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Letter of Comment No: 8
File Reference: FSP46RB

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

Dear Mr. Smith:

BDO Seidman, LLP is pleased to offer comments on the Proposed FASB Staff Position (FSP) FIN 46(R)-b.

We believe that the proposed FSP should not be issued in its current form. We agree with the staff that if an enterprise and its related party are involved with a variable interest entity (VIE), the enterprise should consider whether it has an implicit variable interest in the VIE. We also agree that the decision should be based on an assessment of facts and circumstances with no presumption that an implicit variable interest exists. However, we believe the proposed FSP:

- Provides insufficient guidance on how to decide whether an implicit variable interest exists
- Uses the example ineffectively
- Reaches an erroneous conclusion about lease accounting.

Insufficient guidance

The notion of an implicit variable interest is unfamiliar and subjective. Further, by definition, an implicit variable interest is not documented in writing. Therefore, companies and their auditors have no existing framework for assessing whether an implicit variable interest exists, that is, whether a reporting enterprise will absorb variability. To achieve a reasonable level of consistency in practice, the FASB should provide guidance on how to determine whether an enterprise will absorb variability. We envision guidance in the form of factors to consider, or indicators that an enterprise will absorb variability, so that companies will apply a consistent framework in making their assessments.



<u>Ineffective</u> use of example

The proposed FSP contains an example of a potential implicit variable interest involving a lessor VIE and a lessee, both 100% owned by the same individual. The example is not used effectively to illustrate implicit variable interests, because there are two reasons to doubt that the lessee will absorb variability in this fact situation:

- The same person owns 100% of both entities. The owner absorbs the same variability regardless of which individual entity absorbs it. Therefore, little incentive or economic reason exists to shift losses from lessor to lessee through an implicit variable interest. Stated more colloquially, the owner bears a loss whether he pays it out of his right pocket or his left pocket. Why should anyone expect that one pocket would absorb the other's variability?
- In our experience, real world transactions like the example often are motivated by a desire to minimize income taxes. Private companies often seek to minimize taxable income. When the time comes to build or buy additional real estate, the company sees that the incremental depreciation and interest deductions from owning the additional real estate will create net operating loss carryforwards. If the shareholder owns the real estate through a partnership and leases it to the company, however, the depreciation and interest deductions (which typically exceed the rent income) flow through and reduce his taxes payable. If a loss is incurred on the real estate, the owner faces the same choice. If the company bears the loss, it creates a loss carryforward; if the partnership bears the loss, it may reduce the owner's taxes payable. Hence, the lessee's absorption of variability would be counter to the owner's income tax planning.

We believe it is confusing to illustrate a potential implicit variable interest with an example that provides no reason to think that the lessee will absorb variability from the lessor.

We believe the FSP would be more useful if the existing example were contrasted with another example. The other example would similarly involve a manufacturing company and a VIE whose only business is leasing real estate to the manufacturing company. However, the owners of the leasing VIE would be the children of the owner of the manufacturing company, and a principal motive of the transaction would be to place appreciating real estate in the hands of the children and outside the owner's estate. The children as owners will absorb favorable variability from the VIE. However, if plans go awry and the value of the real estate decreases, the estate tax motivation would be frustrated if the children absorbed the loss. This example would provide an understandable reason for the manufacturing company to absorb unfavorable variability from the leasing VIE.

We believe that contrasting these two examples, and using them to illustrate the application of the factors or indicators (our first recommendation), would make the FSP useful and would result in more consistency in the application of Interpretation 46.



Erroneous conclusion about lease accounting

Footnote 5 of the proposed FSP states that its guidance should not be used to evaluate the classification of leases. We believe that is an erroneous analysis of FASB Statement No. 13, Accounting for Leases. If an implicit variable interest exists through a lessee guarantee of the lessor's debt, that guarantee should be considered in measuring the lease term in accordance with paragraph 5f of Statement 13. Similarly, if an implicit variable interest exists through a lessee guarantee of the residual value of the leased asset, that guarantee should be considered in measuring minimum lease payments in accordance with paragraph 5j of Statement 13. If a lessee guarantee exists and is identified pursuant to Interpretation 46 and the FSP, we do not understand how its existence can be ignored when applying Statement 13.

We recommend that the Board amend paragraph 29 of Statement 13 to state that classification of related party leases should be the same as similar leases between unrelated parties unless either:

- The terms of the transaction have been significantly affected by the relationship (the existing exception in paragraph 29), or
- The lessee has an implicit variable interest in the lessor in accordance with Interpretation 46 and the FSP.

For practical reasons, we recommend that the transition for this amendment be prospective for leases entered into or modified after its effective date.

We would be pleased to discuss our comments with the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,

s/ BDO Seidman, LLP