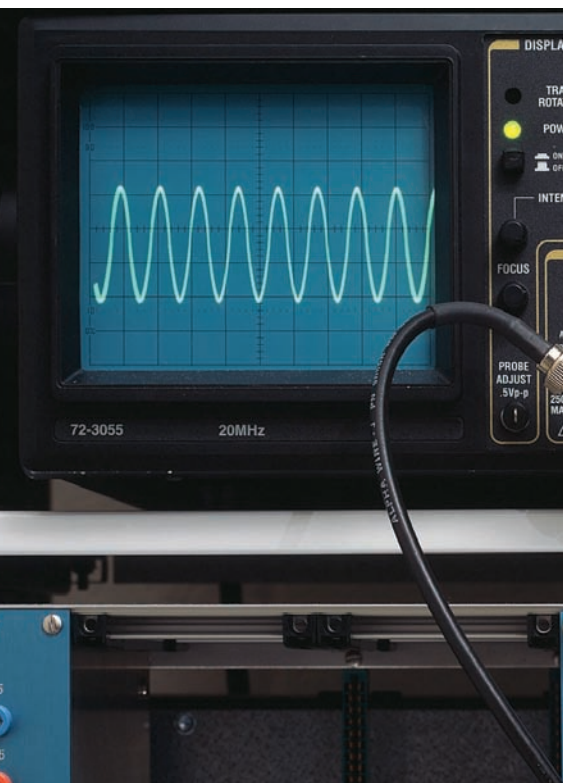


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New Guidance on the Variability of VIEs



New requirements will significantly change the way some companies identify variable-interest entities under Interpretation 46R and how they analyze whether to consolidate those they identify.¹ The new requirements are in a FASB Staff Position on how to distinguish between contracts or arrangements that create variability in an entity (i.e., its risks and rewards) and contracts or arrangements that are exposed to or reduce that variability (i.e., variable interests).² The guidance in the Staff Position affects all aspects of accounting for potential VIEs, including identifying which entities are VIEs, which interests are variable interests, and which party is a VIE's primary beneficiary.

Interpretation 46R provides guidance on when to consolidate an entity based on exposure to risks and rewards, rather than voting control. It describes the characteristics of a VIE and how an entity that is involved with a VIE should determine whether it shares in the VIE's risks and rewards extensively enough to be the VIE's "primary beneficiary" and therefore to consolidate it.

The Staff Position responds to the need for guidance on the relevant risks and rewards that must be identified and evaluated in order to apply Interpretation 46R. That need was clear in the case of contracts that can be either assets or liabilities, such as some derivative financial instruments. For example, an interest-rate swap can be either an asset or liability depending on interest-rate fluctuations. Because an entity's assets are generally not considered variable interests, but its liabilities often are, it was unclear whether the FASB intended that such contracts be considered variable interests in a potential VIE.

The need for guidance on the relevant risks and rewards that must be identified and evaluated was also made clear by two competing approaches to analyzing the variability of a potential

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¹ FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, December 2003, available at www.fasb.org.

² FASB Staff Position No. FIN 46(R)-6, "Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R)," April 2006, available at www.fasb.org.

VIE. One measured variability based on potential fluctuations in cash flows from the entity's assets and operations; the other measured variability based on potential fluctuations in the fair value of those assets and operations. The approaches could result in different conclusions about a potential VIE's variability. For example, an entity's fixed-rate financial assets may have cash flows that fluctuate only in the event of a credit default, but the fair value of those assets can fluctuate significantly because of interest-rate changes. Conversely, the cash flows of an entity's variable-rate financial assets may fluctuate significantly based on changes in interest rates without causing any significant fluctuations in their fair value. The new guidance is intended to result in more uniform accounting decisions in these circumstances.

There are eight examples included in the Staff Position, all of which are critical to understanding the application of its guidance.

Variability Based on an Entity's Design

The Staff Position requires companies to base their evaluations of whether a contract or arrangement creates or absorbs variability on an analysis of the potential VIE's design. The prescribed analysis has two steps. The first step is to analyze the potential risks that the potential VIE is exposed to. The risks include:

- *Credit risk*, such as the risk that the issuer of a bond will default on all or part of its obligations.
- *Interest-rate risk*, such as the risk that the interest payments from a floating-rate financial instrument will vary or that the fair value of a fixed-rate financial instrument will change based on interest-rate fluctuations (the cash flows on fixed-rate instruments may also vary due to prepayment risk).

- *Foreign-currency-exchange risk*, such as the risk that the cash flows from a fixed-price sales contract denominated in a foreign currency will fluctuate because of changes in the rate at which the foreign currency is converted into the entity's functional currency.
- *Price risk*, such as the risk of fluctuations in the prices of assets (e.g., real estate, equity instruments, or commodities used in producing inventories).
- *Operations risk*, such as the risk that the entity's labor costs or other operating costs will fluctuate.

The second step is to determine the risks that the entity was "designed to create and pass along to its interest holders" based on the purpose or purposes "for which the entity was created." In other words, the design test is applied to the risks identified in the first step in order to determine the variability to consider when applying Interpretation 46R. The interests in the entity that are exposed to or reduce that variability are the entity's variable interests.

The Staff Position states that a reporting entity performing the second step should review the terms of the potential VIE's contracts and that the review should include "an analysis of the [potential VIE's] original formation documents, governing documents, marketing materials, and other contractual arrangements entered into by the entity and provided to potential investors or other parties associated with the entity." All relevant facts and circumstances have to be considered when performing the second step, including the following factors:

- The entity's activities,
- The terms of the contracts it has entered into,
- The nature of the interests it has issued,

- How it marketed its interests to potential investors, and
- Which parties participated significantly in the entity's design or redesign.

The Role of GAAP. The Staff Position requires the design analysis to focus on the role that a contract or arrangement plays in the entity, rather than on its legal form or on its accounting classification as an asset or liability. For example, a derivative instrument such as an interest-rate swap could be either an asset or a liability, depending on market conditions. However, the characteristics of the swap that determine whether it is a variable interest are unrelated to its classification as an asset or liability.

The Staff Position maintains that the *characterization* of a contract or arrangement under generally accepted accounting principles may not necessarily depict the role of the contract or arrangement in the entity for purposes of evaluating the entity's design. This idea can have significant effects on the application of the new requirements as the following example illustrates.³

Entity A is formed to "buy" customer receivables from Manufacturing Co., which retains a subordinate interest in, and a call option on, those receivables. Entity A must record an asset as a result of this arrangement, and that asset creates Entity A's variability. In this example, because Manufacturing Co. retains a call option on the receivables, GAAP requires the transaction to be accounted for as a collateralized loan receivable by Entity A (rather than as the customer receivables themselves) and a collateralized debt obligation by Manufacturing Co.

Under the GAAP characterization of Entity A's asset as a collateralized loan receivable, the credit risk of both Manufacturing Co. and Manufacturing Co.'s customers would be considered creators of Entity A's risk

³This example is similar to a fact pattern discussed by the FASB in its deliberations on the Staff Position.

(i.e., variability). Using that characterization, Manufacturing Co. would not be viewed as a holder of Entity A's variable interests because Manufacturing Co. would be considered exposed only to the risk that it creates, and it would not consolidate Entity A even if Entity A is a VIE. The evaluation of Entity A using the GAAP characterization of its asset could result in the conclusion that an investor that provides a majority of Entity A's capital should consolidate Entity A if it is a VIE.

However, if Entity A's asset is instead characterized as the transferred customer receivables, Manufacturing Co.'s credit risk would be excluded from consideration as a creator of risk to Entity A. Using that characterization, Manufacturing Co. would likely be viewed as a variable interest holder of Entity A and would probably be required to consolidate Entity A if it is a VIE because Manufacturing Co. would likely be exposed to most of the variability arising from the credit risk of its customers. This would make little or no difference to the financial statements of Manufacturing Co. (because of its GAAP accounting for the transaction as a collateralized borrowing). However, it might make a significant difference to an investor that provides a majority of Entity A's capital but that would not be required to consolidate Entity A even if it is a VIE.

The Staff Position requires preparers to make significant judgments in evaluating a potential VIE's contracts and arrangements. Its guidance about the relevance of the GAAP characterization of an entity's contracts and arrangements is illustrated in the context of a leasing transaction, but it is likely to play a prominent role in evaluating other arrangements, including service contracts, transfers of financial assets, and capacity purchase agreements (such as power purchase agreements). The guidance will significantly change the way many have applied Interpretation 46R in the past and is likely to be the source of considerable debate.

Application to Derivative Instruments. The Staff Position cites two conditions that together create a strong indication that a derivative instrument is a creator of variability rather than a variable interest:

- The derivative's underlying is an observable market rate, price, index of prices or rates, or other market-observable variable (including the occurrence or non-occurrence of a specified market-observable event); and
- The derivative counterparty is senior in priority relative to other interest holders in the entity.

Derivatives such as total return swaps and option contracts related to a majority of an entity's assets are unlikely to meet both of the above conditions. However, even if both of the above conditions are met, further analysis would be required if the changes in the derivative's fair value or cash flows are expected to offset all, or essentially all, of the risk, return, or both related to a majority of the entity's assets or operations exclusive of the derivative. Under the Staff Position, the additional analysis would consider the role of the derivative contract in the entity's design (as supported by the marketing materials provided to the entity's investors) and whether the derivative counterparty participated significantly in the design or redesign of the entity.

These indicators will reduce the efforts derivative counterparties must expend to evaluate whether many "plain vanilla" derivative instruments represent variable interests in a potential VIE. However, derivative counterparties will still have to determine whether those derivatives offset substantially all of the risk, return, or both related to a majority of the potential VIE's assets or operations. The indicators are nevertheless a significant change from Interpretation 46R's previous guidance on evaluating whether derivatives are variable interests.

Evaluating a Swap: An Example

An entity has \$150 of total assets, including \$60 of variable-rate BB-rated bonds that mature in seven years. The entity has also entered into a pay-variable (LIBOR plus 50 basis points)/receive-fixed interest rate swap with a third-party bank with a notional amount of \$60 and a term of seven years. The third-party bank is senior in priority to the entity's other interest holders. The swap would not represent a variable interest in the entity, because the swap's underlying is based on an observable market rate of interest, the third-party bank is senior in priority to the entity's other interest holders, and the swap relates to less than a majority of the assets held by the entity.

Now assume the \$60 of bonds represented a majority of the assets held by the entity. The swap would still not represent a variable interest in the entity. Although the swap's notional amount relates to a majority of the entity's assets, changes in the cash flows or the fair value of the swap would not be expected to offset all, or essentially all, of the risk, return, or both related to those bonds, because the fair value and cash flows of the bonds are expected to be affected by risk factors other than changes in market interest rates (e.g., credit risk).

Interest-Rate Risk. Interest-rate risk is to be considered part of the variability of a potential VIE that is designed to create that risk and pass it along to its interest holders. For example, if a potential VIE holds fixed-rate investments that will have to be sold prior to maturity to satisfy the entity's obligations, interest-rate risk ordinarily would be considered part of the variability that must be evaluated. On the other hand, if the fixed-rate investments are expected to be held until maturity, interest-rate risk generally can be excluded from the variability that must be evaluated.



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The objective of the requirement that the entity be designed to pass along interest-rate risk to its interest holders in order to consider interest-rate risk a source of variability is to ensure that holders of senior variable interests (such as senior debt) in a potential VIE are not required to consolidate the entity *solely* because of the effect of macroeconomic risk factors in relation to the notional amount of those interests. That circumstance could arise because macroeconomic risk factors, such as interest-rate risk, may have a much greater effect on senior interests, given their size, than on the entity's subordinated interests, which tend to have much smaller notional amounts.

Subordination. The Staff Position states that the variability to which a subordinated interest in the entity is exposed is highly likely to be variability that the entity was designed to create and pass along to its variable interest holders. For example, if an entity issues both senior and subordinated debt to purchase financial assets, and the holders of the subordinated debt will bear the first dollar of credit losses associated with the financial assets, the variability associated with credit risk likely should be considered part of the variability of the entity. The guidance effectively elevates the relevance of variability in an entity's cash flows that arises from factors other than broad macroeconomic factors (e.g., interest-rate fluctuations) in the analysis of the entity's variability. This is because senior interests are generally those that have a priority claim on the entity's cash flows.

Effective Date and Transition

The Staff Position's requirements are to be applied prospectively to all entities that the reporting enterprise first becomes involved with beginning the first day of the first reporting period that begins after June 15, 2006 (the third quarter of 2006 for calendar-year companies). The new requirements need not be applied to entities that have previously been analyzed under Interpretation 46R unless a reconsideration event occurs. Earlier application is permitted for periods for which financial statements have not yet been issued.

Companies also have the option to retrospectively apply the Staff Position from the date Interpretation 46R was initially applied. Retrospective application, if elected, must be implemented no later than the end of the first annual reporting period ending after July 15, 2006. However, the Staff Position must be applied to all entities that the reporting enterprise first becomes involved with prior to the date of retrospective application if that application does not occur at the date that prospective application is required. Retrospective application will require revising previously prepared analyses of variable interests and VIEs to conform to the new design-based analysis.

The descriptive and summary statements above are not intended to be a substitute for the text of Interpretation 46(R), FSP FIN 46(R)-6, or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Entities that are involved with variable interest entities and comply with SEC filing requirements should consult the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.