEC, Congress, and financial statement users on the accounting and disclosures required by Statement 140 and Interpretation 46(R) in the wake of the recent deterioration in the global credit markets.

Mind Your V(IE)s and Qs — Part Two

FASB Issues Exposure Documents That Eliminate QSPEs, Modify the Consolidation Model in Interpretation 46(R), and Expand Required Disclosures

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Introduction

Last week, the FASB issued three exposure documents proposing amendments to the derecognition guidance in Statement 140[1] and the consolidation model in Interpretation 46(R).[2] The exposure drafts reflect the Board's response to the increased scrutiny by SEC, Congress, and financial statement users on the accounting and disclosures required by Statement 140 and Interpretation 46(R) in the wake of the recent deterioration in the global credit markets.

The exposure documents consist of two proposed statements and a proposed staff position:

- Proposed FASB Statement, *Accounting for Transfers of Financial Assets* ("FAS 140 ED"), which would:
  - Remove the concept of a qualifying special-purpose entity (QSPE) from Statement 140 and the related scope exceptions from Interpretation 46(R).
  - Modify the derecognition conditions relating to legal isolation and effective control.
- Proposed FASB Statement, *Amendments to FASB Interpretation No. 46(R)* ("FIN 46R ED"), which would:
  - Modify the consolidation model for variable interest entities (VIEs).
  - Require continual reassessment of consolidation conclusions.
- Proposed FASB Staff Position (FSP) No. FAS 140-e and FIN 46(R)-e, "Disclosures About Transfers of Financial Assets and Interests in Variable Interest Entities," which would:
  - Expand, **for public entities,** the disclosure requirements in Statement 140 about transfers of financial assets to require, among other things, disclosure of (1) a transferor's continuing involvement in transferred financial assets and (2) how a transfer of financial assets to an SPE affects an entity's financial position, financial performance, and cash flows.

1 FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* — a replacement of FASB Statement No. 125.
2 FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* — an interpretation of ARB No. 51.

- Expand, **for public entities,** the disclosure requirements in Interpretation 46(R) about involvements with variable interest entities to require, among other things, nontransferors to disclose significant variable interests in QSPEs and sponsors to disclose their involvements with variable interest entities.

If the proposed amendments become final standards, enterprises involved with QSPEs will no longer be exempt from applying the consolidation provisions in Interpretation 46(R). As a result, previously unconsolidated entities may become consolidated by transferors or other interest holders. Also, because of the proposed modifications to the existing consolidation model in Interpretation 46(R) and the requirement for enterprises to continually reassess consolidation conclusions, enterprises involved with VIEs (even VIEs that are not structured finance vehicles) will need to rethink their previous consolidation conclusions.

If adopted, the amendments to the derecognition guidance in Statement 140 and the consolidation model in Interpretation 46(R) will be effective for fiscal years (and interim periods within those fiscal years) beginning after November 15, 2009.

If adopted, the amendments to the derecognition guidance in Statement 140 and the consolidation model in Interpretation 46(R) will be effective for fiscal years (and interim periods within those fiscal years) beginning after November 15, 2009. The comment period for the proposed statements ends November 14, 2008. If the proposed FSP on disclosure enhancements is adopted, it will be effective for **public entities** for reporting periods (interim and annual) beginning with the first reporting period that **ends** after the final FSP is issued. The FASB has stated that it expects to issue a final FSP in the fourth quarter of 2008. The disclosures may therefore be effective for reporting periods ending in that quarter (e.g., for calendar year-end filers, the proposed disclosures would be included in the December 31, 2008, annual filings). The comment period for the proposed FSP ends October 15, 2008.

Editor's Note: The FASB is holding a public roundtable on both the FAS 140 ED and the FIN 46R ED on November 6, 2008. Individuals interested in participating must notify the FASB by October 27, 2008, and must submit comments on the exposure documents no later than October 30, 2008.

The following table summarizes the proposed amendments in the three exposure documents. A detailed discussion of each proposal is provided in the Appendix.

Decision	Current GAAP	Proposed Amendment
Transfers of Financial Assets		
Elimination of QSPEs	Under Statement 140, financial assets transferred to a securitization vehicle that meets the definition of a QSPE are typically derecognized by the transferor. Under Interpretation 46(R), the assets and liabilities of a QSPE are exempt from consolidation by the transferor and most investors.	The FAS 140 ED proposes to eliminate the concept of a QSPE from Statement 140 and to delete the related scope exceptions from Interpretation 46(R). As a result, transferors and investors in securitization vehicles must consider the consolidation provisions in Interpretation 46(R).
Consideration of Arrangements Made in Connection With a Transfer	Statement 140 does not *explicitly* require that a transferor consider all arrangements or agreements made in connection with a transfer when determining whether derecognition is appropriate.	The FAS 140 ED proposes to *explicitly* require a transferor to consider all arrangements made contemporaneously with, or in contemplation of, a transfer when determining whether derecognition is appropriate.
Legal Isolation of Transferred Financial Assets	Paragraph 9(a) of Statement 140 does not *explicitly* require that a transferred asset be legally isolated from **all** consolidated affiliates of the transferor.	The FAS 140 ED proposes to *explicitly* require that a transferred asset be legally isolated from the transferor and **any** of its consolidated affiliates that is not a bankruptcy-remote special-purpose entity.

The FIN 46R ED modifies the existing consolidation model by proposing a two-step approach for determining whether an enterprise is the primary beneficiary and, therefore, must consolidate a VIE.

Decision	Current GAAP	Proposed Amendment
Transferee's Ability to Pledge or Exchange Transferred Assets	Paragraph 9(b) of Statement 140 currently requires that for a transferor to achieve sale accounting, a transferee (i.e., the purchaser) that is not a QSPE must have the ability to freely pledge or exchange the transferred financial assets. Constraints on the transferee often cause a transfer to fail sale accounting unless the transferee is a QSPE.	Because the FAS 140 ED proposes to eliminate the concept of a QSPE, it also removes paragraph 9(b) in its entirety from the derecognition assessment. Under the proposal, the concept of a transferor constraint on the transferee's ability to freely pledge or exchange the transferred assets is included in paragraph 9(c) of Statement 140.
Derecognition of a Portion of a Financial Asset	Statement 140 does not include specific guidance on when a portion of a financial asset may be derecognized.	The FAS 140 ED proposes prescriptive guidance on when a portion of a financial asset is eligible for derecognition. Under the proposal, a portion of a financial asset is eligible for derecognition only if the transferred portion meets the strict definition of a participating interest.
Initial Measurement of Beneficial Interests That Are Retained by the Transferor	A beneficial interest in a transferred financial asset that is retained by the transferor is initially recognized on the basis of a relative fair value allocation of the previous carrying amount of the asset sold and the beneficial interest that is retained.	The FAS 140 ED proposes that a beneficial interest in a transferred financial asset retained by the transferor be initially recognized at fair value. The proposal also stipulates that a portion of a financial asset retained by the transferor after a transfer of a participating interest should be initially measured on the basis of an allocation of its previous carrying amount.
Elimination of Special Treatment for Guaranteed Mortgage Securitizations (GMSs)	Statement 140 currently allows a transferor to reclassify mortgage loans to mortgage-backed securities in a transfer to a GMS when 100 percent of the interest is retained if the transferor meets certain requirements. Similarly, Statement 156[3] allows a transferor to recognize a servicing asset or servicing liability related to mortgage loans transferred to a GMS.	The FAS 140 ED proposes to eliminate the ability to reclassify mortgage loans to mortgage-backed securities or to recognize a servicing asset or servicing liability in (1) a transfer to a GMS that fails sale accounting or (2) a transfer that results in consolidation of the GMS.
Consolidation of Variable Interest Entities		
Determination of the Primary Beneficiary of a VIE	The consolidation model in Interpretation 46(R) is based on a risks-and-rewards model. The interest holder that absorbs a majority of the expected losses of the VIE, receives a majority of the expected residual returns of the VIE, or both, is the primary beneficiary and should consolidate the VIE.	The FIN 46R ED modifies the existing consolidation model by proposing a two- step approach for determining whether an enterprise is the primary beneficiary and, therefore, must consolidate a VIE. **Step 1** is a qualitative evaluation that considers which enterprise has (1) the explicit or implicit "power to direct matters that most significantly impact" the VIE's activities and (2) the right to receive benefits or the obligation to absorb losses that could be potentially significant to the VIE. **Step 2** is a quantitative analysis that calculates the expected losses and expected residual returns of a VIE and is only applied if the primary beneficiary cannot conclusively be determined in step 1.

[3] FASB Statement No. 156, *Accounting for Servicing of Financial Assets* — an amendment of FASB Statement No. 140.

Decision	Current GAAP	Proposed Amendment
Consideration of Kickout Rights	Kickout rights held by an interest holder are generally not a factor when the interest holder determines the primary beneficiary of a VIE, as the model is not based on control.	The FIN 46R ED proposes that the ability of a group of investors to remove a variable interest holder that *currently* has the "power to direct matters that most significantly impact the activities of the" VIE should be ignored in the determination of whether that interest holder is the VIE's primary beneficiary unless the rights are held by a single enterprise.
Continual Reconsiderations	Interpretation 46(R) requires an enterprise to reconsider whether an entity is a VIE and which interest holder is the VIE's primary beneficiary only if certain triggering events occur (i.e., reconsideration events).	The FIN 46R ED proposes to require that an enterprise continually reconsider whether an entity is a VIE and which interest holder is the VIE's primary beneficiary.

For more information on the FASB's proposals, please refer to the Appendix below.

Appendix

Background

QSPEs play an important role in the accounting for asset-backed securitizations. Currently, Statement 140 permits an enterprise that transfers financial assets to a securitization vehicle that meets the definition of a QSPE to (1) derecognize the transferred assets[4] and (2) be exempt from consolidating the assets and liabilities of the securitization vehicle. In addition, investors in a securitization vehicle that meets the definition of a QSPE typically do not have to consider the consolidation provisions of Interpretation 46(R). Because the concept of a QSPE is crucial to transferors and investors achieving off-balance-sheet accounting, whether a securitization vehicle qualifies as a QSPE has been a significant focus since the issuance of Statement 125[5] (Statement 140's predecessor) in 1996.

Editor's Note: For additional background information on what led the FASB to add these projects to its agenda, see Deloitte's June 18, 2008, *Heads Up*, "Mind Your V(IE)s and Qs." Also see information about Statement 140 and Interpretation 46(R) on the Technical Plan and Project Updates page on the FASB's Web site.

Proposed Amendments to Statement 140

Elimination of QSPEs

The FAS 140 ED proposes to eliminate the concept of a QSPE from paragraph 35 of Statement 140 and the related scope exceptions in paragraphs 4(c) and 4(d) of Interpretation 46(R). Therefore, all new securitization vehicles, as well as those that currently meet the definition of a QSPE, will no longer be exempt from consolidation under Interpretation 46(R). Rather, transferors and other parties that have interests in QSPEs will need to consider the provisions of Interpretation 46(R) to determine whether consolidation is required.

Modification to the Derecognition Provisions

In conjunction with eliminating the concept of a QSPE, the FAS 140 ED proposes certain modifications to the derecognition provisions in paragraph 9 of Statement 140. The proposal (1) requires all arrangements made in connection with a transfer of financial assets to be considered in the derecognition analysis, (2) clarifies when a transferred asset is considered legally isolated from the transferor, (3) modifies the requirement that a transferee have the ability to freely pledge or exchange transferred financial assets, and (4) provides guidance on when a portion of a financial asset can be derecognized.

Arrangements Made in Connection With a Transfer

Statement 140 currently does not explicitly require that all arrangements or agreements made in connection with a transfer of financial assets be considered in the derecognition analysis. This has resulted in diversity in whether arrangements that are made in connection with a transfer of financial assets must be considered in (1) the legal isolation analysis or (2) the determination of whether the transferor has retained effective control over the transferred assets. To eliminate this diversity, the FAS 140 ED proposes that in determining whether a transferor has surrendered control over the transferred assets, an entity consider all arrangements or agreements that are "made contemporaneously with, or in contemplation of, the transfer" of financial assets, even if the arrangement or agreement is not entered into at the time of the transfer.

The FAS 140 ED also clarifies that in determining whether control over a transferred financial asset is surrendered, the transferor and "all of the entities included in the financial statements being presented" must assess whether the conditions in paragraph 9 of Statement 140 have been met. Accordingly, arrangements or agreements with a transferee entered into by a consolidated affiliate of the transferor may result in the transferor not achieving derecognition treatment. For example, a consolidated affiliate of the transferor (e.g., a servicer) that holds a fixed-price call option on the specific transferred asset will cause the transferor to maintain effective control over the transferred assets and fail derecognition.

[4] Derecognition is only appropriate if the remaining conditions in paragraphs 9(a) and 9(c) are satisfied.
[5] FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

Legal Isolation of Transferred Financial Assets

Statement 140 currently requires that to achieve sale accounting, an entity that transfers a financial asset (i.e., the transferor) must surrender control over the transferred asset. Paragraph 9(a) of Statement 140 stipulates that one condition for surrendering control is that the transferred financial asset must be legally isolated from the transferor in the event of the transferor's bankruptcy. With regard to legal isolation, the FAS 140 ED clarifies that a transferred financial asset must be isolated from the transferor and **any** of its consolidated affiliates that are included in the financial statements being presented (other than bankruptcy-remote special-purpose entities).

Editor's Note: Many constituents believe that Statement 140 already requires a transferor to consider its consolidated affiliates in its legal isolation analysis. These constituents point to paragraph 27 of Statement 140, which states that "[d]erecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any **consolidated affiliate of the transferor** . . . ." Nevertheless, the Board decided to require in paragraph 9(a) that legal isolation take into account all consolidated affiliates of the transferor included in the financial statements presented. Depending on an entity's previous interpretations of Statement 140, the Board's clarification may require a transferor to update its legal opinions to take into account the affect of a consolidated subsidiary's involvements with transferred financial assets in its conclusion that the transferred financial assets are legally isolated if there are subsequent transfers pursuant to the previous legal opinion.

Transferee's Ability to Pledge or Exchange Transferred Asset

Paragraph 9(b) of Statement 140 currently indicates that another condition for the transferor's surrendering control over transferred assets is that the party purchasing the transferred assets (i.e., the transferee) must obtain control over the transferred assets. For this condition to be met, the transferee must have the ability to freely pledge or exchange the assets purchased. Currently, Statement 140 provides an exception to this requirement for transfers of financial assets to securitization vehicles that meet the definition of a QSPE.[6] Because the FAS 140 ED proposes to eliminate the concept of a QSPE, the Board deemed it necessary to modify the derecognition provision in paragraph 9(b) to allow securitizers of financial assets to continue to have the ability to achieve derecognition. Accordingly, the FAS 140 ED would eliminate the requirement in paragraph 9(b) that a transferee has the ability to freely pledge or exchange the transferred assets. While the FAS 140 ED proposes to delete paragraph 9(b), the proposal retains the concept of transferee constraints in the proposed amendment to paragraph 9(c). Under amended paragraph 9(c), a transferor would be required to meet two additional conditions to achieve derecognition.

First, a transferor could not maintain control over the transferred financial assets through a restriction on the transferee's ability to pledge or exchange the transferred financial assets. Under the proposal, a transferor will maintain effective control over the transferred assets if a restriction on the transferee (regardless of whether that restriction is imposed by the transferor) is not designed primarily to provide the transferee with a benefit. To aid in the determination of whether a constraint is designed **primarily** to benefit the transferee, the FASB included in the FAS 140 ED an example of a typical securitization transaction. In that example, the Board concluded that a transferor of financial assets to a special-purpose entity (SPE) that is constrained from pledging or exchanging the transferred assets does not maintain effective control over the transferred assets because the constraint is designed to primarily benefit the SPE. The Board indicated that the primary benefit of the constraint is the SPE's ability to market the issuance of securities backed by the transferred assets to prospective beneficial interest holders.

Second, the transferor cannot maintain effective control over the transferred assets through an agreement that makes it probable that the transferee will require the transferor to repurchase the transferred financial assets. Under the proposal, a transferor would maintain effective control over transferred assets if it entered into an agreement with the transferee that "permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial assets." For example, a transferor will maintain control over transferred financial assets if it writes a deep-in-the-money put option to the transferee on the transferred assets that makes it probable that the transferee will put the transferred assets back to the transferor.

[6] Because a securitization vehicle often is limited in its ability to pledge or exchange transferred assets, Statement 140 currently allows a transferor to "look through" the securitization vehicle and consider whether the investors in the securitization vehicle have the ability to freely pledge or exchange their beneficiary interest. However, the opportunity to "look through" the securitization vehicle is only allowed if the vehicle meets the definition of a QSPE. Because the concept of a QSPE is being eliminated, changes to the derecognition provisions in paragraph 9(b) are necessary; otherwise, most transfers of financial assets to securitization vehicles would fail sale accounting because the transferee does not have the ability to freely pledge or exchange the transferred assets.

Editor's Note: The Board deliberated at length whether to delete the concept in paragraph 9(b) that the transferee must obtain control over the transferred assets. Originally, the Board considered only deleting the reference to QSPEs in paragraph 9(b) without deleting the requirement that the transferee have the ability to freely pledge or exchange the transferred financial asset. This would have resulted in most securitization transactions not qualifying for derecognition treatment because the transferee (i.e., the SPE) would not have the ability to pledge or exchange the transferred assets and the transferor would not have the luxury of looking through the SPE to its underlying investors. The decision to focus on whether a transferee receives the primary benefit from a constraint appears to be an attempt to allow securitizers of financial assets to continue achieving derecognition treatment (assuming the transferor is not required to consolidate the securitization vehicle). However, in situations in which the transferor retains a significant residual interest in the transferred assets, clearly identifying which party is receiving the primary benefit of the constraint may become more difficult.

Derecognition of a Portion of a Financial Asset

The final modification to the derecognition model proposed in the FAS 140 ED relates to the accounting for transfers of a portion of a financial asset. As did the FASB's 2005 Exposure Draft, *Accounting for Transfers of Financial Assets* — an amendment of FASB Statement No. 140, the FAS 140 ED provides that a transfer of a portion of a financial asset is eligible for derecognition only if that portion meets the definition of a participating interest. In the proposal, the Board decided to carry forward its definition of a participating interest originally included in the 2005 Exposure Draft with slight modifications.

Initial Measurement of Beneficial Interests That Are Retained by the Transferor

The FAS 140 ED also proposes changes to the provisions related to the initial measurement of beneficial interests retained by the transferor after a transfer of financial assets. Statement 140 currently requires a transferor that retains an interest in transferred assets to initially measure the retained interest by allocating, on the basis of a relative fair value allocation as of the date of the transfer, the previous carrying amount between the assets sold and the retained interest.

In deliberations leading to the issuance of Statements 155[7] and 156, the Board concluded that beneficial interests that relate to transferred assets and that are retained by the transferor are new assets of the transferor and should be initially measured consistently with the initial recognition of other financial assets. Accordingly, the FAS 140 ED requires[8] that all interests in transferred financial assets that are retained by the transferor should be initially measured at fair value rather than at an allocation of previous carrying amounts.[9]

Editor's Note: This change may have a significant impact on the gain or loss that a transferor recognizes on a securitization transaction. Because a retained beneficial interest will be initially recognized at fair value rather than at an allocation of the previous carrying amount of the assets transferred, the difference between the carrying amount of the assets transferred and the fair value of the proceeds received (i.e., the sum of any cash and/or beneficial interest received net of any liabilities assumed) will immediately be recognized as a component of the transaction gain or loss. Under the current guidance in Statement 140, recognition of a portion of this difference is deferred as a component of the cost basis in the beneficial interest that is retained by the transferor and recognized in other comprehensive income if the beneficial interest is classified as available for sale pursuant to Statement 115.[10]

While a beneficial interest in transferred assets that is retained by the transferor is a new asset of the transferor, the FAS 140 ED clarifies that a portion of a financial asset that is retained by the transferor in a transfer of a participating interest is not a new asset and should not be measured at fair value. (This is consistent with the Board's view that a participating interest has risk characteristics that are identical to the portion of the financial asset that was not transferred.) Therefore, under the proposal, a participating interest that is retained by the transferor should be initially measured by allocating, on the basis of a relative fair value allocation as of the date of the transfer, the previous carrying amount between the portion of the assets sold and the participating interest that continues to be held.

[7] FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* — an amendment of FASB Statements No. 133 and 140.

[8] While the conclusion to initially recognize interests that continue to be held by the transferor at fair value was made in deliberations leading to the issuance of Statement 155 or 156, the Board ultimately did not include this requirement in either standard. The Board therefore decided to include it in its current proposal to amend Statement 140.

[9] While this amendment requires beneficial interests that are retained by the transferor to be *initially* measured at fair value, Statement 140 does not provide guidance on subsequent measurement (typically Statement 115 is followed if the beneficial interest held is in security form). Accordingly, the proposal does not require beneficial interests that are retained by the transferor be remeasured to fair value in subsequent periods.

[10] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Note that if a transferor classifies its retained beneficial interests as trading securities pursuant to Statement 115, net income will probably not be affected. This is because the deferred gain or loss that is included in the cost basis of the beneficial interest is recognized in current period earnings as the trading security is subsequently marked to fair value pursuant to Statement 115.

Elimination of Special Treatment for Guaranteed Mortgage Securitizations

Currently, Statement 140 allows an entity that transfers mortgage loans to a QSPE, and that issues securities with a third-party guarantee, to reclassify the transferred mortgage loans to mortgage-backed securities even if the transfer does not achieve sale accounting.[11] This is a common transaction in the mortgage banking industry and is referred to as a guaranteed mortgage securitization (GMS) in Statement 140.

Because the FAS 140 ED eliminates the concept of a QSPE, it also proposes to remove the ability to reclassify mortgage loans to mortgage-backed securities in a GMS. Therefore, under the proposal an entity will only be able to reclassify mortgage loans to mortgage-backed securities if the transfer meets the conditions for sale accounting and the transferee is not consolidated by the transferor pursuant to Interpretation 46(R).

A similar exception exists regarding the recognition of a servicing asset or liability in a transfer to a GMS. Pursuant to Statement 156, an entity that transfers mortgage loans to a GMS can recognize a servicing asset or liability for the right or obligation to service the mortgage loans even if the transfer does not qualify as a sale. To maintain consistency with the proposal to eliminate the GMS exception, the FAS 140 ED proposes to limit the ability to recognize a servicing asset or liability to transfers that meet the conditions for sale accounting and for which the transferor does not consolidate the transferee.

Proposed Amendments to Interpretation 46(R)

Determination of the Primary Beneficiary of a VIE

The proposed amendments in the FIN 46R ED primarily focus on how the primary beneficiary of a VIE is determined. **Note that the proposed amendments do not change the definition of a VIE.** Under the current Interpretation 46(R) model, an entity often needs to perform a quantitative analysis when determining which interest holder in a VIE absorbs a majority of the entity's expected losses or residual returns and is its primary beneficiary. In response to concerns regarding the difficulty in applying this model and the lack of transparency that a risks-and-rewards model often creates, the FIN 46R ED proposes to modify the approach in paragraph 14 of Interpretation 46(R) for determining the primary beneficiary of a VIE.

Under the proposal, the evaluation of whether an enterprise is the primary beneficiary of a VIE is a two-step analysis. First, an enterprise must determine qualitatively whether it has (1) the "power to direct matters that most significantly impact the activities" of the VIE in a manner that impacts the VIE's economic performance and (2) the right to receive benefits or the obligation to absorb losses from the VIE that could **potentially** be significant. If both conditions are met, the enterprise is considered the primary beneficiary and must consolidate the VIE. In performing this analysis, the enterprise is required to consider whether it has any "implicit financial responsibility to ensure that the variable interest entity operates as designed."

Editor's Note: A determination of whether an enterprise has the right to receive benefits or the obligation to absorb losses does not take into account probability. Accordingly, the **mere possibility** that an enterprise could receive benefits or absorb losses that could be potentially significant to the VIE causes the second condition in step 1 to be met. This is a significant change from the current model in Interpretation 46(R), which requires consideration of the probability of various outcomes in the determination of an enterprise's exposure to the VIE's variability. Under the current guidance in Interpretation 46(R), an enterprise that has an obligation to absorb significant losses of a VIE may not be the VIE's primary beneficiary if the possibility of loss is remote. In contrast, by focusing on the possibility rather than the probability that an enterprise will receive benefits or absorb losses under the proposed model, an enterprise may meet the second condition in step 1 even if its economic exposure to the VIE is currently considered minor relative to other interest holders.

In addition, consideration of an enterprise's right to receive benefits and obligations to absorb losses in the second condition to step 1 does not refer to expected residual returns or expected losses as those terms are currently used in Interpretation 46(R). When determining whether an enterprise has a right to receive benefits or an obligation to absorb losses, an entity should consider both implicit and explicit arrangements with the VIE.

If the enterprise can conclusively determine that only one, or neither, of the conditions in step 1 is met, the enterprise is not the primary beneficiary and no further analysis is required. However, if the enterprise cannot determine conclusively whether it is or is not the primary beneficiary of the VIE under step 1, the enterprise is required to perform the quantitative analysis in step 2. Under step 2, an enterprise is required to calculate the expected losses and residual returns of the VIE in a manner consistent with the model that currently exists in Interpretation 46(R). As a result, the variable interest holder, if any, that absorbs a majority of the VIE's expected losses or receives a majority of the VIE's expected residual returns would be identified as the primary beneficiary.

[11] Under the current derecognition provisions in Statement 140, a transfer of financial assets to a QSPE does not achieve sale accounting if all it receives as consideration for the transfer is beneficial interest in the transferred asset. In the mortgage banking industry, banks often transfer mortgage loans to a QSPE and retain 100 percent of the resulting mortgage-backed securities. While such a transaction is not a sale, Statement 140 allows the mortgage bank to reclassify its mortgage loans to mortgage-backed securities if the QSPE obtains a substantive third-party guarantee.

Editor's Note: While the Board's discussions leading to the issuance of the FIN 46R ED focused almost exclusively on structured financing entities, the Board's proposal to amend the consolidation model affects all entities in the scope of Interpretation 46(R). This includes entities such as joint ventures and operating businesses that meet the definition of a VIE in paragraph 5 of Interpretation 46(R). Therefore, enterprises with interests in joint ventures or operating businesses will need to carefully consider how the new consolidation model affects their previous consolidation conclusions.

The FIN 46R ED states that if the power to direct the most significant matters of a VIE is shared among multiple interest holders, this typically results in no party consolidating the VIE under its proposed consolidation model. However, the power must truly be shared, such as in a joint venture arrangement in which all activities require unanimous consent. On the other hand, it is not entirely clear how the proposed consolidation model would apply when multiple interest holders each have the power to direct matters that impact different activities. For example, in a joint venture in which one venturer has the power to direct matters related to manufacturing and the another venturer has the power to direct matters related to distribution, it is unclear which venturer, if any, is the primary beneficiary.

In deliberating its proposed model, the Board contemplated including certain control indicators to aid enterprises in determining whether it has the power to direct the matters that most significantly impact the VIE's activities. Ultimately, the Board decided to exclude these indicators from the FIN 46R ED because of the difficulty in applying general indicators to a broad set of transactions and arrangements.

Rather than provide specific indicators of control or a description of when an enterprise has "power to direct matters that most significantly impact the activities" of the VIE, the Board provided several examples in Appendix A of the FIN 46R ED illustrating the application of the proposed consolidation model. These examples include (1) a commercial mortgage securitization, (2) a collateralized debt obligation, (3) an asset-backed commercial paper conduit, (4) a structured investment vehicle, (5) a guaranteed residential mortgage securitization, (6) a nonguaranteed residential mortgage securitization, (7) a synthetic-lease structure, (8) a hotel management company, and (9) a manufacturer/distributor arrangement.

Editor's Note: A common theme in each example is that the enterprise that performs the day-to-day management of the VIE generally has the "power to direct matters that significantly impact the activities" of the VIE. For example, in the commercial and nonguaranteed residential mortgage securitization examples, the interest holder that manages the assets in default (i.e., the servicer (or special servicer)) is deemed the primary beneficiary because it has the power to direct matters that most significantly impact the activities of the VIE, even if the enterprise performing the management function only has a small amount of economic exposure to the structure. (Note that in both examples, the servicer (or special servicer) has a residual interest in the securitization. This residual interest provides the servicer with a right to receive benefits and an obligation to absorb the losses of the VIE). Because Interpretation 46(R) currently focuses exclusively on an enterprise's exposure to the risks and rewards of the VIE without consideration of whether the enterprise participates in the management of the entity, the consolidation model proposed in the FIN 46R ED is likely to change the primary beneficiary conclusion for many existing VIEs.

Consideration of Kickout Rights

The FIN 46R ED proposes that the ability of third parties to remove or replace an enterprise that currently has the ability to direct a VIE's activities (often referred to as kickout rights)[12] be ignored in the determination of the primary beneficiary of a VIE unless the ability to remove the interest holder can be unilaterally exercised by a single entity.[13] In deliberating its proposed consolidation model, several Board members expressed concern that kickout rights are typically not substantive when associated with VIEs and, therefore, should not change the primary beneficiary determination.[14] As a result, when determining the primary beneficiary of a VIE under the proposal, an enterprise would assess whether the variable interest holder that currently has the ability to direct the activities of a VIE (if coupled with potential significant benefits or potential significant losses) is the VIE's primary beneficiary irrespective of whether third parties have the ability to remove that variable interest holder.[15]

[12] EITF Issues Nos. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," and 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," discuss scenarios when an interest holder (e.g., a minority shareholder or a limited partner) has the power to either remove or block the decisions of the controlling interest holder (e.g., an investor with a majority voting interest or a general partner of a limited partnership). If certain conditions in these Issues are met, the presumption that the majority owner or general partner has a controlling financial interest (and therefore should consolidate) can be overcome.

[13] If a single entity has the ability to unilaterally remove the enterprise that has the *current* power to direct the most significant matters that impact the activities of the VIE, that right, in and of itself, may support that the entity with the kickout right has the power to direct the most significant matters that impact the activities of the VIE.

[14] Because a variable interest holder that has the current power to direct the VIE's activities typically has other involvements with the VIE (e.g., a residual interest or a liquidity arrangement), the Board believes that third parties with kick-out rights have an incentive to not exercise those kick-out rights. The Board believes this incentive to not exercise kick-out rights calls into question whether the kick-out rights are truly substantive.

[15] The Board clarified that its decision to ignore kick-out rights when determining the primary beneficiary of a VIE does not change the consideration of kick-out rights when determining whether (1) an interest is a variable interest under paragraphs B18–B21 of Interpretation 46(R) or (2) whether an entity is a VIE under paragraph 5 of Interpretation 46(R).

Continual Reconsiderations

Because the FIN 46R ED eliminates the concept of a reconsideration event in Interpretation 46(R), the proposal requires a reporting enterprise to continually reconsider its Interpretation 46(R) conclusions. Thus, a reporting enterprise would need to continually reconsider (1) whether an entity in which it has an interest is a VIE and (2) whether it is the VIE's primary beneficiary. Currently, Interpretation 46(R) only requires reconsideration of the status of an entity as a VIE or a VIE's primary beneficiary if certain events occur. In addition to removing the concept of a reconsideration event, the FIN 46(R) ED eliminates the exception in footnote 5 of Interpretation 46(R) that an entity cannot become a VIE solely because of operating losses. Thus, under the proposal an entity may now become a VIE if it experiences operating losses that cause equity at risk to no longer be considered sufficient.

Editor's Note: Because continual reconsideration (as opposed to consideration performed as of each reporting date) is required, if an Interpretation 46(R) conclusion changes during a reporting period, the enterprise will need to determine when in the reporting period the change occurred. For example, if an enterprise determines that it is no longer the primary beneficiary of a VIE, it would need to deconsolidate that particular VIE on the date that the circumstances changed resulting in the enterprise no longer meeting the conditions for consolidation. This is particularly important in determining what amounts should and should not be included in the income statement related to the operations of the VIE. In such a case, the income statement should not include amounts attributable to the VIE after the date that the enterprise determines it is no longer the VIE's primary beneficiary.

In addition, the removal of the exception that an entity cannot become a VIE solely because of operating losses may result in many entities becoming VIEs and thus make them subject to the consolidation guidance in Interpretation 46(R) solely because they experienced significant operating losses.

Proposed Amendments to the Disclosure Requirements in Statement 140 and Interpretation 46(R)

The proposed amendments to Statement 140 and Interpretation 46(R) also include enhanced disclosures to address user concerns regarding a lack of transparency regarding an enterprise's transfer of financial assets and involvements with VIEs. Because the exposure drafts are not expected to become effective until fiscal years beginning after November 15, 2009, the Board issued a proposed FSP that if adopted will make many of the disclosure requirements included in the FAS 140 ED and the FIN 46R ED effective for **public entities** in the reporting period that ends in the quarter that the final FSP is issued. For entities with a November 30 or December 31 year-end, it is likely the disclosures will need to be included in this year's annual financial statements. If adopted, the proposed FSP will enhance the disclosures about transfers of financial assets and interests in VIEs. The proposal requires additional disclosures by **public entities** that are sponsors of VIEs or that have significant interests in entities that are currently considered QSPEs.

The FSP identifies the principal objectives of the disclosures. For public entities subject to the disclosure requirements of Statement 140, the objectives are:

> [T]o provide users of the financial statements with an understanding of:
>
> a. A transferor's continuing involvement in financial assets that it has transferred to an SPE
>
> b. The nature of any restrictions on assets reported by an entity in its statement of financial position, including the carrying amounts of such assets
>
> c. How servicing assets and servicing liabilities are reported under [Statement 140]
>
> d. How a transfer of financial assets [to an SPE] affects an entity's financial position, financial performance, and cash flows.

For public entities subject to Interpretation 46(R), the objectives are:

> [T]o provide users of financial statements with an understanding of:
>
> a. The judgments and assumptions made by the enterprise in determining whether the enterprise must consolidate a variable interest entity and/or disclose information about its involvement with a variable interest entity
>
> b. The nature of restrictions on a consolidated variable interest entity's assets reported by the enterprise in its statement of financial position, including the carrying amounts of such assets
>
> c. The nature of, and changes in, the risks associated with the enterprise's involvement with a variable interest entity
>
> d. The current potential financial effects from an enterprise's involvement with a variable interest entity on the enterprise's financial position, financial performance, and cash flows.

Effective Date and Transition

If adopted, the amendments to the derecognition guidance in Statement 140 and the consolidation guidance in Interpretation 46(R) proposed by the FAS 140 ED and the FIN 46R ED will be effective for fiscal years beginning after November 15, 2009. Statement 140 would be applied prospectively, with the proposed amendments affecting new transfers of financial assets that occur after the date of adoption. The proposed amendments to Interpretation 46(R) apply to **all** VIEs, newly created and existing (including existing entities that were formerly considered QSPEs under Statement 140). If an enterprise is required to consolidate a VIE upon initial application of the proposed amendment to Interpretation 46(R), the enterprise should measure and recognize the assets and liabilities of the VIE pursuant to the initial recognition provisions in paragraphs 18–21 of Interpretation 46(R), except that any amount that would be recognized as goodwill or a gain or loss should be recognized as an adjustment to retained earnings.

In addition, if adopted, the proposed FSP on disclosure enhancements is effective for **public entities** for reporting periods (interim and annual) beginning with the first reporting period that ends after the final FSP is issued. The FASB has stated that it expects to issue a final FSP in the fourth quarter of 2008. The additional disclosure requirements are therefore expected to be effective this year for public entities with reporting periods (interim or annual) that end on November 30 and December 31.

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