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Accounting for Variable Interest Entities

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More than a year after Enron's collapse and bankruptcy filing, the Financial Accounting Standards Board (FASB) issued new accounting rules with a newly defined category of entities known as variable interest entities. Although the purpose of these new rules was to halt accounting abuses generally related to off-balance sheet financings that often resulted in the creation of special purpose entities organized for the purpose of conducting legitimate business, the impact on companies, including partnerships and limited liability companies, remains uncertain.

Under Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), consolidation is required when the total equity investment at risk is not sufficient to finance the "activities without additional subordinated financial support from other parties" (par. 5). The entities will be required to compute the expected cash flows for each variable interest holder in order to determine the primary beneficiary, that is, the party required to consolidate. The primary beneficiary is deemed to be the party with the greater proportion of expected losses or expected residual returns. However, in paragraph 14 of FIN 46, "if one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's expected residual returns, the enterprise absorbing the losses shall consolidate the variable interest entity."

Unlike special purpose entities, the creation of partnerships or limited liability companies for managing real estate ventures does not result in the general partner or managing member recording the transfers of assets and contributions of debt or other liabilities as sales in their own financial statements. Nor are there present contractual trigger events, as often found in a special purpose entity, which would require the general partner or managing member to contribute substantial additional cash or assets.

Within the executive summary of FIN 46, the "Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed." If one took the point of view and evaluated a real estate partnership or limited liability company broadly, one could argue that the risks identified in FIN 46 are not met in the majority of entities that are created; however, if the risks by class (e.g., general partner or limited partner, managing member or member) are analyzed, the risk analysis would always fail and the partner or member recognizing the majority of expected losses would have to consolidate. This is a point where more clarification from the FASB is warranted.

One dissenting FASB member commented that the original purpose of FIN 46 was "to assist in determining when one entity controls another entity in circumstances where control is difficult to discern, because either the structure of the variable interest entity obviates the need for decisions or control has been disguised." If that was the purpose of the interpretation - the outcome of FIN 46 requires that all real estate ventures and investments must be consolidated by a limited partner whose only purpose in an investment is to purchase operating losses and tax credits to manage its current and future tax positions - it would be clear to say that the FASB failed in its responsibility. There is nothing clandestine regarding limited partners' or members' investments in these entities. In addition, the dissenting

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FASB member concluded that control should continue to be the key measure for consolidation, as it was not appropriate for an entity "to report in their consolidated financial statements assets [that] they do not control and liabilities for which they have no responsibility."

Another argument, that FIN 46 may not be applicable, is the notion that an enterprise is not a variable interest entity "if the enterprise, its related parties, and its *de facto* agents were not involved in forming the entity" (par. 6). Therefore, for a third-party investor making its contribution after the entity has been established, there may exist an exclusion from consolidating.

The interpretation is effective for all variable interest entities created after January 31, 2003. For calendar year companies with a variable interest entity created before February 1, 2003, consolidation is not required until December 31, 2004. Intuitively, preparers of financial statements have to believe that the issuance of FIN 46 is focused primarily on off-balance sheet transactions and, therefore, is not applicable in the majority of real estate ventures. The FASB will likely provide further guidance of FIN 46 as the deadlines for consolidation approach. ❖

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