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Proposed FASB Interpretation
To Modify FASB Interpretation No. 46

We appreciate the opportunity to comment on the proposed FASB Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46* (the Modification).

Overall, we believe the Modification clarifies some common misunderstandings about the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51* (the Interpretation). We are concerned, however, that several concepts the Board is seeking to clarify will actually result in more confusion for preparers and auditors. Our specific comments on the Modification should not be interpreted as a request for detailed examples or interpretive guidance on how to apply the Interpretation's modified provisions. Instead, we would like the Board to more clearly articulate the concepts underlying the proposed modifications to the Interpretation, which will allow preparers and auditors of financial statements to consistently apply the Interpretation's provisions. Our comments do not address those provisions of the Modification that we agree with.

As discussed in our October 7, 2003, letter to the Board, we remain concerned that the preparer community is not ready to adopt the Interpretation's provisions. Given the nature of the proposed modifications and the unresolved issues being addressed by FSPs that have not been finalized, we would encourage the Board to revisit for one last time whether a broad-based deferral of the Interpretation's provisions is warranted. We would support a deferral of the Interpretation's provisions until the beginning of the first period beginning after June 15, 2004 (that is, July 1, 2004, for a calendar year end company).

Proposed Scope Exception for Lack of Information

We believe that the scope exception should be expanded to include situations in which an entity is unable to obtain the information necessary to determine if it has a variable interest in an entity created before February 1, 2003. For example, assume an enterprise has a variable interest in a specified asset of an entity. If that asset comprises less than one-half of the fair value of the entity's total assets, the enterprise would not have a variable interest in the entity. If the

enterprise, after making exhaustive efforts, is unable to obtain the information necessary to determine if it even has a variable interest in the entity, we believe it should also be able to apply the proposed scope exception.

Additionally, we believe the scope exception should be modified to require consolidation of a VIE if an enterprise has the information necessary to determine that it is the primary beneficiary of the VIE and can make reasonable assumptions and estimates regarding the entity's financial position and results of operations to consolidate that VIE. For example, assume an enterprise enters into an option to purchase an asset owned by an entity at a fixed price, thereby capping the expected residual returns inuring to the equity holders of the entity. The enterprise is aware that the asset underlying the option is the only significant asset of the entity.

Because the enterprise is able to reasonably estimate the fair value of the asset underlying the option, and knows the option's terms, it is able to determine that (1) the entity is a VIE and (2) it is the primary beneficiary of the entity. Because it was able to make these determinations, the enterprise is able to make materially accurate estimates about the assets in the VIE and the sources of funding for those assets, even though it may be unable to obtain exact information from the entity to consolidate the VIE. Because it is able to make these estimates that fairly present the VIE in the consolidated financial statements in all material respects, we believe in this example it would be inappropriate to apply the proposed scope exception.

We believe that, in general, if an enterprise has, or is able to obtain, the information necessary to determine that it is the primary beneficiary of a VIE, it should generally be able to make reasonable assumptions and estimates to consolidate that VIE, even if it is unable to obtain financial statements directly from the entity for use in its consolidation. We believe that, in these cases, the assumptions should be disclosed, if material.

Proposed Scope Exception for Mutual Funds in Trust Form and Bank Trust Departments

We understand the scope exception for mutual funds in trust form was designed to exempt from the Interpretation's provisions those mutual funds (for example, in Canada) that must, by statute, be maintained in trust form and do not permit the investment manager to be removed from its decision making ability (that is, if the investment manager cannot be removed, the entities would be VIEs and, if no one party absorbs the trust's expected losses, the trustee, as decision maker, may be required to consolidate the trust because it, through its fees, would receive a majority of the trust's expected residual returns).

As currently proposed, the scope exception would exempt all variable interest holders in mutual funds structured as trusts from applying the Interpretation's provisions to their variable interests, even if the mutual fund could have been set up as a corporation. We are already aware of enterprises attempting to structure transactions using trusts in an attempt to analogize to this proposed scope exception. We do not believe the Board should provide a specific scope exception for mutual funds in trust form because similar arrangements may also be identified in

the future, potentially resulting in the need for further modifications to the Interpretation. Instead, we believe the Board should reword the scope exception to incorporate the concept that the effect of local laws and regulations, among other considerations, on an entity's design should be considered in determining whether the entity is subject to the Interpretation's provisions. The Board should also consider what disclosures should be required in these instances.

We also believe that the proposed scope exception for bank trust departments should be modified to apply to any trustee acting in a custodial or fiduciary role that has no other variable interest in the trust. The scope exception could refer to Chapter 17 of the AICPA Audit and Accounting Guide, *Banks and Savings Institutions*, as an example of the types of custodial and fiduciary functions commonly performed by a trustee that are exempt from the scope of the Interpretation. If the Board does not broaden the scope exception, it should clearly articulate its intent about how the scope exception should be applied to analogous situations and whether the scope exception applies only to (1) personal trust accounts and (2) the trustee, or whether it applies to all of a trust's variable interest holders.

Evaluation of Sufficiency of Equity

We believe that the proposed modifications to subparagraph 5(a) following the first proposed sentence, as well as proposed paragraph 9A, should be deleted in their entirety. We understand that the proposed modifications are meant to emphasize that the determination as to whether an entity's equity investment at risk is sufficient to absorb its expected losses is a judgmental determination, and that the sufficiency of equity may be demonstrated through a qualitative assessment. We believe this concept is already well articulated in paragraph C24 of the Interpretation's Basis for Conclusions, which states "(t)he Board's preferred methods ..... are to demonstrate the sufficiency of the invested equity by (a) obtaining financing without additional subordinated financial support or (b) referring to the equity invested in another similar-sized entity with similar assets, liabilities, and other interests that has financed itself without additional subordinated financial support." This paragraph already indicates that the preferred methods for demonstrating the sufficiency of equity are based on qualitative assessments about the entity's capital structure. Paragraph C24 also states, in certain cases, the sufficiency of equity cannot be determined qualitatively, and, therefore, the Board provided an alternative method, which is based on a quantitative analysis.

We believe that the Board's intent with regards to the determination of the sufficiency of an entity's equity investment is already understood, and that, as proposed, the Modification will introduce confusion about how to determine the sufficiency of an entity's equity investment at risk. For example, the proposed changes to subparagraph 5(a) state "(a)n analysis of the entity's expected losses is the benchmark for assessing sufficiency of equity." After a parenthetical reference to Appendix A of the Interpretation, the proposed change states "...computation of expected losses will often depend on subjective judgments...[c]onsequently, qualitative considerations may also be important." We have already seen many readers incorrectly interpret

the proposed modification to require a quantitative analysis of expected losses, which upon completion, should be assessed qualitatively; a circular result.

Characteristics of a Controlling Equity Interest

We strongly disagree with the proposed footnote to be added after *characteristics* in the first sentence of subparagraph 5(b). We believe that if, by design, the equity holders, as a group, have certain rights and obligations as an equity holder through variable interests other than equity interests, and there is some requirement that the two interests be held simultaneously, those interests should also be considered when assessing whether the holders of the equity investment at risk have (1) substantive decision making ability, (2) the obligation to absorb the entity's expected losses, or (3) the right to receive the entity's expected residual returns.

To illustrate our concern, assume a partnership is created to develop commercial real estate. None of the partnership interests have voting rights, but one partner, a real estate developer, makes all significant decisions for the partnership under the terms of a service agreement entered into at inception of the entity. The developer is required to have a substantive equity investment at risk as long as it provides services pursuant to the service agreement. Based on the proposed modification, the entity would be a VIE because there is no decision making for the entity embodied in the equity interests.

Contrast that structure with a limited partnership formed with the real estate developer as the general partner, who makes all significant decisions for the entity. The equity holders could agree to a disproportionate sharing of profits within the equity group to compensate the general partner in a manner similar to how it would be compensated under the service agreement previously described. However in this case, because the decision making for the entity is embodied in an equity interest, the entity is not a VIE (assuming that none of the other criteria in paragraph 5 are violated). Economically, the rights and obligations of the equity holders of both entities are the same, but would be accounted for differently. We do not believe that substantial accounting differences should exist between substantially similar entities.

To further illustrate our concern, assume an at risk equity owner agrees to guarantee the equity investment of another party against certain losses, but that equity investment still participates significantly in the entity's losses to qualify as an equity investment at risk. Pursuant to the Modification's provisions, the entity would be a VIE because a portion of the equity investment at risk would be protected from the expected losses of the entity by a non-equity instrument (that is, the guarantee). We believe the guarantee serves only to allocate losses of the entity among the equity holders as a group, and the group of equity holders still has the obligation to absorb the entity's expected losses. If the entity has sufficient equity to absorb its expected losses, we do not believe the entity should be a VIE as a result of the guarantee.

When our approach to aggregating the variable interest holders' rights and obligations is used, we believe that VIEs would continue to be properly identified through application of the

Interpretation's "anti-abuse" clause. Indeed, as the Board has confirmed, the "anti-abuse" clause should be applied by considering all of the various rights and obligations held by the variable interest holders. Any time an equity holder has variable interests other than its equity investment (for example, a lease, derivative, guarantee, etc.) the equity investor's voting rights will be disproportionate to its obligation to absorb the entity's expected losses to receive its expected residual returns. When substantially all of the activities of the entity are performed on behalf of the investor, the entity will be a VIE.

As another example to illustrate why the equity owners' aggregate rights and obligations should be applied throughout paragraph 5, and VIEs will continue to be properly identified, assume a manufacturer establishes a separate subsidiary and sells more than half of the equity of the subsidiary in a public offering. In connection with creation of the subsidiary, the manufacturer enters into a capacity purchase agreement providing that all of the subsidiary's output will be sold to the manufacturer's customers, to accompany a product that it already sells to those same customers. The manufacturer will schedule production and will set prices. The manufacturer may add or remove time from production schedules, at its option. All of the subsidiary's equipment is subleased from the manufacturer. The manufacturer retains all revenue associated with the products sold by the subsidiary, and reimburses the subsidiary for its costs plus a margin.

In this example, if only the rights and obligations provided to the equity owners through their equity investments are considered, we believe that the entity would be a VIE as the significant decisions relating to the subsidiary's operations are being made through the capacity purchase agreement and not through the exercise of the equity interests' voting rights, and the equity investors in the subsidiary are protected from loss, and limited as to returns, by the cost-plus reimbursement arrangement. We believe the capacity purchase agreement reallocates the decision making ability and the sharing of losses among the equity holders as a group. We believe that this reallocation does not suggest that a controlling financial interest does not exist. In our view, this arrangement is similar to a voting agreement in which the allocation of profits and losses is not determined based on relative ownership, but on a formula. We do not believe the structure with the capacity purchase agreement should be a VIE simply because, *by design*, the rights and obligations are in two interests (that is, the equity investment and the capacity purchase agreement) rather than the equity investment alone, as long as there is some requirement that the two interests be held simultaneously. When the rights and obligations of the equity investors are bundled with the rights and obligations provided to the manufacturer through the capacity purchase arrangement, the entity would appropriately be identified as a VIE through application of the Interpretation's anti-abuse clause.

Reconsideration Events

We generally agree with the proposed modifications to paragraph 7, but believe the Board should address how an acquirer of a troubled loan should perform its analysis pursuant to the Interpretation's provisions.

We believe that a significant difference exists between the modification of troubled debt by an existing lender, and the transfer of troubled debt from one lender to a new lender. When an existing lender agrees to restructure debt in a manner that neither provides additional subordinated financial support nor changes the ownership design of the entity, the lender is generally acknowledging that there is substantial doubt about the ability of the entity to repay the loan under the existing contractual provisions, and agrees to the restructuring in attempt to make the best of a bad situation.

A new lender that acquires troubled debt from the existing lender makes a distinctly different investment decision based on its perception of the potential risks and rewards of the entity. While an existing lender that agrees to a restructuring of troubled debt may be trying to make the best of a bad situation, a new lender makes a separate investment decision about how the risks and rewards of the entity might affect its ability to earn a return on its investment in the loan. Indeed, paragraph 6 of the Interpretation states that the initial determination of whether an entity is a variable interest entity shall be made on the date at which an enterprise becomes involved with an entity.

If a lender that acquires the debt of a financially troubled entity evaluates whether (1) the entity is a VIE and (2) if so, whether it is the primary beneficiary of the entity upon the date of its first involvement with the entity (the date of acquisition of the debt), the assets and liabilities of the entity may be consolidated by two different parties. If the entity was previously considered to be a voting interest entity, the owner of the majority of the entity's outstanding voting stock would continue to consolidate the entity (because a reconsideration event has not occurred for that party), even as the new lender potentially consolidates the VIE as part of its initial consideration. The Board should address how the "by design" concept in paragraph 5 should be applied to an acquirer of a troubled loan.

Calculation of Expected Losses and Expected Residual Returns

We believe the proposed modifications to paragraph 8 will create confusion. We suggest the Board delete these proposed modifications from the final Modification. Instead, we think the Board should clarify its views on the following issues:

1. Should opportunity cost be considered in determining the primary beneficiary of a VIE? Paragraph 8 of the Interpretation (as originally issued) can be read to allow consideration of the opportunity cost that variable interest holders incur as a result of their investment in a VIE when determining the primary beneficiary. We believe that opportunity cost should not be considered when determining the primary beneficiary. Paragraph A19 of the Basis for Conclusions relating to the proposed changes to paragraph 8 states that "(i)n referring to change in fair values of assets as part of the computation of expected losses, the Board intended to refer to the net change over the life of assets to be distributed to variable interest holders in lieu of cash." This would seem to indicate that opportunity costs should not be considered, but we are not sure.

2. When estimating the expected variability in a VIE's long-term return, may anticipated changes in contractual arrangements between variable interest holders be considered? For example, a commercial paper conduit may roll its commercial paper over every 90 days, but the entity may have an anticipated life of thirty years or more. Should the analysis of the entity be limited to the contractual arrangements in place and should assumptions about future issuances of commercial paper be ignored? We believe the answer to this question is "yes" based on the requirement in paragraph 6 of the Interpretation, which states the determination of whether an entity is a VIE should be based on the circumstances at the date of evaluation, including only future changes that are required in existing contracts and governing documents. If so, we would assume each issuance of commercial paper will change the ownership of variable interests in the entity, and should require a reconsideration of whether the entity is a VIE. If future issuances of commercial paper should be considered, the Board should address how expected losses and expected residual returns could be attributed to future purchasers of commercial paper when these parties do not even know that they hold a variable interest.

De Facto Agents

We generally agree with the proposed changes to paragraph 16. However, we believe that the Interpretation should state, either in paragraph 16 or the Basis for Conclusions, that there is a presumption that a party's ability to manage the economic risks or realize the economic benefits of its interests in a VIE are not constrained if approval of a sale, transfer or encumbrance cannot be unreasonably withheld by an enterprise. We believe that the concept of when a constraint exists should be consistent with the concepts included in paragraphs 9 and 30 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* (Statement 140).

Paragraph 30 of Statement 140 states that "...examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld...." If the Board's intent is that the constraint notion included in the Modification be inconsistent with Statement 140, it should clarify its rationale in the Basis for Conclusions and help preparers and auditors understand whether an approval of a sale or transfer of a variable interest not to be unreasonably withheld prevents a party from managing its risks or realizing the benefit of its interests.

Initial Consolidation of a VIE by a Primary Beneficiary

The proposed changes to paragraph 21 that would allow the recognition of goodwill by an enterprise upon first becoming the primary beneficiary of a VIE if the VIE is a business, but not if the VIE is not a business, appear to make the accounting for gaining a controlling financial interest in a VIE that is a business similar to the accounting for the acquisition of a controlling financial interest in a voting interest entity based on the provisions of FASB Statement No. 141, *Business Combinations* (Statement 141). This is consistent with paragraph C45 of the

Interpretation's Basis for Conclusions, which states, in part, "...The Board decided that many of the initial measurement requirements of Statement 141 are appropriate for variable interest entities consolidated for the first time..."

However, certain differences may exist between the allocation of the cost to the assets and liabilities and noncontrolling interests of (1) a newly consolidated VIE pursuant to the Interpretation's provisions and (2) a business pursuant to Statement 141's provisions. Paragraph 18 of the Interpretation requires the primary beneficiary of a variable interest entity to initially measure the assets, liabilities and noncontrolling interests of the newly consolidated entity at their fair values on the date the enterprise becomes the primary beneficiary. Paragraph 37 of Statement 141 describes, in general, how amounts should be assigned to assets acquired and liabilities assumed, except goodwill, in a purchase business combination. Certain of the methods specified in this paragraph may be inconsistent with an allocation based strictly on fair value, as acknowledged in paragraph B100 of the Basis for Conclusions of Statement 141.

As an example, uncertainties about the collectibility of accounts or loans receivable would affect their fair value, but receivables are recorded at the present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. If accounts or loans receivable were assigned an amount equal to their fair value, there would be no need to separately recognize an allowance for uncollectible accounts as stated in paragraph 37 of Statement 141.

Additionally, certain intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination may be recognized as an asset even though they do not meet either the contractual-legal criterion or the separability criterion contained in Statement 141 (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). It is unclear if such assets should be recognized separately from goodwill by an enterprise that becomes the primary beneficiary of a VIE that is a business, because we are not sure whether the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, or Statement 141 should be applied.

We believe that the Interpretation should be modified to require that upon becoming primary beneficiary an enterprise should initially consolidate a VIE that is a business as if it had acquired a controlling financial interest in a voting interest entity, using the provisions of Statement 141. This would create consistent accounting models for gaining a controlling financial interest in a business, irrespective as to whether control is gained through acquisition of a majority of the voting equity interests or becoming the primary beneficiary of a VIE.

Accounting After Initial Measurement

Paragraph C46 of the Interpretation's Basis for Conclusions states "[t]he proposed Interpretation did not include specific guidance on subsequent accounting for consolidated variable interest entities because the Board expected that enterprises would apply consolidation policies

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applicable to subsidiaries. .... the Board decided that the subsequent accounting for consolidated variable interest entities should be no different than the accounting that would apply to a majority-owned subsidiary engaged in the same activities." Based on this, it appears that the Board's intent was that the primary beneficiary of a VIE should account for that VIE in consolidation as if the VIE were being consolidated as a result of the ownership of a majority of the voting equity interests.

The proposed modifications to paragraph 22 of the Interpretation are meant to clarify that the effects of eliminating intercompany transactions when consolidating a VIE should be attributed to the primary beneficiary. This appears to differ from the Board's intent as discussed in paragraph C46 of the Interpretation and the consolidation guidance included in paragraph 14 of ARB 51, which states that "(t)he elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests."

We did not think the Board was seeking to change current consolidation policy, but are not sure. We are aware of a fair amount of confusion about the accounting for intercompany transactions between a VIE and its parent, so we recommend the Board provide a simple example. If the Board's intent is to provide an exception to traditional consolidation practice for the primary beneficiaries of variable interest entities, that fact, and the Board's rationale for doing so, should be discussed more clearly in the Modification's Basis for Conclusions. If the Board does not intend to change current consolidation practice, it should simply refer to ARB 51. We would be happy to provide the Board with that example.

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,

Ernst + Young LLP