

October 10, 2003

Mr. Lawrence Smith  
Director Technical Application & Implementation Activities  
c/o Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856 – 5116

**Re: 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*"**

Dear Mr. Smith:

Citigroup appreciates the opportunity to comment 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*" (FSP FIN 46-d).

Citigroup supports the Board's stated goal of concept-based standard setting and objects to the intricately detailed guidance some constituents have asked the Board to provide. Specifically, Citigroup agrees with the fundamental FIN 46 concept of requiring consolidation of a VIE by the party that has a majority of either the variability of losses or residual returns. We adopted FIN 46 for our September 30, 2003 financial statements by applying the paragraph 8 guidance of allocating the variability in net income and in the fair value of a VIE's assets to parties involved with the VIE. We believe that our analysis resulted in reasonable consolidation decisions as applied to thousands of VIE transactions and, therefore, urge the Board to minimize issuing implementation guidance. However, we also recognize that uncertainty in applying concept-based accounting rules is difficult in an environment where investors, managements, and boards of directors have little tolerance for error.

Given this environment, we are concerned that FSPs may lead to even more conflicting guidance from auditors and result in differing applications in practice, or may differ with Citigroup's decisions in implementing the Interpretation. Therefore, we object to the issuance of FSP FIN 46-d in its current form, partially because it would represent an amendment to FIN 46, as it contradicts paragraph 8(a), and partially for the reasons noted in this letter. We believe the earlier version of FSP FIN 46-d exposed for comment in May 2003 would provide an answer that is consistent with FIN 46. More generally, we believe that, if the FASB believes that it must make

changes to the provisions of FIN 46, it needs to do so via the amendment process. In doing so, the Board should:

- Address all key issues in one document so that constituents are not subject to multiple transition adjustments.
- Perform a limited field test using at least some live fact patterns to ensure that the proposal is operational and achieves the Board's objectives (Citigroup would be pleased to participate in this process); and
- Provide a reasonable period of time for implementation given the complexity of many structures that exist.

Citigroup would be delighted to meet with some or all Board members at your convenience to fully explain some relatively simple structures and the diversity of the views that currently exist in practice<sup>1</sup> if that would help the Board understand why we believe aspects of FIN 46 are unclear. We would welcome the inclusion of others that hold divergent views in that discussion because we envision the purpose of such a meeting would be to help the Board more fully appreciate the level of diversity and confusion in practice on basic concepts.

In the attachment to this letter we elaborate on the specific comments on the text of FSP FIN 46-d. We would be pleased to discuss our comments with you at your convenience. I can be reached at (212) 559-7721.

Sincerely,



Robert Traficanti

Deputy Controller and Head of Accounting Policy, Citigroup

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<sup>1</sup> The structures we have in mind are public (registered) so the Board, its staff and other constituents can independently verify the fact pattern details. We believe that a working group type meeting to discuss these structures would facilitate debate over the accounting concepts and alleviate any concerns about the completeness of facts provided.

***The Inclusion of Fee “Variability” is Inappropriate***

An FSP is an inappropriate means of addressing the accounting guidance prescribed in FSP FIN 46-d, because the guidance does not represent a clarification to paragraph 8(a) of FIN 46. Instead, it is an amendment of FIN 46 and, if the Board believes that it has the appropriate concept, this change should be effected through an amendment to FIN 46 and not an FSP.

Paragraph 8(a) of FIN 46 states the following:

A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's net income or loss...

In contrast, the first paragraph of the response in FSP FIN 46-d states:

For the purpose of calculating an entity's expected losses and expected residual returns, the expected variability in the entity's net income or loss is determined based on the various estimates of net income or loss *available to, or absorbed by, the variable interest holders.*

Although the question raised in FSP FIN 46-d is related to fees and how those fees are included in the analysis of the expected losses and expected residual returns, it appears to us that the concept “available to, or absorbed by, the variable interest holders” should be extended to all variable interests in a VIE (including fees) or to none of them. For example, interest on liabilities issued by a VIE “that are reported as an expense in determining net income or loss” should be added back to net income for paragraph 8(a) purposes. We believe that the guidance in FSP FIN 46-d could be interpreted to require that any return on a variable interest that is reported as an expense be added back to net income in order to determine the VIE's expected losses and expected residual returns. Indeed that is the *only* logical conclusion of the Board's proposal; even though, the applicability of FSP FIN 46-d is seemingly limited to decision maker and guarantor fees. If the Board does not agree with our assessment of the concept behind the response to FSP FIN 46-d, it needs to re-examine its concept.

Further, we believe that FSP FIN 46-d (if applied only to eligible fees) leads to double counting fees in the expected residual return calculations because both the variability and the present value of eligible fees are included in the expected residual returns.

Although a wide diversity in practice has developed with regard to the application of FIN 46, no one (of which we are aware) has calculated the expected losses and expected residual returns of a VIE using the full concept described in FSP FIN 46-d. This is because net income or loss is a well-defined and understood term in generally accepted accounting principles, yet FSP FIN 46-d essentially redefines net income. Thus, we believe that paragraph 8(a) of FIN 46 and the language proposed in FSP FIN 46-d are inconsistent.

As a result of these concerns, Citigroup believes that if the FASB intends to answer the question raised in FSP FIN 46-d, it should do so using the guidance in the initial version of FSP FIN 46-d (issued for comment in May 2003).

### ***The Board's Illustration of Allocating Variability***

FSP FIN 46-d provides an example that demonstrates how the guidance in FSP FIN 46-d should be applied. We continue to believe that the examples provided by the FASB staff (including the example in Appendix A of FIN 46) are not representative of *any* transactions seen in the marketplace. The examples are so simplified that they cannot be applied even by analogy to more complex transactions. Yet many constituents are focusing on the example as a framework for such evaluations. We are very concerned that the example will lead to arithmetically flawed outcomes. For example, we believe that the method used in FSP FIN 46-d to allocate the expected losses and expected residual returns can only be used for a transaction in which the investors (and any decisions makers) share pro rata in the expected losses and expected residual returns. That is, mathematically, the allocation method provided in the FSP FIN 46-d example will not work for transactions that involve more complex capital structures.

We illustrate our concerns in a simple example included as Attachment 2 to this letter. The fact pattern is a simple modification of the example in Appendix A of FIN 46. The modification is the creation of a first-loss, second-loss structure to illustrate the need to perform “waterfall” calculations under FIN 46.

In Attachment 2, Approach #1 – which some believe the FASB staff supports – implies that Investor ABC would consolidate because it absorbs the first \$28,000 of losses (an amount equal to the computed expected loss). In contrast, Approach #2 computes the allocation of losses *if they occur* to the investors. Using those computations, Investor XYZ would consolidate.

Some constituents have taken FSP FIN 46-d’s example as providing support for Approach #1. We do not believe that is the case and note, as an arithmetic matter, the FASB staff’s illustrated approach will only attain the correct answer when there is no cash waterfall – a fact pattern that we never see. That is, the illustration in FSP FIN 46-d *is a special case*. We urge the FASB staff to make the approach it supports clear.

### ***Fixed Fees***

FSP FIN 46-b, “Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers,” makes reference to a “fee [that] has no variability.” We have assumed that the FSP FIN 46-b is referring only to fees that are fixed in dollar amount (as opposed to fees that are fixed in percentage). FSP FIN 46-d clearly states that a “fee is a variable interest because it will receive a portion of the expected residual returns of the entity if they occur.” Thus, it appears that even a fixed fee is a variable interest because there is always the chance (extremely remote) that the cash flows will be insufficient to pay even a fixed fee. We, therefore, believe that the proposal in FSP FIN 46-b is inconsistent with the proposal in FSP FIN 46-d.

## ***Transition***

The initial version of FSP FIN 46-d was consistent not only with the language in FIN 46, but it was consistent with the way many constituents have included fees in their calculations of expected residual returns. Citigroup (as well as many other constituents) based its implementation computations on what we perceive to be clear guidance in FIN 46 and the original FSP. In our case, that effort encompasses extremely complicated data gathering and computations for a large number of transactions. The Board's revised proposal reaches a dramatically different answer than the original FSP. It would be extremely difficult to implement and leads to literally dozens of complicated questions with respect to fees that simply were irrelevant in virtually all cases under the initial version.

The Board has comforted itself that re-evaluation of most entities due to FSP FIN 46-d will not be required because it has provided what it considers to be "prospective" transition guidance. (The guidance in FSP FIN 46-d is applicable to new transactions and required reconsiderations occurring after the proposed FSP is issued.) However, the transition guidance is prospective *only* for existing *static* transactions, which rarely involve decision making fees. As a result, the proposed FSP will be applied prospectively to a *de minimus* subset of transactions that do not exist.

The guidance in FSP FIN 46-d is already considered to be a significant change in how many have interpreted FIN 46. If the guidance in FSP FIN 46-d applies to all variable interests, it will result in the re-evaluation of almost every variable interest entity. (Again, the "prospective" transition guidance in FSP FIN 46-d is an illusion because of the re-evaluation triggers provided in FIN 46.) The Board should consider providing transition guidance that would actually result in prospective application.

Even if the Board does amend FIN 46 to make this change, a significant period of time will be required for constituents to implement it. The proposed time frame is inadequate. Without truly prospective transition guidance, companies and their auditors will need to re-analyze a significant portion of their VIEs, perhaps repeatedly as the Board tinkers with the application of FIN 46. This process could (a) require the use of a considerable amount of scarce resources, and (b) result in several changes in the consolidation answer in at least some circumstances.

**ALLOCATION APPROACH #1****Assumptions:**

Assume the same facts as those presented in the example provided in Appendix A of FIN 46 with the exception of the following:

- There are two investors (Investor ABC and Investor XYZ) that have variable interests in the VIE.
- Investor ABC is subordinate to Investor XYZ, and it absorbs the first losses up to \$28,000
- Investor XYZ absorbs any losses exceeding \$28,000.

**TABLE 1 - EXPECTED CASH FLOWS**  
(Amounts in Thousands)

<b>Estimated Cash Flows</b>	<b>Probability</b>	<b>Expected Cash Flows</b>	<b>Fair Value</b>
650,000	5.00%	32,500	30,952
700,000	10.00%	70,000	66,667
750,000	25.00%	187,500	178,571
800,000	25.00%	200,000	190,476
850,000	20.00%	170,000	161,905
900,000	15.00%	135,000	128,571
	<u>100.00%</u>	<u>795,000</u>	<u>757,143</u>

**TABLE 2 - CALCULATION OF EXPECTED LOSSES**  
(Amounts in Thousands)

<b>Estimated Cash Flows</b>	<b>Expected Cash Flows</b>	<b>Difference</b>	<b>Probability</b>	<b>Expected Losses</b>	<b>Fair Value</b>
650,000	795,000	(145,000)	5.00%	(7,250)	(6,905)
700,000	795,000	(95,000)	10.00%	(9,500)	(9,048)
750,000	795,000	(45,000)	25.00%	(11,250)	(10,714)
800,000	795,000	5,000	25.00%		
850,000	795,000	55,000	20.00%		
900,000	795,000	105,000	15.00%		
			<u>100.00%</u>	<u>(28,000)</u>	<u>(26,667)</u>

**TABLE 3 - ALLOCATION OF EXPECTED LOSSES TO INVESTORS ABC AND XYZ**  
(Amounts in Thousands)

Expected Losses	(28,000)
Allocation to Investor ABC	(28,000)
Allocation to Investor XYZ	0

## ALLOCATION APPROACH #2

Assumptions:

Assume the same facts as those presented in the example provided in Appendix A of FIN 46 with the exception of the following:

- There are two investors (Investor ABC and Investor XYZ) that have variable interests in the VIE.
- Investor ABC is subordinate to Investor XYZ, and it absorbs the first losses up to \$28,000
- Investor XYZ absorbs any losses exceeding \$28,000.

**TABLE 1 - EXPECTED CASH FLOWS**  
(Amounts in Thousands)

Estimated Cash Flows	Probability	Expected Cash Flows	Fair Value
650,000	5.00%	32,500	30,952
700,000	10.00%	70,000	66,667
750,000	25.00%	187,500	178,571
800,000	25.00%	200,000	190,476
850,000	20.00%	170,000	161,905
900,000	15.00%	135,000	128,571
	<u>100.00%</u>	<u>795,000</u>	<u>757,143</u>

**TABLE 2 - CALCULATION OF EXPECTED LOSSES**  
(Amounts in Thousands)

Estimated Cash Flows	Expected Cash Flows	Difference	Probability	Expected Losses	Fair Value
650,000	795,000	(145,000)	5.00%	(7,250)	(6,905)
700,000	795,000	(95,000)	10.00%	(9,500)	(9,048)
750,000	795,000	(45,000)	25.00%	(11,250)	(10,714)
800,000	795,000	5,000	25.00%		
850,000	795,000	55,000	20.00%		
900,000	795,000	105,000	15.00%		
			<u>100.00%</u>	<u>(28,000)</u>	<u>(26,667)</u>

**TABLE 3 - ALLOCATION OF EXPECTED LOSSES TO INVESTOR ABC**  
(Amounts in Thousands)

Estimated Losses	Probability	Allocation to Investor ABC	Fair Value
(28,000)	5.00%	(1,400)	(1,333)
(28,000)	10.00%	(2,800)	(2,667)
(28,000)	25.00%	(7,000)	(6,667)
		<u>(11,200)</u>	<u>(10,667)</u>

**TABLE 4 - ALLOCATION OF EXPECTED LOSSES TO INVESTOR XYZ**  
(Amounts in Thousands)

Estimated Losses	Probability	Allocation to Investor XYZ	Fair Value
(117,000)	5.00%	(5,850)	(5,571)
(67,000)	10.00%	(6,700)	(6,381)
(17,000)	25.00%	(4,250)	(4,048)
		<u>(16,800)</u>	<u>(16,000)</u>