

January 21, 2005

Letter of Comment No: 11
File Reference: FSP46RB

Director, TA&I—FSP
Financial Accounting Standards Board
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Proposed FASB Staff Position No. FIN 46(R)-b
Implicit Variable Interests Resulting from Related Party Relationships under FASB Interpretation No. 46

We appreciate the opportunity to comment on the above-referenced proposed FASB Staff Position (FSP). While we agree with the FSP's concepts, we do not support finalizing the FSP in its current form because:

- FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (the Interpretation) already makes clear that implicit variable interests may exist. In addition, we believe the scope of the FSP is too narrow because implicit variable interests may arise from transactions other than those with related parties in variable interest entities.
- Implicit variable interests may affect the determination of whether an entity is a variable interest entity (VIE), and the FSP addresses only identifying an implicit variable interest if the entity is already determined to be a VIE.
- We do not believe a reporting enterprise that holds an implicit variable interest in a VIE should always apply paragraph 17; we believe that a reporting enterprise should apply paragraph 17 only if the conditions described in the first sentence of paragraph 17 are met.
- Guidance is needed on how to identify implicit variable interests.

Each of our points is discussed in further detail below.

FSP's Scope

The FSP appropriately points out that paragraph B10 of the Interpretation discusses one type of implicit variable interest. Accordingly, we believe that financial statement preparers and auditors already are required to consider whether any implicit variable

interests exist. As such, we believe the FSP is unnecessary. We believe all of the particular facts and circumstances in transactions should be considered in applying all of the Interpretation's provisions. As discussed later, however, we believe that practical guidance is needed to identify implicit variable interests.

If the Board chooses to issue the FSP, however, we believe the conditions in the FSP's question are unnecessary. The FSP's conditions would include in its scope only those situations in which the reporting enterprise and a related party have involvement in a VIE. We agree that a related party's involvement in an entity provides a strong indicator that an implicit variable interest may exist. Indeed, FASB Statement No. 57, *Related Party Disclosures*, states that transactions involving related parties cannot be presumed to be carried out on an arm's length basis. However, implicit variable interests can take many forms, and we believe the FSP's scope does not appropriately contemplate that implicit variable interests can be identified in situations other than when a related party is involved with the entity under evaluation.

One type of implicit variable interest not involving related parties is a transaction between unrelated parties that occurs outside of the entity under evaluation. We believe there are situations in which, after careful consideration of the particular facts and circumstances, such transactions should be considered in applying the Interpretation's provisions. We have observed in practice transactions between two parties involved with an entity that were structured without the entity's involvement in order to achieve a particular accounting result. We do not believe that a transaction between two parties involved in an entity may be ignored merely because the entity under evaluation is not a direct party to the transaction. Instead, we believe that all of the facts and circumstances in a transaction should be considered, and that may lead to a conclusion that a party has an implicit variable interest.

Attachment A to this letter is an excerpt of our firm's interpretive literature in this area. The relatively simple example provided is based on a transaction we have observed in the marketplace. We also have observed more complex transactions in which variable interests arise because one party is acting as an agent of the other party. We believe that if the Board decides to issue a final FSP, it should acknowledge that implicit variable interests take many forms and can occur in transactions other than those included in the FSP's scope.

Implicit Variable Interests Affect Application of All of the Interpretation's Provisions

As drafted, the FSP provides guidance on whether an implicit variable interest in a VIE should be considered in applying only paragraphs 16 and 17 of the Interpretation when

certain conditions exist. We believe that if an implicit variable interest exists, that implicit variable interest should be considered in applying all of the Interpretation's provisions, and not only in determining whether the interests should be aggregated with those of related parties. For example, the existence of an implicit variable interest may cause the entity to be classified as a VIE. The example in Attachment A illustrates this point.

Implications of Implicit Variable Interests on the Paragraph 17 Analysis

We do not agree with the FSP's statement that any time a related party group holds either explicit or implicit variable interests in a VIE, that reporting enterprise should apply the guidance in paragraph 17 of the Interpretation to determine whether it is the VIE's primary beneficiary. In many cases, the related party group will not absorb a majority of the entity's expected losses. We believe that the primary beneficiary determination should be made only if the aggregate variable interests held by those parties would, if held by a single party, identify that party as the primary beneficiary. We suggest the last sentence of the response should be removed and, consistent with our earlier comment, suggest any final FSP include a statement that all of the Interpretation's provisions should be applied.

Implementation Guidance

Because we believe the Interpretation already makes clear that implied variable interests may exist (and not only with related parties), we believe the real issue is how preparers and auditors should identify implicit variable interests. As previously discussed, we have observed a number of structured transactions that gave rise to implicit variable interests. Thus, an FSP that provides guidance on identifying implicit variable interests could be more useful.

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

ATTACHMENT

(Excerpt from E&Y's Financial Reporting Developments Book on the Interpretation)

5(a)-18 Transactions Outside the Entity

(Added December 2004)

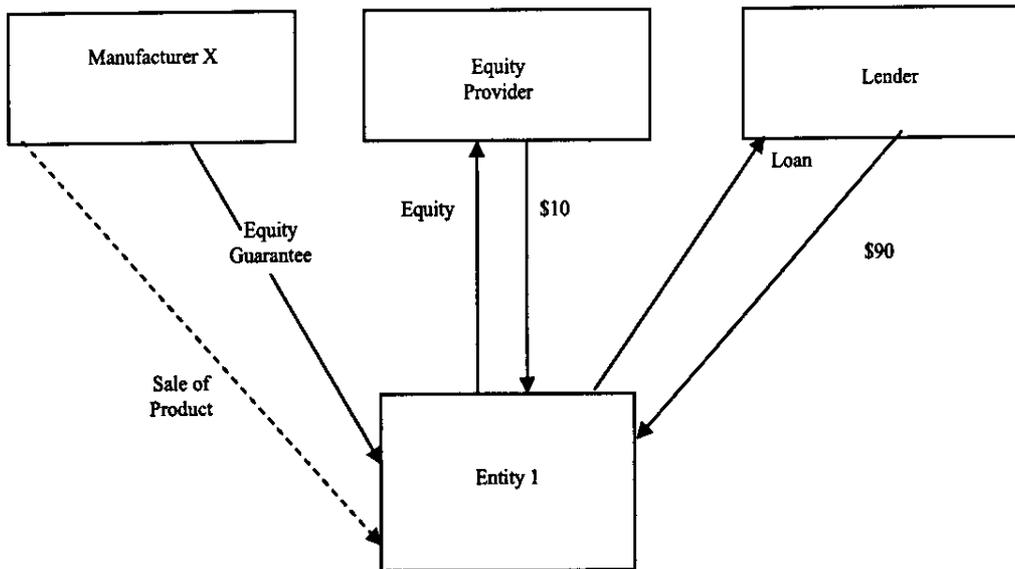
Question: Should transactions that occur outside the entity be considered in determining whether the equity investment is at risk?

Response: We believe transactions that occur outside the entity should be considered not only in determining whether the equity investment is at risk, but also in identifying the parties holding variable interests in the entity and in the entity's primary beneficiary (if the entity is a VIE). In certain cases, the Interpretation's provisions specifically prohibit an equity investment from being considered at risk. For example, an equity investment would not be considered at risk pursuant to paragraph 5(a)(4) if it was financed by an unrelated third party that is also involved with the entity. Because the Interpretation's provisions do not contemplate all potential types of structuring, however, the use of professional judgment (after considering all of the relevant facts and circumstances) will be required.

The following examples illustrate these concepts.

Facts

Manufacturer X sells a product to Entity 1 for \$100. Entity 1 was capitalized by issuing equity (\$10) and debt (\$90) to Equity Provider and Lender, respectively. Manufacturer X writes a put option so that Entity 1 may put the equity to Manufacturer X for \$10 at a future date. The transaction is demonstrated pictorially as follows:

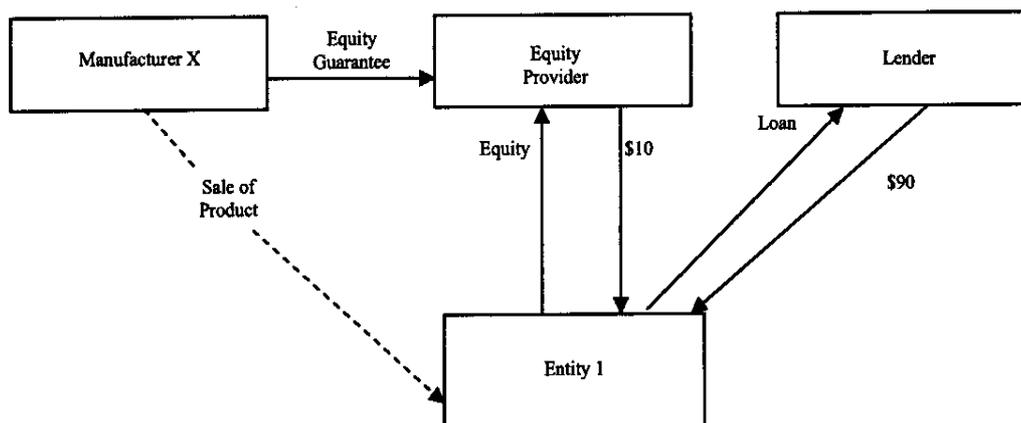


Analysis

We believe the equity investment is not at risk because it does not participate significantly in losses of the entity pursuant to paragraph 5(a). Accordingly, because there is no equity investment at risk, the entity would be a VIE. (The primary beneficiary determination is beyond the scope of this example.)

Additional Facts

Further assume Manufacturer X entered into the same guarantee arrangement at inception of the arrangement with Equity Provider (instead of Entity 1) as follows:



Analysis

We believe the equity investment in this structure also would not be at risk (and the entity would be a VIE) because the substance of guarantee prevents the Equity Provider from being exposed to potential losses of Entity 1. We do not believe that a transaction between two parties may be ignored merely because the entity under evaluation is not a direct party to the transaction. We believe all of the relevant facts and circumstances should be considered in applying all of the Interpretation's provisions.

The SEC staff shares this view, as discussed in a December 2004 speech.

**Speech Excerpts by Jane D. Poulin
2004 AICPA National Conference on
SEC and PCAOB Developments**

Consolidation of Variable Interest Entities

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of FIN 46R. These aspects of a relationship are sometimes referred to as "activities around the entity." It might be helpful to consider a simple example. Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of FIN 46R. The short answer is no. First, FIN 46R specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics of a controlling financial interest as defined in paragraph 5(b) of FIN 46R. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B's investment is at risk and depending on B's ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.

Other "activities around the entity" that should be considered when applying FIN 46R include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under FIN 46R including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.