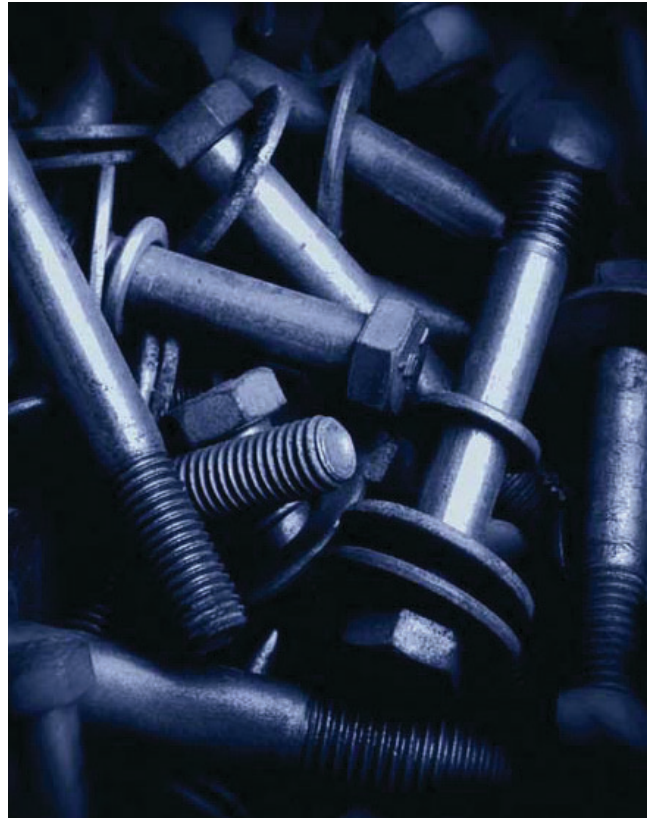


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ALERT

Proposed Changes in VIE Accounting

The FASB proposed significant changes in how companies identify variable interest entities and determine who should consolidate them under Interpretation 46, issued earlier this year. Its proposed additional Interpretation would also clarify a number of provisions.¹ Some requirements are relaxed, but other changes would make it more likely that potential variable interest entities are identified and consolidated, and some would add difficult judgments. The comment period ends December 1, 2003, with a final Interpretation targeted no later than the middle of the same month. Public companies would have to apply the new requirements by the end of periods ending after December 15, 2003.²

THE SCOPE OF INTERPRETATION 46

The first three changes described below would narrow the scope of the Interpretation, and two of them would necessitate difficult judgments and added disclosures. The fourth would broaden the requirements for reconsidering whether an entity is a variable interest entity and which party (if any) should consolidate the entity.

- (1) FASB Interpretation No. 46, Consolidation of Variable Interest Entities, January 2003. Proposed Interpretation, Consolidation of Variable Interest Entities: A Modification of FASB Interpretation No. 46, October 31, 2003.
- (2) For public companies, FASB Staff Position No. FIN 46-6, Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, changed the effective date of Interpretation 46 for entities created before February 1, 2003, from the beginning of periods beginning after June 15, 2003 to the end of periods ending after December 15, 2003, provided those entities were not already consolidated under the requirements of Interpretation 46 in previously-issued financial statements.

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- A proviso accompanies a proposed new exemption for mutual funds in the form of trusts, trusts of bank trust departments, and similar arrangements. According to the proviso, the exemption does not apply if these entities are being used “in an effort to circumvent” the Interpretation’s consolidation requirements. Determining whether such entities are being used as variable interest entities will depend on specific facts and circumstances difficult to evaluate, and the words “in an effort to circumvent” suggests identifying intent, often an extremely difficult matter to judge.
- A proviso also governs the new exemption for entities created prior to February 1, 2003 (which excludes newly organized variable interest entities). They would be beyond the reach of Interpretation 46 *only if* the reporting entity had made an “exhaustive,” but unsuccessful, effort to obtain the information necessary to perform the required evaluations.³ Companies applying this provision would have to determine whether their efforts had been exhaustive, and the FASB is unlikely to explain further what conditions satisfy the notion of exhaustive efforts. Compliance with this provision is expected to come under scrutiny and require significant supporting disclosure and documentation.
- Not-for-profit organizations (as defined in FASB Statement No. 117) would be subject only to Interpretation 46’s related-party provisions.⁴ This would expand the not-for-profit scope exception to include not-for-profit health care organizations, consistent with a recent Staff Position.⁵
- The Interpretation would broaden the circumstances under which a party must reconsider whether an entity is a variable interest entity and which party (if any) should consolidate the entity. These reconsiderations would be required whenever the entity’s design or ownership interests change in a manner that could affect whether an entity is a variable interest entity and whether one should be consolidated. There would no longer be an all-inclusive list of reconsideration (or “trigger-

ing”) events. This proposal would obligate companies to demonstrate that events outside of those previously listed by the FASB would not cause a change in whether an entity is considered a variable interest entity.

WHEN IS AN ENTITY A VIE?

The proposal would revise the requirements about how to evaluate whether equity instruments are not controlling financial interests.

- An entity would be considered a variable interest entity if some of the characteristics that are specified as integral to a controlling financial interest are contained in instruments or contracts other than the equity investment at risk, even if those instruments or contracts are also held by the same investors as the investors in the equity investment at risk. Characteristics that are integral to a controlling financial interest include the ability to make decisions about the entity’s activities through voting or similar rights, the unlimited obligation to absorb the entity’s economic risks, and the uncapped right to realize the entity’s economic rewards. Thus, for example, an entity with an asset manager that is an equity investor and that has significant contractual decision-making rights with respect to the entity’s activities may be a variable interest entity because of the asset manager’s non-equity contractual decision-making rights.
- If substantially all of an entity’s activities are conducted on behalf of a group of related parties, *any one* of which has disproportionately few voting rights, the entity would be a variable interest entity.⁶ A company and its officers or board members, for example, might hold all of the economic interests in an entity, but the officers or board members have voting equity interests and the company has only nonvoting equity interest. In such situations, *all* economic interests in the entity held by the related-party group would be evaluated in determining whether the entity is a variable interest entity, not only the equity interests.

(3) The required information includes that necessary to determine whether the entity is a variable interest entity, to determine which party is required to consolidate the entity if it is a variable interest entity, or to account for the entity in consolidation.

(4) FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, June 1993.

(5) FASB Staff Position, No. FIN 46-1, Applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to Entities Subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*.

(6) This would include all related parties as described in paragraph 16 of Interpretation 46 except for parties that are considered related because of transferability restrictions on their economic interests.

WHEN TO CONSOLIDATE

The Interpretation would revise the requirements about how to evaluate which party must consolidate a variable interest entity and will likely require companies to perform additional work.

- The related-party provisions would be relaxed. For purposes of aggregating the interests of related parties to determine whether a variable interest entity would have to be consolidated, a transferability restriction does not presumptively establish a related-party relationship if contractual approval rights held by one party do not effectively constrain the restricted party's ability to manage the economic risks or realize the economic rewards of its interests. For example, a related-party relationship would not be presumptively created if a restricted party has the ability to realize the economic benefits of its interest by selling that interest without the restricting party's approval, even if the restricting party's prior approval is required for all other transfers or encumbrances of that interest.
- If a group of related parties holds interests that convey a majority of a variable interest entity's economic risks and rewards, the party in the group that is a principal in an agency relationship (or a de facto agency relationship) would have to consolidate the variable interest entity unless the activities of another party in the group are more closely associated with those of the variable interest entity. The party whose approval is required for another party to sell, transfer, or encumber its interest would be the principal in a de facto agency relationship if there is no contractual requirement that the reporting enterprise's approval is not to be unreasonably withheld. However, this would not be the case if the same restriction applies to the other party.

Separately, the proposal would delete most of the guidance describing various types of economic interests and whether they represent variable interests that might potentially require consolidation of a variable interest entity. The FASB has specifically mentioned that it is not satisfied with the guidance regarding liabilities to a variable interest entity and forward contracts with a variable interest entity. This creates uncertainties for companies evaluating variable interest entities with such contracts.

GOODWILL

Companies would be required to recognize goodwill on initial consolidation of a variable interest entity that is a business. This would be similar to the accounting requirements for business combinations except that the assets, liabilities, and non-controlling interests of the variable interest entity would be measured at full fair value rather than allocated fair value. This issue concerned companies with equity-method investees because they would have been required to write off any equity method goodwill if required to consolidate the investees under the existing requirements of Interpretation 46.

CLARIFICATIONS

Most of the proposed clarifications pertain to determining whether an entity is a variable interest entity.

- The equity investment in an entity would not be considered sufficient (and the entity would be a variable interest entity) under Interpretation 46 if the entity must obtain additional subordinated financial support in order to finance its activities, even if that additional support is provided by its own equity investors.
- Language would remind companies that, given the subjectivity that may be inherent in quantifying the amount of equity needed by an entity to absorb the entity's economic risks, qualitative considerations may be important in determining whether an entity's equity investment at risk is sufficient.
- The guidance regarding calculating an entity's economic risks and rewards (i.e., expected losses and expected residual returns) would be clarified to indicate that expected variability in an entity's net income or loss and in the fair value of its assets means the expected variability in the entity's long-term returns available to variable interest holders.
- Both the sufficiency and the characteristics of development stage enterprises' equity would have to be evaluated when determining whether they are variable interest entities. This could be a concern, for example, in accounting for a company that principally performs research and development activities.



- The phrase “if they occur” with respect to absorbing the expected losses or expected residual returns of a variable interest entity would be removed for purposes of determining which variable interest holder should consolidate the entity. This change would, for example, permit companies to determine which party should consolidate a variable interest entity by separately calculating expected cash flows for each variable interest rather than merely allocating the entity’s expected losses to variable interests in order of most to least subordinate. The modified language would give the FASB more flexibility in providing future guidance about how to determine which party should consolidate a variable interest entity.
- Language would clarify that the effects of intercompany eliminations on a consolidated variable interest entity’s net income or expense should be attributed to the primary beneficiary in the consolidated financial statements. For example, a service provider that consolidates a variable interest entity should recognize the amount of its fee (which is eliminated in consolidation) as its share of the entity’s operating results.

EFFECTIVE DATE

Companies that have not yet applied the consolidation requirements of Interpretation 46 to some or all of the variable interest entities that they are involved with would be required to apply the modifications to those entities in accordance with the effective date and transition provisions in Interpretation 46 and related FASB Staff Positions. For other entities to which the consolidation provisions of Interpretation 46 have already been applied (for example, for entities created after January 31, 2003), the effective date of the modifications would be the first reporting period ending after December 15, 2003. Companies would have the option to either report a cumulative effect adjustment for the period in which the modifications are first applied or to restate all periods in which Interpretation 46 has already been applied to comply with the modifications.



Because of the very tight timeframe for issuing the proposed Interpretation and the required effective date of Interpretation 46, companies will need to closely monitor the FASB’s deliberations about variable interest entities between now and the end of the calendar year.

Companies should not treat the descriptive statements above about the proposed Interpretation as if it is what the FASB will finally adopt. They should consult the exposure draft, the final guidance as authoritatively issued, their specific circumstances, and their accounting and legal advisors.

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