# McGladrey & Pullen

Certified Public Accountants

Letter of Comment No: 15 File Reference: 1082-300 Date Received: 12/03/03

McGladrey & Pullen, LLP Third Floor 3600 West 80th Street Bloomington, MN 55431 O 952-835-9930 F 952-921-7702

Nov. 25, 2003

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

RE: Proposed Interpretation: Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46

Dear Mr. Smith:

We are pleased to submit our comments on the Proposed Interpretation: Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46. We generally support the Proposed Interpretation. Our comments included in this letter are listed in three categories: Items Addressed in the Proposed Interpretation, Items Not Addressed by the Proposed Interpretation, and Other Items. Many of our comments are based on inquiries we have received related to privately owned mid-sized and smaller businesses. We do not believe that Interpretation No. 46 provisions are well understood by these businesses and their financial statement preparers, users or auditors. We understand that the Board took into consideration some of the consequences of Interpretation No. 46 to private mid-sized businesses when Interpretation No. 46 was issued, however, we believe some clarification of the language and intent of Interpretation No. 46 in some situations are necessary.

## Category One: Items Addressed by the Proposed Interpretation

Proposed Interpretation Paragraph 3c:

We agree with the addition of subparagraph g. to paragraph 4 of Interpretation No. 46, which would provide a scope exception if a preparer is unable to obtain the information necessary to make the determinations to apply Interpretation No. 46. However, we believe the scope exception conditions should be expanded to cover situations where the information has been obtained to make the determination, the preparer has determined that consolidation or disclosure is required under Interpretation No. 46, but the preparer has no legal right and cannot obtain the permission from the variable interest entity (VIE) to disclose financial and other information about the VIE. We believe this situation will occur in practice and will place preparers in the position of either not complying with generally accepted accounting principles or violating either a contract or law in the disclosure of information required by Interpretation No. 46.

Proposed Interpretation Paragraph 19:

We don't agree that paragraphs B1-B10 of Interpretation No. 46 should be deleted unless the replacement examples are included with the Proposed Interpretation. The concepts of Interpretation No. 46 are difficult to apply. The examples are necessary to confirm that preparers understand the concepts. If these examples are deleted, we urge the Board to direct the staff to prepare revised examples as soon as possible for exposure in an FSP.

Proposed Interpretation Paragraphs 5 and 10:

We agree with replacement wording to paragraphs 7 and 15 of Interpretation No. 46. However, we believe the replacement wording should be expanded to include reference to the situation where the debt may be renegotiated and additional guarantees are obtained by the lender from the reporting entity or other parties. It is unclear if the Board intends that all consequences of operating losses and resulting modifications to the entity's debts be ignored for reevaluation purposes, or only those affecting agreements between the entity and its creditors.

Proposed Interpretation Paragraph 6:

We don't agree with the changes proposed to paragraph 8 of Interpretation No. 46 for the following reasons:

- Paragraph 8 is describing what is to be included in a variable interest entity's expected losses and expected residual returns calculation. We understand this calculation is necessary in many cases to determine if an entity is a variable interest entity (VIE). We also understand that the first step in applying Interpretation No. 46 is to determine if an entity is a variable interest entity. Paragraph 8(a) suggests that before the expected loss calculations can be made, the variable interests need to be identified and the determination made about what their long-term returns are. We are unclear which steps come first.
- We are unclear if the Interpretation No. 46 illustrations in Appendix A and FSP 46-5 are still consistent with this revised description. We suggest the illustrations be updated to be consistent with this revision.
- The wording of the revisions to paragraph 8(a) leaves many questions. What is the horizon for "long-term"? Is it the duration of whatever variable interests exists? Does the term "long-term returm" contemplate both returns and exposures? If the variable interest exposes the reporting entity to only potential losses, such as a guarantee, and no residual returns, should this component of the expected losses calculation be ignored? We suggest paragraph 8(a) be expanded to more completely describe what is intended, and the illustrations in Appendix A and FSP 46-5 modified to conform.

#### Category Two: Items Not Addressed by the Proposed Interpretation

Interpretation No. 46, Paragraph 3:

We understand from discussions with the staff that individuals and sole proprietors are not legal entities and therefore not within the scope of Interpretation No. 46. We suggest adding a sentence to paragraph 3 to make this clear.

The examples provided of entities include "grantor trusts and other trusts." A common arrangement among closely held businesses is to place certain assets into family trusts. We suggest the Board clarify its intent with regard to family trusts by specifying their inclusion or exclusion.

Interpretation No. 46, Paragraph 5(a) (3):

This paragraph discusses that the total equity investment at risk does not include amounts provided to the equity investor directly or indirectly by the entity or other parties involved with the entity. What is unclear is what time frame should be considered when evaluating the source of funds used by the equity investor. For example, an owner of a closely held business may receive a distribution from an entity in 20X1. The entity may be a tax pass-through entity that routinely makes distributions to its owners of some or all of its income on which the owners will be taxed. In 20X3, the owner forms an entity to acquire real estate to be used by the reporting entity. The owner does not have any other business interests and is not otherwise independently wealthy from inheritances, etc. The funds used for the initial equity may be viewed to have come indirectly from a distribution in a prior year, before the formation of the

real estate entity was even contemplated. In this situation, we believe the fact that the reporting entity provides the owner with substantially all sources of funds (both distributions and compensation), should not be viewed as "tainting" all the equity placed into an entity being evaluated as a VIE. However, if the source of equity funds came from distribution that was not consistent with the pattern of distributions or was made in contemplation of an equity contribution to a variable interest entity, that should be viewed as "tainted" for inclusion in the initial equity considerations. We suggest that additional language be added to paragraph 5(a)(3) that would provide guidance to the "indirectly" concept.

### FSP FIN 46-4

FIN 46-4 provides guidance in situations where it is not practicable to obtain all of the information necessary to evaluate the determination of whether an entity is a variable interest entity at the date the enterprise became involved with the entity. The conclusions of the FSP include that the primary beneficiary should measure the assets and liabilities at fair value at the time Interpretation No. 46 is first applied. In many closely held businesses, the historical cost information about the assets and liabilities is available, but the expected losses calculations were never considered or performed, so the calculations must be performed at the time the Interpretation is first applied. There are two topics we believe require further consideration:

- A common consideration with closely held businesses (as well any many other entities) is the terms of a lease with a related party VIE. Paragraph B10 states "Long-term leases with a variable interest entity are not considered in determining the primary beneficiary of that variable interest entity if the lease terms are consistent with market rates at the inception of the lease and the lease does not include a residual value guarantee or similar feature." For leases that existed at the issuance date of Interpretation No. 46, it may not be practicable to determine if the lease terms were consistent with market rates at lease inception. If the lease terms were evaluated at the time the Interpretation is first applied, they would not likely be consistent with current market terms. This may result in few leases that existed at the issuance date of Interpretation No. 46 being "scoped out" according the B10 and therefore unintended identification of these leases as variable interests and inappropriate identification of primary beneficiaries. We believe additional guidance for these situations should be provided.
- □ Following FSP 46-4, the primary beneficiary would consolidate the VIE's assets and liabilities at their fair values at the date of application. However, this seems to contradict paragraph 19 which states "The primary beneficiary of a variable interest entity that is under common control with the primary beneficiary shall initially measure the assets liabilities, and noncontrolling interests of the variable interest entity at the amounts they are carried in the accounts of the enterprise that controls the variable interest entity." We suggest clarifying the initial application for situations where the VIE and the primary beneficiary are under common control and some part of the initial application is based on determinations/calculations done at the date of initial application.

## Category Three: Other Items

#### Deferral of effective date

We agree with the views expressed under "Alternative Views," paragraphs A43 to A46 and support a further deferral of the effective date for both public and nonpublic entities. We believe significant diversity in practice will immediately evolve if the existing effective dates stand without further guidance in applying many provisions of Interpretation No. 46.

# Language of Interpretation No. 46

Much of Interpretation No. 46 is written with terms used inconsistently from how accountants and auditors typically use them. We appreciate the efforts and goals of the Board to issue standards that articulate a principle clearly. However, we don't believe Interpretation No. 46 will achieve the goals of the Board unless the language is made consistent and procedures are clarified. We suggest the Board look again at the words used in the Interpretation and Proposed Amendment.

## Codification of all FSPs

We believe all FSPs that have been issued should be incorporated into this Proposed Amendment. We encourage the Board and staff to consider efficient and effective ways to incorporate the existing FSPs and all future FSPs into the standards in a manner that will be easy to retrieve, understand and apply.

If you have any questions regarding our comments, please contact Jay Hanson at (952) 921-7785 or Ray Krause at (952) 921-7765.

Sincerely,

McGladrey & Pullen, LLP

McGladry & Pullen, LLP