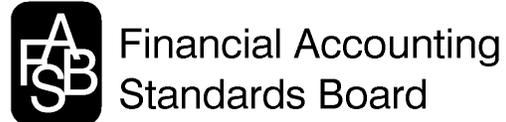


MINUTES



To: Board Members
From: Interpretation 46(R) Team (Burnap, x283; Mathys, x446)
Subject: Minutes of the March 18, 2009, Board Meeting: Interpretation 46(R) Redeliberations **Date:** June 11, 2009
cc: FASB: Golden, Bielstein, Lott, Donoghue, Lusniak, Mayer, Schonefeld, Sperry, Barker, Roberge, Hood, Chookaszian, Posta, Gabriele, Sutay, Glotzer, McGarity, Klimek, C. Smith, Mechanick, Nickell, Mathys, Burnap, Cropsey, Proestakes, Wilkins, Stoklosa, FASB Intranet; IASB: Leisenring, Kusi-Yeboah, Teixeira

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Interpretation 46(R)—Redeliberations
Basis for Discussion: Board Memorandum No. 20, 21, 22, 23, and 24
Length of Discussion: 8:00 a.m. to 9:50 a.m.
Attendance:
Board members present: FASB: Herz, Linsmeier, Seidman, L. Smith, and Siegel
Board members absent: None
Staff in charge of topic: Roberge and Nickell
Other staff at Board table: Golden, C. Smith, Mathys, and Burnap

Summary of Decisions Reached

The Board continued its redeliberations of the Exposure Draft, *Amendments to FASB Interpretation No. 46(R)*, and reached the following decisions:

1. *Definitions of “expected losses and expected residual returns” and “variable interest.”* The Board decided to retain the existing definitions of *expected losses and expected residual returns* and *variable interests* as set out in paragraph 2 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.
2. *Consideration of kick-out rights in the determination of a primary beneficiary and fiduciary responsibility.* The Board affirmed its decision that enterprises should consider kick-out rights in the analysis of power in paragraph 14A(a) of the proposed amendments to Interpretation 46(R) only if those kick-out rights are substantive rights that can be unilaterally exercised by a single party (including its related parties and de facto agents).

The Board acknowledged that retaining the guidance related to kick-out rights in the Exposure Draft results in inconsistencies with EITF Issues No. 04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights,” and No. 96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights.” The Board considered, but decided against, adding a short-term project to reconsider that guidance at this time.

The Board also decided to amend the guidance an entity would use to determine whether fees paid to decision makers or service providers represent a variable interest by removing paragraphs B18–B21 of Interpretation 46(R) (including the requirement for the decision maker to be subject to substantive kick-out rights). The [Board meeting handout](#) described the proposed guidance agreed to by the Board.

3. *Clarification of the power principle.* The Board decided to clarify the proposed power principle as follows:
 - a. Contingent power. The Board decided to provide guidance in the proposed amendments to Interpretation 46(R) to clarify that an enterprise must identify which activities most significantly impact the entity’s economic performance and determine whether it has the power to direct those activities. An enterprise’s ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. A reporting entity does not have to exercise its power in order to have power to direct the activities of an entity.
 - b. Protective rights and participating rights. The Board decided that protective rights should not be considered in assessing whether an enterprise has the power to direct activities that most significantly impact a variable interest

entity's (VIEs) economic performance. The Board also decided that, consistent with its conclusion on kick-out rights, only substantive participating rights that can be unilaterally exercised by a single party (including related parties and de facto agents) should be considered in determining which enterprise, if any, is the primary beneficiary of a variable interest entity.

- c. The inconsistency between paragraphs 5(b)(1) of Interpretation 46(R) and paragraph 14A(a) of the proposed Statement. The Board decided to amend paragraph 5(b)(1) to be consistent with the principle in paragraph 14A(a) and to nullify FSP FIN 46(R)-3, *Evaluating Whether, as a Group, the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003)*, which provides interpretive guidance about the application of paragraph 5(b)(1) of Interpretation 46(R).
- d. Involvement in the design of a VIE. The Board decided that guidance currently in the basis for conclusions of Interpretation 46(R) regarding an entity's involvement in the creation of an entity should be incorporated into the standard. That guidance states:

Although a party may be significantly involved with the design of an entity, that involvement does not, in isolation, establish that party as the party with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the party had the opportunity and the incentive to establish arrangements that result in the party being the variable interest holder with such power. For example, a sponsor's explicit or implicit financial responsibility to ensure that the entity operates as designed may result in the sponsor establishing arrangements that result in the sponsor being the party with the power to direct the activities that most significantly impact the economic performance of the entity.

4. *Shared power.* The Board decided to provide the following additional guidance clarifying the concept of shared power:

Power is shared if two or more parties together have the power to direct the activities of a VIE that most significantly impact the entity's economic performance, and each of the parties sharing power must consent to the decisions relating to those activities. The requirement to consent must be substantive in order to conclude that power is shared.

5. The Board also agreed to add a discussion within the standard about the need for skepticism when an enterprise's exposure to benefits or losses of a variable interest entity is not aligned with its power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

Objectives of Meeting:

The objectives of this meeting were to redeliberate (1) the definitions of “expected losses and expected residual returns” and “variable interest,” (2) consideration of kick-out rights in the determination of the primary beneficiary and fiduciary responsibility, (3) clarification of the power principle, and (4) shared power. The objectives were met.

Matters Discussed and Decisions Reached:

Issue 1: Definition of *Expected Losses and Expected Residual Returns and Variable Interest*

1. Mr. Roberge stated that on January 28, 2009, the Board voted to remove the quantitative analysis of expected losses and expected residual returns, which required that such losses and returns be determined through an expected losses calculation prescribed in paragraph 8 and illustrated in Appendix A of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. This quantitative analysis was required in Interpretation 46(R) for determining, among other things, a variable interest entity’s primary beneficiary. This quantitative analysis also was required in the proposed Statement in situations in which an enterprise concluded that it may be the primary beneficiary of a variable interest entity, but was unable to determine its status through the required qualitative analysis in paragraph 14A of the proposed Statement.
2. Mr. Roberge stated that the Board requested that the staff reconsider and propose alternative language for the definitions of *expected losses and expected residual returns* and *variable interests*, as they are referenced in various other sections of Interpretation 46(R) and have caused confusion in practice regarding their application. In developing alternative language, the Board explicitly requested that the staff not deviate from the Board’s original intent of changing the language and not the meaning of these concepts.
3. Mr. Roberge stated that the staff discussed the revised language with constituents that have extensive experience in applying Interpretation 46(R). The general

consensus among these constituents was that the revised terms would cause more confusion in practice since constituents have had more than five years to apply the current language. The removal of the quantitative analysis in paragraph 14 of the proposed Statement sufficiently clears up the meaning of the terms.

4. **Staff Recommendation:** The staff recommended that the Board not change the language that defines *expected losses*, *expected residual returns*, and *variable interests* and asserted that it believed that the changes would not be necessary to achieve the objectives of the project. The staff believes the objectives have been met through the changes made to the reconsideration events and the removal of the quantitative test in paragraph 14 of the proposed Statement.
5. **Board Decision:** The Board decided to retain the existing definitions of *expected losses and expected residual returns* and *variable interests* as set out in paragraph 2 of FASB Interpretation No. 46(R).
6. **Board Comments:** Ms. Seidman expressed concern that the quantitative analysis that contributes to the identification of a variable interest and of a primary beneficiary may be related, and that the results of the definitions should be considered. Since the Board voted to remove the quantitative assessment used to identify a primary beneficiary, Ms. Seidman clarified that the primary significance of the terms *expected losses* and *expected residual returns* would be used to determine whether an enterprise has a variable interest in an entity. She further clarified that the current mathematical approach to evaluating the risks and rewards would be retained to identify a variable interest. Mr. Roberge pointed out that paragraph 9 of the Interpretation does not require a quantitative test. Ms. Seidman stated that the identification of a variable interest entity (VIE) and the determination of a primary beneficiary would be done almost entirely through a qualitative evaluation of power. She noted that if power is shared, the Board may be asked for some type of quantitative analysis as a backstop to the qualitative assessment.
7. Mr. Herz stated that for determining whether an entity is a VIE, paragraph 9 of the Interpretation says to first conduct a thorough qualitative assessment and if an

answer is not apparent, a quantitative analysis should be conducted. Mr. Herz stated and the staff concurred that users do not usually use a quantitative test to determine whether an entity is a VIE. Mr. Herz stated that the quantitative assessment to determine which enterprise is the primary beneficiary is not typically done, but instead the creators and absorbers of risk and rewards are analyzed. Mr. Roberge confirmed this by stating that the analysis is required in FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*.

8. Mr. Nickell stated that in the Basis for Conclusion in the Interpretation, there is a strong analysis that outlines potential problems with using a quantitative evaluation and seems to encourage a qualitative evaluation.
9. Mr. Linsmeier stated that the current language is very mathematically based, but that the staff appears to be saying that the VIE and primary beneficiary assessment is almost always done qualitatively and that the language is not important. He asked the staff why constituents would not want the language changed if the language was not important.
10. Mr. Roberge stated paragraph 5(a) requires an analysis of the investment at risk to determine whether the equity invested in an entity is a sufficient amount. Constituents have stated that the requirement in paragraph 5(a) is used to set a floor for the amount of equity invested. Once the floor is established, the required amount of equity may increase based on qualitative factors. There is a concern that if the requirement is removed, a floor would no longer be applied to paragraph 5(a). If the language were changed in paragraphs 5(b)(2) and 5(b)(3), Mr. Roberge stated that he is unsure how it should be altered so as to not change how the standard is currently applied. Mr. Roberge stated that if the paragraphs were changed to exclude *expected*, almost every entity could be a VIE, unless the entity was 100% equity funded.
11. Mr. Golden stated that the original intent of changing some of the language was to clarify some of the definitions and concepts around expected losses and variable

- interest. The staff created what was considered to be clearer definitions, but constituents told the staff that they are confident in how to interpret the existing terms and that new language would create more confusion.
12. Mr. Siegel asked whether the intent was to change the words to make the definition clearer or to change the concept. Mr. Roberge answered by saying the intent was to make the definition clearer. Mr. Siegel pointed out that if the words are changed, constituents may try to interpret the words differently such that the concept is altered.
 13. Mr. Smith clarified that the issue at hand is whether there will be problems throughout the proposed Standard if the language is not changed. Messrs. Smith, Golden, and Roberge agreed that the proposed Statement would not be impacted if the language remained unchanged.
 14. Mr. Linsmeier expressed concern about confusion of the word *expected* versus *could be significantly negative or positive losses or returns*. The word *expected* tends to cause constituents to think about the returns and losses that would occur when the initial design of the entity and how it is expected to perform is evaluated, not what happens when unplanned events occur. Keeping the original words may cause enterprises to only consider the original plans for the entity when deciding whether they have a variable interest in the entity. He is concerned that entities will not look into the future to determine whether they are exposed to losses and whether they have a variable interest in an entity, and he wanted to make sure that losses from unexpected events are considered.
 15. Mr. Herz expressed the hope that given recent experiences, enterprises would consider unexpected events to determine whether they have a variable interest in an entity.
 16. Mr. Golden stated that some of Mr. Linsmeier's concerns are addressed by the quarterly requirement to reassess expected losses and residual returns. The reassessment will serve to identify guarantees and other new VIEs.

17. Mr. Linsmeier also expressed concern that an enterprise that implicitly guaranteed an entity would not consolidate the entity until it was required to provide for the guarantee.

Issue 2: Consideration of Kick-Out Rights in the Determination of the Primary Beneficiary and Fiduciary Responsibility

18. Mr. Roberge stated that in the Exposure Draft, *Amendments to FASB Interpretation No. 46(R)*, the Board chose to exclude substantive kick-out rights for purposes of determining which enterprise has power, unless those kick-out rights are held by a single party with the unilateral ability to exercise such rights. He stated that the Board has acknowledged this exclusion is inconsistent with other guidance in GAAP as it relates to kick-out rights, including kick-out rights as used to determine whether a decision maker has a variable interest.
19. Mr. Roberge stated that the staff subsequently met with constituents to learn more about how kick-out rights are applied. The staff learned that kick-out rights are rarely exercised, and the staff is concerned that if kick-out rights are allowed to be used as they are in current GAAP, it would not be difficult for enterprises to insert them in current qualifying special purpose entities. The staff stated that the guidance on kick-out rights for determining whether a decision maker has a variable interest and all the guidance as it relates to kick-out rights should be removed from the proposed Statement. Mr. Roberge stated that the staff also believes the proposed guidance, as described in the Board Meeting Handout, will also aid constituents in determining whether they are an agent or a principal because much can be learned from the manner in which fees are structured. Mr. Roberge stated that based on the staff's proposed changes, the staff believes that the concept of kick-out rights as well as participating rights should also be addressed in EITF 04-5 and 96-16 in order to make such guidance consistent with the proposed Statement (that is, have the same guidance for both voting interest entities and VIEs).
20. **Staff recommendation:** The staff recommended retaining the guidance in the proposed Statement, which is to ignore kick-out rights unless one variable interest holder (including its related parties and de facto agents) has the unilateral ability to

exercise such kick-out rights and add a project to reconsider other authoritative guidance for kick-out rights and participating rights. Further, the staff recommended that the guidance for determining whether a decision-making or service provider fee represents a variable interest should eliminate the requirement for substantive kick-out rights to exist as one of the factors for determining whether the fee represents a variable interest. The staff emphasized that concerns regarding the principal-agency relationship would be addressed by the proposed amended guidance within the Board Handout. Finally, the Board agreed that a decision-maker's or service provider's employees should not be included in the definition of related parties when considering whether these enterprises have another variable interest, as long as the employees are not used to circumvent the Interpretation.

21. **Board decision:** All Board members agreed with the staff's recommendation to retain the guidance in the proposed Statement as described in the above paragraph, but decided to wait to add a project to the agenda to reconsider other authoritative guidance for kick-out rights and participating rights until a future date.

22. **Board Comments:** None.

Issue 3: Clarification of the Power Principle

23. Mr. Nickell stated that several constituents questioned why the Board concluded in Example 1 (securitization of commercial mortgages) of Appendix A of the proposed Statement that the special servicer had the "power to direct matters that most significantly impact the economic performance of the entity." Those constituents stated that because the special servicer could only exercise their power when the underlying loans were delinquent or in default, the special servicer's power was contingent on other events occurring. These constituents questioned why the special servicer would have power when no loans were in default.

24. Mr. Nickell stated that the staff thinks the key issue is that the guidance requires constituents to focus on power as it relates to the activities that most significantly impact the economic performance of the VIE, and not whether the proposed Statement is focused on current power or contingent power. Mr. Nickell noted that

this concept was reflected many times in the examples, but that the staff felt that the concept should be in the proposed Statement as part of the principles.

25. **Staff Recommendation:** The staff recommended that the Board provide clarification that assessment of the “power to direct matters” involves identifying which activities most significantly impact the economic performance of an entity. If those activities only occur based on the occurrence of certain events (such as the default of receivables), power over those activities still represents power over the entity.

26. The staff also recommends a clarification of the first sentence of the power criterion in paragraph 14A(a). The staff recommends the following changes to the first sentence of paragraph 14A(a):

~~The power to direct matters that most significantly impact~~ the activities of a variable interest entity, ~~including, but not limited to, activities that~~ most significantly impact the entity’s economic performance.

27. The staff believes the guidance in the proposed Statement needs to be able to stand on its own without relying solely on the examples to illustrate the key principles. As such, the staff recommends the following addition to paragraph 14A:

An enterprise must identify which activities most significantly impact the entity’s economic performance and determine whether it has the power to direct those activities. An enterprise’s ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the entity. A reporting entity does not have to exercise its power in order to have power to direct the activities of an entity.

28. **Board Decision:** The Board members unanimously agreed with the staff’s recommendation to provide guidance to clarify that an enterprise must identify which activities most significantly impact the entity’s economic performance and determine whether it has the power to direct those activities.

29. **Board Comments:** Ms. Seidman pointed out and Mr. Nickell confirmed that contingent power, as it relates to servicers, is only an issue when an enterprise has a

variable interest in the entity. Mr. Nickell stated that servicers will not always have a variable interest, and that it was stated as an assumption in Example 1 of Appendix A.

30. Mr. Herz gave a hypothetical scenario of a special servicer that holds a debt security of a VIE and only has decision-making power when specified events occur. It was made clear that the debt security held by the special servicer is a variable interest in the VIE, and that the decisions that would need to be made upon the occurrence of a specified event must be analyzed to determine whether those are the activities that most significantly impact the economic performance of the entity.

31. Mr. Smith stated that the primary beneficiary analysis is different for a normal operating entity than a special purpose entity. For an operating company, there are many decisions that need to be made when the entity is doing well. For a special purpose entity, there are few decisions made when the entity is doing well. For a special purpose entity, the focal point should be the decisions that need to be made when the entity does not perform as planned. In both cases, the power should be evaluated over the course of the life of the entity to determine who makes the substantive decisions concerning the entity. Mr. Smith stated that he supports the decision to add the language proposed by the staff. He expressed concern about how this logic impacts a voting interest entity when an enterprise holds an option to obtain a majority of the shares. Mr. Smith suggested adding an example that draws the distinction between how contingent power is applied to VIEs versus how it is applied to voting interest entities.

32. Messrs. Linsmeier and Smith clarified that an outstanding option on a stock does not constitute current power in a voting interest entity since there are significant decisions that need to be made while the option is outstanding. The types of the decisions that need to be made throughout the life of the entity are what need to be considered.

33. Mr. Siegel stated that he agreed with Mr. Smith that power should be evaluated over the totality of the life of the entity. He suggested adding the words *over the*

- life* after the word *economic performance* in the paragraph 21 in the proposed Statement to make sure the proposed Statement is interpreted as intended.
34. Mr. Nickell stated the additional language in paragraph 14A(b) that adds the language *could potentially be significant* would cause variable interest holders to analyze their decision making power over a period a time, not just in the near future.
35. Mr. Linsmeier stated this is the reason not to remove paragraph 14A(b) in the proposed Statement because it serves as a reminder that power needs to be evaluated through time.
36. Mr. Roberge stated that the problem with adding the term *life* is that some entities do not have a defined life. He was concerned that adding additional language may cause a lender that issued an arms-length loan with a material adverse change clause would be considered to have current power. He does not think having lenders consolidate variable interest entities at the inception of the entities is the general intent of the proposed Statement
37. Mr. Smith stated economic performance of an entity does not say *current* because theoretically it is over the entire life. Entities that have an undefined life are more like what he would consider a normal operating entity (non-SPE). SPEs are designed to manage a certain group of assets whose economic performance does have a defined life. For an operating entity there are considerable decisions that have to be made on a day-to-day basis, meaning the power would be evaluated over the life of the entity. An operating entity would probably need a reconsideration event to be considered an SPE.
38. Mr. Linsmeier stated that the power and benefit in an operating entity can be identified on day 1. For an SPE, the most significant power and benefit is not apparent on day 1 but rather when unplanned future events occur, and enterprises must focus on who makes the decisions when those unplanned (or unexpected) future events occur.

39. Mr. Nickell stated that the language in the proposed Statement is consistent with IASB document. He stated that the proposed language in combination with the examples will help provide clarity about how to evaluate the entity.
40. Mr. Herz and Ms. Seidman agreed that the proposed language in paragraph 21 and the example in the proposed Statement should convey that the analysis should be conducted over the life of the entity. Ms. Seidman suggested that an example with an operating entity that is a VIE and has a variable interest holder with limited power be included in the proposed Statement.

Participating and Protective Rights

41. Mr. Nickell stated that several constituents requested that the Board clarify whether and how protective rights and participating rights should be evaluated when evaluating the power criterion in paragraph 14A(a) of the proposed amendments. Some of those constituents noted that, absent further clarification, they would assume that participating rights held by various parties would indicate that no one party has power under paragraph 14A(a). These constituents noted the Board should clarify if participating rights should be evaluated similarly to kick-out rights in the proposed Statement.
42. **Staff Recommendation:** The staff recommended that the Board incorporate the guidance from the IASB Exposure Draft, ED 10 *Consolidation Financial Statements*, regarding protective rights into the proposed Statement (certain changes would be necessary to conform the wording in the IASB guidance to other guidance in the proposed Statement). The staff also recommended that the Board add guidance on participating rights that is consistent with the proposed Statement's guidance on kick-out rights.
43. The staff recommended the following changes to paragraph 14A(a) as part of this recommendation:
- a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance. An enterprise's determination of whether it has the power to direct the activities shall not be

affected by the existence of ~~substantive~~ kick-out rights or participating rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such ~~substantive~~ kick-out rights^{15b} or participating rights^{15c} and such rights are substantive. A single enterprise (including its related parties and de facto agents) that has the unilateral ability to exercise ~~substantive~~ kick-out rights or participating rights may be the party with the power to direct the activities that most significantly impact the entity's economic performance. Protective rights held by other parties do not preclude an enterprise from having the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

- b. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. They include, for example:
- i. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity, or apply only in exceptional circumstances. For example:
 - (i) A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
 - (ii) Other interests might have the right to approve a capital expenditure greater than a particular amount, or the right to approve the issue of equity or debt instruments.
 1. The ability to remove the enterprise that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that enterprise.
 2. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but would not give the franchisor a controlling financial interest in the franchisee. Such rights may protect the brand of the franchisor.

^{15b}This requirement is limited to this particular analysis and is not applicable to ~~other areas within Interpretation 46(R), as amended,~~ or transactions accounted for under other interpretative guidance.

^{15c}Participating rights are the ability to block the actions of the enterprise with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.

44. **Board Decision:** The Board unanimously agreed with the staff's recommendation to incorporate the IASB's guidance in ED 10, *Consolidation Financial Statements*, regarding protective rights into the proposed Statement. The Board also agreed with the staff's recommendation to add guidance on participating rights that is consistent with the proposed Statement's guidance on kick-out rights.
45. **Board Comments:** Mr. Herz stated that he liked that the added language that a franchisor's abilities in a franchising arrangement are generally protective in nature.
46. Mr. Nickell stated that constituents thought FSP FIN 46R-3 only described how the rights of franchisors should be evaluated, which effectively describes them as protective rights. Including the description of franchisor rights in the proposed Statement and using it as a guideline for protective rights achieves the same objective as the FSP. Mr. Nickell also noted that no comment letters from franchises were received, since the scope of the proposed Statement has not been changed and franchises assumed the FSP would be left intact.
47. Mr. Smith agreed that including the language in the proposed Statement was important so constituents would not go to EITF 96-16 and perhaps get different answers.
48. Mr. Golden stated that it was important to include a description of protective rights to make sure participating rights are evaluated in the same manner as kick-out rights.

Inconsistencies between Paragraph 5(b)(1) and Paragraph 14A(a) of the Proposed Amendments

49. Mr. Nickell stated that some constituents stated that the language in paragraph 5(b)(1) of Interpretation 46(R) should be amended to be consistent with the language regarding power in paragraph 14A(a) of the proposed Statement. Those constituents noted that if the language in paragraph 5(b)(1) is not amended, constituents will spend an inordinate amount of time trying to perform a different assessment when considering the decision-making ability of at-risk equity holders,

- as required by paragraph 5(b)(1), as opposed to an enterprise's consideration of their "power to direct matters" as required by paragraph 14A. Constituents recommended making the wording the same or explicitly tell them how to evaluations differ.
50. Mr. Nickell stated FSP FIN 46(R)-3 provides interpretive guidance regarding the application of paragraph 5(b)(1) of Interpretation 46(R). The FSP emphasizes the level of absorption of expected losses when assessing whether equity investors have decision-making rights. Some constituents noted that in practice, the primary purpose that the FSP serves is to indicate how paragraph 5(b)(1) should be applied to a franchise arrangement.
51. **Staff Recommendation:** The staff recommended amending paragraph 5(b)(1) to be consistent with the principle in paragraph 14A(a) and to nullify FSP FIN 46(R)-3.
52. The staff noted counterintuitive results may occur if the principle and underlying guidance in paragraph 5(b)(1) is not consistent with paragraph 14A(a). For example, assume an entity is considered a variable interest entity for the sole reason that kick-out rights are held by a group of non-equity holders (assume these rights are held by a group of lenders). In that fact pattern, the primary beneficiary analysis under paragraph 14A(a) would disregard the kick-out rights unless the rights were held by one party. An event more troubling to the staff would occur when a nonequity holder is the decision maker of an entity (for example, a general partner in a partnership structure); however, because the limited partners possess substantive kick-out rights, a constituent may conclude that the entity is not a variable interest entity under paragraph 5(b)(1) unless that paragraph is changed to be consistent with paragraph 14A(a).
53. The staff recommended the following changes to paragraph 5(b)(1) of Interpretation 46(R) as part of this recommendation; however, additional drafting changes will be necessary to appropriately capture the Board's intent and to address the staff concerns in the previous paragraph (the recommendation will also need to include a reference to the participating rights guidance in paragraph 14A if the Board agrees to add that language):

5b. As a group the holders of the equity investment at risk lack any one of the following three characteristics⁷:

(1) ~~The power, direct or indirect ability through voting rights or similar rights, to direct make decisions about an entity's the activities of an that have a significant effect on the success of the entity that most significantly impact the entity's economic performance.~~

⁷If interests other than the equity investment at risk provide the holders of that investment with the characteristics in criteria b(1)–b(3) of this paragraph or if interests other than the equity investment at risk prevent the equity holders from having the characteristics in criteria b(1)–b(3) of this paragraph, the entity is a variable interest entity. However, interests other than the equity investment at risk that provide the holders of that investment with substantive kick-out rights or substantive participating rights shall not prevent the equity holders from having the characteristic in criterion 5(b)(1) of this paragraph unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such rights.

54. **Board Decision:** The Board unanimously agreed with the staff to amend paragraph 5(b)(1) to be consistent with the principle in paragraph 14A(a) and to nullify FSP FIN 46(R)-3, which provides interpretive guidance about the application of paragraph 5(b)(1) of Interpretation 46(R).

55. **Board Comments:** Ms. Seidman suggested that the basis of conclusions include the Board's intended impact on franchises. She also clarified that franchisors would be stated as an example of a protective right in paragraph 14 of the proposed Statement.

Involvement in the Design of a Variable Interest Entity (Particularly in Structures with Predetermined Decision Making)

56. Mr. Nickell stated that several constituents requested that the Board address how an entity's involvement in formation activities that restrict substantive decision making should be considered in assessing which enterprise has the power to direct matters that most significantly impact the economic performance of the VIE. Some constituents stated that in many structures, the decisions that most significantly impact the activities of the VIE are pre-determined by its governing documents. Other constituents stated that many parties are involved in the design of an entity and the "final product" includes whatever was agreed to by all those parties

(including investors, rating agencies, the sponsor of the structure, and other parties involved in the deal).

57. **Staff Recommendation:** The staff recommended elevating the statements regarding an entity's involvement in the creation of an entity from the Basis for Conclusions in the proposed Statement to paragraph 14A of the final Statement. The staff recommended including explicit reference to consideration of the sponsorship of an entity.

58. The staff recommended the following addition to paragraph 14A(a):

Although a party may be significantly involved with the design of an entity, that involvement does not, in isolation, establish that party as the party with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the party had the opportunity and the incentive to establish arrangements that result in the party being the variable interest holder with such power. For example, a sponsor's explicit or implicit financial responsibility to ensure that the entity operates as designed may result in the sponsor establishing arrangements that result in the sponsor being the party with the power to direct the activities that most significantly impact the economic performance of the entity.

59. **Board Decision:** The Board agreed unanimously with the staff's recommendation to elevate the guidance currently in the Basis for Conclusions in the Proposed Statement regarding an entity's involvement in the creation of an entity.

60. **Board Comments:** None.

The Right to Receive Benefits or the Obligation to Absorb Losses That Could Potentially be Significant to the Variable Interest Entity

61. Mr. Nickell stated that several constituents asked the Board for additional guidance related to the requirement in paragraph 14A(b) of the proposed Statement for the reporting enterprise to have "the right to receive benefits from the VIE that could potentially be significant to the VIE or the obligation to absorb losses of the entity that could potentially be significant to the VIE."

62. Because the definition of *variable interest* is based on an entity having exposure to expected fluctuations in the results of an entity, the staff thinks the Board could

remove paragraph 14(A)(b). The staff understands that the Board may have a significant concern with the removal of paragraph 14A(b) because it will mean that the assessment of whether or not an enterprise has exposure to losses or the right to returns will be based on expected losses and expected residual returns. However, the Board did not change the definition of a variable interest in the proposed Statement.

63. If an enterprise concluded that they were not exposed to the expected losses and expected residual returns of an entity, they would have concluded they did not have a variable interest in the entity and they would not have applied paragraph 14A(b) of the proposed Statement. If the enterprise did conclude that they had a variable interest, they most likely would have concluded that they met the criteria in paragraph 14A(b) as well.
64. **Staff's Recommendation:** The staff recommended removing paragraph 14A(b) from the proposed Statement. The staff did not think it was appropriate to leave paragraph 14A(b) in the proposed amendments because it implies an override of the definition of a variable interest, which is the gating mechanism for determining whether an enterprise needs to consider if it should consolidate another entity.
65. If the Board did not agree with the staff recommendation, the staff recommended that the Board put in the Basis for Conclusion that if an enterprise has a variable interest, it will often meet the criteria in paragraph 14A(b).
66. **Board Decision:** The Board did not agree with the staff's recommendation to remove paragraph 14A(b) from the proposed statement.
67. **Board Comments:** Mr. Nickell stated that a removal of paragraph 14A(b) would mean that enterprises with a variable interest would have exposure to the entity. For example accounts receivable is a variable interest; however, the holder of the variable interest probably would not have power and would determine that they would never be the primary beneficiary.

68. Mr. Linsmeier stated that paragraph 14A(b) contributes to enterprises looking at the current status of the entity and to the future to determine whether they have rights or obligations that could potentially be significant.
69. Mr. Roberge stated that when evaluating whether an enterprise has a variable interest, the enterprise must look throughout the life of the entity.
70. Mr. Nickell stated in the past that enterprises with variable interests, when performing the primary beneficiary analysis, have determined that they are not exposed to 50% of the expected losses and subsequently decided that they would never be the primary beneficiary. Mr. Nickell stated that this concern would go away since the primary beneficiary determination is no longer done on the basis of absorption of expected losses.
71. Mr. Linsmeier stated that he prefers to keep the paragraph because the international community might perceive that what the FASB is doing is different than what is in the IASB's consolidation ED. The IASB's model is based on power and benefits. It becomes more abstract when we say that the FASB consolidation model is solely power based.
72. Mr. Nickell noted Mr. Linsmeier's concern and agreed that leaving the paragraph in would make it clear that the FASB model is power and benefits based.

Issue 4: Shared Power

73. Mr. Nickell noted that the principle of shared power in the Exposure Draft states:

If an enterprise can demonstrate that the power to direct matters that significantly impact the economic performance of the entity is, in fact, shared among multiple parties such that no one party meets the power criteria, then no primary beneficiary exists.

Mr. Nickell noted that constituents raised several questions about shared power during the comment letter process. Some of the examples and conclusions constituents reached in their comment letters indicated that they have a very broad idea of what shared power would be and that shared power would often exist.

74. In the small group meetings that the staff held with Board members, Mr. Nickell also stated there was some confusion regarding how to conclude a situation in which a single activity (for example, the servicing of loans) that was clearly the activity that most significantly impacts the performance of the VIE is performed by multiple parties. Mr. Nickell stated that the example discussed included four financial institutions that transfer loans into an entity and retain servicing for their specific loans, but they also all have an overall interest in the VIE. One financial institution services 40% of the loans while each of the other three financial institutions service 20% of the loans (the “40/20/20/20 example”). Under this example, power is not shared (there is no consent requirement). Multiple Board member interpretations resulted from the 40/20/20/20 example:

- a. All four parties are required to consolidate because they all have power related to servicing, and they all have benefits, and it is not shared power.
- b. The financial institution that services 40% of the loans would have to consolidate because their loans would most significantly impact the performance of the entity.
- c. It was not clear either way what you are supposed to do.

75. Mr. Nickell noted that the staff would need to have further discussions with constituents to understand these fact patterns.

76. **Staff recommendation:** The staff recommended that the Board add the following sentence to the proposed Statement to clarify when power is shared:

Power is shared if two or more parties together have the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance, and each of the parties sharing power are required to consent to the decisions made by the other party or parties. The requirement to consent must be substantive to conclude that power is shared.

77. The staff also recommended that a discussion be added to the Basis for Conclusions regarding the need for skepticism when an enterprise’s economics and power are not aligned.

78. With regard to the 40/20/20/20 example as set forth in paragraph 74, the staff recommended that, to the extent that the Board does not believe the answer is clear under the proposed Statement, the Board should provide additional clarification of whether (a) the party with the *most* power over

the most significant activity should consolidate or (b) the party with the *majority* of power over the most significant activity should consolidate.

79. **Board decision:** The Board agreed with the staff's recommendation to clarify the concept of shared power by adding the language in paragraph 77 of these minutes. The Board also decided to add guidance to paragraph 14 of the proposed Statement to emphasize the need for skepticism when an enterprise's economics and power are not aligned. The Board tentatively decided to not explicitly address the fact pattern in the 40/20/20/20 example.
80. **Board comments:** Ms. Seidman questioned whether the Board needs to explicitly answer the questions raised by Mr. Nickell regarding the 4/20/20/20 example. Ms. Seidman expressed concerns over having a very contrived example, and wondered whether this discussion would simply introduce a different kind of quantitative backstop. Ms. Seidman would prefer to not address this example in the proposed Statement; however, she did request that the staff follow up with constituents to understand if the example is prevalent in practice.
81. Mr. Linsmeier expressed concerns that the language in the proposed Statement could be interpreted such that all four enterprises in the 40/20/20/20 example would have to consolidate because they all have some power over the most significant activities.
82. Mr. Golden stated that if the example had two entities, one with 90% and the other with 10% power over the servicing of the loans, then he would conclude that the entity with 90% has the power over the most significant activities.
83. Mr. Linsmeier stated that his current thinking is that adding language that the party with the *most* power is the one that consolidates. Mr. Nickell responded that the staff could address that request in drafting.
84. Mr. Golden asked whether the Board wants to have the entity with the *most* power or the entity with the *majority* of power to consolidate. Historically, accounting literature has had a bias toward *majority*, which favors bright line interpretations (that is, only a party with more than 50% of the power would consolidate).
85. Mr. L. Smith expressed concern that, in situations in which more and more participants are involved, some structures could end up being consolidated by the

- party with the *most* power, even if that amount of power is very small. Mr. Siegel stated that, to the extent that more and more participants are involved, the likelihood of the group having a sponsor or other governing body increases significantly. In that situation, the sponsor would most likely have the power.
86. Mr. Herz suggested wording to the effect of “significantly more than the next party” rather than simply *more* or *most* power, but he prefers *most*.
87. Mr. L. Smith would prefer that the party with *significantly more* power than the next party should consolidate, so that the party that consolidates really is the one with dominant power, rather than a marginally (for example, 1%) larger amount. Mr. Golden suggested that if multiple parties have power and it is not shared, an entity would not have to have the *majority* (that is, greater than 50% of the power), but it would have to have *the most power* and *significantly more power than any other party*.
88. Mr. Nickell asked how the *significantly more* wording suggested by Mr. Herz would be applied in a situation in which one party has 51% of the power and another has 49% of the power. The first party has power because it has the majority, but it does not have *significantly more* power than the other party.
89. Ms. Seidman expressed concerns that the Board would create a new loophole if it attempts to address the 40/20/20/20 example. She would prefer that the issue be dealt with in practice so that there is a high risk that entities might consolidate rather than a rule that entities could structure around.
90. Mr. Golden expressed skepticism that such transactions as discussed in the 40/20/20/20 example even exist, and therefore the Board should not spend too much time on the subject. However, Mr. Linsmeier stated that this particular issue was discussed by participants at the roundtable meeting in November, and he requested that the staff have more discussions with constituents.
91. Mr. Linsmeier questioned how the Board would handle parties that have power over multiple activities, including a small amount of power over the single most important activity. Ms. Seidman suggested wording similar to that in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and*

Extinguishments of Liabilities, whereby if an entity has power over a combination of activities, it may have effective control.

92. Mr. Nickell asked whether the Board would like to stay silent on this issue at this time. Mr. Siegel stated that the Board is probably better off if they stay silent.
93. Mr. Golden suggested that, in the staff's recommendation for the definition of shared power, the Board elevate the guidance regarding skepticism (see paragraph 77) into the standard instead of noting it in the basis for conclusions.
94. Mr. Golden stated that the staff would do additional research on the specific issue in which the activity that most significantly impacts the entity's performance is a single entity and is performed by multiple parties.
95. All of the Board members concurred that this analysis would be helpful in determining whether explicit guidance should be added.

Follow-up Items:

96. The staff will follow up with recommendations for additional disclosure requirements related to shared power and will provide the Board with a copy of the overall disclosures, which Mr. Roberge stated will be similar to those required in FSP FAS 140-4 and FIN 46(R); however the "significant" qualifier will be removed from the variable interest disclosure requirement, as it was unclear why a concept other than materiality should drive disclosure requirements.
97. Mr. Herz asked the staff to provide the Board with a brief analysis of the staff's discussion with constituents regarding the implementation and usefulness of the disclosures a result of the requirements of FSP FAS 140-4 and FIN 46(R)-8.

General Announcements:

None.