

May 22, 2003

Director, Technical Application and  
Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856

Re: Proposed FASB Staff Position

We are pleased to respond to the Proposed FSP, Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (the "Proposed FSP").

We agree with the premise in the proposed FSP that, when some or all of the variable interests issued by an entity have recourse to all of the entity's assets, separate variable interest entities are not created. In that circumstance, we agree that the variable interests should not be allocated to specified assets for purposes of determining whether a variable interest holder should consolidate the specified asset as to do so would be to potentially require pro-rata consolidation, an outcome that was most recently rejected by the EITF in Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures." However, we are confused as to the meanings of the phrases "effectively separate" and "without accounting allocations" in the answer. Consider the following example:

Investors A and B form a joint venture to acquire two office buildings, each of which has a fair value of \$100 million. Investors A and B each contribute \$10 million to the venture for their 50% equity interests. The venture issues \$180 million of debt to finance the balance of the purchase price of the buildings. The debt is issued in two tranches of \$90 million each – one tranche secured by the first building and the other tranche secured by the second building. Neither tranche has any right to the collateral securing the other tranche.

The venture enters into lease agreements with Company X and Company Y, two unrelated lessees. The terms of the lease agreements require periodic lease payments that will cover the interest on the debt and a return to Investors A and B during the lease term. At the end of the lease term, each lessee is required to (1) exercise a fixed price purchase option or (2) sell the leased asset. If a lessee elects to sell the leased asset and it is sold for less than the venture's acquisition cost, the lessee is obligated to make up the difference, up to a specified amount. If the asset is sold for more than the venture's acquisition cost, the lessee receives the excess as a rent rebate.

It is not clear whether the leased assets, the debt, and the equity in the example above should be considered "effectively separate from the remainder of the entity," or if the form of the equity interests (equity in the entire entity instead of a specific asset) would preclude accounting for the leased assets as separate variable interest entities under paragraph 13 because it would require "accounting allocations" to attribute the equity to each property. Economically the equity investment can be shown to be associated with an individual property. Assume that Company X defaults on its lease obligation at the end of the first year and the fair value of the property has declined to \$80 million at the time of the default. If the property is sold for \$80 million and there is no recovery on the residual value guarantee, Investors A and B will only lose \$10 million, even though the venture had \$20 million of equity at that time, while the holders of the debt issued by the venture and secured by the asset incur a loss of \$10 million. Paragraph 13 of Interpretation No. 46 indicates that a separate variable interest entity is created when

... specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. [Footnote reference omitted]

In the example above, each office building represents "essentially the only source of payment" for one-half of the equity investment made by Investors A and B at inception. Company X's performance under the terms of its lease has no impact on Investor A and B's recovery of the portion of their investment attributed to the office building leased to Company Y, and vice versa. If the fair value of the office buildings decline and Company X is unable to make its residual value guarantee payment, Investors A and B are only at risk for one-half of their equity investment. As such, it seems to us that the venture's equity is, in substance, a variable interest in specified assets, similar to targeted (lettered) stock.

We believe the final FSP should clarify what is intended by the phrases "effectively separate" and "without accounting allocations." Because of the importance of expected losses in Interpretation 46, one approach to determining when an equity investment is "effectively separate" would be to determine if the equity investors would suffer a complete loss of their investment before other variable interests are exposed. If the equity investment does not absorb all losses before other variable interests are exposed, then the equity is effectively a separate interest in specified assets of the entity. We believe the same approach would be applicable to subordinated debt in situations where either there is no residual equity in the entity or the holders of the subordinated debt also own the residual equity interest in the same proportion as the subordinated debt.

We also believe the final FSP should specifically address how paragraph 13 of Interpretation No. 46 should be applied to the example above. Given the economics described in the example, we believe paragraph 13 would require the venture (assuming it is a variable interest entity) to be viewed as two separate variable interest entities.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to Joe Graziano at (732) 516-5560, or Jeff Ellis at (312) 602-8991.

Very truly yours,

Grant Thornton LLP