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October 15, 2003

Mr. Lawrence Smith
Director of Technical Application and
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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FSP FIN 46-d, Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FIN 46 Consolidation of Variable Interest Entities

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the proposed FASB Staff Position (the "proposed FSP"), *Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FIN 46 Consolidation of Variable Interest Entities* ("FIN 46" or the "Interpretation"). While we support the issuance of the proposed FSP because it clarifies the Board's intent regarding fees to decision makers and providers of guarantees of all or substantially all of the entity's assets or liabilities when determining the expected losses and expected residual returns under paragraph 8 of the Interpretation, we believe an alternative method would improve the Interpretation.

An Alternative Approach for Decision Makers

The proposed FSP includes the following comment: "Because decision making is an indicator of the primary beneficiary, fees paid to decision makers and guarantors are added to the variability components of expected residual returns, increasing the likelihood that the decision maker or guarantor will be identify as the primary beneficiary." This sentence implies that the decision maker should be viewed as the holder of the controlling financial interest and therefore the calculation should be modified to give special treatment to decision maker fees (and certain guarantee fees) in a way to bias the calculation so that the decision maker (and guarantor) is determined to be the primary beneficiary. The difficulty with that approach is that it undermines the conceptual foundation of the Interpretation.

We believe a better approach would be to treat decision makers and guarantors the same as all other variable interest holders in the determination of the primary beneficiary. When one party (or group of related parties) has either the majority of the expected losses or the majority of the expected residual returns, or both, then that party would be the primary beneficiary because that fact would overcome a presumption that such a party would give a controlling financial interest to the decision maker or guarantor with less "skin in the game". On the other hand, if no party has the majority of variability of the entity, the current model gives a bias toward the decision maker or guarantor which would be appropriate. In that case, the potentially adverse interests of other variable interest holders would be more dispersed and therefore less likely to counterbalance the power of the decision maker (or guarantor). We suggest that a guarantor or decision maker that has a variable interest greater than any other single participant in the entity (i.e. less than the majority but more than any other variable interest holder) be identified as the primary beneficiary in that case. We believe this approach adequately addresses the concept that decision-making is a strong indicator of the primary beneficiary but is superior to the current approach because it does not change the basic concepts and calculations. We believe this approach also avoids some of the practical difficulties caused by the existing approach

If the Board decides to retain the current approach, we have the following suggestions to improve the guidance in the proposed FSP:

Definition of "Decision maker"

As we previously communicated in our October 3rd response letter on Proposed FASB Staff Position No. FIN 46-c (proposed FIN 46c), *Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities*, we believe that the FASB staff should clarify the definition of the term "decision maker" as that term is used in paragraph 8 to aid in the overall application of FIN 46. We believe that a clarification of the definition is necessary to create a broad principle to be applied in practice to ensure consistent application of the decision making concept among financial statement preparers. Additionally, we believe the FASB staff should reconcile the concept of decision making in paragraph 5(b)(1) and that in paragraph 8, as the distinction between the two decision-making concepts appears inherently inconsistent. In that regard, we suggest that the implications of kick-out rights be addressed with respect to each application of the concept.

Calculation of the Decision Maker or Guarantor Fees

The proposed FSP states that the expected residual returns is equal to the absolute value of the expected losses plus the fair value of the paragraph 8 fees (i.e., fees paid to decision makers or guarantors of substantially all of the entity's assets or liabilities). We believe that "fair value" is not the proper term to describe what is intended by paragraph 8. For example, the fair value

of a fee arrangement would be zero if the fee equals the market value of the services to be provided. Rather, we believe the Board intends the term "fair value", in this context, to mean the present value of the cash flows received for the decision maker or guarantor role. We suggest that the FASB staff clarify this fact. In addition, the FASB staff should comment on the appropriate discount rate that should be utilized in the determination of the present value of the decision maker and guarantor fees.

The Effect of Other Contractual Arrangements with the Decision Maker

The proposed FSP states that "...other interests in the entity held by a decision maker or guarantor are not considered paragraph 8 fees unless those interests represent compensation for the provided service or guarantee." It appears that the FASB staff believes that only those fees that are specifically earned by the decision maker for making decisions would receive the special treatment under paragraph 8. While we agree with this concept, in many cases the fair value of the decision making fees may not be determinable as the decision maker may have multiple interests with the variable interest entity. For example, an enterprise may license its technology to a single-purpose variable interest entity, all of whose cash flows are generated using the technology. In addition, the enterprise may manage the variable interest entity's operations and separate contracts may exist for other services such as administrative services. No market data exists to allocate value to these contracts and a decision maker may structure its contracts any way it wishes. Therefore, it may be possible for decision makers to disaggregate these activities such that the amount of fees specifically identified as compensation for decision-making would be de minimus. We believe that the FASB staff should consider these ramifications prior to the issuance of a final FSP and consider incorporating some broad principles in the determination of the decision maker fee. In order to be effective, those principles would need to provide a description of the broad range of services intended to be included in the definition of decision making activities.

The following describes a suggestion that is much broader than the treatment of paragraph 8 fees and is one that we believe should be addressed regardless of the Board's final decisions on that question:

Allocation of Expected Losses and Expected Residual Returns to Individual Variable Interest Holders

The example in the proposed FSP does not involve different classes of variable interests and thus does not provide guidance on how the determination of the primary beneficiary should be performed when such multiple types of variable interests exist. We believe that guidance should be provided regarding the proper approach for allocating expected losses and residual returns to individual variable interest holders in the determination of the primary beneficiary. Page 10 of the proposed FSP states, "The cash flows that would be available to the variable interests under the expected (probability-weighted) outcome and the expected loss outcome

are allocated to those interests based on contractual arrangements.” The use of the word “outcome” appears to be an endorsement of an approach where the allocation of the expected losses should be done under a single scenario (“bottom up” method). We believe the “bottom up” method does not fairly measure the projected variability of the entity. In other words, this method seemingly ignores any expected cash flow variability that might result (1) when different levels of seniority exist among variable interest holders, (2) when an investor holds multiple types of variable interests in an entity (e.g., equity returns, interest, etc.), or (3) where the profit allocation percentages vary at different levels of profitability (as with “promote fees”, carried interests, and back-end interest arrangements). In addition, given that paragraph A5 of FIN 46 states “...each party would determine its own expected losses and expected residual returns and compare that amount with the total to determine whether it is the primary beneficiary,” we believe the “bottom up” method appears inconsistent with the guidance in paragraph A5 as it does not require a variable interest holder to determine its own expected losses.

An alternative to the “bottom up” method is the “top down” method. Under the “top down” or “scheduling” method, an allocation of cash flow is performed for each future probability weighted cash flow scenario. Each variable interest holder determines its own expected losses and expected residual returns based upon its rights to the cash flows under each scenario based on the various variable interests held by that enterprise. The probability-weighted, present-valued results of those determinations are then aggregated to determine the expected cash flows for each variable interest holder. Each variable interest holder would determine its own expected losses and expected residual returns by calculating the variability around the expected cash flows. These individual expected losses and expected residual returns would be used to determine the primary beneficiary. We believe that the “top down” method is the best method to identify the primary beneficiary because it captures the variability in the entity and allocates this variability to each variable interest holder. We believe that this method achieves the risk and rewards analysis that was contemplated under the FIN 46.

In many cases, the results of applying these two methods will be dramatically different. For example, if the entity described in Appendix A of the Interpretation was originally funded by debt having a fair value of \$743,143 and equity having a fair value of \$14,000, different answers would result depending on which of the two methods were applied. The “bottom up” method would identify the equity investor as the primary beneficiary, while the “top down” method would identify the debt holder as the primary beneficiary. In fact, the “top down” method shows that 79% of the expected losses of the entity are borne by the debt holder.

We believe that the FASB staff should clearly address which method is appropriate in the determination of the primary beneficiary as required by paragraph 14 of the Interpretation.



If you should have any questions regarding our comments, please feel free to contact Doug Tanner at (973) 236-7282, Randy Vitray (973) 236-7223 or Thomas Barbieri at (973) 236-7227.

Sincerely,

PricewaterhouseCoopers LLP