

FASB Emerging Issues Task Force

Issue No: 04-7

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

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References

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

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)

*** The alternative views presented in this Issue Summary 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. FIN 46R provides guidance on how to apply the controlling financial interest criteria in ARB 51 to variable interest entities. Variable interest entities are evaluated for consolidation based on all contractual, ownership, or other interests that expose their holders to the risks and rewards of the entity. Those interests are termed variable interests. An integral part of applying FIN 46R is determining which pecuniary interests are variable interests.

2. Paragraph 2(c) of FIN 46R defines a variable interest as "...contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests." Paragraph B4 of FIN 46R describes what should be considered when determining whether an interest is a variable interest as follows:

The identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity's variability—that distinguishes a variable interest. The role, in turn, often depends on the design of the entity.

3. An entity's variability is the sum of the absolute values of the expected losses and expected residual returns. Expected losses and expected residual returns are derived from expected cash flows of the entity. However, expected losses and expected residual returns refer to amounts discounted and adjusted for market factors and assumptions rather than to undiscounted cash flow estimates.

4. Constituents have raised concerns that FIN 46R is unclear as to how a reporting enterprise should determine whether a contract absorbs variability of an entity; that is, whether the contract should be considered a variable interest. Different approaches for making that determination have been developed and used, which has resulted in inconsistent identification of certain interests as variable interests. Those inconsistencies can have a significant impact on the determination as to what the expected losses of the entity are, whether the entity is a VIE, and, ultimately, which party should consolidate the variable interest entity.

5. The FASB staff is aware of the following four approaches being used to determine whether an interest absorbs variability of an entity:

- a. Fair value approach – the determination as to whether an interest is a variable interest is based on whether the interest absorbs variability in the fair value of the net assets of an entity (exclusive of variable interests).
- b. Cash flow approach – the determination as to whether an interest is a variable interest is based on whether the interest absorbs variability in the cash flows of an entity (exclusive of variable interests).
- c. Combination approach – the determination as to whether an interest is a variable interest is based on whether the interest absorbs variability in the cash flows or fair value of the net assets of an entity (exclusive of variable interests).
- d. By Design approach – the determination as to whether an interest is a variable interest is based on the role of the interest; that is, whether it is used to absorb variability of the entity. In making this determination, many factors should be considered, such as the role of each interest holder, the design of the VIE, the expectations of the interest holders, and the manner in which the VIE was marketed to the interest holders.

6. The FASB staff observes that, although four general approaches are described above and in greater detail below, there are many variations to each approach being used in practice. To assist the Task Force in reaching a consensus on the model to be used to determine whether an interest is a variable interest, the staff believes that the Task Force should consider which of the following attributes inherent in the 4 general approaches should be the foundation for the model:

- All risks inherent in the variable interest entity should be identified and analyzed
- All variability of the VIE created by the nature of its activities and transactions must be absorbed by the variable interests in the VIE
- Interests that absorb fair value variability of the VIE are variable interests
- Interests that absorb cash flow variability of the VIE are variable interests
- Interests that absorb any variability of the VIE are variable interests

- Variability from credit risks should be ignored
- Only the variability related to the distributable value or terminal value of the VIE's net assets should be considered
- Non-cash assets that will be distributed to interest holders are considered to have cash flow variability
- Contracts that both create and absorb variability of a VIE should be bifurcated into separate components to make the determination
- Contracts that both absorb and create variability related to the same risk (for example interest rate risk) should be considered variable interests
- For contracts that both create and absorb variability of the VIE a qualitative analysis of the primary purpose of the contract should be performed
- The absorption of fair value or cash flow variability should not be determinative as a qualitative assessment should be made
- The timing of the transactions of the VIE is critical to the analysis
- The design of the VIE is a critical factor
- The role of the interest relative to the design of the VIE should be considered
- The purpose of the VIE should be considered
- The activities of the VIE and the interest holder should be considered
- How the transaction was marketed to investors and the investors' expectations should be considered.

The staff would like to obtain feedback from the Task Force as to which, if any, of the attributes described above are most relevant. Additionally, the staff is requesting feedback on any other attributes not listed above that Task Force members believe are most relevant.

Interests That Absorb and Create Variability

7. The different approaches may result in different conclusions as to whether certain interests, specifically derivatives, are variable interests. Derivative instruments are frequently designed to absorb one type of variability by creating another type of variability. The following is an example of a derivative (an interest rate swap) that absorbs one type of variability while creating another type of variability:

Assume that an entity is formed and financed with \$100 of debt from an investor. The interest payments on the debt are LIBOR-based. The entity has no equity and is a VIE. The entity's only asset is a high credit quality, fixed rate bond with a par and fair value of \$100, paying fixed interest of 5 percent. The VIE enters into an interest rate swap under which it makes 5 percent fixed payments and receives LIBOR-based payments on the \$100 notional amount.

In this example, the expected losses and expected residual returns of the VIE prior to entering into the interest rate swap result from potential changes in the bond's fair value due to changes in the benchmark interest rate and the bond issuer's credit spread. By entering into the interest rate swap, the VIE has effectively changed its asset from one that generates a fixed rate return to one that generates a floating rate return. As a result, the VIE has mitigated the fair value variability due to the changes in the benchmark interest rate, while exposing itself to the cash flow variability due to changes in the benchmark interest rate. The swap counterparty absorbs the risk (variability) that the bond's fair value will change as a result of changes in the benchmark interest rate (LIBOR) through the receipt of a fixed rate return on the swap as well as the credit risk of the VIE in relation to the swap. In contrast, the other variable interest holders of the VIE absorb the risk (variability) that the VIE's cash flows will change as a result of changes in the LIBOR swap curve through the receipt of a floating rate return on the debt (the swap actually creates cash flow variability for the VIE). In addition, these variable interest holders will also absorb the risk (variability) related to the bond issuer's credit spread as well as the credit risk related to the swap counterparty.

8. The FASB staff understands that this is not solely an issue for contracts that are derivatives under FAS 133. For example, many power purchase agreements that are not accounted for as derivatives under FAS 133 (for example, ones that do not meet the definition of a derivative or are designated as normal purchases or normal sales) and are commonplace in the utility industry could be considered to absorb and create variability. The staff believes that this issue is applicable to situations in which a potential variable interest absorbs variability of a VIE as well as creates and absorbs variability in a VIE.

The Treatment of Synthetic Assets

9. The FASB staff also observes that when determining whether an interest creates or absorbs variability of the VIE's assets, issues have arisen regarding the difference between assets that are physically held/owned by the VIE and positions created by derivative contracts that have similar economic profiles as owning the assets. When analyzing forward contracts pursuant to the guidance provided by paragraphs B12 and B13 of FIN 46R, different conclusions can be reached as to whether a forward contract is a variable interest if one considers synthetically created positions to be assets like the assets created by cash transactions. A contract that creates a similar economic profile to the actual ownership of an asset is commonly referred to as a synthetic asset. A long position in an asset has the economic profile of owning the asset and is created by either purchasing the asset through a cash transaction or synthetically creating the asset through the use of a derivative instrument (for example, a forward to purchase the asset). A short position in an asset has the economic profile of a liability related to the asset and is also created by either a cash transaction or synthetically with a derivative instrument (for example, a forward to sell the asset). A conclusion that a contract synthetically creating a long position in an asset is similar to owning an asset, would lead to another conclusion that the synthetic asset creates risks that are similar to owning an asset and therefore would likely not be a variable interest. Although the staff observes that this is an issue to be addressed when making the determination as to whether an interest is a variable interest, that issue will be addressed separately from the issue of what variability should be considered when making the determination.

10. The FASB staff is aware that the arguments being made by those who believe that synthetic assets are similar to physical assets are also being made in regards to entities that don't have a long position in the asset through a cash transaction or a derivative transaction. Those commentators believe that although they have no transactions creating the long position in the asset, they expect to obtain the asset at some point in time to be used to settle the forward sale of the asset and, as such, to have exposure to the variability in the price of the asset.

11. An overly simplistic example of this would be a VIE that enters into a forward contract to sell a barrel of oil in 90 days at a fixed price. The VIE has neither the oil on hand nor a contract to purchase oil prior to or on the delivery date. The VIE only has the intention to purchase the oil to settle the forward contract. The VIE will have to purchase the oil prior to the forward sale contract settling.

Accounting Issue and Alternatives

Issue 1: What variability should be considered when determining whether an interest is a variable interest?

View A: The determination as to whether an interest is a variable interest (the "determination") should be based on whether the interest absorbs fair value variability.

12. Proponents of View A believe that in making the determination, all risks inherent in the entity should be identified and analyzed. However, these proponents believe that a reporting enterprise should only consider in its analysis whether the interest absorbs the variability in the fair value of an entity's net assets (exclusive of variable interests). View A proponents observe that paragraph 8 of FIN 46R defines expected losses of an entity as "...the expected negative variability in the fair value of its net assets exclusive of variable interests," and describes an entity's expected residual returns as "...the expected positive variability in the fair value of its net assets exclusive of variable interests." This view is further supported by paragraph B2 of FIN 46R, which reiterates a portion of paragraph 2(c) and states, "Variable interests are contractual, ownership or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests."

13. Proponents of View A also believe that paragraph D26 of FIN 46R clarifies paragraph 8 by emphasizing that "...the expected variability in the entity's net income or loss and the expected variability on the fair value of the entity's assets if it is not included in net income or loss" should be considered in determining the expected losses and expected residual returns of the entity.

14. When determining whether a derivative contract or other contract that absorbs and creates variability is a variable interest, proponents of View A believe that a reporting enterprise should only consider contracts that absorb fair value variability of the VIE as variable interests in the VIE's net assets. For instance, consider a VIE that holds fixed rate assets which create fair value variability. The VIE enters into an interest rate swap to convert the fixed rate payments of the asset into floating rate payments. As a result, the VIE no longer has exposure to fair value variability arising from interest rate changes as that exposure is now being absorbed by the swap counterparty. Under View A, the swap would be considered a variable interest.

15. Proponents of View A also believe that the same determination will be made regardless of when the contract was entered into. View A proponents believe that a contract entered into subsequent to the initial design of the entity should be analyzed in a manner consistent with the analysis of a reconsideration event described in paragraph 7 of FIN 46R.

16. Some proponents of View A believe that only the variability in the distributable value of an entity's net assets should be considered. Distributable value is based on the fair value of an entity's net assets at the expected date of distribution to interest holders and not the cash flows of the net assets. For example, a U.S. Treasury bond with a floating interest rate has cash flow risk, but since its distributable value at any point in time before maturity will not be affected by changes in the benchmark interest rates or credit risk, it does not have expected losses and expected residual returns. These proponents argue that cash flows received at market (for example, a floating rate interest payment) do not give rise to expected losses or expected residual returns because the value received is always at market and as such would have no variability. Conversely, a U.S. Treasury bond with a fixed interest rate has expected losses and expected residual returns because its distributable value at any point in time before maturity fluctuates based on changes in the benchmark interest rates. These proponents of View A believe that variability in fair value and cash flows not associated with the distribution of assets should be ignored when making this determination. This enables the fair value approach to be used without considering interim changes in value of assets that are expected to be held to maturity.

17. Opponents of View A believe that the determination should not be made based upon whether an interest absorbs fair value variability alone. View A opponents argue that there are various references in FIN 46R that advocate the importance of both fair value and cash flow variability and, as such, both changes in fair value and cash flows are relevant to the variable interest analysis. They believe that the application of View A would inappropriately exclude contracts that absorb cash flow variability from the population of variable interests. Other opponents believe that when reviewing derivative instruments, the analysis should be based on the design of the entity, the economics of the transaction, and the facts and circumstances of the entity and its relationships with the holders.

View B: The determination as to whether an interest is a variable interest should be based on whether the interest absorbs cash flow variability.

18. Proponents of View B believe that FIN 46R establishes a cash flow model and, as such, an entity's evaluation of an interest should consider only whether the interest absorbs the variability in the cash flows of an entity's net assets. View B proponents observe that although paragraph 8 of FIN 46R describes expected losses of an entity as "...the expected negative variability in the fair value of its net assets exclusive of variable interests," the Board clarified its intention with respect to fair value in paragraph D26 of FIN 46R, by indicating that changes in fair value only matter to the extent such changes impact cash flow distributions to variable interest holders. Further, View B proponents note that paragraph 2(b) of FIN 46R defines expected losses and expected residual returns as "...amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.*" They also observe that the illustration of the computation of expected losses, expected residual returns, and expected variability included in Appendix A of FIN 46R is based on cash flows of the VIE.

19. Proponents of View B also believe that the same determination will be made regardless of when the contract was entered into. View B proponents believe that a contract entered into subsequent to the initial design of the entity should be analyzed in a manner consistent with the analysis of a reconsideration event described in paragraph 7 of FIN 46R.

20. When applying View B to a derivative contract or other contract that absorbs and creates variability, an evaluating entity will only consider contracts that absorb cash flow variability of the VIE as variable interests in the VIE. Proponents of View B believe that the application of this view to a derivative contract that absorbs the cash flow variability of the VIE's net assets is considered a variable interest. For instance, consider a VIE that holds high-credit-quality floating-rate note assets that create cash flow variability. The VIE enters into an interest rate swap to convert the floating rate payments of the assets into fixed rate payments. As a result, the VIE no longer has exposure to cash flow variability as that exposure is now being absorbed by the swap counterparty. Under View B, the swap counterparty would consider that derivative contract as a variable interest in the VIE. If it is assumed that the VIE will hold the notes to maturity, the application of View B to the above example is simplified. Proponents of View B observe that when using the CON 7 approach to determining the VIE's expected cash flows; the floating rate note by itself would create multiple cash flow scenarios. When the interest rate swap is entered into and treated as part of the VIE's net assets, the number of cash flow scenarios diminishes considerably, thus the interest rate swap is proven to absorb or receive variability in the VIE. To contrast that, if the VIE held a risk free, fixed rate note, there would be very few (if not only one) cash flow scenario using the CON 7 approach. An interest rate swap that converted the fixed payments to variable would, if treated as part of the VIE's net assets; create multiple additional cash flow scenarios using the CON 7 analysis, thus the interest rate swap is proven to create variability in the VIE.

21. Some proponents of View B observe that a VIE may, at times, and as contemplated at inception, distribute, transfer, or exchange non-cash assets pursuant to an interest in the entity and believe that such a distribution should be treated as a delivery of cash for the fair value of the non-cash asset to the interest holder. That is, the transaction is treated as if the VIE sold the non-cash asset in the market for cash equal to the assets' fair value and distributed the cash to the interest holder. Thus, fair value variability of the VIE's net assets will also need to be considered. That approach contains attributes that are broader than considering only whether an interest absorbs the cash flow variability in the VIE's net assets.

22. Opponents of View B also argue that there are various references in FIN 46R that advocate the importance of both fair value and cash flow variability and, as such, both changes in fair value and cash flows are relevant to the variable interest analysis. Opponents of View B believe that the application of View B inappropriately excludes certain contracts that absorb fair value variability from the population of variable interests. Some opponents also believe that when reviewing derivative instruments, the analysis should be based on the design of the entity, the economics of the transaction and the facts and circumstances of the entity and its relationships with the holders.

View C: The determination as to whether an interest is a variable interest should be based on whether the interest absorbs either cash flow or fair value variability.

23. Proponents of View C believe that in making the determination, all risks inherent in the entity should be identified and analyzed. Proponents of View C believe FIN 46R emphasizes variability in both cash flows and fair value and, as such, the evaluation of an interest should consider whether the interest absorbs the variability in either cash flows or fair value of an entity's net assets. Proponents of View C believe that identifying whether an interest is a variable interest requires an economic analysis of the rights and obligations of an entity's assets, liabilities, equity, and other contracts.

24. View C proponents observe that paragraph A3 of FIN 46R illustrates the importance of both fair value and cash flow variability and requires expected losses to be based upon the estimated cash flows but also states that in performing the expected loss calculation the "interpretation uses the term *expected losses* to refer to the expected losses based on fair value...."

25. View C proponents believe that the determination as to whether an instrument is a variable interest based solely on whether it absorbs fair value variability of the VIE or solely on whether it absorbs cash flow variability of the VIE (Views A and B), is inappropriate. View C proponents observe that it is difficult to differentiate between what type of variability exists when certain entities may transfer, exchange, or distribute non-cash assets to their interest holders instead of cash. However, by simply looking at cash flow variability, the fair value

variability of those non-cash assets (which is being absorbed by the interest holders through the receipt of an equivalent fair value amount of the assets) would not be considered.

26. Proponents of View C also believe that the same determination will be made regardless of when the contract was entered into. View C proponents believe that a contract entered into subsequent to the initial design of the entity should be analyzed in a manner consistent with the analysis of a reconsideration event described in paragraph 7 of FIN 46R.

27. Proponents of View C believe that all variability created in a VIE by the nature of its activities and transactions must be absorbed by the variable interests in the VIE. As part of the process of identifying the variable interest in the VIE, a reporting enterprise that has an interest that both creates and absorbs variability will need to focus on the individual attributes of the interest to identify all of the creators of variability and all of the absorbers of variability of the VIE. To perform this analysis, certain proponents of View C believe that when reviewing derivative contracts, the contracts should be bifurcated (for analysis purposes) into its separate components or payment streams. Those bifurcated components are individually considered to determine if they create or absorb variability.

28. Those proponents of View C believe that any component that provides a payment to the VIE (floating or fixed cash flow) is considered as a creator of variability for the VIE. For example, a component that provides for a floating payment to the VIE creates cash flow variability, while a component that provides for a fixed payment to the VIE creates fair value variability. Those proponents of View C believe that the variability created by those two payment streams (that is, cash flow variability and fair value variability) are equal if the payment streams are based on the same interest rate index. Consider a VIE that holds fixed rate assets which create fair value variability. The VIE enters into an interest rate swap to convert the fixed rate payments of the asset into floating rate payments. As a result, the VIE no longer has fair value variability as that variability is now being absorbed by the interest rate swap. Instead, the VIE has cash flow variability that is created by the interest rate swap counterparty. The interest rate swap is comprised of two payment streams, one in which the swap counterparty receives fixed rate payments from the VIE and a second in which the swap counterparty makes floating rate

payments to the VIE. The interest rate swap counterparty would consider the fixed rate payment stream component of the derivative contract to absorb fair value variability of the VIE (a variable interest), while the interest rate swap counterparty would consider the floating payment stream component to create cash flow variability in the VIE (not a variable interest). Those proponents generally carry forward the bifurcated payment streams of the derivative contract to the analysis of the expected losses or expected residual returns of the VIE.

29. Proponents of View C also observe that regardless of whether a contract is being analyzed as a whole or in its bifurcated components and as long as both fair value and cash flow variability are being considered, the evaluating entity should arrive at the same determination as to whether the instrument is a variable interest. That is because if one component of the contract absorbs variability, the contract as a whole must be absorbing some variability through that individual stream. That does not mean, however, that the portion of the contract that creates variability in the entity is excluded from subsequent analyses. Such variability would be included in the measurement of the total variability of the VIE.

30. When applying View C to a derivative contract or other contract that absorbs and creates variability, an evaluating entity will consider contracts that absorb fair value or cash flow variability of the VIE as variable interests in the VIE. Proponents of View C believe that the application of this view to a derivative contract that allocates the absorption of fair value or cash flow variability from the VIE's existing assets among the variable interest holder and the counterparty to the derivative is considered a variable interest.

31. Proponents of View C would argue that regardless of what variability is created with a derivative instrument, if the instrument absorbs either type of variability (cash flow or fair value), then it is a variable interest. However, although the interest rate swap (in the example in the background section) is a variable interest, certain proponents of View C observe that the interest rate swap, on its own, would not cause a party to the contract to be the primary beneficiary of the VIE in the example in the background section. The reason for this determination is that, although the interest rate swap creates cash flow variability (in the example in the background section) and absorbs fair value variability, both types of variability pertain to

the same risk (in this example, LIBOR interest rate risk). Aside from the variability related to the VIE's credit risk absorbed by the investors and the swap counterparty, View C proponents would expect the fair value variability related to changes in LIBOR interest rates absorbed by the interest rate swap counterparty and the cash flow variability related to changes in LIBOR interest rates absorbed by other variable interest holders to equal each other in most analyses (qualitative or quantitative) performed to determine which interest absorbs a majority of the expected losses or expected residual returns of the VIE.¹

32. Proponents of View C believe that the analysis described above for an interest rate swap would **not** be true for many other types of derivative instruments (excluding foreign currency swaps) because unlike an interest rate swap, the component parts of many other derivative instruments that create and absorb variability do not *pertain to the same risk*, for example, equity swaps, total returns swaps, commodity swaps, and so forth. For those derivative contracts in which the component parts do not pertain to the same risk, the variability created and absorbed by the two legs of the derivative will not equal.

33. Opponents of View C believe that the absorption of cash flow or fair value variability should not be determinative that the contract is a variable interest. Some of the opponents believe, as articulated in the commentary under View D, that the determination should be made on a more qualitative approach and consider factors in addition to whether cash flow or fair value variability is absorbed.

34. Other opponents of View C believe that when analyzing contracts that both create and absorb variability, a qualitative analysis of the primary purpose of the contract should be considered. For example, if an instrument's purpose was primarily to create fair value variability for the variable interest entity, while absorbing a relatively insignificant amount of variability, the fact that the instrument was not primarily absorbing variability should lead to a qualitative determination that it is not a variable interest. Proponents of View C counter this by observing that there is no qualitative assessment discussed in FIN 46R for determining whether an interest

¹ For derivative contracts not based on the same risk (in this example, changes in LIBOR interest rates), the variability absorbed by the derivative counterparty and the investor will not be equal.

absorbs variability. The interest either absorbs variability or it does not, and that determination should be based on an economic analysis of the transaction as indicated in paragraph B2 of FIN 46R. Proponents of View C believe that FIN 46R does support the qualitative determination (if possible) of the primary beneficiary of a VIE *once the variable interests in the VIE have been identified*, and such qualitative allocation of the variability of a VIE to its variable interest holders can often be performed.

View D: The determination as to whether an interest is a variable interest should be based on a multitude of factors, such as, the entity's design, the role each party has in the entity's activities, the terms of the interest being analyzed, the expectations of the parties involved with the entity, and how the entity was marketed to its investors.

35. Proponents of a View D believe that in making the determination, all risks inherent in the entity should be identified and analyzed. Proponents of View D believe that the determination of whether an interest is a variable interest should not be based solely on whether it absorbs cash flow or fair value variability. Proponents take a more qualitative approach to this determination that considers other factors in addition to the absorption of cash flow and fair value variability.

36. View D proponents believe that the determination as to whether an instrument that both creates and absorbs is a variable interest depends on the role of the instrument relative to the design of the entity. View D proponents observe that paragraph B4 of FIN 46R states, "The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity's variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the entity." Proponents of View D place an emphasis on many factors with respect to the design of the VIE, including the following:

- The purpose of the entity, specifically whether it was established to meet specific economic needs of certain interest holders
- When the interest holder became involved in the entity
- The activities of the entity and the interest holder

- The terms of the contract
- How the transaction was marketed to potential investors
- The expectations of the investors at inception.

37. View D proponents believe the evaluation as to whether an interest is a variable interest requires judgment and should be based on the factors such as described above, as well as all of the facts and circumstances related to the VIE. Assuming that one of the factors to consider is when a holder becomes involved with a VIE, proponents of View D believe that the sequencing of events and transactions is significant. For example, when analyzing the sequencing of a transaction, proponents of View D believe that a forward starting interest rate swap,² although impacting the fair value but not impacting the cash flows of the VIE at inception and during the forward period, but contemplated at inception, would be considered to be in place at inception as that is in line with the holders' expectations.

38. View D proponents observe that an enterprise's involvement in designing and establishing the VIE should be considered, but that this involvement is not determinative. Proponents of View D believe that a reporting enterprise should reach the same determination about whether an interest is a variable interest in the VIE regardless of whether the VIE was designed by the interest holder or other unrelated parties. The analysis of the design of the entity should focus more to which interest holders, those with specific economic requirements, the entity was designed for. Proponents of View D believe that in situations in which the derivative counterparty is the enterprise that the VIE was designed for, that derivative counterparty will most likely use total return swaps, written put options, and forward purchase contracts to absorb most, if not all, of the variability of the VIE. These types of derivative contracts have the effect of absorbing the variability of the VIE.

39. Opponents of View D argue that many of the factors to be considered can be manipulated to achieve a desired outcome. They believe that auditing the consideration of these factors and the sequencing of events would be extremely difficult and impractical. They argue that if View D is

² A forward starting interest rate swap is a transaction that is entered into on a certain date that provides for the exchange of interest rates between the counterparties for periods beginning at a specified point in the future.

selected, then additional information perhaps via examples would be required to illustrate how the facts would be considered. Proponents of View D counter that claim by observing that a qualitative assessment about whose economic needs are being met by the existence of the VIE will be difficult to manipulate.

40. Some opponents of View D note that the sequencing of events and transactions (that is, when the at-market interest rate swap is entered into with the entity) should not be considered a significant factor in the analysis. Placing an emphasis on sequencing could inappropriately consider interest rate swaps entered into in conjunction with new assets purchased by the entity differently from interest rate swaps entered into at inception of the entity. That would not enable a reporting enterprise to appropriately consider the activities of VIEs that frequently add assets, liabilities, and risk management contracts after inception. An example of such a VIE is a managed Collateralized Debt Obligation (CDO) designed to actively buy and sell assets after inception while giving investors a return commensurate with the level of risk desired. Due to the entity's active management, the entity will at times enter into additional derivative instruments for risk management purposes. View D opponents note that significant transactions entered into with the entity after the entity's inception that can alter the determination of the primary beneficiary will be considered reconsideration events as defined in paragraph 7 of FIN 46R and should be assessed with the specific facts and circumstances at that point in time.

41. Still other opponents of View D take a more practical view and would give the counterparty's role in the entity greater weight than the other factors analyzed. These opponents would consider a counterparty entering into a derivative contract with the VIE and no other involvement with the VIE to be providing a service to the VIE. They would not consider such contracts as variable interests similar to the discussion of service contracts in paragraph B22 of FIN 46R.

Issue 2: When determining whether an interest is a variable interest, whether long positions of a VIE that are synthetically created by derivative transactions should be considered in the same manner as a long position created by a cash transaction.

View A: A long position in a VIE created by a derivative instrument should be analyzed in the same manner as a long position created by a cash transaction.

42. Proponents of View A believe that a derivative transaction that creates a long position in an asset for the VIE, creates economic variability for the VIE and, as such, the variability from a synthetic asset position will impact the variability of the VIE and the operating results of the VIE, including other derivative contracts. That variability will be absorbed by other interest holders in the VIE. View A proponents believe that the variability created by the synthetic asset positions is similar to the variability the VIE would be exposed to if those positions were created by assets recognized via cash transactions. Proponents of View A believe that if an interest absorbs the variability in the VIE associated with a long position, regardless of how the long position is created, the interest should be considered a variable interest depending on the outcome of Issue 1.

43. Proponents of View A also observe that by not considering the variability created by synthetic asset positions, the reporting enterprise will not be considering the total variability of the VIE and, as such, may arrive at an incorrect determination of the primary beneficiary.

44. Opponents of View A note that differences exist between exposures created by cash positions held by a VIE and synthetic assets. For example, a VIE that holds a commodity is exposed to the price risk of the asset and other risks such as storage costs. A VIE that *synthetically* holds a commodity through, for example, a forward purchase contract would also be exposed to the price risk of the asset. However, the VIE will not be exposed to storage risk, rather, it will be exposed to delivery risk and the forward counterparty's credit risk.

View B: A long position in a VIE created by a derivative instrument should not be analyzed in the same manner as a long position created by a cash transaction.

45. Proponents of View B believe that FIN 46R makes a clear distinction between assets that are owned or held by the VIE and contracts that represent synthetically created assets or rights of the

entity. They observe that paragraph B17 uses the specific terms *assets held by an entity* and *assets of the entity* as follows:

Assets held by an entity almost always create variability and thus, are not variable interests. However, as discussed separately in this appendix, assets of the entity that take the form of derivatives, guarantees, or other similar contracts may be variable interests.

46. Opponents of View B observe that the application of View B would result in a VIE being exposed to certain risks (risks created by the long positions) that are not being included in the risks being absorbed by the variable interest holders. This runs counter to the belief that all risks created in a VIE must be absorbed by variable interest holders and, as such, may lead to an inappropriate decision regarding the identity of the primary beneficiary of the VIE.

Exhibit 04-7A

EXAMPLES ILLUSTRATING THE VIEWS FOR ISSUE 1

The following examples are presented to illustrate the application of the alternative views presented for Issue 1.

Example 1

Assume a VIE is created and financed with \$100 of 5-year 5-percent debt from investors. In addition to the debt holders, a separate investor has invested \$10 for a residual interest in the VIE. The VIE uses all of the proceeds to purchase investment grade floating rate (LIBOR based) securities. Subsequent to inception, the VIE enters into an interest rate swap to receive 5 percent on the \$110 notional amount and pays a floating rate of interest on the same notional amount. The terms of the swap are customary in these types of transactions. The swap counterparty was involved in the design of the entity. The transaction was marketed to potential investors as an investment in floating rate assets.

Is the interest rate swap a variable interest in the VIE?

Proponents of View A would not consider the interest rate swap to be a variable interest because the interest rate swap is not absorbing fair value variability of the VIE. Through the payment of fixed rate interest, the interest rate swap is creating fair value variability in the VIE (if interest rates increase, the fair value of the fixed rate payments received by the VIE decreases).

Proponents of View B would consider the interest rate swap to be a variable interest because the interest rate swap is absorbing cash flow variability of the VIE. Through the receipt of the floating rate interest, the interest rate swap is absorbing the cash flow variability of the VIE (if interest rates decrease, the cash flows associated with the floating rate payments received by the swap counterparty decreases).

To determine that, proponents of View C would identify the creators of variability for the VIE. The VIE is exposed to the following variability:

- The cash flow variability associated with the floating rate receipts on the securities purchased
- The variability associated with the credit risk of the investment securities
- The variability associated with the credit risk of the interest rate swap counterparty
- The fair value variability associated with the fixed rate payments to be received from the swap counterparty.

Proponents of View C would consider the interest rate swap to be a variable interest because the interest rate swap absorbs the risk that the cash flows to the VIE will change as LIBOR changes (cash flow variability) via the counterparty's variable interest receipts, while it creates fair value risk for the investors as a result of changes in LIBOR, via the counterparty's fixed interest payments. The other interest holders will absorb the variability associated with the credit risk of the investment securities and the swap counterparty, as well as the fair value variability associated with the fixed interest rate on the swap.

Proponents of View D would consider the swap to be a variable interest in the entity. The VIE was not designed on behalf of the investors to include the swap, which supports the fact that the transaction was marketed as an investment in floating rate assets and the investors expected to be investing in floating rate assets. The residual interest holder was originally exposed to the risk that the interest rate mismatches created. Therefore, the role of the swap is to absorb the variability in the cash flows associated with the assets (the swap absorbs the cash flow variability and creates fair value variability in the entity) as opposed to converting the interest rate on the assets to a fixed rate. In other words, the swap is more like a variable interest in the entity as opposed to an asset of the entity.

Example 2

Assume a VIE is created and financed with \$100 of 5-year floating-rate (LIBOR based) debt from investors. The VIE uses the proceeds to purchase investment grade fixed rate securities.

The VIE enters into an interest rate swap to receive a floating rate of interest on the \$100 notional amount and pays 5 percent on the same notional amount. The VIE was designed and established on behalf of debt holders to require a specific floating rate return. The interest rate swap is entered into to address the interest rate mismatch caused by the VIE's purchase of fixed rate assets. The terms of the swap are customary in these types of transactions. The swap counterparty was involved in the design of the entity. The transaction was marketed to potential investors as an investment in fixed rate assets converted to variable rate with the use of the interest rate swap. The swap is entered into at inception of the transaction.

Is the interest rate swap a variable interest of the VIE?

Proponents of View A would consider the interest rate swap to be a variable interest because the interest rate swap is absorbing fair value variability of the VIE. Through the receipt of fixed rate interest, the interest rate swap is absorbing the fair value variability in the VIE (if interest rates increase, the fair value of the fixed rate payments received by the swap counterparty decreases) that is created by the fixed rate securities owned.

Proponents of View B would not consider the interest rate swap to be a variable interest because the interest rate swap is not absorbing cash flow variability of the VIE. Through the payment of floating rate interest, the interest rate swap is creating cash flow variability for the VIE (if interest rates decrease, the cash flows associated with the floating rate payments received by the VIE decreases).

To determine that, proponents of View C would identify the creators of variability for the VIE. The VIE is exposed to the following variability:

- The fair value variability associated with the fixed interest rate on the securities
- The variability associated with the credit risk of the investment securities
- The variability associated with the credit risk of the interest rate swap counterparty
- The cash flow variability associated with the floating interest rate received from the swap counterparty.

Proponents of View C would consider the interest rate swap to be a variable interest because the interest rate swap is absorbing fair value variability of the VIE. The interest rate swap absorbs the risk that the bond's fair value will change as a result of changes in LIBOR, while it creates the risk that the cash flows to the VIE will change as a result of changes in LIBOR. The other interest holders will absorb the variability associated with the credit risk of the securities and the swap counterparty, as well as the cash flow variability associated with the floating interest rate on the swap.

Proponents of View D would not consider the swap to be a variable interest in the entity because the role of the swap is to create a variable-rate return for the investors. The entity was designed on behalf of the investors to include the swap to arrive at a variable rate payment, which supports the fact that the transaction was marketed as an investment in variable rate assets and the investors expected to be investing in variable rate assets. Therefore, the role of the swap is to convert the fixed interest rate on the assets to a variable rate coupon as opposed to absorbing the variability in the fair value of the debt (the swap creates cash flow variability and absorbs fair value variability in the entity). In other words, the swap is more like an asset of the entity as opposed to a variable interest in the entity.

Example 3

Assume a VIE is created and financed with \$100 of 5-year floating-rate (LIBOR based) credit-linked notes. The notes issued are linked to the creditworthiness of XYZ Company. The VIE uses the proceeds to purchase investment-grade floating-rate securities. The VIE enters into a credit default swap with a counterparty. Under the credit default swap, the counterparty receives credit protection on the \$100 notional amount of XYZ Company obligations and, in exchange, pays a fixed premium over the life of the transaction for the credit default protection received. The terms of the swap are customary for these types of transactions. The swap counterparty was involved with the design of the entity. The transaction was marketed to potential investors as a credit-linked note. The swap was entered into at inception of the transaction.

Is the credit default swap a variable interest in the VIE?

Proponents of View A would initially not consider the credit default swap to be a variable interest because the credit default swap is creating fair value variability (credit risk of XYZ Company) for the VIE. However, the derivative counterparty is contingently exposed to credit risk associated with the assets of the VIE, because those assets will be used to fund the payment by the VIE on the credit default swap if XYZ Company defaults. As such, regardless of how little or how improbable the likelihood that the counterparty will absorb that credit risk, it is absorbing some amount of fair value variability in the assets of the VIE and would be considered a variable interest.

Proponents of View B would not consider the credit default swap to be a variable interest because the credit default swap is not absorbing cash flow variability of the VIE. Through the receipt of credit-related payments the swap is creating fair value variability of the VIE.

To determine that, proponents of View C would identify the creators of variability for the VIE. The VIE is exposed to the following variability:

- The cash flow variability associated with the interest rate on the floating rate investment securities
- The variability associated with the credit risk of the investment securities
- The variability associated with the credit risk of XYZ Company
- The variability associated with the credit risk of the credit default swap counterparty.

Similar to the interest rate swap examples described above, the credit default swap both creates variability and absorbs variability. The credit default swap creates variability in the VIE related to XYZ Company's credit risk and the swap counterparty's credit risk. (The credit default swap premium is paid over the life of the transaction by the swap counterparty.) The credit default swap absorbs some of the fair value variability of the investment securities (which is minimal because the investment securities are investment grade and floating rate) because the investment securities serve as the sole source of payment to the swap counterparty in the event of a default by XYZ Company. (It should be noted that some have countered this argument to say that the

consideration of credit risk would require any derivative counterparty to absorb at least some amount of fair value or cash flow variability of the VIE.) Accordingly, proponents of View C would consider the credit default swap to be a variable interest. The other interest holders (the investors in the credit-linked notes) will absorb the fair value variability of the investment securities not absorbed by the credit-default-swap counterparty, the variability associated with the credit risk of the referenced credit and the swap counterparty, as well as the cash flow variability associated with the floating-rate securities.

Proponents of View D would not consider the credit default swap to be a variable interest in the VIE because the role of the swap was to create the synthetic asset (long) position in the referenced credit for the investors. The VIE was designed by the swap counterparty and the investors to include the swap to absorb the exposure to the referenced credit, which supports the fact that the transaction was marketed as an investment with XYZ Company credit risk. In other words, the swap is more like an asset of the VIE as opposed to a variable interest in the entity. Further supporting this conclusion is the fact that the terms of the swap are customary in those types of transactions.

Exhibit 04-7B

EXAMPLES ILLUSTRATING THE VIEWS FOR ISSUE 2

The following examples are presented to illustrate the application of the alternative views presented for Issue 2.

Example 1

Assume a VIE is created and financed with \$100 of debt from investors. The VIE purchases a forward contract to sell (from the VIE's perspective) commodity X to an unrelated party at an established price at a fixed date in the future. The VIE enters into a separate forward contract to buy (from the VIE's perspective) the commodity at a fixed price on the same future date.

Is the forward contract to sell commodity X a variable interests in the VIE?

Proponents of View A would consider the forward contract to sell commodity X to be a variable interest in the VIE because it absorbs some variability of the VIE. The forward contract to sell commodity X absorbs the price variability of commodity X and the credit risk of the counterparty to the forward contract to buy commodity X. When analyzing either forward contract, a reporting enterprise would consider the other derivative contracts to create a short or long position in the commodity for the VIE. The contract that establishes the (synthetic) long position in the commodity creates variability in the VIE as the contract is at a fixed price. As such, although a cash asset may not be recognized, the economic impact of the forward contract to buy commodity X is similar to a cash position in commodity X, thus the VIE is considered to "own" the asset for purposes of applying paragraph B13 of FIN 46R. Following the guidance in paragraph B13, the counterparty to the forward contract to sell commodity X would consider its forward to be a variable interest as it is absorbing the variability in the VIE's position that is the subject of the contract.

Proponents of View B would not consider either of those contracts as variable interests. Regardless of which contract you are analyzing, since the assets are not physically held by the

VIE, the contract would not be considered a variable interest within the guidance provided by paragraph B12 of FIN 46R as those contracts are considered to expose the VIE to variability.

Example 2

Assume a VIE's sole asset is a natural-gas-powered electric-generating facility with natural gas as the primary input to operate the facility. As such, the VIE, as a result of its ownership in the facility, is exposed to variability from changes in natural gas and electricity market prices. The VIE enters into a forward contract to purchase natural gas at a fixed price from a third party. The VIE also enters into a separate power purchase agreement to sell electricity at a fixed price to a third party.

Is the power purchase agreement a variable interest in the VIE?

Proponents of View A would consider the power purchase agreement to be a variable interest because the agreement is absorbing the VIE's variability created by changes in the price of electricity. The VIE has variability to electricity prices (the VIE's most significant risk) because the facility's operations coupled with the gas contract has left the VIE with a significant exposure to electricity prices. The electricity, although not a physically owned asset, is considered an asset of the VIE because the VIE has locked-in the cost of the primary resources (natural gas and the facility itself) needed to create the electricity. Through the forward purchase contract, the VIE essentially has the electricity. Following the guidance in paragraph B13, the reporting enterprise would consider the power purchase agreement to be a variable interest as it is absorbing the variability in the VIE's position in electricity that is the subject of the contract.

Proponents of View B believe that the power purchase agreement is not a variable interest. View B proponents believe this agreement is a forward contract to sell an asset that is not owned by the facility. View B proponents observe that although the facility has the capability to produce the electricity, the electricity does not exist as an asset. As such, paragraph B12 of FIN 46R would not consider the power purchase agreement to be a variable interest as the power purchase agreement is determined to be exposing the VIE to variability. Proponents of View B also

observe that the determination would be unauditible as the counterparty to one of the forward contracts may not be knowledgeable of the VIE's other forward contracts.

Opponents of View B counter this by noting that this difficulty is present only where the VIE is an operating company with many other forward contracts or assets. In VIE transactions involving non-operating entities, the forward counterparty will know the other forward contracts or assets of the VIE because the counterparty will want to ensure that the VIE can deliver under its contract with the counterparty.