

May 27, 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, Application of paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, when variable interests in specified assets of a variable interest entity are not considered interests in the entity under paragraph 12 of Interpretation 46 (the "Proposed FSP").

We do not support the issuance of the Proposed FSP. Although we understand the FASB staff has previously communicated the conclusion in the Proposed FSP to constituents in various meetings, based on our reading of Interpretation No. 46, we do not believe the phrase "expected losses of the entity" has the same meaning as used in paragraphs 5 and 12. Paragraph 12 states, in part:

A variable interest in specified assets *of a variable interest entity* (such as a guarantee or subordinated retained interest) shall be deemed to be a variable interest in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets or if the holder has another variable interest in the entity as a whole.... The expected losses ... applicable to variable interests in specified assets of a variable interest entity shall be deemed to be losses ... of the entity only if that variable interest is deemed to be a variable interest in the entity. [Footnote reference omitted; emphasis added]

As drafted, paragraph 12 would seem to apply only when the entity has been determined to be a variable interest entity. Further, we note that the paragraph appears under the caption "Variable Interests and Interests in Specified Assets of a Variable Interest Entity."

In contrast, the discussion in paragraph 5a is focused on determining if an entity is a variable interest entity. As indicated in paragraph 5a of Interpretation No. 46, an entity is a variable interest entity if:

The total equity investment at risk is not sufficient to permit the entity to finance its activities *without additional subordinated financial support* from other parties. That is,

the equity investment at risk is not greater than the expected losses of the entity.  
[Footnote reference omitted; emphasis added]

The Proposed FSP effectively concludes that a guarantee of (or subordinated retained interest in) specified assets of an entity does not represent subordinated financial support that permits the entity to finance its activities for purposes of applying paragraph 5a. We do not understand that conclusion, particularly when the cost of many transactions would be far more expensive if a guarantee was not provided. By excluding losses that will be absorbed by a guarantee or retained interest from the entity's expected losses, the Proposed FSP ignores the relationship between the sufficiency of an equity investment and the need for a guarantee. Although we do not believe the existence of a guarantee should automatically be taken as evidence that the equity investment is not sufficient to absorb the entity's expected losses, it certainly creates a presumption in our minds that the equity is not sufficient. We are concerned that the Proposed FSP's conclusion will result in fewer entities being deemed to be variable interest entities only because a majority of the expected losses are absorbed by multiple guarantors, allowing those losses to be excluded in determining whether the entity is a variable interest entity; excluding the losses may reduce to a nominal amount the amount of equity investment needed to be sufficient. Consider the following example:

TrustCo, an entity with a finite life and a limited purpose, was created by its partners to acquire and lease real estate to companies with investment grade credit ratings. TrustCo acquired five corporate headquarters facilities and entered into lease agreements with five unrelated lessees. The facilities have approximately the same fair values on the date of acquisition. Under the terms of the lease agreements, periodic lease payments are set to cover interest-only payments on the debt and a return to the limited partners. At the end of the lease term, each lessee is required to (1) exercise a fixed price purchase option provided to the lessee under the terms of the lease or (2) remarket the leased asset. If the lessee elects to remarket the leased asset and it is sold for an amount less than TrustCo's acquisition cost, the lessee is obligated to absorb the loss up to an amount stipulated in the lease agreement. If the asset is sold for an amount in excess of TrustCo's acquisition cost, the lessee will receive the excess proceeds as a rent rebate. The arrangements have been structured so the lessee is able to classify the lease as an operating lease in accordance with FASB Statement No. 13, *Accounting for Leases*.

Because none of the assets' fair values is more than one-half of the fair value of the entity's total assets, paragraph 12 indicates that the residual value guarantees are not considered to be variable interests in the entity. Based on the guidance in the Proposed FSP, in determining the amount of equity sufficient to absorb expected losses, the losses that will be absorbed by the residual value guarantees are not considered to be the entity's losses and the entity therefore would not be required to have equity sufficient to absorb expected losses from ownership of real estate to the extent of the guarantee. The expected losses from owning real estate have effectively been exchanged for expected losses from owning a financial asset where the entity is exposed to a decline in the creditworthiness of the guarantor.

As indicated above, we believe paragraph 5a, as written, requires a variable interest holder to determine when guarantees or subordinated retained interests enable an entity to finance its

activities in the absence of a sufficient equity investment. In many cases, such as in the example described above, a guarantee provides an entity with "additional subordinated financial support" that enables the entity to finance its activities. We believe an entity that needs such a guarantee should be considered to be a variable interest entity. In the lease transaction described above, in the absence of the lessee's guarantee of the assets' residual value at the end of the lease term, the lessor would be required to increase its equity investment or the lessee would be required to increase its periodic payments to amortize the debt used to finance the acquisition of the assets to reduce the risk borne by lenders.

Following from that analysis, once an entity is deemed to be a variable interest entity, the holder would then need to consider the guidance in paragraph 12. As such, even though a guarantee or subordinated interest could result in concluding that an entity is a variable interest entity under paragraph 5a, that guarantee or subordinated interest may not be a variable interest in the entity for purposes of applying the guidance in paragraph 12. In that case, the guarantor or holder of the subordinated interest would not be the primary beneficiary as long as the fair value of the asset to which the guarantee or subordinated interest relates is not more than one-half of the fair value of all assets held by the variable interest entity.

Notwithstanding our comments above, if the Board decides to proceed with issuing the Proposed FSP, we believe the guidance would be improved if the conclusion simply stated that a variable interest holder should determine an entity's expected losses by applying the guidance in paragraph 12 before determining whether the entity is a variable interest entity under paragraph 5. Further, we believe the Proposed FSP should clarify that when losses associated with specified assets are excluded from the entity's losses under paragraph 12, the entity's losses should include an amount for expected credit losses related to guarantors who will absorb losses from specified assets.

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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