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Director of Technical Application and Implementation Activities
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Financial Accounting Standards Board
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P.O. Box 5116
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Letter of Comment No: 97
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Dear Mr. Smith:

BDO Seidman, LLP appreciates the opportunity to offer comments on the Exposure Draft (ED), *Consolidation of Variable Interest Entities—a modification of FASB Interpretation No. 46*. A summary of our major comments is as follows:

- The FASB should defer the effective date of Interpretation 46 for all entities. The new effective date should allow a reasonable period to implement Interpretation 46 after the completion of this modification and all of the pending FASB Staff Positions.
- The FASB should amend the definition of a variable interest entity in paragraph 5b of Interpretation 46 and the treatment of fees to decision makers in paragraph 8 of Interpretation 46.
- The FASB should not alter the first sentence of paragraph 5a to include subordinated financial support provided by equity holders.
- While we generally agree with the proposed changes to paragraphs 7 and 15, we suggest a further change to paragraph 7 related to troubled debt restructurings.

Deferral of Effective Date

The effective date for all of Interpretation 46 should be deferred until the FASB can address the implementation issues in a comprehensive way, allowing enough time for entities to adopt and apply Interpretation 46 in an organized way. Right now, calendar-year public companies are supposed to adopt Interpretation 46 at the end of the fourth quarter, even though:

1. This modification won't be issued until mid-December at best, and the modification deals with only some of the significant implementation issues.

2. One proposed FASB Staff Position (FSP FIN 46-f) has been released for public comment and similarly is expected to be issued in final form in December.
3. We understand that another proposed FSP dealing with several significant implementation issues is imminent, but it probably will not be issued in final form until early 2004.
4. We understand that the redraft of Appendix B of Interpretation 46 is being handled in a third proposed FSP that has not yet been released and, as a result, also will not be issued in final form until 2004.
5. FSP FIN 46-7 on fees to decision makers was issued just before Thanksgiving.
6. We understand that still another proposed FSP dealing with allocations of expected losses and expected residual returns is planned because (1) for relatively simple situations, multiple allocation methods exist that could lead to different conclusions about who is the primary beneficiary, and (2) for more complex situations with "waterfalls" and special allocations, no agreement exists on how to apply the allocations required by Interpretation 46.

Entities should not have to apply Interpretation 46 until all of the significant implementation issues are resolved, and they should have reasonable time to analyze and apply the revised guidance. Without a delay in the effective date of Interpretation 46, public companies will be rushing at the end of December and in early January to implement newly issued modifications and clarifications of key parts of Interpretation 46, knowing that other modifications and clarifications are still pending. This is costly to the affected entities, and it is not conducive to high quality results. One possible result of a rushed implementation date of December 2003, with additional guidance issued early in 2004, is that numerous entities will have restatements or cumulative catch-up adjustments in 2004. If that occurs, it will undermine the credibility of financial reporting in a sensitive and highly visible area. To avoid that possibility, and to facilitate a high quality adoption of Interpretation 46, we recommend that the effective date of Interpretation 46 be delayed until at least six months after the issuance of this modification and all of the associated FSPs.

Finally, we question whether the Board members and staff will have time to adequately consider the comments on this Exposure Draft and the proposed FSPs if the Board is under time pressure to adopt final documents to meet the existing effective date.

Need to Amend Paragraphs 5b and 8

We believe the Board should amend paragraph 5b regarding which entities are VIEs and paragraph 8 regarding the computation of expected residual returns.

This modification proposes to amend paragraph 4 of Interpretation 46 to exempt the trusts in a bank trust department and mutual funds in the form of trusts. We agree with that proposed change, because we do not believe that trustees should consolidate such entities.

The fact that the FASB recognizes the need to exempt those entities reveals flaws in two central elements of Interpretation 46—the definition of a VIE in paragraph 5b and the computation of expected residual rewards.

Both types of trusts generally are funded 100% with the equity of the beneficiaries, and that equity is at risk. The trustee is a hired manager for a fee, hired either by the beneficiaries themselves or by a donor. These trusts should not be construed as VIEs, but the Board acknowledges that paragraph 5b(1) sometimes results in a conclusion that the existence of this type of hired manager arrangement causes the beneficiaries to lack the direct or indirect ability to make decisions about an entity's activities. Such a conclusion indicates that paragraph 5b(1) is too broadly drafted and needs to be rethought.

It is bad enough that paragraph 5b causes these trusts to be identified as VIEs. Even worse is that the specified computations for measuring expected residual returns and allocating them to interest holders, in particular the treatment of fees, sometimes makes the trustee the primary beneficiary. Such a conclusion indicates that the specified computations need to be rethought.

Bank trust departments and mutual funds represent concentrations of affected entities that were able to communicate the anomalous results of Interpretation 46. The same problems revealed by the application of Interpretation 46 to bank trust departments and mutual funds apply to other kinds of hired manager arrangements that, because they are not so prevalent, have not been as clearly communicated to the FASB. Exempting bank trust departments and mutual funds will not solve the anomalous results of applying Interpretation 46 to other hired manager arrangements. Only a rethinking of paragraphs 5b and 8 will solve that problem.

We have one other comment related to this proposed addition to paragraph 4. We do not understand why only mutual funds in the form of trusts are excluded from the scope of Interpretation 46. The same problem exists for the managers of mutual funds organized as corporations or partnerships. We believe that all

mutual funds should be excluded from the scope, not only those in the legal form of trusts.

Subordinated Financial Support from Equity Holders

Paragraph 5a of Interpretation 46 as originally drafted defined a VIE as an entity whose "total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties." The Board proposes to amend that sentence to include subordinated financial support from any party, including the equity holders. We recommend that the Board not amend this sentence, because we believe the proposed change opens opportunities for structuring closely held entities, particularly joint ventures, as VIEs to achieve particular consolidation results.

We have had a number of questions in recent years in which one of the partners in a 50/50 joint venture wanted to consolidate the joint venture, because it wanted to include the revenues of the joint venture in its consolidated revenues. Prior to Interpretation 46, a partner that wanted to consolidate a joint venture needed unilateral control over the joint venture; often the other partner was unwilling to agree to such unilateral control.

After the issuance of Interpretation 46, joint ventures would be VIEs if they needed additional subordinated financial support from parties other than the partners. However, subordinated financial support from the partners alone did not cause a joint venture to be a VIE. Therefore, if the partners provided all of the subordinated financial support, either in the form of equity or in other forms, the joint venture would not be a VIE unless it had some other attribute of a VIE.

The proposed amendment gives the partners the following option. They can provide their subordinated financial support in a form other than equity, for example, subordinated debt or a guarantee of the joint venture's external debt. Then, they can alter the profit and loss sharing so that the partner who wants to consolidate absorbs 50.1% of the expected losses or earns 50.1% of expected residual returns. The other partner retains its 50% vote and joint control over the joint venture; the partner that wants to consolidate achieves its accounting objective without obtaining control. The partner that does not want to consolidate may be more agreeable to a minor change in the profit and loss sharing than to giving up joint control.

The structuring opportunities opened by this wording change can go the other direction. Suppose a parent owns 100% of a loss-making subsidiary that it doesn't want to consolidate any more. Because cumulative losses have reduced

equity, a current re-assessment would indicate that the outside lenders bear more than 50% of expected losses. Therefore, the subsidiary declares a dividend to the parent in the form of subordinated notes, to trigger a reassessment under paragraphs 7 and 15. Now the subsidiary has less GAAP equity and receives other subordinated financial support from its parent. The subsidiary is now a VIE. Parent concludes that the outside lender is the primary beneficiary and deconsolidates the subsidiary.

We think the original wording of the first sentence of paragraph 5a is appropriate. Subordinated financial support from a party other than the equity holders is substantively different from equity or other subordinated financial support provided by the equity holders. Subordinated financial support from another party bears expected losses and has a real economic cost to the equity holders. The equity holders would incur such a cost only if they believed they were better off to provide less equity and incur the cost of the additional subordinated financial support. By contrast, the equity holders in a 50/50 joint venture (or the parent of a wholly-owned subsidiary) would be substantially indifferent between providing \$100 of equity or providing \$3 of equity and \$97 of subordinated debt. If all owners invest in the same proportions, their sharing of expected losses or expected residual returns would be about the same either way. Senior interest owners would similarly be indifferent to whether the owners provided \$100 of equity or \$3 of equity and \$97 of subordinated debt, so long as all of the owners' interests were subordinated to the senior interests.

We recommend that this change not be made.

Reconsideration Events and Troubled Debt Restructurings

Paragraph 7 of Interpretation 46 specifies when the interest holders in an entity should reconsider whether the entity is a VIE. Paragraph 15 of Interpretation 46 specifies when interest holders in a VIE should reconsider who is or might be the primary beneficiary. The Board is proposing to clarify both paragraphs, in part because of questions about the effect on creditors in troubled debt restructurings, and we generally agree with the direction of the changes. However, we do not agree with the words "or the level of subordinated financial support provided to the entity" in paragraph 7 and suggest that they be deleted.

According to paragraph 5, an entity is a VIE if it has certain characteristics *by design*. Footnote 1 and the beginning of paragraph 7 note that an entity that previously was not a VIE does not become a VIE solely because losses erode the entity's equity at risk. An entity that suffers losses may become unable to service its debts and might negotiate a troubled debt restructuring (TDR). As part of the

TDR, the lender might make concessions on the loan terms or exchange debt for equity in the borrower. An exchange of debt for equity represents an *infusion* of equity into the borrower. We believe that the proposed rewording of paragraph 7 would cause the borrower to be reassessed as a VIE if the lender exchanges debt for equity. We disagree with that conclusion and believe that it is inconsistent with footnote 1 and the introduction to paragraph 7. If the borrower had sufficient equity at inception, that is, had sufficient equity *by design*, then an infusion of equity logically cannot cause the equity to become insufficient. If the borrower were already a VIE for other reasons, then the lender's exchange of debt for equity could make the lender the primary beneficiary (a paragraph 15 reassessment), but in the absence of other changes, a lender's exchange of debt for equity does not change the design of the borrower in a direction that would cause the borrower to become a VIE.

Other Comments

We believe the Board should clarify the meaning of clause (ii) of paragraph 5c. The words are subject to varied interpretation about what it means for substantially all of the activities to involve or be conducted on behalf of the investor with disproportionately few voting rights.

We disagree with the new final sentence of paragraph 5c that compares each interest holder's voting rights to its rights to receive expected residual returns from all sources. If one interest holder provides services to the entity in exchange for a market fee with variability, this might result in inappropriately treating the entity as a VIE. For example, if one partner in a 50/50 joint venture licenses technology to the venture in exchange for a market royalty, that partner will have rights to receive expected residual returns that are disproportionate to its 50% voting interest. Absent other factors, that does not seem a reasonable basis to treat the venture as a VIE. We recommend that the FASB exclude interests that represent market prices for the goods or services involved. Alternatively, the FASB could revise the new sentence to discuss only obligations to absorb residual losses.

We strongly recommend that when the last of the final documents related to Interpretation 46 is issued, the Board codify all of the guidance—Interpretation 46, this modification, all of the FSPs—in a single document. It will be much easier for preparers and auditors to properly apply the standard if they can find all of the guidance in a single place.

We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.



Very truly yours,

s/ BDO Seidman, LLP