

November 30, 2005

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Mr. Lawrence W. Smith  
Director, TA&I—FSP  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Proposed FASB Staff Position No. FIN 46(R)-c**  
***Determining the Variability to Be Considered In Applying FASB Interpretation No. 46***

Dear Mr. Smith:

We appreciate the opportunity to comment on the above-referenced proposed FASB Staff Position (FSP). Questions have arisen about how to determine the variability to be considered in applying the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (the Interpretation), since the initial and revised versions of the Interpretation were issued. Several different approaches emerged in practice and, as a result, the EITF added Issue No. 04-7, "Determining Whether an Interest is a Potential Variable Interest Entity" (Issue 04-7), to its agenda. Although the EITF and a working group spent a significant amount of time attempting to develop an operational approach to consistently apply the Interpretation's provisions, the EITF was not able to reach a consensus.

As more fully described in our interpretive guidance, we believe the fair value method, which considers fair value variability in determining whether an interest is a variable interest, generally should be used to measure variability for entities holding primarily financial assets. For businesses and entities holding primarily non-financial assets, we generally continue to support the use of the cash flow method.

We have concerns about issuing the proposed FSP in final form because the FSP lacks a strong conceptual, principles-based foundation. As a result, application of the "by design" method may result in preparers, auditors, and regulators reaching different conclusions while using the same facts. However, given the history of this issue, the time that has elapsed since the original Interpretation was issued, and our understanding that the Board

Director, TA&amp;I—FSP

November 30, 2005

Page 2

had always intended the “by design” approach to be applied, we would not object to finalizing the FSP if the Board addresses the other issues discussed in this letter.

### *Interest Rate Risk*

We generally believe that differences in application of the Interpretation’s provisions arise primarily because of how interest rate risk is considered. As a result, we believe the Board’s views on how interest rate risk should be considered in applying the Interpretation’s provisions should be more clearly articulated in the FSP. After reading footnote 5 of the FSP and the examples included in Appendix A, we are unsure when, if ever, interest rate risk associated with periodic interest payments received or paid by the entity would be considered.

Our reading of the FSP indicates that whenever there is a substantive amount of credit variability in the entity’s investments and there is substantive subordination of that credit risk that is absorbed by certain variable interest holders, the entity generally would not be designed to be exposed to interest rate variability from periodic payments. Our experience indicates that most entities have some level of subordination by which the credit risk is absorbed by certain variable interest holders. Moreover, that subordination would likely be deemed substantive from the entity’s variable interest holders’ perspective. Thus, it is not clear to us when interest rate risk from periodic payments would be a creator of an entity’s variability.

As we understand it, Example 2 illustrates a situation where an entity was designed to create to pass and distribute interest rate risk to its variable interest holders. We believe the FSP states that the variability due to the periodic interest payments would be considered in applying the Interpretation’s provisions. Because the equity holder absorbs the first \$10 of (1) interest rate variability and (2) credit risk, that equity holder would likely be the entity’s primary beneficiary, which is a result that is consistent with paragraph B14 of the Interpretation. If our understanding is correct, we agree with that conclusion.

To illustrate how the “by design” method will be difficult to apply in practice and will yield inconsistent results, assume Example 2’s facts were changed such that, instead of the equity holder implicitly absorbing the periodic interest payments’ variability, the entity entered into a \$100 notional interest rate swap pursuant to which it paid a fixed rate and received a floating rate. In other words, assume the interest rate swap counterparty absorbs the interest rate variability instead of the equity holder. We suspect the Board would conclude that the variability due to the periodic interest payments would not be considered in applying the Interpretation’s provisions, and thus the swap counterparty would not

Director, TA&amp;I—FSP

November 30, 2005

Page 3

absorb the entity's variability because the entity was not designed to create and distribute interest rate risk.

We believe that Example 2 and the simple modification we have described best illustrate why the "by design" method will yield inconsistent results. The interest rate risk and credit risk are identical in both examples, but when the interest rate risk is shifted from the equity holder to the interest rate swap counterparty, the entity's total variability is changed. Moreover, if the variability from interest rate risk was greater than that due to credit risk, the primary beneficiary identified in each example also would change. We do not believe (1) the entity's total variability should decrease and (2) the identified primary beneficiary should change because the equity holder shifted the interest rate variability to the interest rate swap counterparty.

It appears to us, based on our reading of the FSP's examples, that "vanilla" interest rate swap agreements, whose counterparty is someone other than a variable interest holder, will generally not be considered variable interests when there is any meaningful credit risk created by the entity. If that is the ultimate decision reached by the Board, we believe the Board should clearly state that conclusion. Further, because interest rate swaps are merely a series of forward contracts, we believe the Board should amend paragraph B13 of the Interpretation, which states that a forward contract to sell assets owned by the entity at a fixed price will usually absorb the variability in the fair value of the asset.

While footnote 8 to the FSP indicates that a swap counterparty's other involvement may lead to a conclusion that the swap agreement is a variable interest, we anticipate many preparers would not view an interest rate swap as a variable interest given the relative size of the swap market and the ease with which an interest rate swap may be obtained. We believe the Board should clarify footnote 8 to indicate that an interest rate swap agreement may be a variable interest when the swap counterparty has any other involvement with the entity (and not just through holding a debt or equity interest in the entity). Further, we suggest the final FSP clearly indicate the principle that applies to the FSP's conclusion that an interest rate swap may be a variable interest only when the swap counterparty holds another variable interest in the entity.

#### *Foreign Currency Exchange Risk*

It is unclear to us when, if ever, variability from foreign currency exchange risk would be considered in applying the Interpretation's provisions. We have been applying the Interpretation's provisions by looking to the entity's assets. Cross currency swaps that pay the foreign currency out of the entity and receive a different currency would be considered

Director, TA&amp;I—FSP

November 30, 2005

Page 4

variable interests. Example 1(b) appears to indicate that basic cross currency swaps would not be variable interests unless, pursuant to footnote 8, the swap counterparty has other involvement with the entity. As indicated above, we suggest the FSP indicate why there is a different result depending on whether the swap counterparty does, or does not, hold another variable interest in the entity.

We believe the FSP's guidance would be more helpful if the FSP includes an example demonstrating when a cross currency swap would be considered a variable interest.

#### *Qualitative Analyses*

We disagree with paragraph 14's statement that qualitative analyses will often be conclusive in applying the Interpretation's provisions. Given the structured nature of many transactions, our experience has indicated the opposite—that qualitative analyses will often not be conclusive in applying the Interpretation's provisions. The Board should provide the basis for its assertion. We also believe that this guidance on qualitative analyses should be reviewed with the PCAOB staff before the FSP is finalized.

#### *Role of Contract or Arrangement*

Paragraph 9 of the FSP indicates that the role of a contract or arrangement in the design of the entity, rather than the legal form or accounting classification of that contract or arrangement, should dictate whether that interest is a variable interest. It is unclear to us what else should be considered beyond the legal form or accounting classification. We believe this sentence would be clearer if it indicates that the legal form or accounting classification should not solely be determinative.

#### *Other Comment*

The last sentence of paragraph 11 indicates that one should consider whether the interest transfers substantially all of the risk or return or both of certain assets or operations of the entity in analyzing the entity's interests. While this sentence is true, we believe variable interests absorb *any* variability that the entity was designed to create and pass along to its holders. Accordingly, we believe the phrase "substantially all of" should be removed from the paragraph, because a variable interest absorbs variability, regardless of the degree.

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Director, TA&I—FSP

November 30, 2005

Page 5

We would be pleased to meet with the Board or its staff to discuss our comments in further detail.

Very truly yours,

*Ernst & Young LLP*