

# MBA's Accounting Tax and Financial Analysis Conference

## FASB/EITF Update

David Britt, Partner KPMG  
LLP

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# Agenda

- SPE Interpretation
- FIN 45 – Guarantee Project
- EITF 02-09
- EITF 02-12

# SPE Interpretation - Scope

- Applies to a variety of legal structures
- All entities divided into three categories for purposes of the Interpretation
  - Entities for which the consolidation decision is based on voting interests (voting interest entities)
  - Entities for which the consolidation decision is based on variable interests (variable interest entities)
  - Not-for-profit entities
- With the split described above, no need to define SPEs or SOEs

# SPE Interpretation - Scope

A variable interest entity (VIE) meets one or more of the following:

- There are no equity investors or nominal owners or these parties do not have voting or similar rights that control the entity
- The equity investment is insufficient to allow the entity to finance its activities without additional financial support
  - Presumptively 10% of total assets
    - 10% is not a safe harbor
    - Investment ? expected future losses of the entity
    - Entity is able to self-finance based on existing equity

# SPE Interpretation - Scope

- The equity investors or nominal owners do not have an investment at risk or their investment does not provide a return commensurate with the risk. This condition exists if:
  - The investment is not subordinate to all other interests or a return is guaranteed directly or indirectly by the entity or parties involved with the entity
  - The return to equity investors is limited (other than by nature of the assets)
  - The investment was provided or financed directly or indirectly by the entity or parties involved with it

# SPE Interpretation - Scope Exceptions

## Scope exceptions

- QSPEs generally not consolidated by any entity
- Sponsor of an employee benefit plan does not consolidate the plan
- Registered investment companies subject to the 1940 Act do not consolidate non-registered investment companies
- Not-for-profit entities
- Not appropriate to apply consolidation accounting to “virtual SPEs” within a voting interest entity

# SPE Interpretation - Variable Interests

- Any relationship that causes the holder to risk:
  - Losing an investment
  - Incurring a loss due to a contingent obligation to transfer assets to the VIE
- Mechanism to realize the economic risks and rewards from the VIE's activities and to provide support to the VIE
- Examples include:
  - Loans
  - Leases
  - Service, administration or management contracts
  - Purchase contracts
  - Guarantees
  - Retained interests in securitizations

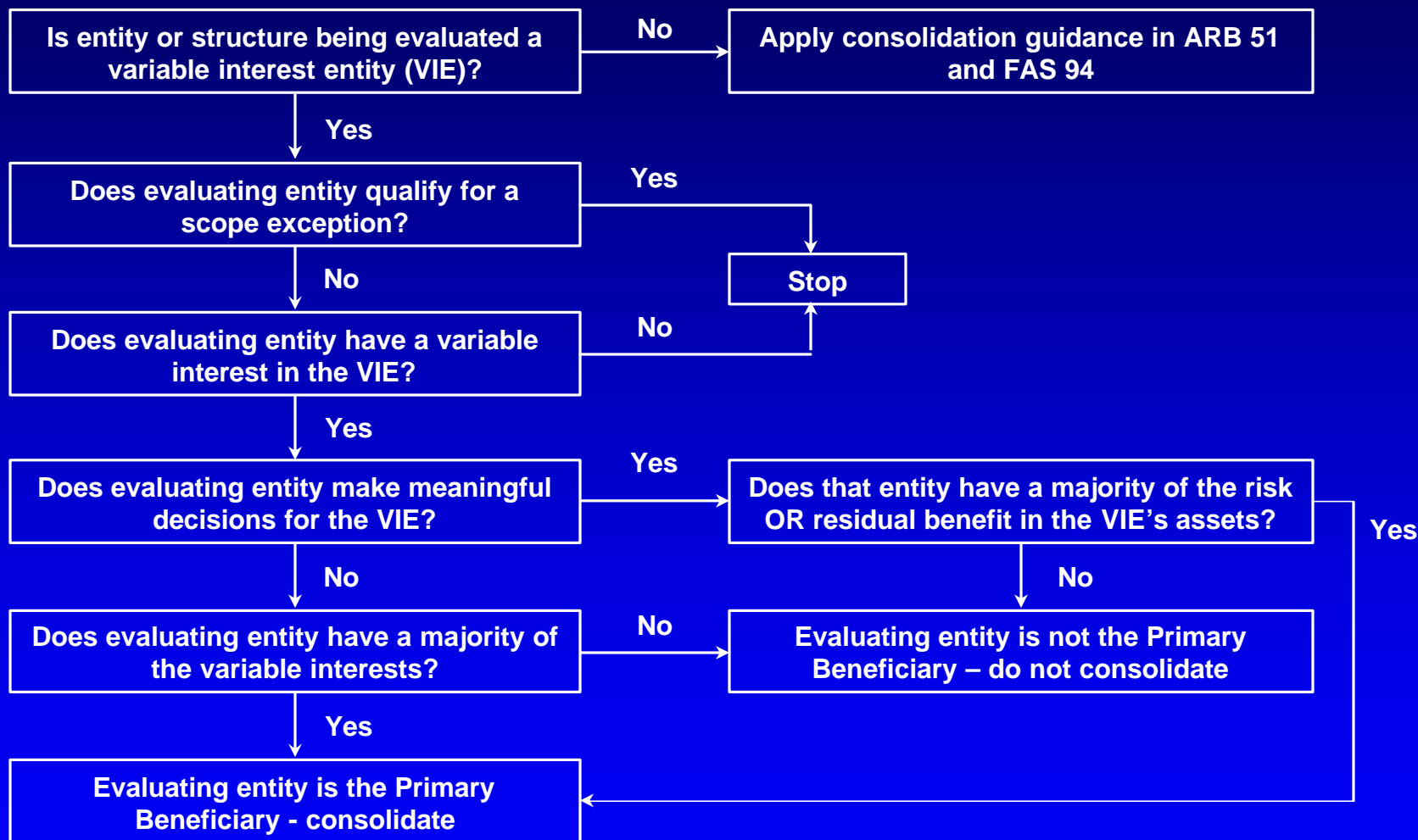
# SPE Interpretation - Primary Beneficiary

- In order to determine a VIE's Primary Beneficiary (PB), must first determine if there is a decision maker for the VIE
  - A decision maker is any party with the authority to purchase or sell assets or make other operating decisions that significantly affect the VIE's revenues, expenses, gains, and losses
  - Decision makers may either be in the position of a service provider or an owner
- A decision maker that holds variable interests that either absorb a majority of the expected future losses OR provide a majority of the residual benefit from the VIE's activities is in the position of an owner and is the VIE's PB

# SPE Interpretation - Primary Beneficiary

- If no decision maker, PB is the entity with a majority of the VIE's variable interests
  - The evaluation of variable interests primarily based on expected future losses but considers the ability to receive or obtain benefits from the VIE's activities
  - The variable interests evaluation must take into consideration both quantitative and qualitative factors
  - The Interpretation will discuss various types of items that would be considered variable interests and will note which of these would usually result in the holder being the PB *only* if that interest was held with other interests (for example holders of investment-grade debt)

# SPE Interpretation - Overview of the Model



# SPE Interpretation - Related Parties

- In addition to FAS 57 related parties, an entity must treat variable interests held by the following other parties as its own in determining if it is the PB
  - Consolidated VIEs
  - Parties that cannot operate without significant support from the entity
  - Agents or de facto agents
  - Parties that received their interests as a contribution from the entity
  - Board members of the entity
  - Employees of the entity

# SPE Interpretation - Related Parties

- If the PB is a combined group of related parties, the following hierarchy determines which party consolidates:
  - In an agency relationship, the principal (not the agent)
  - The party with activities most closely associated with the VIE

# SPE Interpretation - Expected Future Losses

- Expected future losses refers to a probability-weighted estimate of losses without considering possible gains
  - CON 7 approach using probability-weighted cash flows
- Expected future losses are determined by reference to the fair value of the variable interest
- Significant judgment is required in evaluating

# SPE Interpretation - Disclosures

- PB must disclose:
  - Nature, purpose, size, activities, and potential risks of the consolidated VIE
  - Carrying amount and classification of the assets of the consolidated VIE that collateralize the VIE's obligations
  - Restrictions on recourse from VIE's creditors to the PB
- Enterprises other than the PB that hold variable interests that absorb a significant amount of the VIE's expected future losses must disclose:
  - Nature, purpose, size, activities, and potential risks of the VIE
  - Maximum exposure to losses from the VIE

# SPE Interpretation - Effective Date

- Effective for all entities/structures created after Interpretation is issued (very late 2002 or early 2003)
- For existing entities, effective for periods beginning after 6/15/03
  - Different effective dates for calendar-year *public* companies vs. calendar-year *non-public* companies
- Business as usual for purposes of SAB 74 disclosures
- Early application is encouraged

# SPE Interpretation - Transition

- PBs consolidate existing VIEs through either:
  - Cumulative effect adjustment as of the beginning of the period in which the Interpretation is first applied, OR
  - Restatement of previously issued financial statements
    - Restatement encouraged but not required
- If cumulative effect adjustment - assets, liabilities, and noncontrolling interests initially measured and recognized at their carrying amounts
  - If unable to determine carrying amounts, measure at fair value

# SPE Interpretation - Implementation Issues

- Population of VIEs
- Evaluating sufficiency of equity investment
- Fair value measurement
- Evaluating expected future losses
- Comparing variable interests using qualitative considerations
- Related party analysis
- Determining whether fee arrangements are market based
- SAB 74

# FIN 45 – Guarantees

- Disclosure requirements effective for financial statements of interim or annual periods ending after 12/15/02
- Initial recognition and measurement provisions effective on a *prospective* basis to guarantees issued or modified after 12/31/02
- Certain guarantees must be recognized and disclosed, while others only need to be disclosed
- Scope includes
  - Contracts that require contingent payments
    - based on changes in an underlying
    - based on another entity's failure to perform
  - Indemnification agreements (**not of an entity's own performance**)
  - Indirect guarantees of indebtedness of others

# FIN 45 – Disclosures Only Scope

- Only disclosure requirements apply to
  - Guarantees that are accounted for as derivatives
  - Product warranties
  - Contingent consideration in a business combination
  - Guarantees reported as equity
  - Former lessees that are secondary obligors
  - Guarantees between parents and subsidiaries or between entities under common control
  - Parent's guarantee of subsidiary's debt to third party
  - Subsidiary's guarantee of parent's or affiliate's debt to third party

# FIN 45 - Guarantees

- Commercial letters of Credit and Other Loan Commitments are outside the scope
- Non contingent forward contracts are outside the scope
- Subordination arrangements in securitizations are outside the scope

# FIN 45 – Key Provisions

- At time of issuance, guarantor should recognize a liability for the fair value of the guarantee (the noncontingent aspect)
  - Fair value = premium received if issued in a standalone arms-length transaction
  - Fair value must be estimated if issued in a multiple-element transaction
- Accounting for the “debit” not addressed
- Subsequent accounting not addressed

# FIN 45 – Key Provisions

- Disclosures required (regardless of probability that performance will be required)
  - Nature of guarantee
  - Maximum potential undiscounted amount of future payments that guarantor could be required to make
    - Not required for product warranties
    - Current carrying amount of guarantee obligation
  - Nature of any recourse provisions (reinsurance) and collateral the guarantor can obtain and liquidate to cover amounts paid

# **EITF 02-09 : Accounting for the Regaining of Control Over Transferred Financial Assets**

- **Issue : Application of Paragraph 55 of SFAS 140**
  - **Issue I : How to account for the retained interest when the underlying assets are re-recognized.**
  - **Task Force Consensus : No gain or loss on retained beneficial interest, may be gain or loss on reacquired third party beneficial interest.**

# EITF 02-09 : Accounting for the

## ● Regaining of Control Over Transferred Issue : Application of Paragraph 55 of SFAS 140 Financial Assets

- Issue II : How to account for the retained interest when the underlying assets are re-recognized.
- No Task Force Consensus : FASB staff position is asset and liabilities reflected at fair value, based on the fair value of liabilities and no gain or loss on regaining of control.
- Further discussion is planned

# **EITF 02-09 : Accounting for the Regaining of Control Over Transferred Financial Assets**

- **Issue : Application of Paragraph 55 of SFAS 140**
  - **Issue III : Whether to establish an allowance for loan loss reacquisition of transferred assets**
  - **Task Force Consensus : No, they are recorded at fair value**

# EITF 02-09 : Accounting for the Regaining of Control Over Transferred Financial Assets

- Issue : Application of Paragraph 55 of SFAS 140

- Issue IV : What to do with a related servicing asset
- No Task Force Consensus : Issue Summary had three views:
  - No separate servicing asset
  - Do nothing
  - Impairment trigger

# EITF 02-12 : Permitted Activities of a QSPE in Issuing Beneficial Interests

- Issue : How to interpret “significantly limited” and “entirely specified” for a QSPE holding long terms assets funded by short term liabilities
- No consensus reached : Issue Summary has three views:
  - View A : Limited ranges are ok
  - View B : Maturities of beneficial interests (BI) are well supported by assets in the QSPE
  - View C: Limited discretion in issuing future BI. Proceeds used for either redemption of existing BI's or reducing transferor retained interest.