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Mr. Lawrence W. Smith
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Financial Accounting Standards Board
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Letter of Comment No: 12 File Reference: FSP46RB

File Reference No. FIN 46(R)-b

Re: Proposed FASB Staff Position FIN 46(R)-b

Dear Mr. Smith:

We are pleased to comment on the proposed FASB Staff Position FIN 46(R)-b, "Implicit Variable Interests Resulting from Related Party Relationships under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities" (the "proposed FSP").

### The Proposed FSP as Drafted is of Questionable Value

Essentially, the proposed FSP contains a single piece of accounting guidance...an accountant must consider whether an enterprise will be required to provide subordinated financial support to another entity that is potentially a variable interest entity (VIE) despite the lack of a documented variable interest between the enterprise and the entity (i.e., an implicit variable interest) when a given set of circumstances is encountered. While we agree with the answer that the proposed FSP provides, we are not optimistic that the proposal will accomplish very much. In addition, without providing further guidance, we question whether the staff is creating an unusual precedent.

At its essence, the proposed FSP represents a yellow caution flag, intended to warn preparers that related parties provide a fertile environment for undocumented and/or undisclosed arrangements. Using the fact pattern in the example, the FSP is warning the accountant for Manufacturing Company (the enterprise) that the possibility exists that the common owner of both entities (the related party) will (might) require Manufacturing Company to provide subordinated financial support to Leasing Company (the potential VIE). If so, Manufacturing Company has (will have) a variable interest in Leasing Company, even if it is implicit (i.e., it exists in the absence of an explicit, acknowledged oral or written agreement that provides for the support).

The proposed FSP implies that the consideration must be made because (a) the related party intends to cause the enterprise to provide financial support to the potential VIE, if necessary, to protect its interest but has not notified the enterprise of this intention (whether lack of notification is intentional or inadvertent) or (b) the related party has not yet decided on a future course of action to be taken if the potential VIE encounters financial difficulty. The consideration required by the proposed FSP will fail to detect the first of these two situations and the proposed FSP provides no guidance for the

<sup>&</sup>lt;sup>1</sup> We note that AU Section 334, Related Parties, sets forth explicit procedures for independent auditors to follow in circumstances similar to the one described in the draft proposal.

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We predict that a FASB Staff Position that addresses only when to consider whether an implicit variable interest exists because of undocumented and undisclosed arrangements between related parties will inevitably result in numerous questions on how to determine whether a reporting enterprise holds an implicit variable interest. For instance, we believe that when an accountant confronts the circumstance described in paragraph 5 of the proposed FSP, the accountant will need further guidance, such as:

- What factors should be considered in determining whether an implicit variable interest exists?
- Is there a presumption of support in the absence of an explicit variable interest?
- Is there a variable interest if the related party has not decided on a future course of action to be taken if, and only if, the potential VIE requires financial support?
- Is experience with similar transactions in the past compelling evidence? What if there have been no similar transactions in the past?
- Can the implicit variable interest cause the potential VIE to become a VIE?

Without this additional guidance, the proposed FSP strikes us as odd and unprecedented in that it points out a requirement to consider the existence of undocumented and undisclosed arrangements solely in the context of Interpretation 46(R). In fact, there is an entire universe of possible implicit transactions between related parties, especially companies within a consolidated group, as contemplated by FASB Statement No. 57, Related Party Disclosures. Thus, the requirement to consider whether a relationship with other parties affects an enterprise's accounting appears to be a consideration under all generally accepted accounting principles. The guidance that is not clear and is needed by constituents is how an arrangement between related parties affects the accounting.

We have encountered the situation described in the proposed FSP in our practice. Consequently, we developed firm guidance (see the Appendix to this letter) that the staff should consider incorporating if the proposed FSP is finalized. First, our guidance asks whether the related party has the ability to require (or has substantial influence over a decision to require) the reporting enterprise to reimburse or protect the related party from incurring losses on its direct variable interest in the potential VIE. Second, the guidance describes a number of factors that would be useful to the accountant in making the consideration recommended by the proposed FSP. Incorporation of similar guidance into the FSP would help accountants apply Interpretation 46(R) in a consistent manner and stave off many of the implementation questions that we foresee.

## Additional Considerations for a Final FASB Staff Position

Based on other implementation concerns, we recommend that the proposed FSP provide guidance in the following areas:

What types of related party relationships are of concern? We believe that the related party
must have the ability to require (or have substantial influence over a decision to require)
the reporting enterprise to reimburse or protect it from incurring losses on its direct
variable interest in the potential VIE.

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• Paragraph 6 of the proposed FSP states the following:

The determination as to whether an implicit variable interest exists should be based on whether, in substance, the reporting enterprise through its relationship with its related party will absorb the variability of the VIE [footnote omitted].

The phrase "through its relationship with its related party" should be reconsidered. A relationship does not, in and of itself, cause a reporting enterprise to absorb variability; it is the decisions of management of the entities in the relationship that dictate which component absorbs variability. As drafted, the sentence could be misconstrued and lead to a conclusion that the mere existence of the relationship means, de facto, that the reporting enterprise has an implicit variable interest.

· Footnote 3 to the proposed FSP states in part that

Regardless of whether a related party relationship exists, the determination as to whether an implicit variable interest exists should always be based on whether, in substance, the reporting enterprise will absorb the variability of a VIE.

We believe this statement to be too broad, misleading, and to contradict paragraph 5 of the proposed FSP. This sentence indicates that a reporting enterprise must always look through unrelated parties with which it has a contract or other interest to determine if the value of its interest may be affected by a contract between the unrelated party and another third party that may be a VIE. For example, any time a party enters into a derivative to hedge its risk in the variability of a variable interest it holds in a potential VIE, it could be viewed that the derivative counterparty, in substance, absorbs the variability of the potential VIE. This requirement is inconsistent with the objective of Interpretation 46(R). Therefore, the consideration of the existence of an implicit variable interest should be limited to situations involving related parties (including agency relationships) or those in which the reporting enterprise has a direct relationship with the potential VIE.

#### Other Comments

- Paragraphs 2 and 3 of the proposed FSP lead a reader to believe that the objective is to determine which enterprise, if any, should consolidate the VIE. However, the objective is to identify all enterprises that hold variable interests (explicit and implicit) in a potential VIE. The important concept is that without holding a variable interest in a VIE, a reporting enterprise cannot consolidate a VIE. Therefore, the content of the second paragraph of the proposed FSP should be changed to provide background into this important concept and to provide the definition of a variable interest from paragraph 2(c) of Interpretation 46(R). The guidance in paragraphs 16 and 17 should come after paragraph 4 of the proposed FSP as supplemental background.
- We emphasize that the question should be whether the reporting enterprise holds a variable interest in a potential VIE (therefore, the references to holding an implicit variable interest in a VIE should be changed to "a potential VIE"). The proposed FSP should make clear that, although a reporting enterprise may have an implicit variable interest in an entity, that entity may not be a VIE. However, it is also important for the proposed FSP to acknowledge that identifying the existence of an implicit variable interest may cause the entity to be deemed a

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VIE (e.g., the implicit variable interest may protect the equity holders at risk from absorbing expected losses as described in paragraph 5(b)(2) of Interpretation 46(R)).

- Paragraph 5(b) of the proposed FSP states that "A related party of the reporting enterprise
  has a variable interest or potential variable interest in the same VIE." [Emphasis added].
  We do not understand the phrase "or potential variable interest" and believe it should be
  explained or removed from the proposed FSP.
- To help clarify the circumstances requiring consideration, the first paragraph of the example in the proposed FSP should be moved up to the background section (immediately following paragraph 1).
- The proposed FSP should either clarify the importance of the reporting enterprise's related party being "a non-VIE" or remove the phrase from paragraph 4. Whether or not the related party is a VIE does not seem to impact the analysis.
- The solution to the example provided in the proposed FSP states that "an implicit variable interest may be created through an implicit guarantee by Manufacturing Company of the owner's investment in Leasing Company." This could be read that the variable interest is in the owner, not the Leasing Company. However, the intention of the proposed FSP is for a reporting enterprise to consider whether Manufacturing Company (the lessee) is economically guaranteeing the residual value of the Leasing Company's asset. This should be made clear. In addition, the proposed FSP should state whether the potential implicit variable interest described in the example would be an interest in a specific asset as described in paragraphs 12 of Interpretation 46(R).

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We appreciate the opportunity to comment on the proposed FSP. If you have any questions concerning our comments, please contact Bob Uhl at (203) 761-3705 or James Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche LLP

# Deloitte & Touche LLP Comment Letter on Proposed FASB Staff Position FIN 46(R)-b Guidance Issued by Deloitte & Touche LLP From Section 2(c)-5.1 of Accounting Manual on FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities

## DETERMINING WHEN AN IMPLICIT GUARANTEE (VARIABLE INTEREST) EXISTS IN A RELATED-PARTY TRANSACTION

Paragraph B24 of Interpretation 46(R) indicates that an arrangement accounted for as an operating lease (or accounted for as a capital lease) that does not include a guarantee (or similar arrangement) or fixed-price purchase option, and is consistent with prevailing market terms at the inception of the lease, generally does not represent a variable interest to the lessee because the arrangement is a receivable of the lessor entity (the potential variable interest entity (VIE)). However, paragraph B10 of Interpretation 46(R) provides that:

Guarantees of the value of the assets or liabilities of a variable interest entity... or similar obligations such as other... agreements (explicit or implicit) to replace impaired assets held by the entity are variable interests if they protect holders of other interests from suffering losses [Emphasis added]

## Question

What are the considerations to be given to a related party lease to determine whether the lessee has a variable interest in the lessor entity through an implicit guarantee of the assets of the lessor entity?

Note: This Q&A focuses on whether an implicit guarantee exists in a leasing arrangement between related parties. However, whether an implicit guarantee exists should be analyzed in any arrangement with a related party that meets the characteristics described within this Q&A. In this context under Interpretation 46(R), a party must have a direct relationship, other than the implicit guarantee, with the potential VIE to be subject to the implicit guarantee (e.g., an operating subsidiary does not need to consider whether it has implicitly guaranteed all other investments in entities made by its parent if the operating subsidiary does not have a direct relationship, other than the implicit guarantee, with the other entities).

#### Answer

In situations where a lessee does not have an explicit contract with a potential VIE that meets the definition of a variable interest, the lessee still may have a variable interest in the entity through an implicit guarantee. Whether an implicit guarantee exists depends on

the relationship between the related parties and the nature of their variable interests in the lessor entity. Since an operating lease is not a variable interest under paragraph B24 of Interpretation 46(R), there may be no explicit variable interests between the related-party lessor (potential VIE) and lessee. However, it is possible, due to the nature of some related-party relationships, that even absent any form of explicit guarantee or purchase option, the lessee may protect the lessor1 entity from losses on the leased property, and thus, an "implicit guarantee" as described in paragraph B10 is created.

Due to the nature of some related party relationships, the holders of variable interests in the lessor entity may have the ability to exert its influence on the lessee enterprise to require the lessee to protect the lessor from incurring losses on the leased property. Determining whether or not an implicit guarantee exists is important to the analysis of a potential VIE because (1) any implicit guarantee may cause the lessor entity to be a VIE under paragraph 5(b)(2) of Interpretation 46(R) since it protects the holders of equity from the expected losses of the entity, and (2) if an implicit guarantee exists, the lessee or its related parties may hold a variable interest in the lessor VIE and could be the lessor VIE's primary beneficiary. Careful consideration of all of the facts and circumstances is required before concluding that a related-party lessee (and its related parties) has not provided an implicit guarantee of the lessor entity's property.

The determination of whether an implicit guarantee exists is based on all facts and circumstances. The first step in the determination is as follows.

Step 1: Does a party involved with the lessee through an ownership interest in the lessee, or by virtue of holding a significant role in the operations of the lessee, have the ability to require (or have substantial influence over a decision to require) the lessee to reimburse the lessor entity for losses it incurs by virtue of holding the leased asset?

An implicit guarantee, for example, could manifest in a decision to renew the lease at above market rents or in compensation paid directly to the variable interest holder. The guarantee is not limited to an outright reimbursement of the lessee for incurred losses.

Some examples of possible substantial influence under Step 1 include:

- The lessee and the lessor are both controlled by a common parent.
- The lessor is wholly or substantially owned by a stockholder (or group of stockholders) who also owns a stake in the lessee entity, and the stockholder has the ability to exercise substantial influence over the lessee.
- The lessor is wholly or substantially owned by a stockholder (or group of stockholders) who holds a significant role in the operations of the lessee entity (e.g., holding a senior officer or director position in the lessee or a controlling parent company).

If the characteristic in Step 1 is met, an implicit guarantee may exist; proceed to Step 2.

- Step 2: Once it has been determined that an implicit guarantee may exist under Step 1, all factors, including the following, should be considered to determine whether an implicit guarantee does exist:
- Whether there is an apparent economic motivation for the lessee to protect the lessor entity or holders of variable interest in the lessor entity (paragraph B10 indicates that a guarantee cannot exist unless it protects holders of other interests from suffering losses). For example, if the lessee and the lessor are both wholly-owned subsidiaries of a common parent, the parent (as the shareholder in the lessor) would not benefit (on a net basis) from an implicit guarantee.
- Whether the lessee (or its ultimate parent) has a fiduciary responsibility. For example, if the lessee had minority shareholders who would be disadvantaged by an implicit guarantee, a fiduciary responsibility may exist that would prevent or significantly deter an implicit guarantee.
- Whether the lessee (or its ultimate parent) has clear conflict of interest policies that would preclude the existence of an implicit guarantee, and the policies are effectively monitored and violations are reported to a level within the organization with authority over the violator.
- Whether the lessee is subject to regulatory requirements that create significant disincentives or preclude transactions that result in an implicit guarantee, or would raise a question as to the legality of an implicit guarantee.
- Whether similar transactions have occurred in the past in which a loss has been sustained, and there has been no performance constituting an implicit guarantee.
- Whether other unrelated parties (e.g., creditors, legal advisors) are aware of the existence of any implicit guarantee between the related parties to the transaction.

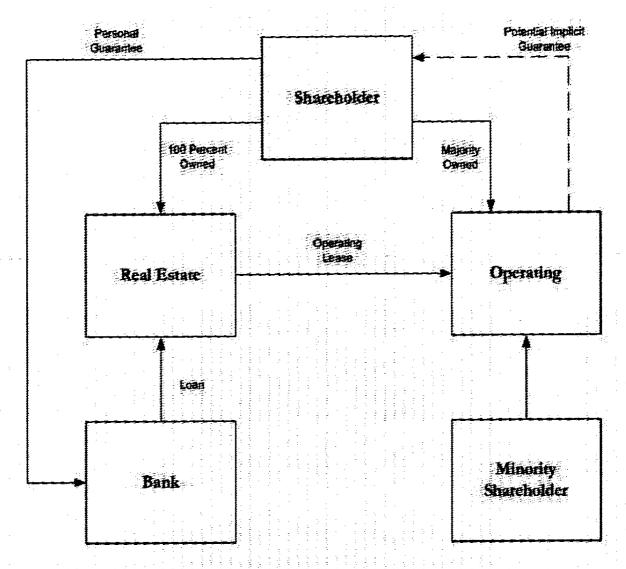
No individual factor necessarily is compelling. All facts and circumstances (including the factors listed above) should be considered in determining whether or not an implicit guarantee exists.

## Example 1 — Implicit Guarantee Exists

Operating Company (Operating) is a nonpublic entity that leases real estate from a related party, Real Estate Company (Real Estate). Real Estate is wholly owned by the majority shareholder of Operating. Real Estate (a VIE) was capitalized with \$30,000 of equity from the majority shareholder and \$970,000 bank debt with recourse to the assets of Real Estate and to the personal assets of the majority shareholder. Real Estate owns no assets other than the real estate asset leased to Operating. The lease contains no explicit guarantees of the residual value of the real estate or fixed-price purchase options. At the inception of the lease, the terms were consistent with fair market rentals. The lease meets the classification for an operating lease in accordance with FASB Statement No. 13,

Accounting for Leases. The operating lease is the only contractual relationship between Operating and Real Estate.

A diagram of the relationship described above follows:



Paragraph B10 of Interpretation 46(R) provides that guarantees of the value of the assets or liabilities of a VIE may be explicit or implicit. Although the operating lease itself does not contain a contractual guarantee of the value of Real Estate's leased asset, the related party relationship between the two entities requires an analysis of whether Operating has provided an implicit guarantee of Real Estate's leased asset to protect the majority shareholder's investment in Real Estate and the majority shareholder's personal guarantee of the debt of Real Estate.

Step 1: Does a party involved with the lessee through an ownership interest in the lessee, or by virtue of holding a significant role in the operations of the lessee, have the ability to require (or have substantial influence over a decision to require) the lessee to reimburse the lessor for losses it incurs by virtue of holding the leased asset?

The majority shareholder does have the ability to require Operating to reimburse it or Real Estate for losses incurred through its controlling interest. Therefore, an analysis under Step 2 must be performed.

Step 2: All factors should be considered to determine if an implicit guarantee exists.

The majority shareholder has economic motivation to require Operating to reimburse it for losses incurred by Real Estate because the minority interest holder will incur a portion of the losses pushed to Operating. Absent any other factors that would lead to a conclusion that the majority shareholder is unable to require performance, an implicit guarantee exists.

The implicit guarantee would result in Operating holding a variable interest in Real Estate (this implicit guarantee of Real Estate's leased asset exists whether the guaranteed payment is made directly to Real Estate or directly to the majority shareholder). If the combined variable interests of Operating (i.e., through its implicit guarantee of the assets of Real Estate) and the majority shareholder (i.e., through its equity interest and personal guarantee of the debt) absorb a majority of the expected losses or receive a majority of the expected residual returns, the related party group (i.e., the majority shareholder and Operating) must follow the guidance in paragraph 17 of Interpretation 46(R) to determine which enterprise will consolidate Real Estate. This analysis would most-likely result in Operating consolidating Real Estate as the primary beneficiary because it appears that the activities of Real Estate are most-closely associated with Operating.

Under the facts and circumstances above, the related-party group would absorb more than half of the expected losses and expected residual returns of the entity because all of the assets and obligations of Real Estate are guaranteed by the related-party group. Conversely, if the debt holder only had recourse to the assets of Real Estate and not to the personal assets of the majority shareholder, Operating would need to analyze whether the combined interests of the related-party group or the debt holder absorbs a majority of the expected losses of Real Estate.

## Example 2 — Implicit Guarantee Does Not Exist

Enterprise H (H) is a public holding company with two wholly-owned subsidiaries, Entity R (R) and Enterprise O (O). Enterprise O is a regulated operating entity that must file stand-alone financial statements with its regulator. The regulator requires that all related-party transactions entered into by O be on market terms, and also imposes certain restrictions on dividends that O can pay. Entity R is a real estate company whose only asset is a building leased to O. The lease is a long-term, market-rate operating lease with no explicit residual value guarantee or purchase option. Entity R is funded by 20 percent equity issued to H and an 80 percent intercompany loan from H. Since an operating lease is not a variable interest under paragraph B24 and since O and R are related parties, O must consider whether it has provided an implicit guarantee to R because of H's potential ability to require O to fund any losses of R.

Step 1: Does a party involved with the lessee through an ownership interest in the lessee, or by virtue of holding a significant role in the operations of the lessee, have the ability to require (or have substantial influence over a decision to require) the lessee to reimburse the lessor for losses it incurs by virtue of holding the leased asset?

Enterprise H, through its 100 percent ownership in O, has the ability to control O. Therefore, an analysis under Step 2 must be performed.

Step 2: All factors should be considered to determine if an implicit guarantee exists.

The following analysis is performed:

- Enterprise O and Entity R are both wholly-owned subsidiaries of Enterprise H. Therefore, the parent would not benefit (on a net basis) from an implicit guarantee.
- Enterprise O is subject to regulatory requirements that require transactions with related parties to be transacted at market terms. In addition, there are significant disincentives within the regulatory requirements for capital transactions.

Absent any other overriding factors leading to a conclusion that H is able to require O to protect it from losses incurred on their investment in R, an implicit guarantee does not exist.