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

Re: October 31, 2003 Exposure Draft (ED) of a Proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46* [File Reference 1082-300]

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 above-referenced ED and is providing the following comments for your consideration.

GENERAL COMMENTS

Concerns with the scope and clarity of the proposed interpretation, coupled with some continuing issues previously expressed to the Board and staff verbally and through comment letters, precipitate TIC's call once again for

- An exemption from the consolidation provisions of FIN 46, and a return to optional combination under ARB 51, for single-owner, commonly controlled entities, and
- Additional time for nonpublic entities to implement the remaining provisions of FIN 46 and its related pronouncements.

TIC believes the evidence supporting our position is overwhelming.

Following the issuance of FIN 46, many implementation issues surfaced and remain unresolved today. The major ones are:

- Pervasive lack of understanding (and misunderstanding) of basic principles underlying FIN 46 due to the complexity of the topic, the lack of implementation guidance and the writing style employed in the standard.
- Lack of consensus concerning basic application issues,

- A conservative interpretation of the standards by some (especially "Big-4" firms) that has led to apparently inappropriate consolidation of entities that do not qualify as VIE's, and
- Emergence of unintended consequences that are creating significant implementation issues.
- Keeping up with the numerous additional proposals and pronouncements that have or will be issued.

New guidance is now being issued in a piecemeal fashion, yet many more issues remain. Although TIC appreciates the FASB's efforts in issuing the additional interpretations, more guidance will be necessary as practitioners and preparers begin to improve their understanding of the standard. The modifications in this ED are intended to clarify many of the detailed rules in FIN 46, but it has only been partially successful in doing so.

TIC encourages the FASB to defer the effective date for all aspects (recognition, measurement and disclosure) of the VIE consolidation standards for nonpublic companies until years beginning after June 15, 2005 to allow time for:

- the FASB to resolve emerging issues in this area,
- the development of reliable implementation guidance for the issues faced by our constituency, and
- the development of adequate learning materials to educate our constituency on the implementation of this standard.

We request that the deferral be announced as soon as possible before year-end work begins on December 31 financial statements.

TIC has found that the existing deferrals in FIN 46 are not enough. Although nonpublic entities do not have to consolidate qualified VIE's created before February 1, 2003 until the end of the first annual reporting period beginning after June 15, 2003, none of the additional guidance has provided any relief from the:

- disclosure provisions of the standard, which are effective immediately if the entity believes it is reasonably possible that the entity will consolidate or disclose information about a VIE (regardless of when the VIE was created) when FIN 46 becomes effective; or
- consolidation provisions of the standard for VIE's created on or after February 1, 2003.

These provisions effectively require entities to apply the process in FIN 46 for determining when an entity is a VIE or when it may be a primary beneficiary of a VIE. As a result, the transitional guidance has provided nonpublic companies with very little relief from the immediate burdens of FIN 46.

In addition, TIC has a number of specific concerns regarding the above-mentioned ED:

- The discussion on related parties fails to address important issues for nonpublic companies that arise when VIE's are established that are under common control.
- The scope exception detailed in paragraph 4(g) may not be practicable to apply.
- The discussion of de facto agency and de facto principal is unclear.
- The guidance in the ED does not sufficiently clarify the methodology for determining future "expected losses" and "residual returns" and does not mitigate the audit issues that arise in testing the probabilities surrounding the expected losses and returns.
- The presentation of minority interests in consolidation is unclear, especially when the VIE is or becomes profitable.

Our comments below will illustrate our specific concerns regarding FIN 46 and the ED to modify FIN 46.

SPECIFIC COMMENTS

TIC members who have started implementing FIN 46 with their clients are encountering numerous problems that warrant delaying the effective date for all aspects of the VIE consolidation standards. The examples below attempt to highlight the confusion, controversy, unintended consequences and implementation difficulties the committee members have encountered in order to encourage the FASB to take the time to address within the authoritative standards these important, common transaction types.

Since the FASB did not defer all of the provisions of FIN 46, nonpublic entities are struggling to comply with the disclosure requirements in paragraph 26 of FIN 46 and the consolidation rules for VIE's created after January 31, 2003 (paragraph 27). One of the biggest problems in complying with the disclosures required by paragraph 26 is that it is often very difficult to obtain needed information about some of the entities that are potential VIE's, especially those that are currently having financial difficulties. For example, FIN 46 requires consolidation of certain brother/sister entities which previously were not consolidated. Many of these entities did not require the preparation of external financial statements in the past. Accordingly, obtaining detailed financial information necessary to evaluate whether these entities are VIE's and to consolidate them, if necessary, will require time.

Most of the issues encountered by TIC members relate to VIE affiliates of entities under common control. TIC believes that consolidating commonly controlled entities makes little sense in view of the inherent control exercisable by the common shareholder.

Conceptually, TIC does not understand why a "virtual entity" (i.e., an individual who owns real estate and the related nonrecourse debt personally rather than through an entity) is scoped out of FIN 46, while real estate held within an entity controlled by the same individual would be considered a VIE in most cases and would have to be consolidated with its primary beneficiary. In TIC's view, using different accounting principles for essentially the same transaction produces an artificially inconsistent result that is not representationally faithful to the substance of the transaction. TIC would

maintain that if consolidation doesn't make sense for an owner's personal assets, then consolidation of a shell corporation used to hold those assets is likewise not a meaningful presentation for financial statement users.

TIC has found a point of controversy concerning the frequently encountered situation where a sole shareholder owns a real estate leasing entity that leases only to an operating company that he/she also owns. If the VIE's only commitment is a lease with a Primary Beneficiary and the operating company has not guaranteed the real estate entity's debt, some believe the real estate company is a VIE requiring consolidation and others believe it isn't. TIC believes the real estate entity should not be a VIE. If the real estate entity becomes bankrupt, the operating company would not absorb the majority of the downside risk—rather, that burden would fall on the sole owner. Similarly, a common owner with significant wealth who guarantees the debt of the real estate entity does not qualify as the primary beneficiary under FIN 46. Instead, the guarantee is attributed to the operating entity, even though the risks and rewards may belong solely to the individual owner.

Furthermore, we believe a consolidation of the VIE by the operating company may cause their financial statements to be misleading to users, as it would include assets (with potential fair value equity) that are not available as collateral. The operating company has no legal claim or right to either sell or borrow against the assets of the VIE. A lease with no other commitments by the operating company should not cause it to consolidate the VIE.

To illustrate this issue, TIC presents the following example. One person has a 100% equity interest in four corporations that each run restaurant franchises in four different cities and a 100% interest in a fifth company that owns all of the real estate used by each restaurant. In this example, it is clear that the true primary beneficiary is the individual owner because he clearly owns 100% of the stock in all of the corporations. In addition, many of such real estate partnerships have a single debt instrument financing all of the properties. Guidance is necessary to address situations when the property qualifies as a "silo," but the related debt does not qualify as a "silo."

Other TIC members have many clients across a number of industries (e.g., auto dealerships and restaurant chains) that structure their holdings in this manner. One single owner creates a new entity for every new venture established. For example, a sole owner of an auto dealership decides to open up a new dealership in a different town. The owner contributes minimal amounts personally to the new dealership. The auto manufacturer operates the floor plan. All other operations are financed through the existing dealership, which provides operating funding via affiliate loans to the new venture. All significant losses are funded by the existing dealership. The new company is based on the financial stability of existing ones. Under FIN 46, the pre-existing dealership is deemed to own a VIE, which generally would be consolidated. This situation is further complicated by the existence of cross guarantees which may require consolidation even if direct financing is not provided.

In the restaurant world, having to consolidate these entities would change the way the owners do business. Normally, they just move cash around at will.

The common characteristics of most of these examples are:

- Each entity created by the owner is established for a specified purpose.
- The owner can decide to switch risk among the entities whenever and however he/she chooses. Sometimes these entities go back to the owner or the entity becomes profitable and the VIE's debt is paid off. The primary risk taker has now switched.

Under FIN 46, all multiple entity relationships need to be individually analyzed for consolidation. However, TIC finds that this consolidation exercise will not provide the users of these financial statements (lenders, bonding companies, etc.) with decision-useful information and will be cost prohibitive for the client.

As another example, TIC members have common control owners with numerous (as many as 60) separate companies. If the bank has loaned money to Company A, the lender requires separate, not consolidated, financial statements for Company A The lender's request will then trigger the need for parent company only financial statements, which are not permissible under existing GAAP, unless consolidating financial statements are presented [Accounting Research Bulletin No. 51, paragraph 24]. If Company A is negotiating with a prospective lender, rather than an existing one, the practitioner would not even be able to report on the entity using special purpose financial presentation standards [AICPA *Professional Standards*, Volume 1, Section AU 623.22+, "Special Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions."] These restrictions have the effect of forcing the client to pay for more services than are necessary to meet users' needs. Small companies do not understand and often cannot afford this needless expense.

Another concern for companies that are under the control of a sole owner is that the primary beneficiary of a VIE may frequently be forced to reconsider the need to consolidate one or more VIE's, in accordance with paragraph 15 of the ED, as the owner changes the contractual arrangements or structure of the entities and shifts debt among entities. If this is the FASB's intention, expanded guidance will be needed for reconsolidation and deconsolidation.

TIC believes the arguments used in FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of* Others, paragraph A24, for not recording separate company liabilities for guarantees issued among corporations under common control may also be justification for exempting many commonly controlled entities from consolidation. If a VIE and primary beneficiary are all part of a controlled group in the hands of one owner, there are no real arm's length transactions between the parties. The owner has complete control over the resources and obligations of each entity. Furthermore, existing related party disclosure rules would provide any necessary disclosures in separate company financial statements.

If the FASB decides not to exempt commonly controlled entities from the FIN 46 rules, clear guidance must be provided in the authoritative standards with accompanying examples to help preparers and practitioners efficiently sort through the maze of entities that must be considered for consolidation (and potentially reconsolidation). Otherwise, comparability within this segment will never be achieved. It is important for the Board to remember that FIN 46 affects compilation and review clients as well as audit clients, so clear, complete guidance, as well as additional implementation time, is especially important.

Paragraph 2c of the proposed interpretation to FIN 46 (which amends paragraph 4g of FIN 46) provides for situations where consolidation may not be required. The guidance presented will not be practical in many cases. The phrase "after making an exhaustive effort" will be difficult to interpret in practice. For example, if individual direct ownership rests with an unrelated individual, does the owner's refusal to provide adequate financial information required to consolidate qualify as an "exhaustive effort"? This situation is expected to be common where there is a guarantee of operating results or the provision of operating capital by a non-financial institution (i.e. venture capital firm).

Despite the issuance of this ED, TIC members continue to have difficulty understanding the theory behind and appropriate calculation of "expected losses" discussed in paragraph 5(b) of FIN 46. For example, TIC members have found that "expected losses" have been difficult to ascertain for start-up ventures that (potentially) qualify as VIE's in a number of situations. Most owners believe their venture will provide sufficient returns. The probability of these returns will be impossible to predict. Appendix A to FIN 46 indicates that enterprises "...should use their best efforts..." to achieve the objectives of paragraphs 5a and 5b when probabilities cannot be estimated. TIC is uncertain what this means and believes that any amount labeled as "expected losses" will present a valuation issue for auditors.

TIC understands the FASB staff will be working on a replacement for Appendix B, *Variable Interests*, to better explain this concept. TIC encourages that effort to proceed as soon as possible because lack of a comprehensive explanation of the term hinders implementation of the standard.

TIC has a growing concern regarding the presentation of minority interests in the consolidated financial statements and believes authoritative guidance is needed in the standards on this issue. When TIC members have attempted to apply basic consolidation procedures to minority interests, it is unclear whether a separate minority interest line is needed, especially if past losses of the VIE turn to profits.

TIC has also found that transitional guidance is needed related to consolidating related party VIE's at fair value. Some believe you don't have to go all the way back to the inception of the VIE and others believe you do. Paragraph 28 of FIN 46 states that "carrying amount" refers to the amounts that would have been carried in the consolidation had the interpretation been effective when the enterprise first met the

conditions. Commonly, this is when the entity was first created. As a result, significant time may be necessary to investigate prior year financial records.

The ED introduced new concepts relating to de facto agents and de facto principals. These terms should be defined and more adequately explained, including interpretive examples.

In summary, many practitioners and their clients have not fully grasped the overwhelming impact of this interpretation. As such, TIC believes that significant unintended errors in financial reporting are quite likely. In addition, since VIE consolidations may result in reductions in equity, debt covenant violations, violations in bonding requirements and violations in minimum capital requirements will occur. This could have a detrimental impact on businesses without revisions in debt agreements, bonding agreements and state statutes. All of these take time.

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