Deloitte.

Heads Up

Audit and Enterprise Risk Services

June 18, 2008
Vol. 15, Issue 27

In This Issue:

Mind Your V(IE)s and Qs

FASB Decides to Eliminate QSPEs and Modify the Consolidation Model in Interpretation 46(R)

by Chris Rogers, Robin Kramer, and Randall Sogoloff, Deloitte & Touche LLP

Introduction

The FASB recently decided to remove the concept of a qualifying special-purpose entity (QSPE) from Statement 140[1] and the related scope exceptions from Interpretation 46(R).[2] In addition, the FASB decided to (1) make certain changes to the derecognition provisions in Statement 140 and (2) modify the consolidation model in Interpretation 46(R). As a result, if these decisions become final, enterprises involved with QSPEs will no longer be exempt from applying Interpretation 46(R); thus, previously unconsolidated entities may have to be consolidated. Also, because of the potential modifications to the existing Interpretation 46(R) model, enterprises involved with variable interest entities (VIEs) (even VIEs that are not structured finance vehicles) will need to rethink their previous consolidation conclusions. The FASB is expected to issue an Exposure Draft for public comment on the amendments to Statement 140 and Interpretation 46(R) this summer. The FASB has proposed that the amendments be effective for all VIEs (except for certain existing QSPEs) and new transfers of financial assets for fiscal years beginning after November 15, 2008. A one-year deferral is proposed for existing QSPEs meeting certain criteria.

The FASB's decisions are in response to increased scrutiny of Statement 140 and Interpretation 46(R) by the SEC, Congress, and financial statement users in the wake of the recent deterioration in the credit markets. The FASB has stated that "[c]onstituents have voiced concerns over the lack of transparency (either through consolidation or disclosure) of the enterprises' involvement with structures that contained significant risk; for example, they cite an inability to understand the nature of the enterprises' involvement and maximum exposure and an inability to assess the current status of their exposure."

Editor's Note: The following summary represents the authors' understanding of Board decisions made over the course of several Board meetings occurring between April 2, 2008, and June 11, 2008, regarding the FASB's projects to amend Statement 140 and Interpretation 46(R). Board decisions are tentative and do not change current accounting requirements. Official positions of the FASB are determined only after extensive due process and deliberations. For more information about the decisions reached by the Board, see the Statement 140 or Interpretation 46(R) project Web page on the FASB's Web site.

[1] FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* — a replacement of FASB Statement No. 125.

[2] FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* — an interpretation of ARB No. 51.

The following table summarizes the decisions reached by the Board through its June 11, 2008, meeting. The table is followed by a detailed discussion of each decision.

Decision	Current GAAP	Proposed Amendment
Elimination of QSPEs	Under Statement 140, financial assets transferred to a securitization vehicle that meets the definition of a QSPE are typically derecognized by the transferor. Under Interpretation 46(R), the assets and liabilities of a QSPE are exempt from consolidation by the transferor and most investors.	The Board voted to eliminate the concept of a QSPE from Statement 140 and to delete the related scope exceptions from Interpretation 46(R). As a result, transferors and investors in securitization vehicles must consider the consolidation provisions in Interpretation 46(R).
Legal Isolation of Transferred Financial Assets	Paragraph 9(a) of Statement 140 does not *explicitly* require that a transferred asset be legally isolated from **all** consolidated affiliates of the transferor. Paragraph 9(a) also does not *explicitly* require that the legal isolation analysis take into account **all** arrangements made in connection with a transfer.	The Board voted to explicitly require that a transferred asset be legally isolated from the transferor and **any** of its consolidated affiliates that is not a bankruptcy-remote special-purpose entity. In addition, the legal isolation analysis must take into account **all** arrangements made in connection with a transfer.
Transferee's Ability to Pledge or Exchange Transferred Assets	Paragraph 9(b) of Statement 140 currently requires that for a transferor to achieve sale accounting, a transferee (i.e., the purchaser) that is not a QSPE must have the ability to freely pledge or exchange the transferred financial assets. Constraints on the transferee often cause a transfer to fail sale accounting unless the transferee is a QSPE.	Because the Board voted to eliminate the QSPE, it also decided to remove paragraph 9(b) in its entirety from the derecognition assessment. The concept of a transferor constraint on the transferee's ability to freely pledge or exchange the transferred assets will now be included in paragraph 9(c) of Statement 140.
Derecognition of a Portion of a Financial Asset	Statement 140 does not include specific guidance on when a portion of a financial asset may be derecognized.	The Board voted to provide prescriptive guidance on when a portion of a financial asset is eligible for derecognition. Under its proposal, a portion of a financial asset is eligible for derecognition only if the transferred portion meets the strict definition of a participation interest.
Initial Measurement of Beneficial Interests That Are Retained by the Transferor	A beneficial interest in a transferred financial asset that is retained by the transferor is initially recognized on the basis of a relative fair value allocation of the previous carrying amount of the asset sold and the beneficial interest that is retained.	The Board voted to require that a beneficial interest in a transferred financial asset that is retained by the transferor be initially recognized at fair value. In contrast, the Board also decided that a portion of a financial asset that is retained by the transferor after a transfer of a participating interest should be initially measured on the basis of an allocation of its previous carrying amount.
Elimination of Special Treatment for Guaranteed Mortgage Securitizations (GMSs)	Statement 140 currently allows a transferor to reclassify mortgage loans to mortgage-backed securities in a transfer to a GMS when 100 percent of the interest is retained if the transferor meets certain requirements. Similarly, Statement 156 allows a transferor to recognize a servicing asset or servicing liability related to mortgage loans transferred to a GMS.	The Board voted to eliminate the ability to reclassify mortgage loans to mortgage-backed securities or to recognize a servicing asset or servicing liability in (1) a transfer to a GMS that fails sale accounting or (2) a transfer that results in consolidation of the GMS.

Decision	Current GAAP	Proposed Amendment
Determination of the Primary Beneficiary of a VIE	The consolidation model in Interpretation 46(R) is based on a risks-and-rewards model. The interest holder that absorbs a majority of the expected losses of the VIE, receives a majority of the expected residual returns of the VIE, or both, is the primary beneficiary and should consolidate the VIE.	The Board voted to modify the existing consolidation model by introducing a two-step approach into Interpretation 46(R). Step 1 in determining the primary beneficiary is a qualitative analysis that takes into account who has the explicit or implicit power to affect the VIE's activities. Step 2 is a quantitative analysis using a calculation of expected losses and expected residual returns that is only applied if the primary beneficiary cannot be determined in step 1.
Consideration of Kickout Rights	Kickout rights held by an interest holder are not factored into the determination of the primary beneficiary of a VIE.	The Board voted that the ability to remove a variable interest holder that *currently* has the ability to direct the activities of a VIE should be ignored when determining whether that variable interest holder is the VIE's primary beneficiary.
Continual Reconsiderations	Interpretation 46(R) requires an enterprise to reconsider whether an entity is a VIE and which interest holder is the VIE's primary beneficiary only if certain triggering events occur (i.e., reconsideration events).	The Board voted to require that an enterprise reconsider whether an entity is a VIE and which interest holder is the VIE's primary beneficiary as of each reporting date (i.e., quarterly and annually).

Many questions have arisen about whether the modification of currently performing subprime mortgage loans held in QSPEs in which default is reasonably foreseeable violates the passive nature of a QSPE.

Background

QSPEs play an important role in the accounting for asset-backed securitizations. Currently, Statement 140 permits an enterprise that transfers financial assets to a securitization vehicle that meets the definition of a QSPE to (1) derecognize the transferred assets[3] and (2) be exempt from consolidating the assets and liabilities of the securitization vehicle. In addition, investors in a securitization vehicle that meets the conditions of a QSPE typically do not have to consider the consolidation provisions of Interpretation 46(R). Because the concept of a QSPE is crucial to transferors and investors achieving off-balance-sheet accounting, whether a securitization vehicle qualifies as a QSPE has been a significant focus since the issuance of Statement 125[4] (Statement 140's predecessor) in 1996.

Statement 140 describes a QSPE as a conduit or a custodian that passively holds financial assets for the benefit of beneficial interest holders. Paragraph 35 of Statement 140 lists several prescriptive conditions that must be met for a special-purpose entity to be considered a QSPE. These conditions are meant to restrict the types of assets that a QSPE may hold and the types of activities that a QSPE may engage in. Because of the prescriptive nature of the conditions in paragraph 35, numerous implementation issues have surfaced regarding whether the activities of a securitization vehicle are limited enough to be in accordance with the passive nature of a QSPE. Standard-setting initiatives in response to these implementation issues date back to the issuance of Statement 125 but have not yet successfully addressed them.

Several of these implementation issues have recently been compounded by the deterioration in the credit markets. Specifically, many questions have arisen about whether the modification of currently performing subprime mortgage loans held in QSPEs in which default is reasonably foreseeable violates the passive nature of a QSPE. In response to these questions, SEC Chief Accountant Conrad Hewitt issued a January

[3] Derecognition is only appropriate if the remaining conditions in paragraphs 9(a) and 9(c) are satisfied.
[4] FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

2008 letter requesting that the FASB "immediately address the issues that have arisen in the application of the QSPE guidance in Statement 140" and that any amendments to Statement 140 "be effective no later than years beginning after December 31, 2008."

Editor's Note: Conrad Hewitt's letter was issued in response to the accounting implications of the American Securitization Forum's Streamlined Foreclosure and Loss Avoidance Framework (the "ASF Framework"). The ASF, coordinating with the Department of Treasury, developed the ASF Framework to encourage mortgage servicers to refinance or modify risky subprime mortgage loans. However, questions were raised regarding whether such modifications pursuant to the ASF Framework violated QSPE status under Statement 140. In his letter, Mr. Hewitt stated that "[the SEC] will not object to continued status as a QSPE if . . . loans are modified pursuant to the specific screening criteria in the ASF Framework." Mr. Hewitt also acknowledged that the SEC believes his letter is only an interim step in addressing the issues associated with QSPEs. (For more information about Mr. Hewitt's letter and the ASF Framework, see Deloitte's *Financial Reporting Alert* 08-1.)

If the FASB's decisions become incorporated into a final standard, all new securitization vehicles, as well as those that currently meet the definition of a QSPE, will no longer be exempt from consolidation under Interpretation 46(R).

Proposed Amendments to Statement 140

In response to Mr. Hewitt's request, the FASB aggressively began pursuing a project to eliminate the concept of a QSPE in early 2008. The following paragraphs explain the FASB's decisions regarding the proposed amendments to Statement 140.

Elimination of QSPEs

The FASB decided to eliminate the concept of a QSPE from paragraph 35 of Statement 140 and the related scope exceptions in paragraphs 4(c) and 4(d) of Interpretation 46(R). Therefore, if the decisions become incorporated into a final standard, all new securitization vehicles, as well as those that currently meet the definition of a QSPE, will no longer be exempt from consolidation under Interpretation 46(R). Rather, transferors and other parties that have interests in QSPEs will need to consider the provisions of Interpretation 46(R) to determine whether consolidation is required (refer to the proposed effective date and transition provisions below).

Modifications to the Derecognition Provisions

In conjunction with its decision to eliminate the concept of a QSPE, the Board decided to make certain modifications to the derecognition provisions in paragraph 9 of Statement 140. The Board decided to (1) clarify when a transferred asset is considered legally isolated from the transferor, (2) eliminate the requirement that a transferee have the ability to freely pledge or exchange transferred financial assets (although certain constraints preclude a sale under paragraph 9(c), as described below), and (3) provide guidance on when a portion of a financial asset can be derecognized. (For the proposed amendments to paragraph 9 and the definition of "participation interest," see an excerpt from the April 2, 2008, Board handout in the Appendix of this *Heads Up*.)

Legal Isolation of Transferred Financial Assets

Statement 140 currently requires that to achieve sale accounting, an entity that transfers a financial asset (i.e., the transferor) must surrender control over the transferred asset. Paragraph 9(a) of Statement 140 stipulates that one condition for surrendering control is that the transferred financial asset must be legally isolated from the transferor in the event of the transferor's bankruptcy. When considering legal isolation, the Board clarified that a transferred financial asset must be isolated from the transferor and **all** of its consolidated affiliates that are included in the financial statements being presented (other than bankruptcy-remote special-purpose entities). The Board also clarified that the legal isolation analysis must take into account **all** arrangements that are made in connection with a transfer.

Transferee's Ability to Pledge or Exchange Transferred Assets

Paragraph 9(b) of Statement 140 currently indicates that another condition for the transferor's surrendering control over transferred assets is that the party purchasing the transferred assets (i.e., the transferee) must have the ability to freely pledge or exchange the assets purchased. For this condition to be met, the transferee must obtain control over the transferred assets. Currently, Statement 140 provides an exception to this requirement for transfers of financial assets to securitization vehicles that meet the definition of a QSPE.[5] Because the concept of the QSPE is being eliminated, the FASB deemed it necessary to modify the derecognition provision in paragraph 9(b) to allow securitizers of financial assets to continue to achieve derecognition.

Because the concept of the QSPE is being eliminated, the FASB deemed it necessary to modify the derecognition provision in paragraph 9(b) to allow securitizers of financial assets to continue to achieve derecognition.

The Board elected to eliminate the condition in paragraph 9(b) that a transferee have the ability to freely pledge or exchange the transferred assets. Therefore, under the Board's proposal, a transferor that transfers financial assets to a securitization vehicle that does not have the ability to freely pledge or exchange the transferred assets can still achieve derecognition as long as the remaining conditions in paragraphs 9(a) and 9(c) are met. The Board did, however, decide to retain the concept of transferor restrictions from paragraph 9(b) and moved it to paragraph 9(c). Under the proposed amendment to paragraph 9(c), a transferor, in addition to determining whether it maintains effective control over transferred assets through a right to repurchase assets or an ability to cause the return of specific assets, will now need to consider whether a constraint it imposes on the right of the transferee to pledge or exchange transferred assets causes it to maintain effective control over the transferred assets.

Derecognition of a Portion of a Financial Asset

The final modification to the derecognition model proposed by the Board relates to the accounting for transfers of a portion of a financial asset. In a manner consistent with its 2005 Exposure Draft, *Accounting for Transfers of Financial Assets* — an amendment of FASB Statement No. 140, the Board decided that a transfer of a portion of a financial asset is eligible for derecognition only if that portion meets the definition of a participating interest. Therefore, the Board decided to carry forward its definition of a participating interest originally included in the 2005 Exposure Draft. (For the definition of participating interest, see the April 2, 2008, Board handout in the Appendix of this *Heads Up*.)

Initial Measurement of Beneficial Interests Retained by the Transferor

In addition to eliminating the concept of a QSPE and modifying the conditions for derecognition, the Board decided to make other minor changes to the provisions of Statement 140. One such change relates to the initial measurement of beneficial interests retained by the transferor after a transfer of financial assets. Statement 140 currently requires a transferor that retains an interest in transferred assets to initially measure the retained interest by allocating, on the basis of a relative fair value allocation as of the date of the transfer, the previous carrying amount between the assets sold and the retained interest.

[5] Because a securitization vehicle often is limited in its ability to pledge or exchange transferred assets, Statement 140 currently allows a transferor to "look through" the securitization vehicle and consider whether the investors in the securitization vehicle have the ability to freely pledge or exchange their beneficial interest. However, the ability to "look through" the securitization vehicle is only allowed if the vehicle meets the definition of a QSPE. Because the concept of a QSPE is being eliminated, changes to the derecognition provisions in paragraph 9(b) are necessary; otherwise, most transfers of financial assets to securitization vehicles would fail sale accounting because the transferee does not have the ability to freely pledge or exchange the transferred assets.

In deliberations leading to the issuance of Statements 155[6] and 156,[7] the Board decided that beneficial interests that relate to transferred assets and that are retained by the transferor are new assets of the transferor and should be initially measured in a manner consistent with the initial recognition of other financial assets. As a result, the Board decided that all interests in transferred financial assets that are retained by the transferor should be initially measured at fair value rather than at an allocation of previous carrying amounts.[8] However, the requirement to initially recognize interests that are retained by the transferor at fair value was not included in either Statement 155 or 156, so the Board decided to include it in its current proposal to amend Statement 140.

While the Board agreed that a beneficial interest in transferred assets that are retained by the transferor is a new asset of the transferor, it decided that a portion of a financial asset that is retained by the transferor in a transfer of a participating interest is not a new asset and should not be intially measured at fair value. (This is consistent with the Board's view that a participating interest has risk characteristics that are identical to the portion of the financial asset that was not transferred.) As a result, the Board decided that a participating interest that is retained by the transferor should be initially measured by allocating, on the basis of a relative fair value allocation as of the date of the transfer, the previous carrying amount between the portion of the assets sold and the participating interest that is retained.

The Board decided that a portion of a financial asset that continues to be held by the transferor in a transfer of a participating interest is not a new asset and should not be measured at fair value.

Elimination of Special Treatment for Guaranteed Mortgage Securitizations

Currently, Statement 140 allows an entity that transfers mortgage loans to a QSPE, and that issues securities with a third-party guarantee, to reclassify the transferred mortgage loans to mortgage-backed securities even if the transfer does not achieve sale accounting.[9] This is a common transaction in the mortgage banking industry and is referred to as a guaranteed mortgage securitization (GMS) in Statement 140.

Because the Board decided to eliminate the concept of a QSPE, it also decided to remove the ability to reclassify mortgage loans to mortgage-backed securities in a GMS. As a result, under the amendment to Statement 140, an entity will only be able to reclassify mortgage loans to mortgage-backed securities if the transfer meets the conditions for sale accounting and the transferee is not consolidated by the transferor pursuant to Interpretation 46(R).

A similar exception exists regarding the recognition of a servicing asset or liability in a transfer to a GMS. Pursuant to Statement 156, an entity that transfers mortgage loans to a GMS can recognize a servicing asset or liability for the right or obligation to service the mortgage loans even if the transfer does not qualify as a sale. To be consistent with its decision to eliminate the exception to reclassify mortgage loans to mortgage-backed securities, the Board decided to limit the ability to recognize a servicing asset or liability to transfers that meet the conditions for sale accounting and for which the transferor does not consolidate the transferee.

6 FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* — an amendment of FASB Statements No. 133 and 140.

7 FASB Statement No. 156, *Accounting for Servicing of Financial Assets* — an amendment of FASB Statement No. 140.

8 While this amendment requires that beneficial interests that are retained by the transferor be *initially* measured at fair value, Statement 140 does not provide guidance on subsequent measurement (FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is typically followed if the beneficial interest held is in security form). As a result, this proposed amendment does not require that beneficial interests that continue to be held by the transferor be remeasured to fair value in subsequent periods.

9 Under the current derecognition provisions in Statement 140, a transferor of financial assets to a QSPE does not achieve sale accounting if all it receives as consideration for the transfer is a beneficial interest in the transferred asset. In the mortgage banking industry, banks often transfer mortgage loans to a QSPE and retain 100 percent of the resulting mortgage-backed securities. While this transaction is not a sale, Statement 140 allows the mortgage bank to reclassify its mortgage loans to mortgage-backed securities if the QSPE obtains a substantive third-party guarantee.

Proposed Amendments to Interpretation 46(R)

In addition to its project to amend Statement 140, the Board added a project to its agenda to reconsider its consolidation model in Interpretation 46(R). The Board added this project to address concerns expressed by constituents regarding the lack of transparency by enterprises involved with entities within the scope of Interpretation 46(R) and the significant increase in the number of entities that will be within the scope of Interpretation 46(R) because of the elimination of the QSPE concept. The following paragraphs explain the FASB's decisions regarding the amendments to Interpretation 46(R).

Determination of the Primary Beneficiary of a VIE

The Board's reconsideration of Interpretation 46(R) primarily focuses on how the primary beneficiary of a VIE is determined. (Note that the Board is not reconsidering which entities meet the definition of a VIE.) Under the current Interpretation 46(R) model, an entity often needs to perform a quantitative analysis when determining which interest holder in a VIE absorbs a majority of the entity's expected losses or residual returns and is its primary beneficiary. In response to concerns regarding the difficulty in applying this model and the lack of transparency that a risks-and-rewards model often creates, the Board decided to modify the approach for determining the primary beneficiary of a VIE in paragraph 14 of Interpretation 46(R).

The determination of the primary beneficiary of a VIE should first involve a qualitative assessment of which interest holder has a controlling financial interest in the VIE.

The determination of the primary beneficiary of a VIE should first involve a qualitative assessment of which interest holder has a controlling financial interest in the VIE. The Board therefore proposed that a reporting enterprise with a variable interest or variable interests in a VIE is the primary beneficiary of the VIE if it has (1) the power to direct matters that significantly affect the activities and success of the VIE and (2) the right to receive benefits from the VIE that could **potentially** be significant (regardless of probability), the obligation to absorb losses of the VIE that could **potentially** be significant (regardless of probability), or both.

A reporting enterprise is only required to quantitatively consider expected losses and residual returns if it is unable to determine qualitatively whether it satisfies the two conditions above. (For the proposed amendments to paragraph 14 of Interpretation 46(R), see an excerpt from the June 11, 2008, Board handout in the Appendix of this *Heads Up*.)

Editor's Note: While the Board's discussions to date have focused almost exclusively on structured financing entities, the Board's proposal to amend the consolidation model affects all entities within the scope of Interpretation 46(R). This includes entities such as joint ventures and operating businesses that meet the definition of a VIE in paragraph 5 of Interpretation 46(R).

In deliberating its proposed model, the Board contemplated including certain control indicators to aid in determining whether a reporting enterprise has the power to direct the activities of the VIE. Ultimately, the Board tentatively decided to exclude these indicators because of the difficulty in applying general indicators to a broad set of transactions and arrangements. The Board also discussed how its control approach will apply to various common structured financial vehicles.[10] The Board directed the FASB staff to include these examples in an appendix to the Exposure Draft to illustrate the application of its modified approach to various common entities.

[10] In FASB education sessions held before its June 11, 2008, meeting, the Board applied its proposed model to various sample structured finance vehicles, including (1) an agency mortgage-backed securitization, (2) a multiseller asset-backed commercial paper conduit, (3) a commercial mortgage-backed securitization, (4) a collateralized debt obligation, and (5) a structured investment vehicle. It is expected that the application of the Board's proposed model to these, and potentially other, sample structures will be included in an appendix to the Exposure Draft.

Consideration of Kickout Rights

The Board also decided that the ability of a third party to remove or replace an enterprise that *currently* has the ability to direct a VIE's activities should not be considered when determining the primary beneficiary of a VIE (this is often referred to as kickout rights).[11] In deliberating the proposed consolidation model, several Board members expressed concern that kickout rights are typically not substantive when associated with VIEs and therefore should not change the determination of the primary beneficiary.[12] Thus, when determining the primary beneficiary of a VIE under the Board's proposed model, the variable interest holder that *currently* has the ability to direct the activities of a VIE (if coupled with potential significant benefits or potential significant losses) is the VIE's primary beneficiary irrespective of whether a third party has the ability to remove that variable interest holder.[13]

The Board hopes that the proposed disclosure amendments will increase transparency regarding an enterprise's securitization activity, involvements with VIEs, and methods for applying both Statement 140 and Interpretation 46(R).

Continual Reconsiderations

The Board also decided that a reporting enterprise must continually reconsider whether (1) an entity in which it has an interest is a VIE, (2) it is the VIE's primary beneficiary, and (3) it has a significant variable interest in a VIE. Therefore, a reporting enterprise must reconsider its Interpretation 46(R) conclusions as of each reporting date (i.e., quarterly and annually). Currently, Interpretation 46(R) only requires reconsideration of the status of an entity as a VIE or a VIE's primary beneficiary if certain events occur.

Disclosure Requirements

In addition to the amendments discussed above, the Board decided to amend the disclosure requirements in both Statement 140 and Interpretation 46(R). The Board hopes that these disclosure amendments will increase transparency regarding an enterprise's securitization activity, involvements with VIEs, and methods for applying both Statement 140 and Interpretation 46(R).

Effective Date and Transition

Finally, the Board proposed that the amendments to Statement 140 and Interpretation 46(R) be effective for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for (1) new transfers of financial assets occurring after the effective date, (2) all interests in entities created after the effective date, and (3) entities created before the effective date that do not meet the existing definition of a QSPE. The

[11] EITF Issues 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," and 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," discuss scenarios in which an interest holder (e.g., a minority shareholder or a limited partner) has the power to either remove or block the decisions of the controlling interest holder (e.g., an investor with a majority voting interest or a general partner of a limited partnership). If certain conditions in these Issues are met, the presumption that the majority owner or general partner has a controlling financial interest (and therefore should consolidate) can be overcome.

[12] Because a variable interest holder that has the current power to direct the VIE's activities typically has other involvements with the VIE (e.g., a residual interest or a liquidity arrangement), the Board believes that third parties with kickout rights have an incentive not to exercise those kickout rights. The Board believes that this incentive not to exercise kickout rights calls into question whether the kickout rights are truly substantive.

[13] The Board clarified that its decision to ignore kickout rights when determining the primary beneficiary of a VIE does not change the consideration of kickout rights when determining whether (1) an interest is a variable interest under paragraphs B18–B21 of Interpretation 46(R) or (2) an entity is a VIE under paragraph 5 of Interpretation 46(R).

Board is proposing a one-year deferral of its proposed amendments for entities created before the effective date that meet the current definition of a QSPE.[14] Thus, the proposed amendments would not be effective for existing QSPEs until fiscal years beginning after November 15, 2009.

The Board decided that if the initial application of the proposed amendments to Interpretation 46(R) results in the consolidation of a VIE that was previously not consolidated or the deconsolidation of a VIE that was previously consolidated, this change should be applied by recognizing a cumulative-effect adjustment for the difference between the carrying amount before the adoption of the proposed amendment and the net carrying amount upon consolidation or deconsolidation as of the beginning of the first fiscal year in which the proposed amendment is adopted.

[14] It is expected that the deferral will apply only to those QSPEs created before the effective date of the proposed amendment that (1) meet (and continue to meet) the current definition of a QSPE, (2) do not issue new beneficial interests, and (3) do not receive financial assets they were not committed to receive before the date of adoption. While the Board did not officially vote on this component of the transition, it was included in both of the original transition alternatives presented to the Board.

Appendix: Excerpts From Recent Board Meeting Handouts

April 2, 2008, Meeting

Derecognition Criteria

The staff recommends that the derecognition criteria (paragraph 9) in Statement 140 be amended as follows (subject to drafting changes) (Added text is underlined and deleted text is ~~struck out~~.):

A transfer of a financial asset~~s~~, a group of financial assets, or a participating interest in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*) ~~(or all or a portion of a financial asset) in which~~ shall be accounted for as a sale if the transferor surrenders control over ~~those~~ the transferred financial asset(s). ~~shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange.~~ The transferor has surrendered control over transferred financial assets if and only if *all of the following conditions* are met:

a. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. The isolation analysis must consider all arrangements made in connections with the transfer.

~~b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).~~

c. The transferor, or any of its consolidated affiliates included in the financial statements being presented or its agents, does not maintain effective control over the transferred financial assets through ~~either~~ (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity ~~or,~~ (2) the ability to unilaterally cause the holder to return specific assets, other than through a **cleanup call** (paragraphs 50–54), or (3) a restriction imposed by the transferor on the right of the transferee to pledge or exchange the transferred financial assets.

The recommended amendments to the derecognition model focus on whether the transferor has retained control over a transferred financial asset. Determination of whether the transferor has surrendered control will be assessed under paragraph 9(a) — whether the asset has been isolated from the transferor and its creditors, and under paragraph 9(c) — whether the transferor maintains effective control over the asset. The existing paragraph 9(b) will no longer be included in the derecognition model; however, a criterion similar to the existing paragraph 9(b) will be incorporated into paragraph 9(c). The amendment to paragraph 9(c) will focus on whether the transferor constrains the transferee in a manner that indicates that the transferor maintains effective control over the transferred asset.

Unit of Account

The 2005 FASB Exposure Draft, *Accounting for Transfers of Financial Assets*, stated that a transfer of a portion of a financial asset is eligible for derecognition if such portion meets the definition of a participating interest. Utilizing the definition provided in the Exposure Draft, with editorial changes, the staff recommends that a participating interest have the following characteristics:

1. It represents an ownership interest in an individual financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
2. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates, or its agents) in proportion to the share of ownership represented by each. Servicing fees representing adequate compensation and, if applicable, a share of the contractual interest representing all or a portion of the transferor's gain on sale received by the transferor as consideration related to the sale of the participating interest are not included in that determination. The ownership shares remain constant over the life of the original financial asset.
3. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder.

4. Neither the transferor (or its consolidated affiliates, its agents, or a bankruptcy trustee or other receiver for the transferor, its consolidated affiliates, or its agents) nor any participating interest holder has the right to pledge or exchange the entire inancial asset in which they own a participating interest.

The staff recommends that the derecognition provisions in Statement 140 should apply to portions that meet the definition of a participating interest, similar to the provision included in the Exposure Draft. Without providing such guidance, the staff believes structuring opportunities will arise that would enable the transferor to circumvent the derecognition criteria, as well as the consolidation criteria in Interpretation 46(R).

June 11, 2008, Meeting

Objective

An entity (including any related parties or de facto agents) is the primary beneficiary of a variable interest entity (VIE) if the entity has a variable interest (or a combination of variable Interests) in the VIE that provides the entity with a controlling financial interest. The entity whose variable interest or interests provide the entity with (1) the power to direct the activities of the VIE and (2) the right to receive benefits from the VIE that could potentially be significant and/or along with the obligation to potentially absorb losses of the VIE that could potentially be significant is the primary beneficiary. Generally, the purpose and design of a VIE, including the risks the VIE creates and passes through to its interest holders, should provide key indicators as to which entity, if any, is the primary beneficiary.

The determination of which entity, if any, is required to consolidate a VIE will be performed using a qualitative analysis (Step 1) and, if necessary, a quantitative analysis (Step 2) using a calculation of a VIE's expected losses and expected residual returns as illustrated in Appendix A of Interpretation 46(R). The qualitative analysis of an enterprise's right to receive benefits and/or along with the obligation to potentially absorb losses of the VIE as part of Step 1 is not to be performed using the quantitative analysis prescribed in Step 2. Only one entity, if any, is expected to be identified as the primary beneficiary of a VIE.

Step 1 — Qualitative Analysis

Qualitatively determine if an entity has a controlling financial interest in a VIE. This qualitative determination shall include an assessment of the characteristics of the entity's interest(s) and the VIE's primary purpose, including the risks that the VIE was designed to create and pass through to its variable interest holders. Based on this qualitative analysis, an entity shall determine if it has:

1. The power to direct matters that significantly impact the activities and success of the VIE
2. The right to receive benefits from the VIE that could potentially be significant and/or the obligation to absorb losses of the VIE that could potentially be significant. This criterion includes an entity's implicit or explicit financial responsibility to ensure that a VIE operates as designed.

This assessment should enable an entity to determine if it is or is not the primary beneficiary in a VIE. If an entity believes that it may be the primary beneficiary but that the qualitative analysis is not determinative, it shall perform the quantitative analysis pursuant to Step 2 below.

Step 2 (If Necessary) — Quantitative Analysis

An entity shall determine if, through its variable interest, the entity absorbs the majority of the VIE's expected losses, receive the majority of the VIE's residual returns, or both. However, the primary beneficiary identified under this quantitative analysis, if any, must have more than an insignificant ability to influence decisions or matters that could impact the success of the VIE to be its primary beneficiary. If one entity absorbs the majority of a VIE's expected losses and another absorbs the majority of the entity's expected residual returns, the entity absorbing the majority of a VIE's expected losses is considered the primary beneficiary.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Standards and Communications Group, please register at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts presented each month on:

- Sarbanes-Oxley.
- Financial reporting.
- Corporate governance.
- Driving enterprise value.
- Private companies.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Join *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available now for this upcoming 90-minute *Dbriefs* webcast:

- Quarterly Accounting Roundup: An Update of Important Developments (June 25).

Use the link above to register. The webcast begins at 2 p.m. (EDT).

Technical Library: The Deloitte Accounting Research Tool

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. In addition, Technical Library subscribers receive *Technically Speaking*, the weekly publication that highlights recent additions to the library.

For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.