

**FASB Emerging Issues Task Force**

**Issue No:** 04-7

**Title:** Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity

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**Previously Distributed EITF Materials:** Issue Summary No. 1, dated June 18, 2004; Issue Summary No. 1, Supplement No. 1, dated September 16, 2004, Issue Summary Supplement No. 2, dated November 1, 2004

**References**

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, a replacement of FASB Statement No. 125* (FAS 140)

FASB Statement No. 52, *Foreign Currency Translation* (FAS 52)

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R)

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (CON 7)

AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51)

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**\* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

## Background

1. At the June 30–July 1, 2004 and September 29–30, 2004 EITF meetings, the Task Force discussed various methods to determine whether an interest in a potential variable interest entity (VIE) is a variable interest. Two of those methods are the Fair Value Method and the Cash Flow Method.<sup>1</sup> Since the Task Force was unable to reach a consensus as to which of these two methods was most appropriate, it requested that the FASB staff develop an approach that incorporates a screen that would be used to determine when the Cash Flow Method or the Fair Value Method should be used by a reporting enterprise in determining whether an interest in a potential VIE is a variable interest. At the November 17–18, 2004 EITF meeting, the FASB staff presented four different types of screens for the Task Force’s consideration. The Task Force:

- Rejected a screen based on the creators of variability
- Rejected a screen based on the variability the entity was designed to be exposed to
- Rejected a screen based on the predominant risks that the entity was designed to be exposed to
- Accepted a screen based on the nature of the operations of the entity—Financial VIEs are presumed to use the Fair Value Method while Non-Financial VIEs are presumed to use the Cash Flow Method. The approach is referred to herein as the Presumption Approach.
- Discussed overcoming the presumptions based on the risks and design of the entity.

2. The Task Force asked the FASB staff to work with the FIN 46(R) Implementation Issues Resource Group to further develop the screen that is based on the nature of the operations of the entity. Specifically, the Task Force requested that the FASB staff develop (a) the definition of a Financial VIE, (b) the criteria that would overcome the presumption of which approach to use, and (c) examples illustrating the application of the approach to Financial and Non-Financial VIEs. This Issue Summary Supplement will describe (a) the Presumption Approach prepared by the FASB staff with input from the Resource Group, (b) the observations made by the Resource

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<sup>1</sup> The Fair Value Method as described in Issue Summary No. 1 requires that only variability in the fair value of the net assets of an entity (exclusive of variable interests) should be considered when determining whether an interest is a variable interest. The Cash Flow Method is also described in Issue Summary No. 1 and requires that only variability in the cash flows of the net assets of an entity (exclusive of variable interests) should be considered when determining whether an interest is a variable interest.

Group and the FASB staff, (c) the principles that comprise the Presumption Approach to be discussed further by the Task Force, and (d) an alternate method presented by certain members of the Resource Group called the Risk Approach. In addition, Exhibit 04-07A includes example transactions to illustrate the application of the Presumption and Risk Approaches for Task Force consideration.

## ***PRESUMPTION APPROACH***

### **Definition of Financial Variable Interest Entity**

3. The Presumption Approach is based on the nature of the operations of the entity and, therefore, the following definition is critical to the application of this approach:

Financial Variable Interest Entity—An entity for which the majority of its activity is (and is expected to be throughout its life) to buy, hold, and manage or trade *financial assets* as defined in FAS 107 and FAS 140, in order to generate income, capital appreciation, or both for its investors and/or itself. *Financial assets* include cash, evidence of an ownership interest in an entity, and a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity. A majority of such an entity's assets, based on fair value of the assets, is expected to be financial assets, **and** a majority of its net income is expected to be derived from such assets. The determination of whether an entity is a financial variable interest entity is made in consideration of both quantitative and qualitative information.

### **Presumption Approach - Methodology**

4. The Fair Value Method is presumed to be the appropriate method to calculate the expected losses of an entity, which is used to determine whether an interest absorbs variability of the entity and, as such, is a variable interest in the entity if the potential VIE meets either of the following conditions: (a) the potential VIE is a *financial* entity that derives its value from the active management of its assets, or (b) the potential VIE is a *non-financial* entity that derives its

value from the active management of non-financial assets that are “readily convertible to cash,”<sup>2</sup> such as certain commodities. It is presumed that the Cash Flow Method would be the appropriate approach to use if neither of those conditions were met. The presumption to use either the Fair Value Method or the Cash Flow Method could be overcome (thus, requiring that one or the other method be used) in circumstances in which the application of the presumed method results in the consideration of variability that the potential VIE was not *clearly designed* to be exposed to. The staff believes that the presumption would be overcome infrequently. The determination of whether the Fair Value Method or the Cash Flow Method is appropriate shall only be reconsidered in conjunction with an event that causes a reconsideration as to whether the entity is a variable interest entity in accordance with paragraph 7 of FIN 46R.

### **Guidance for At-The-Money Swaps**

5. In conjunction with the application of the Presumption Approach, the following guidance for at-the-money swaps is provided:

*Interest rate swaps (other than basis swaps) and foreign-exchange currency swaps are not considered variable interests in the entity provided that they are designed to economically hedge the interest rate or foreign currency exchange rate risk the entity is exposed to. In addition, the following conditions must also be met:*

- a. *The swap's fair value upon inception of the contract with the potential VIE is zero<sup>3</sup>*
- b. *The interval between repricings of the variable rate in the swap is frequent enough, relative to the frequency of such repricing in the market that the related assets are traded in, to justify an assumption that the variable payment is at a market rate*
- c. *The swap's notional amount is less than or equal to the notional amount of the entity's instruments that are exposed to the interest rate or foreign currency exchange rate risk*

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<sup>2</sup> Assets that are readily convertible to cash have (a) interchangeable (fungible) units and (b) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. Refer to footnote 5 of FAS 133.

<sup>3</sup> If there is a reconsideration event relative to the entity's status as a variable interest entity, the swap's fair value is not required to be zero at the time of the reconsideration.

- d. *There are no other unusual terms that may indicate that the swap is also economically absorbing variability not related to the cash flow variability created by the entity as a result of interests that reprice to market rates*
- e. *The swap counterparty has seniority over other interest holders in the potential VIE.*

6. This guidance would effectively require all parties involved with the potential VIE to not consider swaps that meet the above conditions to be variable interests but rather consider those swaps as part of the cash flows of the net assets of the potential VIE for purposes of determining the expected losses and expected residual returns of the potential VIE. For example, if a potential VIE holds floating rate assets, issues fixed rate debt, and enters into a pay floating rate/receive fixed rate interest rate swap (effectively fixing the interest rates on the assets), for purposes of determining the expected losses and expected residual returns, the reporting enterprise would consider the cash flows received from fixed rate assets (the combination of the floating rate assets plus the effect of the interest rate swap) to be cash flows of the net assets of the potential VIE.

7. Proponents of the Presumption Approach, which is based on clearly defined terms and includes additional guidance for certain swaps, believe that it will be established as a more disciplined approach that will be sufficient to resolve consistency issues that exist in practice today. These proponents believe that the definition of a Financial VIE is clear, will not require much interpretation, and will generally result in the appropriate variable interest holder consolidating the VIE. Proponents believe that this approach, with the override that is based on the design of the potential VIE, is consistent with paragraph B4 of FIN 46(R), which states that when identifying the variable interests, the role of the interests must be considered and that role often depends on the design of the entity. These proponents also believe that the ability to overcome the presumption is sufficiently limited to ensure that only in circumstances in which the presumed method arrives at a clearly counterintuitive Primary Beneficiary designation (or lack thereof), will a different method be utilized. This limited override will restrict reporting enterprises from arbitrarily overriding the presumptions.

8. Opponents of the Presumption Approach believe that its application, which includes (a) evaluating the nature of the entity's operations, (b) determining whether an entity has overcome the presumption, and (c) permitting special treatment for certain swap transactions, is overly complex for determining whether an interest is a variable interest. Other opponents of the Presumption Approach believe that it is not consistent with paragraph B4 of FIN 46R as it will exclude certain variability from the analysis. For example, when the Fair Value Method is applied to a Financial VIE, certain cash flow variability is not incorporated into the analysis. Likewise, when the Cash Flow Method is applied to a Non-Financial VIE, certain fair value variability is not incorporated into the analysis.

9. Other opponents of the Presumption Approach believe that the presumptions are established to effectively analyze the overwhelming majority of transactions and that those presumptions should not be overridden under any circumstances. These opponents believe that even a limited ability to overcome the presumptions, brings additional judgment into the analysis and will make for less consistency in the application of FIN 46R. Proponents of the Presumption Approach counter that argument by stating that there are situations in which the presumed method would not be appropriate and such flexibility is required to rectify those situations. For example, an actively managed Financial VIE may have variable rate assets and issued an overwhelming majority of variable rate interests and a small minority of fixed rate interests. Assuming that there was no subordination provided by either of the interests, the application of the Fair Value Method would result in the minority holder of the interests being the primary beneficiary, when it is clear that the entity was designed to be predominantly exposed to cash flow variability. Opponents of this approach believe that the ability to overcome the presumed method based on the design of the entity has the potential of being broadly interpreted and will result in reporting enterprises having too much discretion, which would result in the inconsistent application of this approach. These opponents believe that with the design of the entity being the critical aspect to overcome the presumed method, an evaluating entity may arbitrarily not consider certain variability, which is not consistent with FIN 46R. These opponents also believe that basing the evaluation on the design of the potential VIE as distinguishing criteria will be extremely difficult and impractical to apply in a disciplined manner. These opponents are concerned that the

information used will be subjective and cannot be objectively verified, which in turn raises audit concerns and comparability issues.

10. Still other opponents of the Presumption Approach believe that the approach is flawed because the application of either method (presumed method or “other-than-presumed-method”) does not consider the differences between senior interests and subordinated interests. As such, these opponents believe that the primary beneficiary determinations (or lack thereof) under this approach are biased toward notional amounts of interests being the most relevant factors in consolidation. For example, a VIE may issue senior fixed and senior floating tranches of variable interests as well as a subordinated tranche. In that case, the application of either method under the Presumption Approach will not identify the subordinate interest holder as the primary beneficiary since the alternative method will likely result in a senior interest holder being identified as the primary beneficiary (due to the higher notional amount on senior interests). These opponents believe that this result is inconsistent with paragraph B9 of FIN 46R, which states that the holder of the most senior beneficial interests likely would not be the primary beneficiary of a VIE. These opponents observe that there would be many situations in which the primary beneficiary designation would be based on the notional amount of the interest and often not result in an equity holder being designated as the primary beneficiary. These opponents also believe that the use of the Presumption Approach will result in a greater number of entities being considered VIEs as the inclusion of all variability that impacts the senior interests on a notional basis may result in the equity of the potential VIE being insufficient when applying paragraph 5 of the FIN 46R.

### ***RESOURCE GROUP OBSERVATIONS***

11. The FASB staff met with the Resource Group on two separate occasions following the November EITF meeting to discuss the Task Force’s request to further develop the Presumption Approach. The FASB staff worked closely with the Resource Group in developing (a) the definition of a Financial Variable Interest Entity, (b) the criteria to overcome the presumptions, and (c) the criteria necessary for certain swap transactions to be considered as part of the net assets in the analysis as described in the Presumption Approach.

12. In regard to the definition of a Financial Variable Interest Entity, the Resource Group unanimously supported the definition provided above in paragraph 3. When supporting the definition, one Resource Group member questioned whether the threshold for asset and income levels should be set at “majority” or something higher (for example, “substantially all”). The Resource Group voted to keep the threshold in the definition at “majority.”

13. In regard to the Presumption Approach, 7 of the 11 Resource Group members were in favor of recommending the Presumption Approach to the Task Force, with the expectation that the presumption to use either approach would be overcome only in very narrowly defined circumstances. These seven Resource Group members, as well as certain other Resource Group members, believe that a broad range of opportunities to overcome the presumed method based on the design of the entity is an alternative way to use the Design Approach (which was previously rejected by the Task Force at the September 29–30, 2004 EITF meeting). Some of these Resource Group members also believe that a list of factors to be considered in overcoming the presumption should be provided as part of the Presumption Approach. The FASB staff and the Resource Group were unsuccessful in developing a list of factors that would overcome the presumptions in only a narrow range of circumstances. Therefore, the Presumption Approach, as currently drafted, clarifies that the presumption would be overcome in very limited circumstances.

14. Three of the Resource Group members objected to recommending the Presumption Approach to the Task Force. These three members, all of whom are preparers, agreed with the proponents of the Presumption Approach that there are circumstances in which neither the strict application of the Fair Value Method nor the strict application of the Cash Flow Method, will appropriately measure the risk and, as such, the variability of the entity. These Resource Group Members recommended an alternate approach (the Risk Approach) to address this issue. The Risk Approach focuses the analysis on only the significant variability of an entity, as this represents the variability that will drive the Primary Beneficiary designation. This approach further describes significant variability as the variability that disproportionately impacts the subordinated interest holders. These members observe that this approach is currently being

consistently applied in practice and compensates for the Presumption Approach's complex, multiple step process while still arriving at Primary Beneficiary designations that are similar to those arrived at under the Presumption Approach.

15. None of the other Resource Group members recommended presenting the Risk Approach to the Task Force. However, the FASB staff believes it is beneficial to include the Risk Approach that is currently being applied in practice, to assist Task Force members in making an informed decision as to whether the Presumption Approach is the most appropriate approach. Therefore, the Presumption Approach and the Risk Approach are both presented in this Supplement along with examples reflecting the application of each approach.

16. One of the Resource Group members did not vote to recommend either the Presumption Approach or the Risk Approach to the Task Force. This Resource Group member believes that a screened approach is required but that it should be applied in a different manner than proposed by the Presumption Approach. This Resource Group member recommended that the Task Force consider a new multi-step, screened approach that features:

- A rule-based designation of all interests as either net assets or variable interests.
- The selection of either the cash flow method or fair value method as appropriate for analyzing the entity, based on which method results in the scenarios with the most variability for the potential variable interest entity.
- The computation of expected losses for the entity (using the above selected method) to determine the sufficiency of equity at risk in evaluating whether the entity is a VIE and, possibly, an additional expected loss calculation performed with the senior interests (as defined by rule) being considered as part of the net assets.

The FASB staff has not provided this new multi-step screened approach in full nor has it contemplated the views of its proponents and opponents in this Supplement as the FASB staff was instructed by the Task Force to further develop the screened approach, which was tentatively agreed to at the November EITF meeting (the Presumption Approach). In addition, since this new screened approach is not currently being used in practice, the FASB staff is hesitant to

provide it as part of the Task Force's decision making process. Three other Resource Group members were in favor of considering this and other screened approaches further if the Task Force requests the FASB staff and the Resource Group to bring additional screened approaches back to the Task Force at a later date. The FASB staff will ask the Task Force if it wants to consider alternative screened approaches when considering the Presumption Approach.

17. In regard to the Presumption Approach, although the Task Force did not include the specific guidance for certain swap transactions in the preliminary decision, it expressed that it would consider such action prior to finalizing the approach. At-the-money swaps generally create and absorb equally offsetting amounts of variability. Because the variability created and the variability absorbed offset each other, the swap counterparty would generally not absorb a majority of the expected losses of the entity, therefore, the swap counterparty would not be considered the primary beneficiary of the VIE. Although the swap counterparty does absorb some credit risk of the VIE, swaps are generally senior to other interest holders. However, the application of either method within the Presumption Approach (absent the additional guidance for certain swap transactions) would only consider one type of the swap's cash flows (absorbers or creators of variability) and could potentially cause the swap counterparty to be designated as the Primary Beneficiary. Therefore, the FASB staff included the narrowly drafted guidance in the Presumption Approach to ensure that the counterparty to at-the-money swap transactions would not be considered the Primary Beneficiary of a variable interest entity when either the Fair Value Method or the Cash Flow Method is being applied.

18. Two Resource Group Members objected to the specific guidance provided for swap transactions. The basis for the objection by one of the Resource Group members was that that member believed it was inappropriate to provide this guidance for foreign currency swap transactions as that member believes these transactions create or absorb variability but do not necessarily create and absorb equally offsetting amounts of variability. The basis for the objection by the other Resource Group member was that the additional guidance is inconsistent with the concept of variable interests as defined by FIN 46R and that providing this guidance for swaps but not for other senior interests could result in significant variability being disregarded.

19. In addition, three Resource Group members who supported the Presumption Approach recommended that the Task Force consider removing this Issue from its agenda. The three Resource Group members recommended this course of action as all of the alternatives discussed to date omitted some variability from the analysis, which is not consistent with the consideration of all variability under FIN 46R.

### ***PRINCIPLES OF THE PRESUMPTION APPROACH***

20. Prior to deciding on whether to finalize the Presumption Approach, the Task Force may wish to discuss two aspects of this approach that became sources of debate among members of the Resource Group. Those two aspects relate to (a) the ability to overcome the presumption and (b) the availability of additional guidance for at-the-money swap transactions.

#### **Overcoming the Presumption: Limited or Many Circumstances**

21. In regard to the criteria to overcome the presumption, the Task Force should decide whether the presumption should be overcome in only limited circumstances. Proponents of limiting the circumstances in which the presumption would be overcome believe that this is what the Task Force had expressed when it discussed the Screened Approach at the November EITF meeting. These proponents believe that unless it is very clear that the use of the presumed method will result in a primary beneficiary designation (or lack thereof) that is not intuitive, the presumed method should be applied. These proponents believe that limiting the opportunities to overcome the presumption is consistent with the Task Force's stated goal of consistent application of FIN 46R. Opponents to limiting the circumstances in which the presumptions can be overcome believe that it will result in too stringent of a rule being established for the use of the presumed method and would limit the flexibility required to apply the many judgments required by FIN 46R. Other opponents believe that the reporting enterprise should not be allowed to overcome the presumption under any circumstances (the approach would no longer be a presumption approach). These opponents believe that including a presumption will provide reporting enterprises with the opportunity to circumvent the requirements of FIN 46R and will also result in inconsistent treatment. These opponents also believe that by not providing the ability to overcome the presumption, the most consistent application of the Interpretation will result.

### **Overcoming the Presumption with Limiting Language or Factors/Examples**

22. Assuming the Task Force decides to retain the ability to overcome the presumption in limited circumstances (as currently drafted), the Task Force should decide whether the language as currently drafted is sufficiently clear that it will result in minimal opportunities to overcome the presumption. Some Resource Group members suggested that factors or examples be used to illustrate when it would be appropriate to overcome the presumption. The FASB staff believes one example that could be considered involves "Static" type entities (entities that do not derive value from active management of the assets held). The FASB staff believes that although this notion is presently incorporated into the definition of a Financial Variable Interest Entity, it could be removed from the definition and included as an example to overcome the presumption. The FASB staff believes another example that could be considered would be based on the nature of the assets (inclusive of swap transactions) of the entity. Proponents of the use of examples or factors believe these suggestions will provide the necessary guidance to promote consistent application of FIN 46(R). Opponents believe that examples or factors could be construed as providing a set of rules that are applicable in all circumstances.

### **Guidance for At-The-Money Swaps**

23. Another issue for the Task Force to consider with the Presumption Approach, as written, is the additional guidance provided for at-the-money swap transactions. If the additional guidance is excluded from the approach, there may be instances in which the swap counterparty would be considered the primary beneficiary because swaps both create and absorb variability and the Presumption Approach would require the sole use of either the Cash Flow Method or the Fair Value Method, which would cause only one type of the swap's cash flows (absorbers or creators of variability) to be considered. If only the variability being absorbed by the counterparty is considered, that variability may exceed the variability being absorbed by the subordinated interest holders, as well as other holders, and cause the swap counterparty to be the Primary Beneficiary. The proponents of the additional guidance believe this conclusion would be inappropriate since interest rate swaps are generally designed to create and absorb equally offsetting amounts of variability. These proponents also believe that the additional guidance is a necessary and practical expedient to counterparties, as these parties rarely, if ever, absorb a

majority of expected losses of a VIE when all variability is being considered. That is, the swap is merely swapping one form of interest rate risk for another and therefore not acting like a variable interest.

24. Opponents of the inclusion of the additional guidance believe that it is not necessary given the ability to overcome the presumption afforded by the Presumption Approach. These opponents note that in circumstances in which a swap counterparty would be considered the primary beneficiary, an entity would likely meet the criteria to overcome the presumption. Proponents counter this point by observing that the more limited the circumstances are to overcome the presumptions, the less likely the designation of a swap counterparty as the Primary Beneficiary would be able to be overcome. Other opponents of the additional guidance observe that this is an additional rule to be followed in applying an already complex Interpretation. These opponents believe that this represents an amendment to FIN 46(R) and therefore should be dealt with by the Board.

## ***RISK APPROACH***

### **Reasons for the Risk Approach**

25. Proponents of the Risk Approach agree with the Task Force that neither the Fair Value Method nor the Cash Flow Method, applied narrowly, appropriately measures the variability of the entity for determining the primary beneficiary. However, considering interest rate variability as a significant factor in determining the primary beneficiary in all cases (such as in the Presumption Approach) would result in a model that no longer places the consolidation focus on the entity's subordinated interests. The Presumption Approach attempts to compensate for this inconsistency through a multi-step process that includes an override when the conclusion reached is not intuitive and through additional guidance for certain swap transactions.

26. One of the principles of the Risk Approach is identifying the significant variability in a potential VIE. Proponents of the Risk Approach believe this principle is consistent with paragraph 6 of FIN 46(R), which states that not all variable interest holders have a significant variable interest in a variable interest entity. These proponents believe that not all expected

variability of an entity is significant and should impact the determination of which enterprise is the primary beneficiary.

27. Proponents of the Risk Approach note that the principle of identifying significant variability is clearly evident in paragraph B9, which states that senior beneficial interests, whether fixed or floating, normally would absorb little of the entity's expected variability. Proponents of the Risk Approach believe that paragraph B9 illustrates why the focus in determining which enterprise is the primary beneficiary should be on whether a type of variability creates the significant risk(s) to the entity's subordinated interest(s). The variability may or may not include all of the entity's variability.

### **Risk Approach - Methodology**

28. When determining whether a reporting enterprise has a variable interest in a potential variable interest entity and could be the primary beneficiary, it is the variability that disproportionately affects and creates significant risk(s) to the entity's subordinated interest(s) holders that is relevant. A subordinate interest may take many forms, including a debt, equity or derivative instrument. The defining characteristic of a subordinated interest is that its cash flows are disproportionately affected by certain variability due solely to its terms or its position in the VIE's payment priority, rather than simply due to the notional amount of the interest.

29. The following three principles are used when applying the Risk Approach. The application of these principles is reflected in the examples in Exhibit 04-07A:

- (1) Gain an understanding of the rights and obligations of the variable interest entity's counterparties considering the following factors:
  - a. The entity's activities
  - b. The terms of the rights and obligations of the entity's assets, liabilities, equity, and other contracts and their respective roles with the VIE
  - c. Whether contractual arrangements create and/or absorb variability.
- (2) Identify the types of variability of the entity that create the significant risk(s) to the entity's subordinated interest(s). This step acknowledges that not all types of variability

should impact the determination of whether an enterprise is the primary beneficiary. (A holder of a subordinated interest in a VIE is exposed to the types of variability of the entity that create the significant risk(s) of the entity.)

- (3) Determine which enterprise is the primary beneficiary by analyzing expected losses/expected residual returns based on the types of variability identified in Principle (2) and the variable interest holders that absorb the variability. This can be done qualitatively or quantitatively.

30. Proponents of the Risk Approach acknowledge that interest rate risk may be a significant risk impacting the subordinated interests of a VIE in certain circumstances. For example, when there are asset sale activities that create realized gains and losses for the subordinated interest holder(s), interest rate risk may be significant. This may occur in an actively managed vehicle or when there is a mismatch between the maturities of the assets and liabilities of a VIE. An example of this fact pattern is depicted as Example 2 in Exhibit 04-07A.

31. Proponents of the Risk Approach believe that foreign exchange risk due to the mismatch between the currency denominations of an entity's assets and liabilities should be viewed in a manner consistent with interest rate risk and thus focus on foreign exchange rate risks of the VIE that disproportionately impact the subordinated interest holders.

32. Proponents of the Risk Approach observe that it is an operational approach because it is currently being applied in practice. Proponents of the Risk Approach believe that it is superior to the Presumption Approach because it provides conceptually consistent, yet more direct and simpler, means with which to reach many of the same conclusions as the Presumption Approach in a manner that is more in line with how market participants economically view their investments. These proponents observe that the Risk Approach is applied without necessitating additional guidance for certain types of instruments. Such guidance adds complexity to an already complex Interpretation.

33. Opponents of the Risk Approach observe that it disregards any variability that does not disproportionately affect subordinated interest holders, which is inconsistent with the expressed

notions of paragraph B4 of FIN 46R that all variability must be considered. The opponents believe that the risks being disregarded may be significant. Opponents of the Risk Approach believe that this approach relies on the presumption that subordinate interests that are sufficient in regards to the economic losses to be incurred by the entity will also be sufficient to cover the expected losses of the entity as contemplated by FIN 46R. FIN 46R describes expected losses differently from economic losses.

34. Opponents also observe that the Risk Approach requires the review of a number of contracts that the potential VIE is a party to, to determine what risks disproportionately affect the subordinated interests. These opponents observe that not all interest holders have access to these other documents, a condition that would hinder the consistent operation of this approach and would also require additional judgments to be made to apply an already complex Interpretation. These opponents observe that the necessity to look at many more documents makes the application of the Risk Approach much more complex.

## **QUESTIONS FOR THE TASK FORCE**

35. As a result of responding to the Task Force's requests from the November EITF meeting, the FASB staff and Resource Group members have provided the Task Force with considerable additional information to consider as it tries to arrive at a consensus related to this Issue.

36. Based on the information set forth in this Supplement, the Task Force should consider whether it wishes to proceed with the Presumption Approach.

37. If the Task Force decides to proceed with the Presumption Approach, the following issues need to be resolved:

- Should the Presumption Approach permit a reporting enterprise to overcome the presumption?
  - If yes, should the ability to overcome the presumption be narrow (as currently drafted) or more broad in nature?

- Should the Presumption Approach include factors or examples that illustrate when the presumption can be overcome?
- Should the Presumption Approach include additional guidance for certain types of swap transactions?

38. If the Task Force decides not to proceed with the Presumption Approach (before or after resolving the additional issues) the FASB staff observes that the Task Force will be left with only the following options for proceeding with this Issue:

- Proceed with or explore further the Risk Approach
- Explore other screened approaches
- Remove the Issue from the EITF agenda.