New and Improved?  
FASB Revises and Refines FIN 46

Introduction and Background

Only a month before reaching its first anniversary — and well before all companies have adopted its accounting provisions — FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46), has been substantially revised (FIN 46R). FIN 46 and FIN 46R chart heretofore unexplored consolidation territory.

FIN 46 invented a new way to characterize a legal entity for purposes of financial accounting — a corporation, partnership, trust, etc. each could be characterized as a variable interest entity (VIE). A legal entity that is a VIE lacks sufficient controlling equity at risk, and it confounds a traditional consolidation analysis based on the accounting convention of majority voting control. To overcome that problem, FIN 46 established a new framework to identify the accounting parent of a VIE. Often, the framework required the use of a complex method to analyze the economic prospects of a VIE. Based on this analysis, the VIE’s primary beneficiary is the single party (if there is one) that has a majority of the risks or rewards of the VIE. The primary beneficiary includes the assets and liabilities of the VIE in its consolidated financial statements.

These landmarks survive intact under FIN 46R. Like many first maps of newly discovered lands, FIN 46’s paths were difficult to follow; too often they led explorers into almost insurmountable obstacles and, sometimes, back to where they started. Think of FIN 46R as a map redrawn. Even with a better map in hand, the journey promises to be arduous. But travelers should be better equipped to eventually reach their final destinations.

Summary of Key Changes

Here are the key differences between FIN 46R and its predecessor, FIN 46. Turn to the appendix for additional details on these points, examples, and a discussion of many other changes FIN 46R makes.

FIN 46R Exempts Many Entities That Are Businesses

FIN 46R now scopes out many — but not all — businesses, as that term is defined in the Interpretation. A business — assuming it is scoped out of FIN 46R — should be consolidated with its accounting parent (if it has one) only when required by long-standing, conventional consolidation guidance, most notably Accounting Research Bulletin No. 51, "Consolidated Financial Statements" (ARB 51). Under FIN 46, any business potentially could have been a VIE (and, if so, subject to the Interpretation’s unique consolidation requirements) depending on the design of the business’ capital structure.

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and other factors. Note that an entity whose primary activity is **asset-backed financing** or who acts as a **single-lessee leasing entity** cannot qualify for the scope exemption in FIN 46R, even if it would otherwise be a business. If such an entity is a VIE, it is covered by FIN 46R’s consolidation requirements.

### Delayed Effective Date

FASB partially delayed FIN 46’s effective date (for most public companies until no later than the end of the first reporting period ending after March 15, 2004. The delay notwithstanding, public companies must apply either FIN 46 or FIN 46R to **special-purpose entities** (SPEs) no later than the end of the first reporting period ending after December 15, 2003.

**Example.** Company X, a calendar-year-end reporter, has an interest in two entities. Only Entity 1 is an SPE. Company X has not yet been required to apply the accounting provisions of FIN 46 to either entity.

No later than 12/31/03, Company X must apply either FIN 46 or FIN 46R to evaluate whether Entity 1 is a VIE [note: many SPEs will be VIEs] and whether Public Company X is Entity 1’s primary beneficiary. No later than 3/31/04, Company X must apply FIN 46R and evaluate whether Entity 2 is a VIE and whether Company X is Entity 2’s primary beneficiary. [Note that if Company X had applied FIN 46 to Entity 1 at 12/31/03, at 3/31/04 it must re-evaluate Entity 1 under the provisions of FIN 46R].

A whole set of factors needs to be considered in determining the deadline for the application of FIN 46 or FIN 46R. Tread carefully and see the attached appendix for more details.

### Clearer Definition of a Variable Interest

FIN 46R improves the definition of a **variable interest** and provides more understandable illustrations than those originally provided in FIN 46. The definition is key – for example, only the holder of a variable interest can ever be a VIE’s primary beneficiary. In some cases, the improved definition will cause a company to reverse an earlier conclusion that its position constitutes a variable interest in a VIE. One example – FIN 46R makes it clear that sponsors of conventional **trust preferred vehicles** cannot consolidate the accounts of the trust because they do not have a variable interest in the vehicle. FIN 46R’s better definition is only a relative improvement. Drawing the line between a VIE’s variable and non-variable interests will continue to represent a significant challenge in many cases.

**Decision Makers/Certain Guarantors Are Less Likely to Be Primary Beneficiaries**

Under FIN 46, decision maker fees and certain guarantee fees were treated as unique types of variable interests in a VIE. The special treatment increased the odds that decision makers and providers of certain guarantees would end up as a VIE’s primary beneficiary. FIN 46R eliminates the bias, putting these fees on an equal footing with other variable interests. In fact, fees paid to a decision maker may not even be a variable interest at all if certain stringent conditions are satisfied. One result? Fewer asset managers will find themselves tagged as the primary beneficiary of structured vehicles that issue collateralized debt obligations.

Although the attached appendix answers many questions about FIN 46, it leaves unanswered what might be the most common query of all: Does FIN 46R resolve all of the issues that followed the initial release of FIN 46? Of course not – certainty is an unrealistic goal for any accounting standard, especially one that tackles the difficult issues in FIN 46 and FIN 46R. That said, preparers, auditors and financial statement users will still find that the terrain is rough. Like all difficult journeys, travelers should be armed with sufficient time and resources.
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Appendix
Questions and Answers Related to FIN 46R

Scope Changes and Voting Interest Entities

Note: While this appendix covers many of the more significant changes FIN 46R makes to FIN 46, it is not designed to be completely comprehensive and some less significant changes are not discussed. If a number of the changes seem to “ring a bell,” that is because FIN 46R incorporates some of the guidance previously released as FASB Staff Interpretations (FSPs).

1. Are all businesses exempt from the requirements of FIN 46R?

No. Even if an entity otherwise meets FIN 46R’s definition of a business, it is not exempt from the requirements of the Interpretation if its activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee arrangements. Also, FIN 46R should be applied to other businesses in the following circumstances:

- The reporting enterprise (i.e., the potential variable interest holder including its related parties) participated in the design or redesign of the business. (However, if the business is an operating joint venture or a franchisee, it is exempt from FIN 46R even if the reporting entity participates in the design or redesign, unless it has one of the characteristics below.)
- The business is designed so that substantially all of its activities involve or are conducted on behalf of the reporting enterprise.
- The reporting enterprise provides more than half of the total of the equity, subordinated debt, and other subordinated financial support to the entity.

2. What is a business?

According to Appendix C of FIN 46R, three steps, briefly summarized below, are used to determine if an entity is a business:

1. Identify the elements that constitute the set of activities and assets of the entity.
2. Compare the elements with a complete set of elements for the set to constitute normal business operations. Normal business operations require activities/assets involving inputs, processes and outputs.
3. Determine whether missing elements, if any, lead to the conclusion that the set is not a business. Consider the difficulty or cost of obtaining the missing element(s).

3. Are personal trusts in bank trust departments and mutual funds organized as trusts specifically exempt from FIN 46R?

No. FASB had proposed a specific exemption for these entities in the October Exposure Draft that preceded FIN 46R. FASB concluded that the exemption was unnecessary because FIN 46R removes the bias towards decision maker consolidation as discussed in Question 11.

4. Have non-registered investment companies been scoped out of FIN 46R?

No, but see the next paragraph. Both FIN 46 and FIN 46R prohibit registered investment companies [i.e., those that are subject to Regulation S-X, Rule 6-03(C)(1)] from consolidating any entity that is not also subject to the same rule. Neither FIN 46 nor FIN 46R exempt non-registered investment companies from their scope.

Nonetheless, FASB has deferred the effective date of FIN 46R for investment companies that are accounting for their investments in accordance with the AICPA Audit and Accounting Guide, Audits of Investment Companies. The deferral does not apply to investments made after March 27, 2002 by an investment company that is not a separate legal entity.
5. A reporting enterprise is having difficulty obtaining the information required to (1) determine if an entity is a VIE, (2) determine whether it is a VIE’s primary beneficiary, or (3) perform the consolidation accounting for a VIE of which it is the primary beneficiary. Does FIN46R provide any relief?

Yes, if the VIE was created before December 31, 2003\(^1\) and the reporting enterprise has made an exhaustive effort to obtain the necessary information. In these cases, the VIE in question is exempt from the consolidation requirements of FIN 46R for that reporting enterprise. However, the scope exception applies only as long as the reporting enterprise continues to be unable to obtain the necessary information, and specific disclosures are required. FIN 46R notes that the inability to obtain necessary information is expected to be infrequent, especially if the reporting enterprise participated in the design of the entity.

6. Paragraph 5 of FIN 46 identified the critical characteristics of a Voting Interest Entity (VoIE)\(^2\). Does FIN 46R modify these characteristics?

Under FIN 46 and FIN 46R, when the characteristics of paragraph 5 are met, the entity is a Voting Interest Entity\(^3\). To determine if the VoIE has an accounting parent, its investors apply long-standing, conventional consolidation guidance, most notably ARB 51 rather than FIN 46 or FIN 46R.

While FIN 46R changes some of the language in paragraph 5, the modifications are largely technical. We don’t foresee these changes altering a conclusion that an entity is or is not a VoIE.

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\(^1\) Implicitly, FASB expects that entities newly formed after this date will be designed to make the necessary information available.

\(^2\) To be a VoIE under Paragraph 5 of FIN 46 and FIN 46R, an entity’s total equity at risk must be sufficiently large enough to permit the entity to finance its activities without additional subordinated financial support for other parties. Further, the group of equity holders at risk must have all of the characteristics of a controlling financial interest. Finally, a VoIE cannot provide some investors with voting rights disproportionate to their economic exposure if all or substantially all of the entity’s activities involve or are conducted on behalf of an investor with disproportionately few voting rights. Consult paragraph 5 for the very important details that are only generally described in this footnote.

\(^3\) In addition to VIEs and VoIEs, FIN 46 and FIN 46R address qualifying special purpose entities (QSPEs) as described in FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and predecessor guidance. Transferors of assets to QSPEs and, usually, investors in beneficial interests issued by QSPEs do not consolidate the QSPE according to FIN 46 and FIN 46R.
Determining Variable Interests and Analyzing VIEs

7. Does FIN 46R always require a quantitative assessment of an entity’s expected losses?

No, although compared to its predecessor, FIN 46R raises the prominence of undertaking a qualitative assessment in lieu of an expected loss calculation. It states that a quantitative assessment is required to be performed only:

if, after diligent effort, a reasonable conclusion about the sufficiency of the entity's equity at risk cannot be reached solely on qualitative considerations… (paragraph 9)

Further, FIN 46R permits a qualitative assessment of factors not specifically cited in FIN 46. Paragraph D31 cites as other important qualitative considerations the following: the design of the entity, the apparent intentions of the party that created the equity, debt ratings, interest rates, and other financing terms.

Example. An entity has an unlimited life and its activities are not tightly constrained. Its equity interests do not appear designed to require additional subordinated financial support. There are no arrangements that appear designed to provide subordinated financial support, and the entity has been able to obtain commercial financing arrangements on customary terms.

Under the circumstances, the equity at risk would be expected to be sufficient based on a qualitative assessment of the preponderance of the evidence. The entity would not be considered a VIE if all of the other requirements of paragraph 5 are met.

8. How has FIN 46R clarified the definition of a variable interest (also see Question 9)?

FIN 46R clarifies that variable interests absorb or receive the expected variability created by the assets, liabilities and other positions of a VIE that are not, themselves, variable interests.

One of the knottiest problems under FIN 46 has been segregating a VIE’s variable interests from its other positions that are not variable interests. Under FIN 46, the definition of a variable interest was vague and its illustrations were not particularly illuminating. FIN 46R, especially its revamped Appendix B, helps.

Why is it important to distinguish a VIE’s variable interests from its other positions? First, the holder of a position in a VIE that is not a variable interest (assuming the holder owns no other positions) can never be its primary beneficiary. Second, the distinction is needed to appropriately calculate the expected losses and the expected residual returns of a VIE.5

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4 Expected variability has a specific meaning under FIN 46 and FIN 46R. Based on a probability-weighted scenario analysis, the entity’s single expected cash flow attributable to its non-variable interests is determined. All probability-weighted cash flow amounts less than the expected cash flow represent the entity’s negative variability and give rise to expected losses. All probability-weighted cash flows above the expected cash flow represent the entity’s positive variability and give rise to expected residual returns. The sum of the absolute values of expected losses and expected residual returns (after discounting to fair value) is the total expected variability of the entity. Thus, even if a VIE is virtually certain to be profitable (i.e., its income will exceed its expenses) it will still have expected losses and expected residual returns. Appendix A of FIN 46 and FIN 46R illustrate the concept.

5 Remember, the expected loss calculation is used to determine both the sufficiency of the equity investment at risk and to identify the VIE’s primary beneficiary. The VIE's primary beneficiary is the single party (including its related parties and de facto agents) that bears a majority of the expected losses of the VIE. If no single party is the primary beneficiary based on expected losses, then the single party (including related parties and de facto agents) that is entitled to a majority of the VIE’s expected residual returns is the VIE’s primary beneficiary. If no entity bears a majority of the VIE’s expected losses or is entitled to a majority of its expected residual returns, the VIE has no accounting parent because no single entity is the VIE’s primary beneficiary.
9. **What are some examples that illustrate the difference between variable and non-variable interests?**

Appendix B of FIN 46R contains a number of examples included in the table below. Appendix B notes that its discussion is not determinative because “the descriptions are not intended to be exhaustive of the possible roles, and the possible variability, of the [VIE’s] assets, liabilities, equity and other contracts.”

<table>
<thead>
<tr>
<th>Item</th>
<th>Variable or non-variable interest?</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity instruments issued</td>
<td>See separate question below</td>
<td></td>
</tr>
<tr>
<td>• Fixed rate debt</td>
<td>Variable</td>
<td>A debt holder's interest absorbs the variability of the entity's assets in that the debt holder is exposed to the entity's ability to pay. A holder of only the most senior interest of a variable interest entity likely would not be the VIE's primary beneficiary assuming that subordinated interests are large enough to absorb the entity's expected losses and the debt instrument does not embed derivatives exposing the holder to additional amounts of the VIE's expected variability</td>
</tr>
<tr>
<td>• Floating rate debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Other non-derivative liabilities (e.g., trade payables)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantees held by the VIE</td>
<td>Variable*</td>
<td>The guarantor absorbs the variability of specified assets</td>
</tr>
<tr>
<td>Put options on a VIE's asset(s) purchased by the VIE and similar arrangements</td>
<td>Variable*</td>
<td>Same as guarantees held by the VIE. The option writer is exposed to the variability of the assets related to the option’s underlying</td>
</tr>
<tr>
<td>VIE writes an option, guarantee or similar</td>
<td>Usually, non-variable</td>
<td>Such contracts usually create variability (i.e., the VIE writes a put option on an asset owned by another party). However, if a VIE writes a stand-alone call option on a specific asset or group of assets it owns, for example, the holder of the option absorbs variability and the contract would be a variable interest*</td>
</tr>
<tr>
<td>• Fixed price forward contract to buy assets not owned by the VIE</td>
<td>Non-variable</td>
<td>Typically such contracts create variability because they expose the VIE to fair value changes in the assets underlying the forward</td>
</tr>
<tr>
<td>• Fixed price contract to sell assets not owned by the VIE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed price forward contracts to sell assets owned by the entity</td>
<td>Variable*</td>
<td>The counterparty on the forward absorbs the variability in fair value of specified assets of the entity that are the forward’s underlying</td>
</tr>
<tr>
<td>Item</td>
<td>Variable or non-variable interest?</td>
<td>Comments</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>Depends on facts and circumstances</td>
<td>Instruments that expose the VIE to risks that increase its expected variability are not variable interests. A counterparty on a derivative whose underlying is a market interest or currency rate usually will not be a primary beneficiary unless the primary cause of the entity's variability are the same or similar interest or currency rates. Total return swaps on assets are variable interests in the specified assets to which they relate*</td>
</tr>
<tr>
<td>Derivatives embedded in assets or liabilities that are clearly and closely related to the host</td>
<td>Evaluate the entire instrument without separate consideration of the embedded derivative</td>
<td></td>
</tr>
<tr>
<td>Derivatives embedded in assets or liabilities that are not clearly and closely related to the host</td>
<td>Evaluate the host and the derivative separately</td>
<td></td>
</tr>
<tr>
<td>Assets of the VIE</td>
<td>Non-variable</td>
<td>Assets are typically the major source of a VIE's variability. See above for guarantees, purchased put options and similar</td>
</tr>
<tr>
<td>Fees paid to a decision maker</td>
<td>Variable unless the conditions described in Question 10 are met</td>
<td></td>
</tr>
<tr>
<td>Service provider contracts</td>
<td>Typically non-variable unless one of the conditions in FIN 46R, paragraph B22 is violated.</td>
<td></td>
</tr>
<tr>
<td>Operating lease of a VIE lessor, no purchase option or residual value guarantee</td>
<td>Non-variable</td>
<td>The operating lease is the economic equivalent of a receivable and thus exposes the VIE to variability (e.g., lessee performance)</td>
</tr>
<tr>
<td>Standalone residual value guarantee of a VIE's leased asset and purchased options covering the leased assets</td>
<td>Variable*</td>
<td>These contracts absorb the variability of specified assets.</td>
</tr>
<tr>
<td>Operating lease of a VIE's leased asset with an embedded residual value guarantee and/or purchase option</td>
<td>Variable*</td>
<td>The embedded option is not clearly and closely related to the lease cash flows (i.e., the economic equivalent of a receivable as described above). Thus, the scheduled lease payments are not a variable interest but the separately considered embedded guarantee/option would be a variable interest.*</td>
</tr>
</tbody>
</table>

*Variable interests in specified assets whose value is less than half of the total fair value of the VIE's assets are not considered variable interests of the entity.
**Example.** A VIE holds floating-rate debt securities to maturity. It issues three classes of fixed-rate beneficial interests. The senior class is highly rated (e.g. AAA) as to timely payment of principal and interest. The other two classes are subordinate to the senior class. The VIE also enters into an interest rate swap with a major commercial bank to fix the mismatch in interest rates between its assets and liabilities.

The VIE’s debt security assets are not variable interests - they create variability (attributable to credit and interest rate risk). The interest rate swap is a variable interest because it absorbs the interest rate variability caused by the floating rate assets. All of the VIE’s obligations under beneficial interests are variable interests.

The holder of the senior debt obligation will not be the VIE’s primary beneficiary because the likelihood of the senior debt participating in the VIE’s expected variability is so low. The commercial bank or a majority holder of the subordinated debt class is the candidate to be the primary beneficiary. The question is which is larger – the interest rate variability absorbed by the bank as swap counterparty or the credit risk, absorbed by the subordinated debt class.

10. **Is an equity investment in a VIE always a variable interest? What are the implications of the answer for Trust Preferred Vehicles?**

Equity investments in a VIE are variable interests unless the equity investment is not at risk. Even then, the equity interest might represent a variable interest if it exposes the equity owner to the VIE’s expected variability.

**Example.** Commercial Bank sponsors a trust preferred vehicle. The vehicle raises $97 by issuing preferred stock to investors unrelated to Commercial Bank. Commercial Bank invests $3 for the common stock of the trust. The trust lends, in the form of a note, $100 to Commercial Bank. The terms of the note, if satisfied, will service the dividend on the preferred stock and provide funds for its redemption. The trust is a VIE.

Commercial Bank’s equity investment is not at risk because it obtained the funds for its common stock investment from the trust. Commercial Bank is not exposed to the VIE’s variability. The preferred shareholders bear the losses borne by the trust if Commercial Bank defaults on its obligation. Any loss Commercial Bank suffers on its common stock investment is recouped by the “gain” it experiences by virtue of defaulting on the note.

Because Commercial Bank does not have a variable interest in the Trust, it cannot be the VIE’s primary beneficiary and cannot consolidate the Trust.

**Example.** VIE issues notes to third parties for $75 and common stock to Sponsor for $25. It invests $25 in a senior debt obligation of Sponsor (highly creditworthy) and $75 in a portfolio of credit risky debt securities issued by unrelated third parties.

Sponsor’s investment in common stock is not at risk. Nonetheless, Sponsor is exposed to the variability of the VIE. In effect, the Sponsor’s note will fund losses that the VIE incurs on its $75 of risky assets, for the benefit of the VIE’s noteholders. The common stock investment, in effect, acts like a guarantee by Sponsor of the risky assets, capped at $25. Because guarantees are often variable interests (see Question 13), Sponsor should treat its common stock “investment” as a variable interest in the entity and evaluate whether it is the VIE’s primary beneficiary.

11. **Assume a decision maker’s fees are treated as a variable interest under FIN 46R. How does FIN 46R alter FIN 46’s treatment of decision maker fees that are variable interests?**

FIN 46 observed that:

A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics [i.e., majority of expected losses or expected residual returns] that would require consolidation of the variable interest entity.

FIN 46R does more than eliminate the above observation – it modifies FIN 46’s method for calculating a decision maker’s share of the expected residual returns of a VIE, reducing the likelihood that the decision maker ends up being the VIE’s primary beneficiary.
Example. For a quarterly fee, Asset Manager Co. ("AM") manages the assets of CDO Vehicle, a VIE. It also owns a percentage of the Vehicle’s junior debt. Assume the following additional facts:

- Expected losses and expected residual returns of the CDO Vehicle – $145
- No single holder, including AM, is exposed to a majority of the vehicle’s expected losses
- AM’s participation in CDO Vehicle’s expected residual returns due to its management agreement and its ownership of junior debt – $30
- Fair value of fees under AM’s asset management agreement – $105

Under FIN 46, AM consolidates the Vehicle because it is its primary beneficiary. The table below compares the calculations required by FIN 46 and FIN 46R:
12. **When does a decision maker consider its fees a variable interest in a VIE?**

In the example above, AM’s decision maker fees are treated as a variable interest although the fees (plus AM’s other variable interest) did not cause AM to be the vehicle’s primary beneficiary. However, decision makers need not consider their fees to be a variable interest in a VIE at all if certain stringent conditions of FIN 46R are satisfied.

A decision maker does not treat its fees as a variable interest if its role is essentially one of a hired service provider to or an employee of the VIE. When is that the case? Here are the conditions:

<table>
<thead>
<tr>
<th>Condition</th>
<th>Comments</th>
</tr>
</thead>
</table>
| 1         | The fees are compensation for services provided and are commensurate with the level of effort required to provide the services | The following factors may indicate that fees are excessive and the condition is not met:  
- The arrangement includes terms, conditions, or amounts that are not customarily present in similar arm’s length service arrangements  
- The total amount (and/or the total expected variability) of the expected fees is large vis-a-vis the total VIE’s expected return to its variable interest holders (and/or the total expected variability of the VIE) |
| 2         | The fees are at least as senior as other operating liabilities of the entity (e.g., trade payables) | |
| 3         | Except for the fees described in this table, the decision maker (including related parties) does not hold interests in the variable interest entity that participate in the entity’s expected variability | • Interests are considered individually and in the aggregate.  
• A “trivial” amount of participation in the expected variability is permitted |
| 4         | The decision maker is subject to substantive kick-out rights | The decision maker can be removed by a simple majority of the voting interests (excluding those held by the decision maker and its related parties) and there are no significant barriers to the exercise of the kick-out rights. FIN 46R discusses other characteristics of substantive kick-out rights in paragraph B20(b). |

**Example.** As discussed in the previous example, AM acts as the vehicle’s decision maker. AM must consider its fees to be a variable interest because it holds other interests that more than trivially participate in the entity’s expected variability (i.e., AM’s ownership of a percentage of the junior class of bonds).

Potentially – somewhat ironically – a decision maker’s fees can vary (e.g., based on a percentage of the vehicle’s net income or asset value) and yet not be considered a variable interest. All four conditions must be satisfied, including the considerations related to the extent and variability of fees mentioned in 1 above.

**Example.** A decision maker is entitled to the following fee arrangement. It receives a quarterly fixed fee that is senior to all other obligations of the entity. It also receives a subordinated incentive fee based on a percentage of the entity’s net income.

The decision maker’s fees are a variable interest in the entity. The arrangement violates condition 2. If all components of the fees were senior, the decision maker would need to consider the other conditions in the table to determine whether the fee arrangement represents a variable interest.
13. Does FIN 46R alter the treatment of certain guarantee fees paid by a VIE?

Yes. Under FIN 46, a guarantor of all or substantially all of the value of a VIE's assets had to add the fair value of the fees under the guarantee arrangement to its participation in the entity's expected variability from any other variable interest it holds. FIN 46R removes this provision, eliminating a bias against guarantors of all or substantially all of the fair value of a VIE's assets (in the same manner in which FIN 46 removes the bias against decision maker fees that are variable interests).

Under FIN 46 and FIN 46R, guarantors do not always consider a guarantee to be a variable interest in a VIE. Expected losses related to variable interests in specified assets are excluded from the calculation of the entity's expected losses unless the specified assets constitute a majority of the assets of the VIE.

14. Do restrictions on a holder's right to sell its interest always create a de facto agency relationship?

Not always. Assume Company A and Company B are not related to one another except that they both hold an interest in a VIE. If Company B cannot sell, transfer or encumber its interest without the prior approval of Company A, FIN 46 treated Company B as a de facto agent of Company A. This created a related party relationship under FIN 46 and the collective holdings of A and B were evaluated together for purposes of determining whether the VIE had a primary beneficiary.

FIN 46R explains that application of the provision depends on the facts and circumstances. For example, if Company B is entitled to sell its interest without prior approval (although approval is required for other transfers including pledging the interest as security for a loan), a de facto relationship is not created. Another example? If the right of prior approval is designed solely to prevent the transfer to a competitor, less creditworthy holder or a less qualified holder, a de facto agency relationship is not created (assuming that there are other buyers who could qualify).

15. How should the single primary beneficiary be determined from a group of related party holders of variable interests in a VIE?

Under FIN 46 and FIN 46R, a number of circumstances cause the existence of a de facto agency relationship (one such circumstance is discussed in Question 14). Under FIN 46, the principal in the de facto agency relationship was tagged as the primary beneficiary if, collectively, the related party group was sufficiently exposed to the VIE's expected losses or expected residual returns.

FIN 46R modifies this approach. The primary beneficiary within a related party group is the one most closely associated with the VIE. A principal-agent relationship is one factor among several to consider in making the judgment about which member of the group is most closely associated with the VIE.6

16. When should a reporting enterprise reconsider whether an entity is a variable interest entity? Does a troubled debt restructuring trigger a redetermination?

Both FIN 46 and FIN 46R state that a non-VIE does not become a VIE because it incurs losses. A reporting entity reconsiders whether an entity is a VIE if one or more of the following occur [FIN 46R's changes to FIN 46 are indicated by blue (deletions) and green (additions)]:

a. The entity's governing documents or contractual arrangements among the parties involved changed are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.

b. The equity investment or some part thereof is returned to the equity investors, and other interests parties become exposed to expected losses of the entity.

c. The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.

d. The entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses.

FIN 46R stipulates that a troubled debt restructuring (defined in FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, paragraph 2) does not trigger a redetermination.

6 The other factors FIN 46R cites are as follows:

- The relationship and significance of the VIE's activities to the various parties within the group
- A party's exposure to the expected losses of the VIE, and
- The design of the VIE.
17. When must a variable interest holder reevaluate its status as to whether it is a primary beneficiary?

Under FIN 46 and FIN 46R, whenever an enterprise becomes involved with a VIE, it must determine whether it is the VIE's primary beneficiary. The table below compares the events under FIN 46 and FIN 46R that trigger a reconsideration of a party's status (primary beneficiary or not).

<table>
<thead>
<tr>
<th>FIN 46</th>
<th>FIN 46R</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity's governing documents or the contractual arrangements among the parties change</td>
<td>Same, except that the change must reallocate expected losses and expected residual returns between the existing primary beneficiary and unrelated parties.</td>
</tr>
<tr>
<td>For the primary beneficiary, it sells all or part of its variable interests to unrelated parties</td>
<td>Same.</td>
</tr>
<tr>
<td>An existing primary beneficiary must reconsider its status if the VIE issues new variable interests to unrelated parties.</td>
<td>A reconsideration is always triggered when a non-primary beneficiary acquires additional interests, regardless of the source.</td>
</tr>
<tr>
<td>For a party that is not a primary beneficiary, it acquires interests (1) newly issued by the entity or (2) previously held by the primary beneficiary</td>
<td></td>
</tr>
</tbody>
</table>

Implementation Dates and Other

18. What are the effective dates for the accounting provisions of FIN 46 and FIN 46R?

Even the question of when to implement FIN 46 and FIN 46R is complicated. FIN 46 featured staggered implementation depending on when a VIE was created and the type of enterprise that was implementing the standard. The fact that the implementation date has been postponed twice (first via FSP FIN 46-6 and later via FIN 46R) muddies the question even further. See Question 4 for a discussion of non-registered investment companies.

Prior to FIN 46R, FIN 46 (issued in January 2003) and FSP FIN 46-6 (released on October 9, 2003) required implementation of the accounting provisions no later than the dates indicated in the table below [changes due to FSP FIN 46-6 are shown in bold]:

**FIN 46 Effective Dates Before the Issuance of FIN 46R**
*(See Next Table for Effects of FIN 46R)*

<table>
<thead>
<tr>
<th>Interest Holder Is a:</th>
<th>Entity Being Evaluated Under FIN 46 for Consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Entity</td>
<td>Created after January 31, 2003 Effective immediately</td>
</tr>
<tr>
<td></td>
<td>No change</td>
</tr>
<tr>
<td></td>
<td>Created before February 1, 2003 Beginning of first interim or annual</td>
</tr>
<tr>
<td></td>
<td>End of the first interim or annual period ending after December 15, 2003 (assuming that the entity had not issued financial statements reporting the entity in accordance with FIN 46). The public entity can elect the deferral on an entity-by-entity basis.</td>
</tr>
<tr>
<td>Non-public Entity</td>
<td>Created after January 31, 2003 Effective immediately</td>
</tr>
<tr>
<td></td>
<td>No change</td>
</tr>
<tr>
<td></td>
<td>Created before February 1, 2003 No change</td>
</tr>
</tbody>
</table>
**Example.** Public Company, a calendar-year reporter that is not a “small business issuer,” has an interest in entities A, B and C. Entity C was created on February 28, 2003. Before it issues its third quarter financial statements, Public Company elects to defer the effective date of FIN 46 for Entity A but not for Entity B under the provisions of FSP FIN 46-6. Assume that after application of FIN 46, Public Company has determined (for Entity A would have determined) that each of the entities is a VIE and that Public Company would be each entity’s Primary Beneficiary.

Public Company’s interim and annual consolidated financial statements include the accounts of the VIEs as follows (PRIOR TO CONSIDERING FIN 46R DISCUSSED BELOW):

- March 31, 2003 – VIE C
- June 30, 2003 – VIE C
- September 30, 2003 – VIEs B and C
- December 31, 2003 – VIEs A, B and C
- March 31, 2003 – VIEs A, B and C

FIN 46R delays again the effective date of the Interpretation (except for special-purpose entities) and adds separate effective dates for a Public Entity that is a Small Business Issuer as defined in SEC Regulation S-B 228.(a)(1). The table below summarizes FIN 46R’s effective dates.

### FIN 46R Effective Dates

<table>
<thead>
<tr>
<th>Interest Holder Is a:</th>
<th>Entity Being Evaluated Under FIN 46R for Consolidation</th>
<th>Special-purpose entities*</th>
<th>Other entities*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Enterprise – non small business issuer</td>
<td>Entity to which FIN 46 has been applied in previously issued financial statements</td>
<td>Apply FIN 46 or FIN 46R (choice is on an entity-by-entity basis) no later than the end of the first reporting period that ends after December 15, 2003.</td>
<td>No later than the end of the first reporting period that ends after March 15, 2004.</td>
</tr>
<tr>
<td>Public Enterprise – small business issuer</td>
<td>Same as other public companies.</td>
<td>Same as other public companies.</td>
<td>No later than the end of the first reporting period that ends after December 15, 2004.</td>
</tr>
<tr>
<td>Nonpublic Enterprise</td>
<td>Not discussed in FIN 46R.</td>
<td>No special requirement – see column “Other Entities.”</td>
<td>Beginning of the first annual reporting period that begins after December 15, 2004. For entities created after December 31, 2003, FIN 46R must be applied immediately.</td>
</tr>
</tbody>
</table>

* FIN 46R must be applied to all entities no later than the effective date shown in the column headed “Other entities”.

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**January 16, 2004**
Example. Same facts as previous example. The effect of FIN 46R is as follows:

- December 31, 2003 – Public Company can exclude VIE A unless the VIE is an SPE. If Public Company chooses to include VIE A, it can apply the provisions of FIN 46 or FIN 46R.

Example. Asset Manager, a public company that is not a small business issuer, concluded that FIN 46 required it to consolidate the accounts of VIE 1, a collateralized debt obligation issuer. Asset Manager included the assets and liabilities of the VIE in its September 30, 2003, consolidated financial statements. Under FIN 46R, Asset Manager will no longer qualify as the VIE’s primary beneficiary.

On December 31, 2003, Asset Manager can elect to early apply the provisions of FIN 46R to the VIE and deconsolidate its assets and liabilities. If Asset Manager does not make this election, it must deconsolidate the VIE in its March 31, 2004 financial statements.

19. Assume a reporting enterprise (public, non-small business issuer) with a calendar-year end has applied FIN 46 to certain of its entities but not to others. Assume none of the entities is an SPE. What choices are available to the reporting enterprise at December 31, 2003?

With respect to the entities to which the reporting enterprise has already applied FIN 46, it can elect to continue using the provisions of FIN 46 or early apply FIN 46R. It must use one or the other. It can decide to early apply FIN 46R on an entity-by-entity basis.

With respect to the entities to which the reporting enterprise has an interest and has not already applied FIN 46, it can elect to apply FIN 46, FIN 46R or neither in its December 31, 2003 financial statements. Again, the choice is on an entity-by-entity basis.

Example. Public Co. X, with a calendar-year end, has an interest in three entities, 1, 2 and 3. They are all similar in structure and operation, none of them is an SPE, and Public Co. X has not yet applied FIN 46 to any of them. At December 31, 2003, Public Co. X could apply FIN 46 to Entity 1, FIN 46R to Entity 2 and neither FIN 46 nor FIN 46R to Entity 3. Public Co. X should expect probing questions from bewildered equity analysts who follow its financial statements.

As the above discussion indicates, FIN 46 and FIN 46R will be applied inconsistently between companies and possibly within an individual company. Companies should carefully evaluate the need for supplemental disclosure if it elects to stagger its implementation of the Interpretation or if its adoption will not align well vis-a-vis its peers.

20. How does FIN 46R change FIN 46 with respect to goodwill?

FIN 46 prohibited a reporting enterprise from recording goodwill when it first determined that it was the primary beneficiary of a VIE. Instead, a primary beneficiary reported any excess of the primary beneficiary’s “cost” over the fair value of the VIE’s “net assets” as an extraordinary loss. FIN 46R removes this prohibition, but only when the VIE is a business (see Question 2).

If an entity has already written off goodwill because it has already applied FIN 46, the goodwill cannot be reinstated.