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**Proposed FASB Staff Positions on
Certain Issues Related to FASB Interpretation No. 46**

We appreciate the opportunity to comment on the proposed FASB Staff Positions (FSPs) on FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (the Interpretation).

As we prepared our comments on the proposed FSPs, we took an opportunity to assess preparers' readiness to adopt the Interpretation's provisions. Even after nine months from the issuance of the Interpretation, we believe significant confusion still exists on how to implement the Interpretation's provisions. Indeed, one FSP provides guidance on the fundamental issue on how to calculate expected losses and expected residual returns. The FASB staff and the Board are issuing FSPs and are proposing significant modifications to the Interpretation, some of which will not be finalized until after many public companies have prepared and released financial information for the reporting period ending September 30, 2003. While the final and proposed FSPs will help reduce preparers' confusion, we expect that, collectively, these FSPs will likely result in significant changes to preparers' current analyses in determining (1) whether an entity is a variable interest entity and (2) its primary beneficiary (if indeed it is a variable interest entity).

We already see a significant amount of confusion in the preparer community about which proposed FSPs and tentative Board decisions we, as auditors, would accept for inclusion in the current reporting period. Some of the proposed FSPs probably should be applied to the financial statements for the quarter ended September 30, 2003 (even though they are not yet final), while others will be applied with a cumulative effect adjustment in subsequent periods. The confusion about which FSPs to adopt in which periods is further delaying preparers' efforts to implement the Interpretation's provisions. Public companies may also reach different conclusions regarding the appropriate accounting for similar interests in comparable variable interest entities until all of the proposed guidance becomes effective. The limited deferrals provided by the proposed FSPs will result in public companies adopting the provisions of the Interpretation in a piecemeal

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fashion, depending on the type of entities in which they hold variable interests and the speed at which they are able to complete their analysis of the effect of adoption.

We are concerned that the potential revisions to previously reported information (whether through a cumulative effect adjustment or by restatement) within a short period after the initial adoption of the Interpretation along with a lack of comparability in reporting by public companies will lead to confusion among users of financial statements. This confusion will further undermine the confidence of their users, something the Board had sought to restore through the issuance of the Interpretation.

It is for these reasons that we believe the entire financial reporting community would benefit from a broad-based deferral of the Interpretation's provisions until the Board can clarify its intent on several basic implementation issues and can codify its current thinking in a modified standard, which then can be applied consistently by preparers and auditors. We believe that the very earliest the Interpretation should become effective for public companies should be the beginning of fiscal periods beginning after June 15, 2004 (July 1, 2004, for calendar year end companies). This deferral would (1) allow time for implementation issues to be addressed and resolved, (2) provide companies with more time to understand and implement the Interpretation's provisions, consistently, without the need for the reporting of multiple cumulative effect adjustments or restatements, and (3) help reduce potential confusion among users of financial statements.

If the Board does not decide to provide a broad-based deferral, we would support the issuance of the FSPs that defer the effective date of certain provisions of the Interpretation. Additionally, we have comments relating to the other proposed FSPs. Our comments are organized by proposed FSP.

Proposed FSP No. FIN 46-a, *Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, for Nonregistered Investment Companies*

We support the deferral of the effective date of the Interpretation's provisions for nonregistered investment companies until the AICPA finalizes its proposed Statement of Position on the clarification of the scope of the Audit and Accounting Guide, *Audits of Investment Companies*.

Proposed FSP No. FIN 46-b, *Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, for Certain Decision Makers*

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We understand the Board currently intends the scope of the proposed FSP to include only a decision maker that (1) receives fees that are fixed in amount and (2) does not have other variable interests that absorb any of the entity's expected losses or receive any of the entity's expected residual returns. We support the concept underlying the deferral of the effective date of the Interpretation for these types of decision makers, but the final FSP should expand the definition of decision makers included in its scope. Many decision makers, such as asset managers and other service providers, have contracts that compensate them based on the value of the assets they manage. For example, an asset manager may receive compensation based on a fixed percentage of the fair value of the assets it manages. While such asset managers theoretically provide subordinated financial support to the entity because the service contract absorbs some of the entity's expected losses (that is, the fee has variability), we generally believe an asset manager with a service contract that provides for fees that are (1) fixed in percentage (but not amount) and (2) whose payment is not subordinated to any other cash flows of the entity should not include those fees in the expected residual returns of a variable interest entity provided that the decision maker does not have any other variable interests that absorb the entity's expected losses or receive its expected residual returns. We believe a service provider that meets these conditions should apply proposed FSP No. FIN 46-d and include only the variability in its fees in the calculation of the entity's expected losses and expected residual returns (and should not include the fair value of its fees in the entity's expected residual returns).

Proposed FSP No. FIN 46-c, *Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities*

We disagree with the position in the proposed FSP that the existence of kick-out rights should not be considered in determining whether a service provider is a decision maker of a variable interest entity. If the members of the at risk equity group hold substantive kick-out rights that allow the service provider to be removed without cause, along with other conditions as described later, we believe that there is a rebuttable presumption that the service provider (decision maker) is acting as an agent on behalf of the at risk equity holders, who are the true decision makers for the entity.

We believe that the party identified as having significant decision making ability in determining whether the entity is a VIE should be the same party identified as a decision maker for purposes of applying paragraph 8(c). If the holders of the equity at risk have the ability to make decisions about the entity's activities through voting rights or similar rights and have substantive kick-out rights, then that group is the entity's decision maker, and the fair value of the fees paid to the

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service provider should not be included in the calculation of expected residual returns for the entity.

The proposed FSP should be clarified to state that determining whether kick-out rights are substantive is a matter of facts and circumstances and requires judgment, but could be considered substantive if, for example:

1. Some minimum number of variable interest holders has the right to call a vote for removal of the decision maker without cause at any time.
2. A vote to remove the service provider is required to be acted upon by the VIE.
3. A simple affirmative majority vote is required to retain or remove the service provider.
4. No economic barriers compel the variable interest holders to retain the service provider (for example, the VIE may lose access to a brand name or trademark that would result in a significant decrease in the fair value of the VIE if the decision maker was removed or a significant fee must be paid to the terminated or newly hired service provider).
5. No other contractual arrangements (for example, a loan covenant) prohibit replacement of the decision maker.
6. Removal of the decision maker cannot result in the dissolution or liquidation of the entity.
7. Variable interest holders are able to withdraw their investments from the entity without significant penalty.

We believe that this general approach is consistent with the guidance provided in EITF Issue No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, and EITF Issue No. 98-6, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights*. The underlying concept in each of these Issues is that, under the voting interests consolidation model, the ultimate measure of control is the extent of an entity's uncontested decision-making authority. EITF 96-16 concludes that consolidation by the investor with a

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majority voting interest is not appropriate if the decision-making authority of the majority owner can be overridden by a vote of a minority interest shareholder as a result of its substantive participating rights. Similarly, EITF 98-6 concludes that ultimate control does not reside with the general partner of a limited partnership if the limited partners can remove the general partner at will.

Consistent with this concept of ultimate control, if variable interest holders in a VIE, without significant penalty or burden, have the right at any time to remove the service provider and select a replacement, consistent with our model, the kick-out rights would be considered substantive. Accordingly, the ultimate controlling authority over service provider's decisions, which significantly affect the financial results of the VIE, would reside with the variable interest holders that collectively possess the substantive kick-out rights, who are also the entity's true decision makers.

Proposed FSP No. 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.*

We support the issuance of clarifying guidance as to the treatment of fees paid to a decision maker. We believe there is confusion about how such fees should be included in determining both the expected losses and expected residual returns of a variable interest entity and the amounts allocable to variable interest holders for purposes of determining a variable interest entity's primary beneficiary. To further alleviate this confusion, we believe that the FSP should clarify the theory behind the inclusion of the fair value of fees (and not the variability in fees) paid to decision makers and guarantors in the computation of an entity's expected residual returns. This will help financial statement preparers and auditors better understand the intent of the Board with respect to such fees.

While we agree that the concepts underlying the proposed FSP are sound — service contracts are variable interests and, as such, should be included in the calculation of expected losses and expected residual returns — we prefer a far simpler approach that does not require the computation of variability in the fees, but instead includes the fair value of the fees paid to a decision maker in the entity's expected residual returns. Fees paid to a party as compensation for providing services as the decision maker of an entity do not represent a return on an investment in the entity, and potential negative variability in the fees does not represent a potential loss of amounts invested in the entity, but rather a smaller amount of compensation for services

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provided (that is, the lower fees represent an opportunity cost to the decision maker and not a realized loss).

If the potential variability in the fees paid to a decision maker is to be included in the determination of an entity's expected losses and expected residual returns, the final FSP should be modified to require only an amount equal to the excess of the fees received by the decision maker over the potential variability in its fees to be added to the amount of expected residual returns allocable to its variable interest. This approach would result in the decision maker's expected residual returns equaling the fair value of the fees it receives from the entity. Under the approach included in the proposed FSP, the potential positive variability in the fees in the expected residual returns calculation should be added to the fair value of the fees paid to the decision maker. By including the variability in the fee along with the fair value of the fees in the expected residual returns calculation, the decision maker's expected residual returns will be greater than the fair value of the fee itself, which we believe is inappropriate and illogical. To illustrate our point, assume the following:

	Expected Losses	Expected Residual Returns
Variability – other than fees	\$ 100	\$ 100
Variability – fees	6	6
Fair value of fees		20
Total entity	<u>\$ 106</u>	<u>\$ 126</u>

As written, the proposed FSP would require the allocation of at least \$26 to the decision maker (assuming the decision maker holds no other variable interests). We believe the calculation should be performed as follows instead:

	Expected Losses	Expected Residual Returns
Variability – other than fees	\$ 100	\$ 100
Variability – fees	6	6
Fair value of fees (\$20-\$6)		14
Total entity	<u>\$ 106</u>	<u>\$ 120</u>

Only \$20 should be included in the entity's expected residual returns computation because the decision maker cannot have expected residual returns that are greater than the fee itself.

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The penultimate paragraph of the section of the proposed FSP entitled *Calculation of Expected Losses* states “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.” We agree that returns on other investments in the entity (for example, a loan or an equity position) should not be included in the fair value of the fees paid to a decision maker or guarantor. However, this paragraph can also be read to indicate that fees received by a decision maker for services other than the services provided as a decision maker (for example, it may service the variable interest entity’s assets) should not be included in the fair value of fees. We believe that all fees received by a decision maker as compensation for services (regardless of their nature) should be included in the fair value of the fees. We believe this paragraph should be modified to clarify this concept.

We also believe the example computation of expected losses and expected residual returns allocable to the decision maker included in the proposed FSP could be simplified. Our suggested approach is in Appendix A to this letter.

Proposed FSP No. FIN 46-e, *Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, for Certain Interests Held by a Public Entity*

As previously described, we would support a broad-based deferral of the Interpretation’s provisions until a period after the proposed FSPs and the modification to the Interpretation are finalized. If the Board does not decide on such a broad-based deferral of the effective date for applying the Interpretation’s provisions, we would support the limited deferral of the Interpretation’s provisions proposed by the FSP, with modifications.

We understand the Board’s intent in issuing this FSP is to provide preparers more time to evaluate enterprises that were not previously thought of as special-purpose entities as potential variable interest entities. The second condition for deferral in the proposed FSP states that the entity under evaluation cannot hold predominantly financial assets. Certain ongoing businesses not previously evaluated as special-purpose entities (for example, finance companies and insurance companies) hold predominantly financial assets. These businesses clearly are not special-purpose entities, and present the same challenges in applying the Interpretation’s provisions as do entities that hold predominantly nonfinancial assets. We believe the scope of the final FSP should be expanded to include those entities that are considered to be a business, as that term is defined in EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. Alternatively, the Board could consider deleting this condition.

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We also believe that the fourth condition is not necessary. We believe that requiring companies to apply the provisions of the Interpretation to variable interests in entities that would otherwise meet the criteria for deferral, except for the completion of the determination of the appropriate accounting under the Interpretation, (1) reduces the comparability of financial information among companies and (2) serves only to delay the implementation efforts of enterprises in applying the Interpretation's provisions.

Transition

The proposed FSPs have differing effective dates and transition provisions. We believe that the effective dates and transition provisions should be standardized to some future date and that no restatement of prior period financial statements should be required.

We would be pleased to discuss any of these specific concerns with you, the Board members, or other staff at your convenience.

Very truly yours,

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Appendix A — Computing Variability in Decision Makers' Fees

If the final FSP No. 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*, requires that the potential variability in fees paid to a decision maker be included in the calculation of an entity's expected losses and expected residual returns, we believe that the example provided in Exhibit A to the FSP should be reworked to make it more understandable. Expected losses and expected residual returns should be computed based on cash flows that would be available to the variable interest holders under the various possible cash flow outcomes and allocated according to the contractual arrangements among the variable interest holders. Using the assumed amounts from the example presented in Exhibit A to the proposed FSP, expected losses and expected residual returns attributable to the decision maker's fees can also be computed as follows:

Undiscounted Possible Decision Maker Fees	Present Value Of Possible Decision Maker Fees	Fair Value Of Decision Maker Fees	Difference	Estimated Probability Of Fees	Expected Losses	Expected Residual Returns
\$ 32,500	\$ 30,952	\$ 37,857	\$ (6,905)	5%	\$ (345)	\$ -
35,000	33,333	37,857	(4,524)	10%	(452)	-
37,500	35,714	37,857	(2,143)	25%	(536)	-
40,000	38,095	37,857	238	25%	-	60
42,500	40,476	37,857	2,619	20%	-	524
45,000	42,857	37,857	5,000	15%	-	750
				100%	<u>\$(1,333)</u>	<u>\$ 1,333</u>

We suggest this table be incorporated into the final FSP.