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new york state society of

NYSSCPA

certified public accountants

530 fifth avenue, new york, ny 10036-5101
www.nysscpa.org

November 26, 2003

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

By e-mail: director@fasb.org

Re: Proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46*

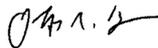
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Dear Mr. Smith:

The New York State Society of Certified Public Accountants, the oldest state accounting association, representing approximately 30,000 CPAs, welcomes the opportunity to comment on the Proposed Statement of Financial Accounting Standards noted above.

The NYSSCPA Financial Accounting Standards Committee deliberated the Exposure Draft and, prepared the attached comments. If you would like additional discussion with the committee, please contact Robert Dyson, chair of the Financial Accounting Standards Committee, at (212) 842-7565, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,



Jeffrey R. Hoops
President

Attachment

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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

FINANCIAL ACCOUNTING STANDARDS COMMITTEE

COMMENTS ON FASB EXPOSURE DRAFT

**Proposed Interpretation, *Consolidation of Variable Interest Entities, a
modification of FASB Interpretation No. 46***

File Reference 1082-300

November 26, 2003

Principal Drafters

**Roseanne Farley
Robert Dyson**

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COMMENTS ON FASB EXPOSURE DRAFT

Proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46*

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General Comments

While the issues relating to variable interest entities (VIEs) require clarification, we concur with the alternative views, expressed by three Board members, that this proposed interpretation does not address all questions that have been raised and does not provide a reasonable implementation period that would allow efficient adoption. Despite the clarification of certain issues, the proposed interpretation fails to clarify certain other issues, which will cause reporting problems and result in further inconsistencies in practice.

We recommend that the FASB prepare a comprehensive standard on the identification and classification of off-balance sheet entities. The most important attribute in determining whether to consolidate an entity is control, which still lacks a generally accepted definition. In describing control in regards to VIEs, the FASB considers risk of loss to be a form of control. The risk of loss may be an indicator of control when the entity with the risk of loss exercises legal recourse or takes action to avoid the loss, but the risk of loss remains defined so loosely that different reporting entities will continue to arrive at different conclusions given similar facts and circumstances. Under the proposal, some VIEs could be consolidated by more than one entity while others might not be consolidated at all. The lack of clear criteria for consolidation will lead to excessive diversity in practice, requiring even more FASB interpretations and FASB staff positions (FSPs). FSP FIN 46-6 defers the effective date for entities that have not yet adopted FIN 46 until the end of the first interim or annual period after December 15, 2003. We recommend that the FASB defer the provisions of FIN 46 not yet effective and suspend current provisions until the Board has completed a comprehensive standard that clarifies the accounting for VIEs and qualified special purpose entities (QSPEs).

Specific Comments

Scope Issues

- The scope exceptions for not-for-profit corporations and for mutual funds in the form of trusts and similar arrangements are appropriate changes.

Ambiguity of Tests

- FASB's motivation to further clarify expected losses and returns is understandable, and the goal of identifying the primary beneficiary of a VIE is appropriate because intermediary parties have been recognized incorrectly as the primary beneficiary. Nonetheless, we concur with the minority view that there remains too much ambiguity in the calculation of expected losses and the application of the expected residual returns test, which are the key factors for determining which entity will consolidate a VIE.

Need for an Objectives-Oriented Standard

- Off-balance sheet entities require a comprehensive study applying an objectives-oriented approach, as discussed in the recent Securities and Exchange Commission (SEC) study of principles-based accounting. Both VIEs and QSPEs are off-balance sheet entities whose characteristics determine whether they are consolidated. Proper accounting for off-balance sheet entities requires identification of the off-balance sheet entity and consideration of various characteristics to determine whether consolidation is required. In addition to clarifying those characteristics leading to consolidation, a new comprehensive statement would also reduce differences in applying Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FIN 46 to the same off-balance sheet entity. The FASB expressed concern on this issue in paragraph A13 in its June 10, 2003 ED on QSPEs.

Overload Generated by Current Approach

- Since issuing FIN 46 in January 2003, the FASB has issued six final FSPs and proposed one FASB interpretation and five additional FSPs. The FASB also has issued a proposed Statement of Financial Accounting Standards on QSPEs in June 2003. Additional changes to the standards appear to be in store. Paragraph A41 of the ED promises future FSPs to replace the proposed elimination of sample variable interests presented in paragraphs B1 to B10 of FIN 46. While the FSPs' purpose of providing an opinion on a single issue is worthwhile, both auditors and preparers find that the volume and rapidity of changes in these standards make them more difficult to apply than reasonable.

Definition Control is the Underlying Need

- As we noted in our letter dated July 30, 2003 on the proposed amendment to FASB Statement 140 regarding QSPEs, the most significant principle that should determine consolidation is ultimate control, and the derecognition of related assets and liabilities should occur only when such control no longer exists. That is, a consensus definition of control, indicating when an entity must be consolidated by another, should precede specific standards on consolidation. To date, the FASB has not issued definitive guidance on determining control of off-balance sheet entities. Paragraph 5 of the ED refers to control issues but does not sufficiently clarify what constitutes control. Rather, it refers to consolidation of VIEs in the absence of a definition of control.

The changes to paragraph 5(b) describe the characteristics of a controlling financial interest as the right to make decisions, the obligation to absorb losses, and the right to receive residual returns of the entity. The changes to paragraph 5(a) note that “subjective judgments about probabilities of future events” may be needed to assess the sufficiency of equity. These qualitative considerations will likely promote inconsistency in practice because of differing interpretations.

- A working definition of control would establish proper criteria that reflect the economic substance of the arrangement, which the SEC identified as a critical part of objectives-oriented standards. Preparers and auditors could then apply these criteria to the facts and circumstances of transactions not specifically addressed by the standard. Application of these criteria would serve as the basis of certain decisions, such as whether to consolidate, and of the determination of the percentage of control the reporting entity has over the off-balance sheet entity.
- The failure to define control has resulted in a rules-based approach that has not addressed many aspects of off-balance sheet entities while resulting in the standards overload discussed above. Despite the description in paragraph 5, the ED is not informative in determining minority interest and results of operations if the reporting entity concludes it must consolidate the VIE. This is particularly true where control is present through a combination of equity ownership and risk of loss, such as development stage enterprises and investments accounted for under the equity method of accounting. Examples in the ED focus on off-balance sheet entities in which a reporting entity has only a risk of loss and not an equity interest. In addition, other parties could provide funds at any time, resulting in frequent changes in the entity consolidating an off-balance sheet entity, which would degrade financial reporting consistency. The ED also does not specifically address the effect of guarantees accounted for under FIN 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which would add to the risk of loss. FSP FIN 46-5 only presents an example of accounting for a guarantee of residual value and not the debt, the more common form of guarantee.
- Because of a lack of a working definition of control, both the ED and original pronouncement require the various stakeholders of an entity to determine the relationship between their ownership in a VIE and that of other parties. This presumes a level of coordination between stakeholders that, as a practical matter, does not always exist, resulting in companies not obtaining the appropriate data. Some information may be difficult to obtain depending upon the role of the affected party, such as the requirement that an entity that was not previously considered a VIE must reconsider its position whenever the design of the entity or ownership interest change. However, the exception for entities unable to obtain information for VIEs created before February 1, 2003 benefits companies that do not maintain appropriate documentation or do not make an “exhaustive effort to obtain the information.” Although the ED notes that the “inability to obtain the necessary information is expected to be infrequent, especially if the enterprise was involved in the creation of

the entity," this exception has the potential to be manipulated. As a result, certain VIEs could potentially not be consolidated when the requirements for consolidation are met.

Convergence with International Standards

- Using the basic concept of control, once it is defined satisfactorily, would require extensive judgment by financial statement preparers, auditors, and regulators, but such judgments are preferable to detailed and frequently-changing rules whose applications may conceal substance. The possible difficulties of writing a comprehensive standard should not be a deterrent from pursuing a proper long-term solution. The FASB should also consider how its approach will converge with the current and future standards of the International Accounting Standards Board, which have focused on, and are likely to continue to focus on, the principle of control.