PROPOSED FASB STAFF POSITION

No. FIN 46-f

Title: 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, *Consolidation of Variable Interest Entities*

Comment Deadline: December 14, 2003

Q—An entity shall be subject to consolidation according to paragraph 5(b)(1) of Interpretation 46 if, as a group, the holders of the equity investment at risk (the equity group) lack the direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights. How should variable interest holders evaluate whether the equity group lacks the direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights?

A—The evaluation should be based on *the extent to which* the total equity investment at risk provides the equity holders as a group the ability to make decisions about an entity's activities through voting rights or similar rights. The equity group would not lack the characteristic in paragraph 5(b)(1) of Interpretation 46 in situations in which the equity group holds *all* voting rights or similar rights, and, conversely, the equity group would lack the characteristic in situations in which the equity group holds *no* voting rights or similar rights. There are situations in which both the equity group and the parties outside the equity group hold voting rights or similar rights such that each has the ability to make or participate in decisions about an entity's activities. In those situations, emphasis should be placed on the ability of the equity group to make decisions that have a significant impact on the success of the entity as well as the extent to which the equity group absorbs expected losses and receives expected residual returns of the entity.

The ability to make decisions that have a significant impact on the success of the entity becomes increasingly important to the equity group as the amount of the equity investment increases. The greater the equity as compared to the expected losses of the entity, the less likely it is that the equity group would be willing to give up the ability to make decisions consistent with their interest or permit others to make decisions counter to the equity group's interests. Parties outside the equity group may be subject to risk by holding variable interests in an entity that vary with the success of the entity in achieving a desired return, but that risk may be significantly mitigated by the amount of the equity group's equity investment.

Judgment often will be necessary in evaluating whether the equity group can make decisions that have a significant impact on the success of the entity. It is not possible to create a list of decisions that an equity group must be able to make in order to determine whether the equity group lacks the characteristic in paragraph 5(b)(1) since the types of decisions can vary depending on the nature of the activities conducted by an entity. If the equity group has the ability to make decisions that have a significant impact on the success of the entity and the equity group has an obligation to absorb the expected losses and has the right to receive the expected residual returns of the entity, the equity group likely possesses the characteristic set forth in paragraph 5(b)(1), regardless of the fact that other parties may also have decision making rights.

The exhibit to this FSP illustrates how the paragraph 5(b)(1) evaluation should be performed to a franchise arrangement.

Effective Date and Transition

The guidance in this FSP is effective for all arrangements to which Interpretation 46 has been or will be applied. If the application of the guidance in this FSP results in changes to previously reported information, the cumulative effect of the accounting change should be reported as of the beginning of the quarter in which the final FSP is posted to the FASB website. (The quarter in which the final FSP is posted is expected to be the quarter beginning October 1, 2003, for a calendar-year entity.)

The provisions of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. For enterprises that have not yet applied the provisions of Interpretation 46 to variable interests in variable interest entities in accordance with the effective date provisions of paragraph

27 of Interpretation 46 or FSP FIN 46-6, the guidance should be applied as a part of their adoption.

Exhibit

Some constituents have questioned whether the decision-making authority of the franchisor in a typical franchise arrangement results in the equity group lacking the characteristic in paragraph 5(b)(1) such that all franchise arrangements are variable interest entities. The FASB staff believes it was not the Board's expectation that all franchise arrangements would be variable interest entities. Rather, the FASB staff believes it was the Board's expectation that franchise arrangements with equity sufficient to absorb expected losses would normally be designed to provide the equity group (the franchisee) with key decision-making ability to enable it to have a significant impact on the success of the entity (the franchise). That is, the decision-making authority would be sufficient for the equity group to significantly influence the fair value of the franchise. The FASB staff understands that the evaluation as to whether the franchisee lacks the characteristic in paragraph 5(b)(1) can be difficult, since franchise arrangements typically provide franchisors certain decision-making ability with respect to the operations of the franchise, the level of which can vary depending on the arrangement. The FASB staff believes there is an important distinction between having the ability to make decisions that have a significant impact on the success of a franchise and having the ability to make decisions that protect the franchisor's brand. The franchisor is effectively licensing its brand to the franchisee for a specified period of time and therefore is likely to require certain decision-making rights to ensure that the level of quality associated with the franchisor's brand is maintained. These franchisor rights do not necessarily limit the franchisee's ability to make decisions that have a significant impact on the success of the franchise. For example, a franchise agreement may allow the franchisor to participate in the following decisions (not intended to be all-inclusive):

- The right to approve the location of the retail facility or geographic area in which the franchisee is permitted to operate
- The right to require equipment, signs, menuboards, supplies, and other items necessary in connection with adding new approved products to be acquired, installed, and utilized at the retail facility as soon as possible consistent with franchisor requirements

- The right to approve the products that may be sold at the retail facility
- The right to approve suppliers for purchases of inventory, advertising materials, training materials, uniforms, packaging, computer hardware, insurance, and all food and beverage ingredients and products
- The right to approve the days and hours or operation
- The right to approve the franchisee's marketing plan
- The right to approve relocation of a retail facility
- The right to approve a sale of the franchise.

Although many of these decisions are important to the success of the franchise, the FASB staff believes that the franchisor's ability to participate in those decisions would not necessarily result in the equity group lacking the characteristic of paragraph 5(b)(1). The equity group would not lack the characteristic of paragraph 5(b)(1) so long as the franchisee maintains control over decisions that significantly impact the success of the franchise. These would typically include control over the day-to-day operations of the franchise, including, but not limited to, hiring and firing of management, establishing what prices to charge for products or services, and making capital decisions of the franchise.

The FASB staff understands that in some situations the franchisor may provide financial support to the franchisee or the franchisee's obligation to absorb expected losses or receive expected residual returns of the franchise is limited. In those situations, the ability to make decisions that have a significant impact on the success of the franchise becomes increasingly important to the franchisor because of the additional risk borne by the franchisor. Although the level of equity as compared to expected losses may mitigate the additional risk of the franchisor, in some instances the franchisor will require the franchisee to provide the franchisor the ability to make all decisions that have a significant impact on the success of the franchise. In those instances, the equity group would lack the characteristic in paragraph 5(b)(1) and, as a result, the franchise would be considered a variable interest entity. However, in other situations, the franchisor may require the franchisee to relinquish some, but not all, of its ability to make those decisions that have a significant impact on the success of the franchise. In those situations, all facts and circumstances need to be considered in determining whether the franchisee lacks the characteristic in paragraph 5(b)(1). The level of equity in comparison to expected losses may be a particularly telling indicator as to whether the franchisee lacks the characteristic in paragraph 5(b)(1).

It should also be noted that even if the franchise is deemed to be a variable interest entity because the franchisee lacks the characteristic of paragraph 5(b)(1), the level of equity provided by the franchisee may keep the franchisor from being considered the primary beneficiary of the variable interest entity.

Submitting Comments on a Proposed FSP

Responses from interested parties wishing to comment on a proposed FSP must be received in writing by the comment deadline indicated for each FSP. Interested parties should submit their comments by email to **director@fasb.org**, and include "Comments on Proposed FSP" along with the reference number (for example, FSP FIN 46-f) in the subject line of the email. Those without email may send their comments to "Director, TA&I—FSP" at the following address:

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Responses should not be sent by fax.