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Certified Management Accountant Program
Certified in Financial Management Program

October 2, 2003

Mr. Robert H. Herz
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Bob,

The Financial Reporting Committee (FRC) of the Institute of Management Accountants wishes to share its views on the proposed FASB Staff Position (FSP) FIN 46-e. The FRC believes that a deferral of the effective date of FIN 46 is both appropriate and necessary. Further, we support the FASB's decision yesterday to shorten the comment period of the FSP so that a final decision could be reached in a time frame that would allow registrants to apply the deferral in their 3rd quarter financial reports. We also believe that the Board should evaluate whether a longer deferral is warranted in light of evolving interpretations of FIN 46 and the proposed amendment, which the Board approved for exposure on September 17th. Our views are explained further below. In addition, as we agreed during our liaison meeting on September 5th, we have included in an attachment to this response certain interpretive issues related to FIN 46 that merit the Board's consideration. We believe that these issues underscore the need for a deferral.

We believe that most companies understand that FIN 46 does not apply solely to SPEs. We know that it applies to a broad array of entities from joint ventures and partnerships to corporations with traditional voting rights. If these entities are thinly capitalized and the voting interests do not have substantive decision-making rights, we know that they can be variable interest entities, even though they may be operating companies. What has not been well understood or generally accepted by practitioners are emerging interpretations that relate to both the scope and requirements of FIN 46. Certain of these interpretations expand the effect of FIN 46 beyond consolidation of entities that were designed to keep debt or losses out of the creator's financial statements. The affected arrangements include equity method investments in suppliers, true joint ventures and partnerships that are sufficiently capitalized (in some cases, all-equity financed) and whose equity owners do exercise control over its activities (i.e., substantive decision-making is occurring at the ownership level). The more complex criteria of FIN 46 – criteria that are the subject of continuing debates – have the potential to require consolidation of

a new genre of VIEs. This broader definition of variable interest entities has the potential to adversely affect the consistent application of FIN 46 and thereby comparability of financial statements. In the present environment, the credibility of all stakeholders in financial reporting requires that we carefully consider and agree on the implications of these interpretations on the scope of the standard and allow companies time to reassess their inventory of consolidated and unconsolidated entities in accordance with whatever consensus emerges from that debate.

Towards that end, the FRC recommends the following with respect to the proposed FSP:

- The proposed deferral should apply to all entities that meet the first three conditions proposed in FSP 46-e, regardless of whether the determination of the entity as a VIE has been completed. We believe the fourth condition should be removed for three reasons: (1) we do not believe that companies that did a better job of implementing FIN 46 should be disadvantaged relative to those who have taken a more casual approach, (2) accounting firms have differing views on which of these non-SPE arrangements should be consolidated and it is possible that preliminary conclusions that an entity is a VIE may be overturned by subsequent research and consensus among the experts, and (3) applying to some, but not all, entities within this category will produce significant inconsistencies among and within reporting companies.

- The Board should consider whether the deferral should be for a period longer than three months to allow companies sufficient time to reassess their inventory of entities in accordance with the latest interpretations of the standard. Each time a change is made to the FIN 46 application guidance, either formally (as the Board did through a proposed amendment two weeks ago) or informally (as accounting firms and companies document what they have learned through application of the standard to particular fact patterns), companies are required to go back and reexamine their previous analyses. This usually will require accountants and attorneys to reevaluate the relevant governing documents to see whether they contain provisions affected by an emerging interpretation. Such research takes time and considerable effort.

- The Board should delete the proposed disclosure called for in paragraphs (a) through (d). Companies are already required to provide the information called for in paragraphs (b) and (c) by paragraph 26 of FIN 46. We do not believe the information called for by paragraph (a) would be relevant to users as the number of entities to which the interpretation has not been applied bears no correlation to the potential for losses by the reporting entity.

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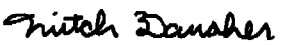
We appreciate your consideration of our comments. Please feel free to contact me at (203) 373-3563 if you have any questions regarding this letter or the issues listed in the attachment.

Sincerely,



Mitchell A. Danaher
Chair, Financial Reporting Committee
Institute of Management Accountants

At our September 5th liaison meeting with the Board, the FRC agreed to provide additional information on issues we are addressing with respect to implementation of FIN 46. These have been divided into two groups: (1) issues that we believe require resolution to assure a consistent application of FIN 46, and (2) issues related to proposed or expected FSPs and technical corrections to FIN 46.

Issues relating to a Consistent Application of the Standard

Issue 1: Franchisors and similar business relationships

Assume for purposes of this issue that a party (the "Franchisee") creates newly formed entity (Entity A) to acquire a franchise agreement from a franchisor. Entity A has been adequately capitalized. While most practitioners understand that entities that are either thinly capitalized or obtain the majority of their financing from the franchisor could be VIEs subject to consolidation under FIN 46, we believe that many accountants and preparers of financial statements have yet to comprehend the full effect that FIN 46 may have in this area. For example, franchisors typically have significance influence over their franchisees and the related Entity A. A franchisor may have the right to approve site location, asset acquisitions, asset disposition, store layout, services and products offered by the franchisee, prices charged for such services and products, store hours, etc. In addition, many franchise agreements restrict the Franchisee from selling or disposing of its franchise agreement without approval of the franchisor. As a result, after executing the franchise agreement, Franchisee has unilateral control over the day-to-day operations of the store location and the power to initiate and propose other actions subject to franchisor approval. If the franchisor owns no equity in Entity A, the rights of the franchisor to approve significant actions of Entity A could be viewed as precluding the Franchise (i.e., the holders of Entity A's equity) from controlling Entity A's activities, which would cause the arrangement to meet the condition in paragraph 5(b)(1) of FIN 46. This condition, when coupled with the restrictions over the Franchisee's ability to sell its franchise agreement without the approval of the franchisor, would lead to the conclusion that the Franchisee would be a related party of the franchisor pursuant to paragraph 16(d)(1) of FIN 46 and thus require consolidation of Entity A by the franchisor under either paragraph 17(a) or 17(b), even though the equity investment made by the Franchisee in Entity A is sufficient to absorb Entity A's expected losses, if they occur.

A literal reading of paragraph 5(b)(1) of FIN 46 may be interpreted to require that a franchise be included within FIN 46's scope when the franchisor is granted participating rights but does not hold an equity interest. We question whether this reading is reflective of the Board's intent. The Committee does not agree that the above fact pattern should result in consolidation of the franchisee. We believe that if the owners of a business have substantive equity at risk, and as part of a commercial arrangement with a substantive counterparty they agree to various restrictions in exchange for valuable rights, then they still have the normal rights of equity owners and paragraph 5(b) does not apply. So, if in exchange for exclusive franchise rights in a territory (or exclusive distributorship or dealership or supply rights in other industries), the owners agree to reasonable restrictions imposed by the franchisor (or manufacturer) for valid business reasons, the owners would still be deemed to have the normal rights of equity owners and the franchisee/distributor/dealer/supplier would not be a VIE. If the Board did not intend for

FIN 46 to apply to these arrangements, we ask that the Interpretation be amended to clarify how the Board intended it to be applied.

Issue 2: Allocation of losses to noncontrolling interest holders.

Other than upon the initial consolidation of a VIE, FIN 46 provides no specific guidance for consolidation of a VIE. Upon initial consolidation, paragraph 21 of FIN 46 requires that the excess of (a) the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests over (b) the fair value of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the variable interest entity be reported as an extraordinary loss in the period in which the enterprise becomes the primary beneficiary. We have two questions related to the consolidation of a VIE. First, upon initial consolidation of a VIE, should the primary beneficiary allocate a portion of the extraordinary loss to the noncontrolling interest holders? A similar issue arises in the day 2 accounting. If a VIE has losses that will not be absorbed by the primary beneficiary, but will be absorbed by other holders of variable interests, should those losses be allocated to the other variable interest holders in consolidation?

To illustrate our two questions, assume the following two fact patterns:

Issue 2(a)- Assume Investor A purchases a 20% equity interest in Entity B for $10 cash. The implied fair value of Entity B is $50 ($10 divided by 20%). In the historical stand alone financial statements of Entity B, there is preexisting goodwill of $40, fixed assets of $60, debt of $70 and $30 of pre-investment equity. Assume that the carrying values of the fixed assets and debt approximate their fair values, implying that the fair value of the goodwill is $60. Further assume that it was determined that Entity B is a variable interest entity because of paragraph 5(b)(1) problems, and that Investor A (the manager of Entity B) is the primary beneficiary. In initial consolidation, Investor A would record on its balance sheet $60 of fixed assets, $70 of debt and $40 of noncontrolling (minority) interest (the implied fair value of minority interest is 80% multiplied by $50). The differential of $60 would be recorded as an extraordinary loss during the period of initial consolidation. Should any portion of the $60 extraordinary loss be allocated to the noncontrolling interest holder upon initial consolidation?

Paragraphs 18 and 21 of FIN 46 require that the noncontrolling interests initially be recorded at fair value and the primary beneficiary recognize an extraordinary loss for any goodwill resulting from consolidating the VIE. Paragraph 18 clearly states "the primary beneficiary of a variable interest entity shall initially measure the assets, liabilities, and noncontrolling interests of the newly consolidated entity at their fair values at the date the enterprise first becomes the primary beneficiary." There are different views regarding whether paragraph 18 requires the goodwill to be expensed before measuring the assets, liabilities, and noncontrolling interests at their fair values, or if the expense is recognized after measuring the assets, liabilities, and noncontrolling interests at their fair values.

If the expense for goodwill was required to be recognized before measuring the assets, liabilities, and noncontrolling interests at their fair values, then allocating any portion of the extraordinary loss to the noncontrolling interest holders would result in recording the noncontrolling interest at

less than its fair value at the date the enterprise first becomes the primary beneficiary. If the expense for goodwill was required to be recognized after the initial measurement of the fair values of the assets, liabilities, and noncontrolling interests of the VIE, then allocation of the loss from writing off any goodwill may be appropriate. We seek confirmation as to which interpretation is reflective of the Board's intent and suggest the issuance of an FSP to communicate the appropriate interpretation.

Issue 2(b) – Assume that Entity A is a variable interest entity that is consolidated by a senior lender. The Company is capitalized with equity of $5, subordinated debt of $400 and senior debt of $1,000. The senior lender, holder of the senior debt, in its consolidated financial statements, allocates losses of Entity A to the equity holder (one of the noncontrolling interests) until it is reduced to $0. The question becomes, should any further losses of Entity A be allocated to the other noncontrolling interest holder (subordinated lender), or is the senior lender prohibited from allocating losses to the subordinated lender because doing so would represent an extinguishment of debt, even though the debt has not met the requirements for extinguishment under FAS 140?

Given the current authoritative guidance, some accountants may allocate losses to the equity holders until their equity interests have been reduced to zero and record all further losses against the earnings of the primary beneficiary, even though other variable interest holders (which hold debt instruments) would absorb the economic losses of the VIE and the primary beneficiary is not committed to support the VIE's operations. Other accountants question the logic of this answer and believe that for purposes of consolidation, all variable interests (even debt instruments) in a VIE should be deemed "equity" and accounted for in a manner similar to equity interests in an entity that is consolidated under the control model of ARB 51. We seek the views of the FASB staff on this issue and whether it would be acceptable under GAAP to view variable interests in a VIE in a manner similar to equity interests in a normal consolidation model and thus gains and losses would be allocated to all variable interests under an appropriate method, such as hypothetical liquidation at book value. If this interpretation is incorrect, we request the views of the FASB staff regarding the appropriate interpretation.

In a related matter, FIN 46 magnifies an issue relating to the consolidation of certain limited life entities and the related accounting for the noncontrolling interest in partnerships, joint ventures, and similar limited life entities. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* requires most equity instruments held by noncontrolling equity holders in these entities to be accounted for as debt and measured at fair value in the consolidated financial statements. FIN 46 gives no special consolidation guidance regarding this issue and thus noncontrolling equity interests in many limited life entities will be required to be accounted for as debt. We believe that additional guidance, or an amendment to FIN 46 or FASB Statement No. 150 is necessary.

Issue 3: Bankruptcy

Certain members of the accounting profession have obtained informal guidance that an entity in Chapter 11 or 7 Bankruptcy would not be subject to consolidation under FIN 46 by a variable interest holder during the period that the entity is in bankruptcy. We note that emergence from bankruptcy would be a triggering event pursuant to paragraph 7 of FIN 46 and would appear to require an evaluation under FIN 46 of whether the entity is a VIE at that time. We seek confirmation on these views from the FASB staff.

In this regard, we would note that it is possible that a pre-existing VIE that was previously consolidated under FIN 46 may be deconsolidated by the parent company upon entering bankruptcy and during the period it is in bankruptcy. We assume that some form of triggering event occurred at that date and some accountants believe that when an entity enters bankruptcy, its contractual arrangements are effectively modified, leading to a conclusion that a reassessment event under paragraph 7 of FIN 46 has occurred. Because the controlling shareholders may be precluded from exercising control over certain of the entity's activities (because certain decisions require court approval), the entity in bankruptcy may be a VIE. In addition, an enterprise may acquire variable interests (such as public bonds at discounted prices) on the open market while an entity is in bankruptcy, expecting to obtain a majority of the entity's common stock when it emerges from bankruptcy and not be required to consolidate the entity under FIN 46 until it emerges from bankruptcy. In the event the staff concludes that FIN 46 applies, even to an entity in bankruptcy, we note that if the entity in bankruptcy is deemed to be a VIE, it may be difficult at times (if not impossible) for an investor to obtain the information necessary to determine the bankrupt entity's expected losses or determine if it is the bankrupt entity's primary beneficiary. In addition, audited financial information in order to perform the consolidation will likely not be available.

Issue 4: Treatment of fees paid to equity holders (but not decision makers)

Paragraph 5(a)(3) states that fees paid to equity investors should be excluded from the amounts included as equity that is "at risk" for purposes of determining whether an entity's total equity investment at risk is sufficient. For example, if Investors A and B each contribute $50 into an entity and Investor A receives a fee of $20, Investor A's equity investment at risk would be reduced to $30. In certain circumstances, an equity investor may contract to provide substantive services (integral to the activities of the entity) to the entity subsequent to its involvement date at market rates or at rates above or below market for those services.

Some accountants believe that all fees paid to equity investors should be evaluated individually to determine whether such fees reduce the investment made by the investors. These accountants believe that the intent of the language in paragraph 5(a)(3) was to prevent an equity investor who has contributed monies (or other assets) in return for its equity interests from reducing its risk by receiving a return of capital disguised as a "fee." Consideration should therefore be given to whether any of the fees represent in substance a return of capital to the investor. If the fees, in substance, reduce the investor's equity at risk, they would reduce their equity investment by the amount of the fees. Conversely, if the fees represent market compensation for services, the fees would not be considered in applying paragraph 5(a).

We believe fees paid to equity investors should be assessed on a case-by-case basis in order to determine whether such fees in substance should reduce the equity investor's total equity investment at risk. If this interpretation is incorrect, for example if all fees paid to equity investors (who are non-decision makers) should reduce the equity investment at risk, we request the views of the FASB staff regarding the appropriate interpretation.

Issue 5: Treatment of "sweat" equity and similar interests at the occurrence of a triggering event

Upon a triggering event for reconsideration under paragraph 7, amounts that were previously precluded from the total equity investment at risk may have appreciated in value. In other words, a variable interest that was not considered at risk originally (for example "sweat" equity) may have appreciated in value and become equity at risk in the entity. In this regard, paragraph B2 states, "Equity investments in a variable interest entity are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 5 of this interpretation.)" Some accountants believe that the occurrence of a triggering event does not change the initial characterization of the variable interest, thus they should be excluded from the determination of total equity investment at risk at the reconsideration date as well.

Other accountants believe that since the fair value of the variable interest changes with changes in the entity's net asset value, the holder of this investment has a variable interest that is at risk in the entity. Although the investment must be excluded at the initial determination of the total equity investment at risk in accordance with paragraph 5(a)(3), as the value of the investment appreciates the holder of the investment accumulates equity that is truly at risk. Therefore, at the occurrence of a triggering event that requires reconsideration, the fair value of all equity investments should be considered in determining the total equity investment at risk in the entity.

The FASB staff has previously indicated that, upon the occurrence of a reconsideration event, the fair value of the possible VIE's equity would be compared to its expected losses, determined as of the date of the reconsideration event. However, it is not clear that the FASB staff has focused on this issue. We believe it would be appropriate to include the fair value of each variable interest holder's equity investment as equity at risk at each reconsideration event, notwithstanding its previous treatment in the equity at risk test.

Issues related to proposed FSPs and technical corrections

We understand that there are a number of proposed FSPs and technical corrections being contemplated by the FASB staff and the Board. We further understand that one of those proposed FSPs will relate to how an enterprise should determine which parties absorb a majority of the expected losses and expected residual returns.

With respect to how an enterprise should determine which party absorbs a majority of the expected losses and/or expected residual returns of a VIE, we have an additional question related to this proposed FSP. The question relates to how an option premium affects the determination of which party absorbs a majority of a VIE's expected losses and expected residual returns.

For example, assume that Investor A and Investor B own 10% and 90% of the common stock of

Entity C. Entity C was capitalized solely with equity ($10 from Investor A and $90 from Investor B). Investor A writes an option allowing Investor B to sell its common stock to Investor A for $50. Investor B pays Investor A an $18 premium for that option. At issue in determining the Investors' shares of Entity C's expected losses is whether or not it would be appropriate for the Investors to consider the $18 premium. Some accountants believe that Investor A does not share in Entity C's expected losses with respect to the put until those losses exceed the $18 premium. Others would not consider the premium in the evaluation of Investor A's share of expected losses. Similar questions arise with respect to Investor B. We seek the views of the FASB staff on this issue and whether it is appropriate to consider the premium in the evaluation of each investor's share of the entity's expected losses.