FASB Interpretation No. 46 (FIN 46)
Consolidation of Variable Interest Entities

FIN 46 was issued by the Financial Accounting Standards Board on January 17, 2003. The long awaited interpretation ends one of the longest projects undertaken by the FASB, concluding over 20 years of effort to reformulate accounting standards for consolidation. Prompted by the Enron debacle and the SEC, work on consolidation was expedited over the last twelve months. This effort included a third exposure draft, the first of which was issued in 1995, public roundtable meetings and countless hours of public deliberation and redeliberation by the FASB in the past year. The final product is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements.*

Initially conceived in 2002 as an interpretation for consolidation of special purpose entities, FIN 46 instead divides the population of legal entities into those consolidated through voting interests and those consolidated by "variable interests" where voting interests do not reflect the controlling financial interest in an entity and its assets and activities. The Board rejected the distinction created in its June exposure draft between SPEs and "substantive" entities – the latter being companies that conduct business operations and have employees and sufficient equity to finance their activities – and instead recast the focus on identifying the party that has the controlling financial interest in the assets of an entity.

Variable interests are contractual, ownership or other financial interests that subject a party to the expected losses and residual returns generated from the assets and activities of an entity. All parties involved with entities, including those without any nominal equity interest or voting rights, will need to undertake an analysis of their and other parties' relationships to an entity to determine if they have the controlling financial interest and should, therefore, consolidate the entity.

Structured finance transactions such as true leases, credit tenant leases, synthetic leases and securitizations will survive, consistent with the Board's stated intention of not amending the literature comprising GAAP for these financings. Market true leases and credit tenant leases are afforded special treatment under the Interpretation and can avoid evaluation for consolidation regardless of the use of a SPE. Lessees under synthetic leases can avoid consolidation if title to assets is held in an entity consolidated by voting interests. Securitizations using qualifying special purpose entities (QSPEs) under Statement 140 are exempt from consolidation, encouraging greater use of this type of entity for restructuring and new transactions. However, existing structures of many commercial paper conduits sponsored by U.S. commercial banks and other U.S. GAAP companies will need to be reorganized in many cases to avoid consolidation. Similarly, asset managers in collateralized debt obligations (CDOs) will likely have unintended consolidation results. Partnership structures with one party bearing most of the risk and reward are at risk of consolidation with that party.

Summary and Observations

- FIN 46 is effective after January 31, 2003 for newly created variable interest entities (VIEs) and VIEs in which an enterprise obtains an interest after that date. For existing entities, FIN 46 will apply retroactively to public companies at the beginning of the first fiscal period beginning after June 15, 2003. Thus, there will be approximately five months of transition time to evaluate consolidation and to restructure if necessary, desired and possible to avoid consolidation.
- Disclosure requirements, however, are in effect for parties involved with entities for any financial statements issued after January 31, 2003, immediately affecting 10-Qs and 10-Ks of public companies. These requirements affect companies that believe it is reasonably possible that they might need to consolidate an entity prospectively as well as if they have a significant involvement with a VIE. The timing of these disclosure requirements, in the near term, will be challenging given that it will take some time to digest and understand the actual impact of the Interpretation.
- The Interpretation applies to entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 provides principles for these determinations with limited guidance on specific situations; no case studies or examples are provided even though the Board circulated such items in conjunction with the "fatal flaw" draft in December. If entities otherwise satisfy criteria for consolidation by voting interests, the equity investors would consolidate through the applicable existing standards including voting interests under ARB 51 and joint venture and leveraged lease accounting. It is possible that no party may consolidate in cases in which the risks of an entity are adequately dispersed.
- The Board acknowledged the many and complex uses of contracts and arrangements with entities that are used to circumvent control through voting interests. FIN 46 is an attempt to lay out broad principles for evaluation of all such interests in an entity. The document goes through brief presentation of these concepts with appendices shedding more light on the Board's rationale and provides sample quantitative analysis of expected losses and residual returns and descriptions of variable interests.
- Since the document is not explicit on commonly used entities, implementation and determination of the actual implications of FIN 46 will be left to the public accounting firms. The distinction between VIEs and voting interest entities will be pivotal in the realm of structured finance. It is not safe to assume that that an entity used in structured finance in the past is not a VIE unless it is a large enterprise with significant capital and many different lines of business. It will likely take weeks, if not months, for the public accountants and industry to develop a consensus on application of FIN 46.
- Significantly, FIN 46 lays the groundwork for consolidation of a portion of assets contained within a VIE if assets are insulated from the reach of recourse creditors of a VIE. In that case, one or more assets contained within a VIE may be deemed a separate VIE even though no legal entity exists. The obvious targets and concern are multi-asset entities used for leasing and securitization.

- While the overall analysis required by parties involved with entities may be cumbersome, FIN 46 provides some shortcuts for enterprises if it is apparent that their interest is not a significant variable interest and for long-term leases or service contracts in which market terms are provided and no residual guaranty or similar feature exists. Similarly, fixed and unconditional liabilities owed by a VIE (i.e., investment grade debt) are not considered a variable interest in the entity. These provisions will eliminate analysis of many commercial arrangements undertaken on a market basis.
- FIN 46 nullifies portions or all of EITF Issues No. 90-15 and 96-21 (good explanation and detail is provided in Appendix D). Thus, the pre-existing standards for capitalization such as 3% minimum equity no longer apply when voting interest entities are involved. The provisions of FIN 46 will govern when variable interests must be analyzed.

Variable Interest Entity

Entities subject to consolidation under FIN 46 would have one of the following characteristics:

1. *The equity investment at risk is not sufficient to finance the entity independently.*
   That is, the equity available is less than the expected losses of the entity. Equity investments may not be derived from fees payable, amounts financed by another party involved with the entity or interests issued in exchange for interests in a VIE. It is presumed that 10% equity is sufficient but greater or lesser amounts may be appropriate if it can be demonstrated that the entity needs no further financial support or there is observable market or performance data that supports a different amount. For example, banks are normally capitalized below 10% and this practice is consistent with regulatory requirements, loss history and competitive practice.

2. *The equity investors lack any of the characteristics of controlling financial interest.*
   - Ability to make decisions about activities through voting or similar rights, either directly or indirectly.
   - Obligation to absorb expected losses, including the first risk of loss, without guaranty of return or other protection from losses (i.e. third party guarantees).
   - Right to receive the residual benefits and returns, including no limit on the investor's return under the arrangements and operative documents (i.e., fixed buyout rights or renewals under a lease).

Scope

Certain entities are exempted from evaluation under FIN 46. These include not-for-profit organizations, QSPEs, separate accounts of life insurance entities and employee benefit plans. There is an anti-abuse provision in the exception for not-for-profits that would presumably be carried over to other exempted entities if the intent was clear.

Expected Losses and Residual Returns

Expected losses and returns form the underpinning for quantifying variable interests and determining which of the parties should consolidate a variable interest entity as the "primary beneficiary." Losses and returns are comprised of the expected variability in an entity's net income or loss and in the fair value of its assets. Fees to decision makers and to providers of guarantees of the value of all or substantially all of an entity's assets or liabilities are also included. Appendix A to FIN 46 contains an example to determine the fair value of expected cash flows under Concepts Statement No. 7 and shows how to calculate the expected losses based on fair value. The variable interests of each party will need to quantified in this manner and compared.

Consolidation

The party with the majority of the expected losses or expected residual returns will consolidate but the party with majority of losses will consolidate over one with only expected upside. If no party holds the majority of either, no one consolidates on the premise that the risks are adequately dispersed. Ability to make decisions is considered a strong indicator of the existence of exposure to losses or returns that would cause consolidation.

Determination of expected losses and returns and consolidation occurs only upon creation of a new entity or upon initial involvement with an entity even though actual losses may exceed expected losses. Consolidation decisions will be reconsidered only upon a change in the governing documents or contractual arrangements, return of an investor's equity investment or the undertaking of additional activities or acquisitions of assets by an entity that increases its expected losses.

Interests in Specified Assets of a Variable Interest Entity

One of the thorniest elements of the exposure draft and subsequent redeliberations was multi-asset leasing and securitization entities, including most notably, commercial paper conduits. Many existing entities will have significant adverse consolidation results unless they are adequately restructured prior to June 30, 2003.

FIN 46 provides that if a VIE exists, specified assets held by the entity can be treated as a separate entity for consolidation analysis if the assets are essentially the only source of payment for specified liabilities and other interests. In that case, a subgroup of assets within a VIE needs to be analyzed as to whether it is consolidated into the VIE through voting interests or with another party through variable interests. This "mini"-consolidation analysis can result in distinct assets within a VIE being consolidated with a party other than that which is considered the primary beneficiary of the VIE. These assets would then be shed from the overall VIE, so the primary beneficiary of the larger VIE would only consolidate the remaining assets. This process results in consolidation of a portion of assets within an entity for which there has been no previous foundation in GAAP and despite the fact that there may be no legal entity around the assets. This approach will subject individual assets contained in leasing companies and securitization vehicles that are VIEs to consolidation with a party other than the primary beneficiary of those entities. Therefore, determination of whether these leasing companies and securitization vehicles are VIEs is a critical evaluation under FIN 46.

If the fair value of the specified assets represents more than half of the fair value of the total assets of the VIE, then the holder of the variable interest in the specified assets is considered to have a variable interest in the entity as a whole (limited practical application where one group of assets constitutes the majority of an entity). This exposes the holder to consolidation of the overall VIE potentially rather than just certain specified assets.

Disclosure

Financial statements issued after January 31, 2002 must contain information about a VIE if it is reasonably possible that a reporting company will consolidate or a company has a significant involvement with an entity. The initial disclosure requirement includes the nature, purpose, size and activities of the VIE and the reporting company's maximum exposure to loss resulting from its involvement.

A primary beneficiary must disclose similar information about the VIE itself in addition to the carrying amount and classification of assets that are collateral for the entity's obligations and lack of recourse, if any, that creditors have to the general credit of the primary beneficiary.

Companies that have a significant variable interest in a VIE, but are not the primary beneficiary must disclose information on the nature, purpose, size and activities of the VIE, the nature of their involvement with the VIE and when it began and the maximum exposure to loss.

Disclaimer: *The information on FIN 46 contained in this memorandum is solely the views of 42 North Structured Finance, Inc. Readers and preparers should rely on advice from their own auditors.*