

FASB Interpretation No. 46 Revised

CDOs in the Heartland

March 25, 2004



History

- Pre-Enron
 - Proliferation of CDOs
 - Marketplace acceptance
 - Lack of accounting guidance for CDOs regarding consolidation
 - ARB 51 & SFAS No. 94 (general consolidation standards)
 - EITF No. D-14, 90-15 and 96-21 (transactions involving SPEs)
- Fall of ENRON = Scrutiny of any non-voting entity
- Post-Enron
 - January 2002: SPE “quick-fix” consolidation project added to FASB’s agenda
 - January 2003: FASB issued FIN 46
 - FIN 46 criticisms immediately followed issuance
 - December 2003: FASB issued FIN 46R for clarification

Substance of FIN 46R

- Basically, FIN 46R requires that **four questions** be addressed:
 - Do you have an entity? (paragraph 3)
 - Does the entity qualify for a scope exception? (paragraph 4)
 - Is the entity a variable interest entity (VIE) or a Voting Interest Entity (VOE)? (paragraph 5)
 - If the entity is a VIE, who is the primary beneficiary? (paragraphs 14-17)
 - Identify all “variable interests” (VIs) in the entity
 - Quantify to what extent VIs participate in the economics of the entity
 - If VIs held by one party expose it to >50% of entity’s “expected losses” or “expected residual returns”: the holder is the entity’s PB, and must consolidate the VIE
 - If entity is deemed to be a VOE: apply consolidation guidance outside of FIN 46 (ARB 51/SFAS 94, EITF 97-2, etc.)

Question 1: Do You Have An Entity? [FIN 46R par. 3]

- Any “legal structure” used to conduct activities or hold assets
- Examples of structures:
 - Corporations
 - Partnerships
 - Limited liability companies
 - Grantor trusts and other trusts
- Portions of entities or aggregations of assets are not separate entities unless the entire entity is a VIE
 - E.g. divisions, departments, branches, certain pools of assets
- Majority-owned subsidiaries are entities separate from their parents
 - May be VIEs – consolidation analysis may be required

Question 2: Does the Entity Qualify For A Scope Exception? [FIN 46R par. 4]

- FIN 46R applies to all entities, except:
 - Not-for-profit organizations (SFAS No. 117)
 - Employee benefit plans (SFAS Nos. 87, 106, 112)
 - Qualifying special purpose entities (SFAS No. 140)
 - Investment companies subject to SEC Regulation S-X, Rule 6-03(c)(1)
 - All other investment companies (temporarily)
 - Separate accounts of life insurance entities
 - Information – Out
 - Businesses (EITF 98-3 & Appendix C)
 - Governmental entities
- Certain qualifications to the above exceptions apply

Question 3: Is the Entity a Variable Interest Entity (VIE)? [FIN 46R par. 5]

An entity is a **Variable Interest Entity** if either condition exists:

- Total equity investment at risk is not sufficient to permit the entity to finance its activities
 - Consider only those interests classified as equity by issuer
 - Eligible equity must “participate significantly” in entity’s profits/losses
 - Consider both qualitative and quantitative factors (10% test) (par. 9)
- As a group the holders of the equity investment at risk lack any one of the following characteristics:
 - Voting or similar rights that control the entity
 - Unlimited obligation to bear the entity’s economic risks
 - Uncapped right to receive the entity’s economic rewards
 - Disproportionate vote (less vote than economics) and substantially all activities on behalf of that investor

Question 4: Who Is the Primary Beneficiary (PB)? [FIN 46R para. 14-17]

- Enterprise that consolidates a VIE is the PB
- An enterprise consolidates a VIE if its VIs will:
 - Absorb majority of the entity's expected losses (ELs); and/or
 - Receive majority of the entity's expected residual returns (ERRs)
- What are ELs and ERRs (par. 8)?
 - ELs: expected negative variability in FV of entity's net assets, exclusive of VIs
 - ERRs: expected positive variability
 - Expected variability includes returns/losses from operating results
- FIN 46R also addresses:
 - Timing of initial PB determination and triggering events (par. 15)
 - Variable interests held by related parties (SFAS No. 57) and de facto agents (par. 16-17)

Typical CDO Structure: FIN 46R Considerations

- Why will most CDO entities be scoped into 46R?
 - A legal entity
 - Does not qualify for scope exception
 - Paragraph 5 analysis: typically leads to a VIE determination –
 - Equity may be inadequate to absorb expected losses
 - Debt holders may have substantive “owner-like” rights
 - Collateral manager frequently cannot be removed except for low-probability “cause” events

- What are the CDO entity’s VIs?
 - Definition: Contractual, ownership or other pecuniary interests in an entity that change with changes in FV of entity’s net assets (exclusive of other VIs)
 - Equity
 - Sub debt
 - Guarantees of debt (wrappers)
 - Derivatives
 - Potentially, fees paid to collateral manager and other service providers

CDO Collateral Managers: FIN 46R Considerations

- Collateral manager's fees: how treated under 46R?
 - VIE decision-maker: has “direct or indirect ability to make decisions that significantly affect the results of the activities” of a VIE
 - CDO entity's CM: typically deemed a decision-maker
 - CM agreement: consider a VI unless conditions cited in par. B19 are present:
 - Arrangement at market (fees “commensurate” with services provided)
 - Paid senior in the waterfall
 - Substantive kick-out rights ⁽¹⁾ (par. B20):
 - CM removed by a simple majority vote and
 - No significant barriers to exercise kick-out right exist
 - CM holds no other interest in CDO other than a “trivial” interest

(1) December 2003 SEC speech indicated that the B20 guidance represents the most recent thinking on whether a kick-out right is substantive. The SEC staff is evaluating if/how this guidance should be extended to other consolidation evaluations, such as in the context of SOP 78-9.

CDO Collateral Manager: FIN 46R Considerations, cont'd

- Upshot: CM agreement will almost always be considered a VI in a CDO entity
 - Must estimate fee stream's variability in EL/ERR analysis
 - However, absent CM's significant other involvement with a CDO entity, typical CM agreement will rarely cause CM to be tagged as PB
- FIN 46R represents a major improvement over FIN 46
 - FIN 46 required that the fair value of a decision-maker's fee be included in the ERR determination
 - Frequently resulted in CM being tagged as the CDO entity's PB (fees plus CM's customary 20-25% equity interest)
 - FIN 46 approach introduced unwarranted bias toward identifying decision-makers as PBs

FIN 46R Example: Typical CDO Structure

- CDO entity has financial assets of \$100 million financed by issuance of non-recourse debt and equity:
 - Class A (senior) classes: \$75 million; 5.00%
 - Class B (subordinated) classes: \$17 million; 7.00%
 - Equity tranche: \$8 million

- Collateral manager VIs:
 - 20% of entity's equity
 - Management fee
 - Base (senior/sub): 40 bps
 - Incentive fee of 25% if cash-on-cash IRR to equity holders exceeds 12%

FIN 46R Example: Typical CDO Structure

FIN 46R CDO Example-Discussion:

- Question 4 presents challenges in the typical CDO structure:
 - Economic risks are effectively disbursed
 - No one enterprise exposed to majority of the losses
- To do an expected loss calculation or not?
- Who is the decision maker? Are the decision maker fees a VI?
- Implications of FIN 46R reporting (i.e. consolidation) for CDO managers:
 - Inflated balance sheet
 - Earnings volatility
 - Potential shareholder and investor confusion

Appendix A: Accounting Advisory Group

Services

- **“On-Call” Advisory:** Real time response to investment bankers and analysts on questions regarding specific application of accounting literature.
- **Transaction Analysis:** Review of transactions and related documentation for accounting implications, including analyses of securitizations, debt and equity offerings, derivatives hedging strategies and mergers and acquisitions.
- **Accounting Implementation Projects:** Assisting company management with the creation of books and records and the development of processes for the application of new or revised accounting pronouncements.
- **US GAAP Conversions:** Providing project management assistance and advice on foreign acquisitions with respect to the identification and development of US GAAP financial information required for reporting to parent company.
- **Training:** Presentations of latest accounting developments and standards to investment bankers, analysts and company management.

Expertise

- Consolidations – FIN 46
- Special Purpose Entities
- Securitizations – SFAS 140
- Derivatives – SFAS 133
- Leasing – SFAS 13
- Debt/Equity Transactions
- Investments
- Business Comb/M&A – SFAS 141/142
- Income Taxes
- Compensation Arrangements
- Revenue Recognition
- International Financial Reporting Standards
- SEC Reporting

Appendix B: Curriculum Vitae



Name	<ul style="list-style-type: none"> ▪ David A. Augustyn
Position	<ul style="list-style-type: none"> ▪ Partner, Transaction Services, Chicago
Qualifications	<ul style="list-style-type: none"> ▪ BBA (accounting), University of Notre Dame; CPA; American Institute of Certified Public Accountants; Illinois CPA Society
Experience	<ul style="list-style-type: none"> ▪ Mr. Augustyn focuses on providing accounting advice under US GAAP for structured products, financial instruments, including derivatives, and various forms of business combinations. Mr. Augustyn has performed such services for both buy-side and sell-side clients in on-call and project-oriented capacities. Specifically, Mr. Augustyn has extensive experience in providing advice to clients who are structuring transactions to comply with FIN 46 consolidation guidance as well as SFAS 140 including meeting the sale criteria and special purpose entity qualification rules as well as accounting and disclosures of guarantees under FIN 45 and SFAS 150 liabilities and equity classification.
Sector experience	<ul style="list-style-type: none"> ▪ Commercial and investment banking, insurance, consumer and industrial products, semi-conductors and wireless telecommunications





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