



December 1, 2003

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: File Reference 1082-300

Dear Sirs and Madams:

We are pleased to comment on the Proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46* (the Proposed Interpretation). We commend the Board and FASB staff for their continuing efforts to resolve the challenging conceptual and implementation issues surrounding FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46).

As we have indicated in previous comment letters, we continue to recommend that the FASB provide a full deferral of FIN 46 for three important reasons:

- Several critical implementation questions are being addressed through a number of proposed FASB Staff Positions (FSPs) as well as the Proposed Interpretation. This critical guidance is expected to be finalized in late December. Still another FSP on identifying variable interests and computing expected losses is to be proposed and finalized in December. This guidance to be issued is critical to understanding and implementing the provisions of FIN 46. The current effective date does not give constituents enough time to absorb and apply the Proposed Interpretation and FSPs.
- We understand that the FASB staff plans to issue an FSP on the allocation of expected losses in early 2004. This concept is so integral to FIN 46 that we recommend FIN 46 be deferred until at least three months after that guidance is issued to provide concurrent adoption of the new guidance and to allow

constituents adequate time to understand and apply the provisions of such new guidance.

- Still other critical implementation issues, which we have included in Appendix B to this letter, remain unresolved. We have previously communicated most of these issues to the Board. These issues should be resolved prior to the effective date of FIN 46.

We agree with the Alternative Views set forth in paragraphs A43 through A46 of the Proposed Interpretation. As acknowledged in paragraph A45 of the Proposed Interpretation, providing for a reasonable deferral would also avoid the awkward result of constituents recording a cumulative effect of an accounting change upon adoption of FIN 46 and potentially again in 2004 when they adopt the FSP to be issued on the allocation of expected losses.

Our comments on the modifications made in the Proposed Interpretation are covered in Appendix A to this letter.

Should you have any questions regarding our response, please contact Bob Uhl at (203) 761-3705 or Jim Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche, LLP

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Modifications to Paragraph 2

- Subparagraph 2(c) and paragraph 6 of FIN 46, as proposed to be modified, contain different definitions of a variable interest. We recommend conforming the definition of a variable interest to provide consistency within FIN 46, as proposed to be modified. In addition, the paragraph 6 definition indicates that variable interests are those investments or other interests that will absorb portions of a VIE's expected losses or receive portions of a VIE's expected residual returns, or both. Paragraph 8, as proposed to be modified, implies that it is the identification of variable interests that drives the calculation of expected losses, thus making the definition in paragraph 6 appear circular.

Modifications to Paragraph 4

- We support the addition of a scope exception for an enterprise that is unable to obtain the information necessary to complete the FIN 46 analysis as outlined in paragraph 2(b) of FIN 46. However, we believe the scope exception should not be restricted to entities created before February 1, 2003. At the very least, this date should be extended to the issuance date of the Proposed Interpretation as many constituents (although aware of FIN 46) did not immediately appreciate the nature or extent of the information required when FIN 46 was issued. Further, the significant implementation issues encountered in adopting FIN 46 that remain under study make it unrealistic to think that at the date FIN 46 was originally issued, it was immediately apparent how transactions should be structured so that information to determine VIE or primary beneficiary status would be available.
- We support the scope exception in subparagraph 4(h) of FIN 46, as proposed to be modified, for mutual funds in the form of trusts and trusts of a bank's trust department and similar arrangements. However, we believe that it would be helpful to articulate the conceptual basis of this scope exception in order to clarify what is meant by "similar arrangements," and to prevent parties from incorrectly applying this scope exception by analogy. In addition, we believe that articulating the conceptual basis for the scope exception will make inclusion of the phrase "organized and operated in a manner consistent with customary existing practices" unnecessary. We do not understand this phrase and note that practices that may be deemed customary change over time.
- We believe that there is confusion among practitioners on the scope exception in paragraph 4(a), as proposed to be modified. To clarify the Board's intention, we suggest replacing the last sentence in paragraph 4(a) with the following. "This scope exception exempts both (1) not-for-profit organizations from being required to evaluate their interests in entities under FIN 46 and (2) enterprises from

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evaluating interests in not-for-profit entities under FIN 46. If a not-for-profit entity is used by a business enterprise to circumvent the provisions of this Interpretation, that not-for-profit entity shall be subject to this Interpretation.”

Modifications to Subparagraph 5(a) and Paragraph 9A

- We agree that qualitative considerations should be important in the analysis of whether an entity has equity at risk sufficient to permit it to finance its activities without additional subordinated financial support as provided in paragraphs 5(a) and 9A of FIN 46, as proposed to be modified. It would be helpful if the Board would provide examples of qualitative indicators that demonstrate both sufficiency and insufficiency of equity.
- When determining if the total equity investment at risk is sufficient to permit an entity to finance its activities without additional subordinated financial support, we believe that qualitative considerations should be evaluated, and if they are not determinative, an expected loss calculation should be performed to determine whether the equity investment at risk exceeds expected losses. This is consistent with the view expressed in paragraph 9A of FIN 46, as proposed to be modified. However, paragraph 5(a) of FIN 46, as proposed to be modified appears to contradict this notion by indicating that an analysis of an entity’s expected losses is the benchmark for assessing the sufficiency of equity at risk. Paragraph 5(a) should be modified to be consistent with paragraph 9A. See our other comments on paragraph 9A later in this Appendix.
- We note that the new language in paragraph 5(a) states that the “computation of expected losses will *often* depend on subjective judgments about probabilities of future events. . .” (emphasis added). We believe that since the computation of expected losses is based on future expectations, and judgments about probabilities of future events, the computation will *always* depend on subjective judgments. We suggest that the word “often” be removed from the sentence.

Modifications to Subparagraphs 5(b)-(c)

- The Basis for Conclusions of the Proposed Interpretation should include an example of when the last sentence in subparagraph 5(c) of FIN 46, as modified, would be applicable.
- We recommend that the terms “expected losses” and “expected residual returns” in the last sentence of paragraph 5(c) of FIN 46, as proposed to be modified, be replaced with the terms “potential losses” and “potential returns,” otherwise the sentence may never be viewed as operational. In subparagraphs 2(e), 5(b)(2) and

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5(b)(3) of FIN 46, as modified, we believe the Board intended for the phrases “expected losses” and “expected residual returns” in these paragraphs to denote the single expected loss and expected residual return outcome resulting from an expected loss/residual return calculation as outlined in subparagraph 2(b) of FIN 46. This concept is in contrast to the concept of **potential** losses and **potential** returns (if they occur) that we believe is the intended meaning as the terms are used in paragraph 5(c) of FIN 46, as proposed to be modified. Consider the following example. Two enterprises each contribute \$1 million (aggregate equity of \$2 million) in exchange for a 50% equity interest in an entity and one of the enterprises also provides subordinated debt. If the expected losses and expected residual returns of the entity are calculated to be \$1.5 million, the subordinated debt would not absorb any of the expected losses or receive any of the expected residual returns of the entity (i.e., the equity would absorb the expected losses and receive the expected residual returns thus meeting the criteria in paragraphs 5(a), 5(b)(2), and 5(b)(3)), thus the voting rights would be considered proportional pursuant to the first condition in paragraph 5(c). However, the subordinated debt would have exposure to absorb potential losses. If the first condition of paragraph 5(c) was to consider all interests that have exposure to potential losses, the voting rights would not be considered proportional. The Board should also consider whether any further explanation is needed to help readers understand the different notions. The differences are subtle, yet significant.

- We believe that there is confusion over whether an agreement between parties involved with the same entity could cause the equity invested by one enterprise to be excluded from the at-risk equity pursuant to paragraph 5(a) of FIN 46, as proposed to be modified. If the amount of this equity that is not considered to be at risk is sufficient to block the at-risk equity holders from making certain decisions, the entity would lack one of the characteristics of a controlling financial interest (similar to the notion expressed in the first footnote to 5(b), as proposed to be modified). Consider this example. Two joint venturers, X and Y, are the only equity participants in a joint venture and each have 50% of the vote. X provides a put option to Y such that Y may put its joint venture interest to X at an exercise price equal to the amount Y invested. Because the put option is not a variable interest in the entity, it is unclear whether the put option causes Y’s interest to be excluded from at-risk equity pursuant to paragraph 5(a)(1) of FIN 46 (i.e., Y does not participate in losses of the entity). One may also argue that Y’s interest should be excluded from at-risk equity pursuant to paragraph 5(a)(4) of FIN 46 because the amount “invested” in the entity by Y is no different than a loan to X (i.e., Y has loaned X an amount to be invested in the entity in exchange for a return of the principal plus a portion of the profits of the entity). In either case, if Y’s investment is not considered equity at risk, that would render the at-risk equity participant (enterprise X) without the direct or indirect ability to make

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decisions about the entity's activities (pursuant to paragraph 5(b)(1) of FIN 46) even though the put option is between the two enterprises rather than an interest in the entity.

Modifications to Paragraph 7

- Paragraph 6 of FIN 46, as proposed to be modified, indicates that the initial determination of whether an entity is a VIE shall be made on the date at which an enterprise becomes involved with the entity. Paragraph 7 of FIN 46, as modified, indicates that an entity that previously was not subject to this Interpretation shall not become subject to it simply because of losses. It also indicates that a reconsideration event occurs whenever the design of the entity or ownership of interests in the entity changes in a manner that could change that determination. As written, it is unclear to us whether the purchase of a variable interest in an entity directly from one enterprise by another enterprise, that was previously unassociated with the entity, would cause the purchasing enterprise to assess the VIE status of the entity at the point of the purchase or at the point when the interest it purchased was created (unless there are later reconsideration events). Through this purchase transaction, neither the design of the entity nor the interests in the entity changed in a manner that could change the determination of VIE status, yet a new party became involved with the entity. If the purchasing enterprise is required to assess VIE status in accordance with paragraph 6 of FIN 46 and if the entity had incurred losses since inception, the purchasing enterprise could potentially deem that the entity is a VIE because of the losses the entity incurred since inception when it does not appear that a reconsideration event has been triggered. If the transfer is not a reconsideration event, the other interest holders may not deem the entity to be a VIE whereas the new purchaser would. If the transfer is a reconsideration event, other owners of interests in the entity may not be aware of the transfer and that a potential reconsideration event occurred. We believe that it would be helpful to include language that would indicate whether a purchasing enterprise could rely on the transferor enterprise's determination of VIE status of the entity (if there is a reasonable basis for doing so) or, at least make its determination using information at the date the interest was created (or at the latest reconsideration event if there was one).
- It is unclear to us whether a delayed equity contribution - when made - triggers a reconsideration event. The circumstance we envision is that an investor unconditionally committed to a delayed contribution at the formation of the entity. The design of the entity would not change as a result of this delayed equity contribution (it was anticipated from inception) but the ownership interests in the entity would change. If this would qualify as a reconsideration event, would it be appropriate to initially calculate expected losses only through the date upon which

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the contribution was scheduled to occur and compare that amount to the amount of equity at risk at inception (because the entity would expect to re-perform the expected loss calculation at the contribution date)?

Modifications to Paragraph 8

- Although we agree that the original wording in paragraph 8 should be improved, we do not believe that “long term return to variable interests” is an improvement and may actually mislead some readers to infer that short-term cash flows should be excluded. We prefer “the net present value of cash flows available to or provided from variable interest holders.” Further explanation of this notion might include the concept that these cash flows must reflect the entity’s cash flows prior to any distributions to, or receipts from, the variable interest holders.

The addition of an example such as the following would also be helpful to constituents:

Entity X is a single-asset entity financed with 95 percent variable-rate debt and 5 percent equity. Entity X is a VIE. Assume the asset is not a variable interest and the variable-rate debt and the equity are variable interests.

Interest on the debt is reflected as interest expense in Entity X’s net income prepared in accordance with generally accepted accounting principles. Because the debt holder has a variable interest in Entity X (and ignoring the effects of accruals), cash outflows related to interest expense must be added back to the net income amount in arriving at cash flows available to and provided from holders of variable interests in the entity. The debt service also represents a return to the debt holder, and those expected cash flows must be allocated to the debt holder for purposes of determining whether the debt holder is the primary beneficiary.

- We recommend that the Board clarify paragraph 8 to clearly differentiate between the components of expected losses versus the components of expected residual returns. We suggest the following language: “A variable interest entity’s expected losses are the negative variability in the net present value of cash flows available to or provided from variable interest holders. A variable interest entity’s expected residual returns are the positive variability in the net present value of cash flows available to or provided from variable interest holders plus the fair value of (a) fees to the decision maker (if there is a decision maker), and (b) fees to providers of guarantees...”

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Modifications to Paragraph 9

- We support the addition of paragraph 9A but believe that the word “estimate” in the first sentence and “estimated” in the second sentence should be replaced with the words “determine” and “determined,” respectively.
- Paragraph 9A, as written, could be misinterpreted by constituents to be a prohibition against performing an expected loss calculation. Accordingly, we suggest you revise the second sentence to read as follows: “If, after a diligent effort, a reasonably well supported conclusion is reached based solely on qualitative considerations, the exercise required by paragraph 9(c) need not be completed.
- The last sentence in paragraph A20 of the Proposed Interpretation states that, “Paragraph 9A was added to further emphasize the importance of qualitative analysis and to illustrate the process that the Board expects enterprises to apply.” We do not believe that paragraph 9A illustrates a process. If paragraph 9A is not further modified to illustrate how a qualitative determination might be made, we suggest that the sentence in paragraph A20 end after the word “analysis.”

Modifications to Paragraph 16

- The revisions to the related parties’ paragraphs should indicate that a party is constrained if it does not have the ability to “pledge an asset as collateral and thus obtain all or most of the cash inflows that are the primary economic benefits of the asset.” This notion and wording are taken from paragraph 161 of FASB 140.

For example, Enterprise X holds a \$1,000,000 interest in a VIE (VIE 1). Enterprise Y, another holder of an interest in VIE 1 has the right to approve all sales and transfers of Enterprise X’s interest. Enterprise X may encumber its interest in VIE 1 without the approval of Enterprise Y. However, financial institutions will only loan \$300,000 to Enterprise X using its \$1,000,000 interest as collateral. Although Enterprise X is able to encumber its interest, because Enterprise X cannot realize all or most of the cash inflows that are the primary economic benefits of the interest, Enterprise X is constrained.

Modifications to Paragraph 17

- As currently written, paragraph 17 of FIN 46, as proposed to be modified, allows enterprises that absorb a majority of the expected losses, receive a majority of the residual returns, or both to establish related party relationships to avoid consolidating the entity if its related party has activities that are more closely

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associated with the entity. For example, assume that a private equity group (PEG) is investing in a VIE that will develop real estate and the PEG would like to avoid consolidation. PEG contributes \$96 million to the entity in exchange for 96% of the equity of the entity and solicits Investor 1 who contributes \$4 million in exchange for 4% of the equity of the entity. Investor 1 is a private real estate developer. PEG and Investor 1 each constrain the other from selling, transferring or encumbering their interests. Some believe that, even though PEG absorbs 96% of the profits and losses of the entity, Investor 1 would consolidate the entity because its activities (real estate developer) are more closely associated with the activities of the VIE (developing real estate).

We believe that paragraph 17 should be revised to indicate that if a member of a related party group, by itself, has a variable interest that absorbs a majority of the expected losses, receives a majority of the expected residual returns, or both, it should consolidate the VIE regardless of whether its related party is more closely associated with the entity. If no party in the related party group, by itself, absorbs a majority of the expected losses or receives a majority of the expected residual returns, and if the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, the party with activities that are most closely associated with the entity is the primary beneficiary.

- We believe that both qualitative and quantitative factors should be considered in determining which party's activities are most closely associated with the entity. We struggle in fact patterns in which the qualitative factors indicate that one party is more closely associated, while the quantitative factors indicate another party may be more closely associated. Clarifying guidance would be helpful.
- Additionally, paragraph 17 should provide guidance on whether it is possible to reach a conclusion that no one enterprise is more closely associated with an entity (e.g., a true joint venture) and thus no enterprise would consolidate the entity.

Modifications to Paragraph 22

- The last sentence of paragraph 22, as proposed to be modified, states: "The resulting effect of that elimination on the net income or expense of the variable interest entity shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements." Is the intention of this sentence to change conventional consolidation guidance? Although the example provided in paragraph A40 in the Basis for Conclusions is helpful, we believe that practitioners will more readily understand the guidance with an example that includes the impact of hypothetical transactions between the

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primary beneficiary and the entity on the consolidating income statement and balance sheet of the primary beneficiary.

Effective Date and Transition

- The transition guidance in paragraph 20 of the Proposed Interpretation should be revised to read “This Interpretation shall be effective for financial statements issued for **interim or annual** periods ending after December 15, 2003, for variable interests and variable interest entities to which the provisions of Interpretation 46 **apply**, on or before December 15, 2003.” The current phrase “have been applied, or should have been applied” could be read to unnecessarily imply that errors in application have occurred.

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The following list of implementation issues is organized based on the paragraph number of FIN 46 to which the issues relate. The list includes certain comments we have previously made in informal communications with the staff.

General

- The number of separate pieces of guidance on the consolidation of variable interest entities is becoming difficult for even the most sophisticated of enterprises to work through. We believe that all of the guidance, including items expected to be issued subsequent to the effective date of the modification, should be eventually compiled into a single document that includes FIN 46, as modified, in its entirety.

Paragraph 5 – Identifying variable interest entities

- In many joint ventures, a partner enters into a contract to buy a significant amount of the venture’s product at cost, plus a fixed fee. Does this type of arrangement cause the entity to be a VIE as the cost-plus arrangement could be viewed as a guarantee? Is the contract to buy the product a variable interest?

Paragraph 8-10 – Expected Losses and Expected Residual Returns

- We believe that expected losses and expected residual returns as described in paragraph 8 of FIN 46 are flawed. Appendix A of FIN 46 indicates that a key principle to the expected cash flow example is that the probability-weighted discounted cash flows should equal the fair value of all of the variable interest holders’ interests. This is not the case, for example, in low-income housing structures. The fair value of the limited partner’s interest is realized mainly through pass-through tax credits rather than through a distribution of assets. However, paragraph 8 does not call for the value of such tax credits to be included in the calculation as they do not represent a cash flow of the potential VIE.
- As communicated in our comment letters on FSP 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* and FSP FIN 46-e, *Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, for Certain Interests Held by a Public Entity*, several significant implementation issues remain unresolved as it relates to the expected losses and expected residual returns calculation, which is the “gateway” to determine whether an entity is a VIE and which enterprise should consolidate the VIE. These issues are as follows:

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- What is the proper basis for assigning probabilities?
- How should historical trends be considered?
- Should only observable data be used to support assertions, especially forward based assumptions?
- What cash flows should be included in the calculation?
- How to treat cash flows of a service contract, payments by a guarantor, etc.?

- We have concluded that an entity can have, at most, only one decision maker. If this conclusion is not consistent with the intention of the Board, we believe that related implementation guidance is needed.

- As stated in our comment letter on the initial proposed FSP on *Treatment of Fees Paid to Decision Makers and Guarantors in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FIN 46*, further clarification as to what should be included in amounts identified as decision maker and guarantor fees would be helpful. The following issues in this regard remain unanswered:
 - Do decision maker and guarantor fees include consideration implicitly (as well as explicitly) provided through features embedded in other contractual terms or ownership? For example, assume an entity is leasing substantially all of the assets from a VIE and provides a residual value guarantee on the assets in exchange for an implicit reduction in lease payments. Should the amount that represents the reduction in lease payments be bifurcated and should the fair value of that amount be included in calculating the entity's expected residual returns?

 - Are up-front fees paid to a decision maker included in the paragraph 8(b) amount regardless of whether they are variable? For example, a structuring or finder's fee for services up to the point of closing or as a prepayment for services to be rendered in the future. Further, should fees received in prior periods continue to be included in the paragraph 8(b) amount upon a reconsideration event?

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- In calculating fees to be included as decision maker fees, should all fees paid to the decision maker be included, whether those fees are for services that involve decision making or not? If not, what guidelines should be followed to ensure that fees to decision makers are not “hidden” in other arrangements?

Paragraph 14-15 – Determining the primary beneficiary (PB)

- We have previously commented that the approach for allocating expected losses and expected residual returns illustrated in Exhibit A of FIN 46-d is not operational in complex structures and structures with multiple risks that are shared disproportionately amongst various variable interest holders. Further, constituents (including ourselves) have developed a variety of methods to calculate expected variability and allocate this variability to variable interest holders. Disturbingly, the methods fail to identify the same primary beneficiary even when the methods incorporate identical assumptions and estimates about the timing and amount of the expected cash flows. The Board noted in paragraph A23 of the Proposed Interpretation that it may choose to specify or limit the allocation technique(s) in the future. As of the date of this letter, the Board has not expressed a final determination about possible implementation guidance. We continue to believe that resolving this issue prior to the effective date of FIN 46 is of paramount importance.

Paragraph 26-29 – Effective Date and Transition

- Under paragraph 29, is it acceptable to record the cumulative-effect adjustment as of the beginning of the current year of adoption and restating interim periods for the current year? Currently, a literal read only allows restating previously issued financial statements for one or more years. However, by allowing the restatement as of the beginning of the current period (1/1/2003 for 12/31/2003 year-ends), comparative financial reporting would be improved in subsequent interim and annual periods.