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Proposed FASB Staff Position FIN 46-d re: FASB Interpretation No. 46, Consolidation of Variable Interest Entities

Dear Mr. Smith:

Our comments on proposed FASB Staff Position (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 FASB Interpretation No. 46, Consolidation of Variable Interest Entities, are discussed below. In addition, the Appendix to this letter provides suggested changes to enhance the clarity of the FSP.

We believe the proposed FSP is helpful in clarifying that fees to decision makers and guarantors of substantially all of an entity's assets or liabilities are included in the entity's total residual returns based upon the total amount of such fees rather than the variability in those fees. We also believe it is helpful that the Board has expanded the FSP to address a broader range of issues as questions continue to arise in practice about how to calculate entity-level expected losses and expected residual returns as well as how to determine the primary beneficiary of a variable interest entity. However, we believe there are additional issues that the FSP should address that may require this FSP or other proposed additional guidance on the Interpretation to be clarified or modified. We acknowledge that some of these issues already have been discussed with the staff on different occasions, however we offer some additional insights into these issues in this letter for your consideration.

We believe the Board should address the issue of what the assumed period used to estimate variability in an entity's net income or loss should be if the entity has an indefinite life or is a revolving structure. Likewise, we believe the Board should address



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the issue of what the assumed period of service should be for situations in which a decision maker's service contract is renewed annually or is perpetual subject to a right of removal for nonperformance and/or the fee is derived as a percentage of the value of a revolving pool of assets.

In addition, the proposed FSP indicates that "For the purpose of calculating an entity's expected losses and expected residual returns, the expected variability in the entity's net income or loss is determined based on the various estimates of net income or loss available to, or absorbed by, the variable interest holders." We are not sure how to apply that requirement in certain situations. Some instruments, such as derivatives, can introduce, absorb, or reallocate variability of a variable interest entity. Instruments that are similar to derivatives, such as certain guarantees and forward purchase contracts, may also have that effect. When a derivative or similar instrument introduces variability into a variable interest entity, we believe it is not appropriate to calculate the variability in the entity's net income or loss exclusive of the impact of the derivative (even though the derivative counterparty is a variable interest holder according to the guidance in paragraph B6 of the Interpretation). For example, we believe a put option or guarantee provided by a variable interest entity to an enterprise increases the variability in the variable interest entity's net income or loss. That is, the instrument creates additional variability in the possible cash flows that could be received by the investors in the variable interest entity and, therefore, should be included in the determination of the variable interest entity's expected losses and expected residual returns.

A related issue that we believe the FSP or similar guidance should address is the extent to which it is appropriate for an entity's liabilities to be considered in the evaluation of the entity's expected losses and expected residual returns (i.e., entity-level variability). Paragraph 8(b) of the Interpretation requires a calculation of variability based on the fair value of only an entity's assets. However, an entity's net income is affected both by its assets and its liabilities. In part because estimates of an entity's expected cash flows are based on subjective analyses and are difficult to substantiate, we had considered that paragraph 8 implied that the estimates of entity-level variability should be grounded principally in the fair value of the entity's assets. We also had considered that the variability in liabilities that represent capital of the entity (for example, variability in interest expense) should be excluded in estimating entity-level variability, but that variability in other "operating" liabilities of the entity should not be excluded. We believe that the proposed FSP would require interest expense to be added back to the estimates of net income or loss used in developing the estimates of net income or loss available to, or absorbed by, the variable interest holders because the lenders are variable interest holders. However, that is not completely clear based on the proposed FSP. Additionally, in calculating entity-level variability it is not clear what to do with other



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liabilities such as guarantees provided by the entity or put options written by the entity. Presumably the existence of such instruments in an entity requires a greater level of equity in order for the entity to finance its activities without additional subordinated financial support than would be necessary without the existence of those instruments.

These issues lead us to believe that an entity's variability should be affected by derivatives and similar instruments that it enters into, but not by the variability in cash flows from instruments that comprise part of its capital (including the variability in interest expense from debt of the entity). Our understanding is that part of the purpose for the expected losses analysis is to determine the amount of equity that an entity should have in order to finance its own operations. We believe that the amount of that equity should not be reduced or increased as a result of actual liabilities that comprise part of the entity's capital.

Finally, we believe the methodology used to determine the primary beneficiary in the illustration in the proposed FSP may not be applicable to a number of the fact patterns that we have encountered in practice. The illustrated methodology appears to adequately address straightforward fact patterns in which there is a clear sequence in the distribution of the entity's cash flows to its variable interest holders. However, the sequence of cash flow distribution is often extremely complex and does not lend itself to the type of modeling illustrated in the FSP. We believe that paragraph A5 of the Interpretation suggests an alternative in such circumstances is to determine the variability in the fair value of each variable interest holder's interest in order to allocate the entity-level expected losses and expected residual returns to variable interest holders. For example, we believe that approach is necessary in a transaction structure in which cash flows are separated into interest only and principal only strips or in which an interest such as nonrecourse debt causes the cash flows of the entity not to be shared in a consecutive fashion or in proportion to the stated interests of investors. In those circumstances, we believe the variability in the fair value of each party's variable interest must first be known to determine the entity's primary beneficiary. We have developed a methodology to apply in such circumstances that we would be pleased to further discuss with the Board. In any case, we believe this is an area in which further guidance from the Board would be helpful, because we have found in several fact patterns that the selection of the methodology for purposes of allocating an entity's expected losses and expected residual returns has a dramatic impact on the determination of which party, if any, is the primary



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beneficiary of a variable interest entity. With further guidance from the Board, an acceptable level of comparability in this area will develop in practice.

If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Kimber Bascom at (212) 909-5664.

Very truly yours,

KPMG LLP

KPMG's Comments on Proposed FASB Staff Positions FASB Interpretation No. 46, Consolidation of Variable Interest Entities

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 FASB Interpretation No. 46, Consolidation of Variable Interest Entities

Q—How do fees described in paragraphs 8(c) and 8(d) of Interpretation 46 and other variable interests in an entity affect the calculation of *expected losses* and *expected residual returns* of the entity?

Background

Paragraph 8 lists four components of expected losses and expected residual returns. Those components are:

- (a) The expected variability in the entity's net income or loss
- (b) The expected variability in the fair value of the entity's assets (except as explained in paragraph 12) if it is not included in net income or loss
- (c) Fees to the decision maker (if there is a decision maker)
- (d) Fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

For purposes of this FSP, components (c) and (d) are referred to as paragraph 8 fees. Note that components (a) and (b) are variability in net income or loss and changes in asset fair value; whereas components (c) and (d) are the fair value amounts of the fees. Fees described in paragraph 8 will always be variable interests in the entity. According to paragraph 6 of Interpretation 46, "... interests that will absorb portions of a variable interest entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur are called variable interests." Even if a paragraph 8 fee is a fixed amount, the fee is a variable interest because it will receive a portion of the expected residual returns of the entity if they occur.

A—Calculation of Expected Losses

For the purpose of calculating an entity's expected losses and expected residual returns, the expected variability in the entity's net income or loss is determined based on the various estimates of net income or loss available to, or absorbed by, the variable interest holders. Therefore, paragraph 8 fees and other variable interests that affect income, expense, gains, or losses of a variable interest entity should be added back to the

estimates of net income or loss used in developing the estimates of net income or loss available to, or absorbed by, the variable interest holders.

Paragraph 14 of Interpretation 46 provides the guidance for determining whether a variable interest entity has a primary beneficiary and who that primary beneficiary is. If a variable interest or combination of interests of an entity (with consideration of interests held by its related parties and de facto agents) will absorb a majority of the expected losses if they occur, that enterprise is the primary beneficiary and it is not necessary to compute expected residual returns. That is true even if expected residual returns will be larger than expected losses. If a primary beneficiary is not identified based on the analysis of expected losses, it will be necessary to analyze expected residual returns.

Calculation of Expected Residual Returns

If a variable interest entity does not pay paragraph 8 fees, the amount of the entity's expected residual returns is equal to the absolute value of its expected losses (as demonstrated by the example in Appendix A of Interpretation 46). If the variable interest entity pays paragraph 8 fees, the amount of the expected residual returns is equal to the absolute value of the expected losses plus the fair value (as opposed to the variability) of the paragraph 8 fees. The fair value of each paragraph 8 fee should be based on information that is consistent with the assumptions, such as cash flows and discount rates, used to determine the variable interest entity's expected losses.

The Basis for Conclusions section of Interpretation 46 states:

The ability to make decisions is not a variable interest, but if the decisions significantly affect the value of the variable interests, decision making will almost certainly be directly or indirectly associated with the holder of a significant variable interest. For that reason, decision making is an indicator of the primary beneficiary of a variable interest entity.

Guarantors of the values of all or substantially all of the entity's assets and guarantors that all or substantially all of the entity's liabilities will be paid are also likely to have the ability to make significant decisions for the entity. 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 identified as the primary beneficiary. Expected residual returns allocated to a decision maker or guarantor receiving paragraph 8 fees would include (1) the decision maker's or guarantor's allocated

¹ If the example in Appendix A of Interpretation 46 provided a decision maker with a fee of five percent of cash flows to be paid at the end of the year, the paragraph 8 fee would be \$37,857 (\$795,000 \times 5% = \$39,750, discounted for 1 year at 5 percent).

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share of the variability components (paragraphs 8(a) and (b)), if any, plus (2) the fair value of the decision maker's or guarantor's paragraph 8 fees.

For purposes of calculating expected losses and expected residual returns of the entity, 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.

The Exhibit A of FSP FIN 46-d to this FSP illustrates a calculation of expected losses and expected residual returns and the determination of the primary beneficiary when fees are paid to a decision maker.

Effective Date and Transition

The guidance in this FSP is effective for initial evaluations of arrangements and required reconsiderations of arrangements that occur after the beginning of the first fiscal quarter following the date the final FSP is posted to the FASB website. (The beginning of the first fiscal quarter after the final FSP is posted is expected to be January 1, 2004 for a calendar year entity.) Early application for initial evaluations and required reconsiderations is encouraged.

Application of the guidance in this FSP to reevaluate whether an existing entity is a variable interest entity and whether an existing variable interest holder is the primary beneficiary of a variable interest entity is encouraged. If applying the guidance in this FSP to reevaluate existing arrangements results in changes to previously reported information, the cumulative effect of the accounting change shall be reported as of the beginning of the fiscal quarter to which the reevaluation applies. For example, if a calendar-year entity reevaluates arrangements existing as of July 1, 2003, the previously issued third quarter financial statements should be restated with the cumulative effect adjustment reflected in the third quarter financial statements. If a calendar year entity reevaluates arrangements existing as of October 1, 2003, the cumulative effect adjustment should be reflected in the fourth quarter financial statements.

The requirements of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

For enterprises that have not yet applied the provisions of Interpretation 46 to variable interests in variable interest entities in accordance with the effective date provisions of paragraph 27 of Interpretation 46, the guidance should be applied as a part of its initial adoption.