

Letter of Comment No: 3
File Reference: FSP46RB

January 18, 2005

Mr. Lawrence Smith, CPA
Director, Technical Application & Implementation Activities--FSP
Financial Accounting Standards Board
401 Merritt 7
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Re: December 6, 2004 Proposed FASB Staff Position (FSP) FAS 46(R)-b, *Implicit Variable Interests Resulting from Related Party Relationships under FASB Interpretation No. 46 (revised December 2003)*, Consolidation of Variable Interest Entities

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the Proposed FSP and is providing the following comments for your consideration.

TIC believes the proposed FSP, as written, will not accomplish its stated purpose, which is to reduce the diversity in practice in applying FIN 46(R) when a VIE has multiple related party relationships. The proposal successfully clarifies that related parties with intercompany market value leases aren't necessarily exempt from consolidation, but it does not provide sufficient guidance to identify other implicit variable interests within a related party group. It raises more questions than it answers. Therefore, in TIC's view, significant diversity in practice will continue after this proposal is issued.

TIC has several recommendations to improve the clarity of the proposal in certain fundamental respects.

Paragraph 5 describes two conditions that must exist before a reporting entity must consider applying the related party provisions of FIN 46(R). Basically, the reporting entity must have "an interest in, or other involvement with, a VIE" (other than an explicit variable interest). TIC expects the quoted phrase will be confusing to many preparers and practitioners. The phrase implies that the condition described may be subject to a

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materiality threshold, such that an immaterial interest in, or involvement with, a VIE would allow a reporting entity to conclude that the FSP did not apply.

To prevent misapplication of paragraph 5 of the FSP, TIC suggests that the final FSP incorporate some of the guidance from paragraphs B4, B5 and B10 of FIN 46(R). These paragraphs emphasize that the nature or size of assets or liabilities that represent interests in, or involvement with, a VIE are not the determining factors of a variable interest. Rather, “the relative significance of a variable interest will be determined by the design of the variable interest entity” (FIN 46(R), paragraph B5). “It is the role of the item—to absorb or receive the entity’s variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the entity” (FIN 46[R], paragraph B4). If the asset or liability or other involvement of the reporting entity in the VIE could be used to protect holders of other interests in the VIE from loss, then condition 5a in the proposed FSP would be met, regardless of the materiality of the interest or involvement. This notion is not clearly stated in the proposal, as written.

Our second issue with the proposed FSP concerns the second sentence in paragraph 6, which says:

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.

This language is essentially repeated in the last sentence of the example in the FSP, without further explanation. TIC believes examples are clearer if they illustrate the principle rather than simply repeat it. The example should provide some guidance as to how an implicit guarantee of the owner’s investment would be evident and identifiable.

TIC is uncertain how to interpret the phrase “in substance” in this context and how this phrase would differ in meaning from “the party, within the related party group, that is most closely associated” with the VIE (FIN 46[R], paragraph 17). One of the indicators of “the party most closely associated” is the party within the group that has exposure to the expected losses of the VIE. Yet, identification of the party that would absorb the variability would seem to be what we are trying to determine. TIC sees this reasoning as circular and unhelpful.

We recommend the Board reconsider the use of the “in substance” phrase, especially since the existing conceptual framework rejects the notion of substance over form as a “vague idea that defies precise definition” (FASB Statement of Financial Accounting Concepts 2, *Qualitative Characteristics of Accounting Information*, paragraph 160).

TIC believes alternative language is needed to more clearly articulate the nature of an implicit variable interest. Paragraph 4 of the proposal cites one example in paragraph B10 of FIN 46(R). Using the example as a guide, TIC suggests that an implicit variable

interest would be an implied or inferred agreement or commitment that would obligate one party to relieve other variable interest holders of loss. Implicit variable interests should be those that would be understood or taken for granted by most people given a particular relationship between two parties. If other implicit variable interests could arise from the positive variability of a VIE, those should be described also. TIC believes that clarification of this concept is critical to the purpose of this FSP and its successful application.

TIC also believes that further interpretation is necessary to indicate how the “in substance” phrase ties to the notion that the reporting enterprise must determine, in some manner, the entity or person that “will absorb” the variability of Leasing Company. The phrase “will absorb” implies certainty of occurrence but doesn’t describe how that would be achieved. TIC is uncertain whether the phrase should be tied to legal or presumptive rights or obligations and whether some level of evidence has to support the existence of implicit variable interests. It would seem that if the presumption could be overcome, no implicit variable interest would exist.

TIC considered the following scenarios, assuming the same basic facts as the example in the proposed FSP, to illustrate our difficulties with the proposal. In each example below, the lender has not asked for cross-guarantees among members of the related party group on loans outstanding.

- The common owner of Manufacturing and Leasing Companies is independently wealthy, even without the assets of Manufacturing Company. The owner has the ability to absorb the variability of the Leasing Company but has not specifically committed to doing so. (In some cases, the owner may not know who would absorb the variability of the VIE.) TIC believes the owner’s wealth, apart from the two entities, is a key factor in determining that, in substance, the reporting enterprise (Manufacturing Company) will not absorb the variability of the VIE (Leasing Company), even though it is not certain that the owner “will absorb” it. In this example, therefore, TIC would conclude that the Manufacturing Company would not have an implicit variable interest in the VIE.

However, some TIC members wondered whether all guarantees of the VIE’s debt made by an individual owner would be considered implicit guarantees by the reporting entity. Some believed that the lack of cross-guarantees on the VIE’s debt may nonetheless indicate an implicit guarantee by the reporting entity since the bank could essentially take control of any entity in the controlled group if the owner defaulted.

- The common owner of Manufacturing and Leasing Companies is wealthy as a result of his investment in Manufacturing Company and has no significant wealth outside of Manufacturing Company. The owner has both the ability and the intention, based on past practice, to move cash from one entity to another. In this example, the reporting entity (Manufacturing Company) may have an implicit variable interest in Leasing

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Company. The owner would have both the ability and intent to cause the reporting entity to absorb (based on past practices) the variability of Leasing Company by using one entity to fund the losses of another.

Some TIC members questioned, however, whether cash transfers were necessarily indicative of an implicit variable interest. They may be made for convenience and not as part of a planned effort to absorb VIE losses.

- The Manufacturing Company pays a dividend to the common owner, who then funds the Leasing Company VIE. In this transaction, it would appear that, in substance, the Manufacturing Company is indirectly funding the Leasing Company such that the Manufacturing Company has an implicit variable interest in the Leasing Company.

TIC recommends that the final FSP include the above examples (including those that illustrate scenarios that do not require consolidation) and thereby clarify whether they are correct interpretations of the “in substance” phrase and the evidence needed to support how to determine which related party will absorb the variability of the VIE.

While the existence of implicit variable interests in a VIE resulting from related party relationships will always be a facts-and-circumstances determination, TIC believes there is room for additional clarifying language that will improve the application of the final FSP without eliminating the need for exercising professional judgment. Without this clarification, an audit issue will arise as to how to gain comfort that a reporting entity will absorb the variability of a VIE.

Finally, TIC suggests that a reminder be added to the final FSP to clarify the next steps in the analysis. If the reporting entity has an implicit variable interest in the VIE, then the variable interests in the VIE that are held by the related parties must be treated as the reporting entity’s interests for purposes of determining the primary beneficiary. In some cases, the common owner may have the same variable interests in the VIE as the reporting entity. A tie-breaker analysis would then be necessary to determine the true primary beneficiary and whether the reporting entity would have to consolidate the VIE.

The reminder would be a helpful addition to ensure that constituents understand the implications of having an implicit variable interest. Without it, many may incorrectly assume that a reporting entity with an implicit variable interest in a VIE must automatically consolidate the VIE.

TIC’s constituents continue to struggle with understanding FIN 46(R) and are continuously calling for plain-English guidance relating to this and other standards. TIC strongly recommends that all future FASB pronouncements or guidance relating to FIN 46(R) follow a plain-English approach. The language and style used to explain the Board’s opinions are the ultimate measure of a functional standard.

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TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees