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October 2, 2003

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Proposed FASB Staff Positions FIN 46-a, FIN 46-b, and FIN 46-c re: FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

Dear Mr. Smith:

Our comments on proposed FASB Staff Positions (FSPs) FIN 46-a, FIN 46-b, and FIN 46-c are discussed below. In addition, the Appendix to this letter provides suggested changes to enhance the clarity of the FSPs.

Proposed FSP FIN 46-a—Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Nonregistered Investment Companies

We support the issuance of this FSP. We believe the Board is taking the appropriate step in deferring the applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46 or the Interpretation) to the accounting by investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1), but are currently applying the accounting guidance in the AICPA Audit and Accounting Guide, *Audits of Investment Companies* (the Investment Company Guide), for their investees. To clarify the scope of the FSP, the Board should clarify that the deferral of the effective date of FIN 46 with respect to affected investment companies applies only to those companies' accounting for *their investees*, which means that the deferral does not eliminate the requirement for other parties involved with the investment company to apply the provisions of FIN 46 in evaluating whether to consolidate the investment company. Also, the Board should consider extending the paragraph 4(e) scope exception to investees of other entities that report all or certain of their assets at fair value. Such entities include, for example, employee benefit plans and other types of trusts, as well as broker-dealers. Finally, the guidance in the second paragraph of the proposed FSP regarding investment companies that are not separate legal entities could be eliminated since paragraph 3 of FIN 46 indicates that the Interpretation does not apply to entities that are not separate legal entities.

Proposed FSP on Interpretation 46 (FSP FIN 46-c)

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**Proposed FSP FIN 46-b—Effective Date of FASB Interpretation No. 46,
Consolidation of Variable Interest Entities, for Certain Decision Makers**

We support the issuance of this FSP. We believe that it is appropriate for the Board to consider excluding from the scope of FIN 46 decision makers whose only involvement with a variable interest entity is a fixed fee that does not expose the decision maker to any of the variable interest entity's expected losses and does not convey to the decision maker the right to receive any of the variable interest entity's expected residual returns. In those circumstances the fee does not represent a variable interest because it does not change based on changes in the entity's net asset value. The Board has also discussed whether fees paid to a decision maker should be considered "fixed fees" if they represent a fixed percentage of a variable interest entity's assets. While it would not be consistent with the guidance in paragraph 2 of FIN 46 to consider such fees to not be variable interests, we believe it would be appropriate for the Board to consider excluding them from the fees considered for purposes of paragraph 8(c) of the Interpretation. Essentially, in that circumstance the "regular" mechanics of the Interpretation with respect to consolidation based on identifying the party with interests that absorb a majority of the entity's economic risks and rewards function appropriately without the need for the additional formula weighting toward consolidation introduced by paragraph 8(c).

**Proposed FSP FIN 46-c—Impact of Kick-Out Rights Associated with the Decision
Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of
FASB Interpretation No. 46, *Consolidation of Variable Interest Entities***

We do not understand the Board's rationale for concluding that a service provider should be considered a decision maker based on the nature of the services it is providing even if equity and/or debt holders have substantive rights to remove the service provider without cause. However, we agree with the Board's conclusion if the kick-out rights are nonsubstantive. FIN 46 indicates that it is applicable when voting interests are not effective in identifying controlling financial interests. Although the consolidation requirements of FIN 46 generally are based on participation in a variable interest entity's economic risks and rewards, the Interpretation indicates that the objective of that requirement is to identify controlling financial interests obtained through means other than voting equity interests. As a result, control remains the core principle underlying consolidation of one entity by another. Therefore, it is not clear why it would be appropriate to conclude that a service provider that can be removed against its will at any time by other parties involved with an entity has control over the entity and, therefore, should be required to consolidate the entity. In that case, the service provider's involvement with the entity is controlled by other parties, and the service provider is acting on behalf of those other parties in performing services for the entity rather than itself controlling the entity.

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One of the criteria used to determine whether an entity should be evaluated for consolidation under the requirements of FIN 46 is whether its equity participants have the direct or indirect ability to make decisions about the entity's activities through voting or similar rights. If they do, and if they have the other two characteristics of a controlling financial interest, the entity is not evaluated for consolidation under FIN 46 provided that the amount of the equity at risk is sufficient. The Board's conclusion regarding decision makers in this proposed FSP raises operational concerns about how to evaluate whether an entity's equity participants have the direct or indirect ability to make decisions about the entity's activities through voting or similar rights when the entity has a service provider with the direct or indirect ability to make decisions that significantly affect the results of the entity's activities *even if* the entity's equity participants hold substantive kick-out rights with which to remove the service provider if they so choose. This fact pattern arises, for example, in mutual funds where the fund advisor has the ability to significantly affect the results of the mutual fund's activities but can be removed without cause at the direction of the fund's investors. For these reasons, we believe that substantive kick-out rights, whether held by equity or debt investors, should preclude the service provider from being considered a decision maker (i.e., there should be symmetry between the paragraph 5(b)(1) evaluation and the paragraph 8(c) evaluation).

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If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Kimber Bascom at (212) 909-5664.

Very truly yours,

KPMG LLP

**KPMG's Comments on Proposed FASB Staff Positions
FASB Interpretation No. 46,
Consolidation of Variable Interest Entities**

**Proposed FSP FIN 46-a—Effective Date of FASB Interpretation No. 46,
Consolidation of Variable Interest Entities, for Nonregistered Investment Companies**

The Board directed the FASB staff to issue this FASB Staff Position (FSP)¹ deferring the effective date for applying the provisions of Interpretation 46 to investments of investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1), but are currently accounting for their investments in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, *Audits of Investment Companies* (the Audit Guide). Paragraph 4(e) of Interpretation 46 states that an enterprise subject to SEC Regulation S-X, Rule 6-03(c)(1), shall not consolidate any entity that is not subject to that same rule. Other investment companies that are currently accounting for their investments in accordance with the specialized accounting guidance in the Audit Guide should not apply the provisions of Interpretation 46 to those investments until the Board has completed its consideration of whether to modify paragraph 4(e). The effective date of Interpretation 46 to investments of those investment companies is delayed while the AICPA finalizes its proposed Statement of Position (SOP) on the clarification of the scope of the Audit Guide and accounting by the parent companies and equity method investors for investments in investment companies. Following AICPA issuance of the final SOP, the Board will consider modifying paragraph 4(e) of Interpretation 46 to provide an exception for companies that apply the Audit Guide as revised by the SOP.

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The guidance in this FSP is effective for financial statements issued after the final FSP is posted to the FASB website. If applying this FSP results in changes to previously reported information, the cumulative effect of the accounting change shall be reported as of the beginning of the first period ending after the final FSP is posted to the FASB website. The requirements of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

Deleted: This effective date deferral does not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity, unless those investments were acquired pursuant to an irrevocable binding commitment that existed prior to March 28, 2002. (See *ETTF Abstracts*, Topic No. D-74, "Issues Concerning the Scope of the AICPA Guide on Investment Companies," for additional information on the applicability of the Audit Guide to nonregistered investment companies.)
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¹ The Board directed the FASB staff to issue this guidance in the form of an FSP rather than an FASB Technical Bulletin. Although the delay of an effective date is identified as one of the uses of a Technical Bulletin, procedures for issuing an FSP provide for ease of distribution, for retrievability, and for the expansion of the exposure period from the 15 days provided for by Technical Bulletins to 30 days.

**Proposed FSP FIN 46-b—Effective Date of FASB Interpretation No. 46,
*Consolidation of Variable Interest Entities, for Certain Decision Makers***

The Board directed the FASB staff to issue this FASB Staff Position (FSP)¹ deferring the effective date for applying the provisions of Interpretation 46 for a decision maker that receives fees paid by a variable interest entity if the fee has no variability and the decision maker has no exposure to any of the expected losses of the entity and no right to receive any of the expected residual returns of the entity. In those circumstances, the decision maker should not apply the provisions of Interpretation 46 to that variable interest entity until the Board has completed its consideration of a modification to the application of Interpretation 46, paragraph 8(c), that may affect those parties.

The guidance in this FSP is effective for financial statements issued after the final FSP is posted to the FASB website. If applying this FSP results in changes to previously reported information, the cumulative effect of the accounting change shall be reported as of the beginning of the first period ending after the final FSP is posted to the FASB website. The requirements of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

¹ The Board directed the FASB staff to issue this guidance in the form of an FSP rather than an FASB Technical Bulletin. Although the delay of an effective date is identified as one of the uses of a Technical Bulletin, procedures for issuing an FSP provide for ease of distribution, for retrievability, and for expansion of the exposure period from the 15 days provided for by Technical Bulletins to 30 days.

Proposed FSP FIN 46-c—Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

Q—Paragraph 8(c) of Interpretation 46 requires fees to the decision maker (if there is a decision maker) to be included in the calculation of expected residual returns. Does an investor's or another party's ability to remove the decision maker (that is, kick-out rights), with or without cause, enable the decision maker's fees to be excluded from the computation of expected residual returns as required by paragraph 8(c)?

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A—No. The existence of kick-out rights does not affect the status of a decision maker in the application of paragraph 8(c). That is, the ability of investors or other parties to remove a decision maker does not obviate the requirement to include fees to the decision maker in the computation of expected residual returns in accordance with paragraph 8(c), and in the evaluation of whether the decision maker is the primary beneficiary of the entity.

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The paragraph 8(c) requirement results in a consideration, in all cases, of whether the decision maker receives a majority of the entity's expected residual returns in the determination of the primary beneficiary calculated pursuant to paragraph 14 of Interpretation 46.

Effective Date and Transition

The guidance in this FSP is effective for all arrangements to which Interpretation 46 has been or will be applied. If the application of the guidance in this FSP results in changes to previously reported information, the cumulative effect of the accounting change shall be reported as of the beginning of the quarter in which the final FSP is posted to the FASB website. (The quarter in which the final FSP is posted is expected to be the quarter beginning October 1, 2003 for a calendar-year entity.)

The provisions of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

For enterprises that have not yet applied the provisions of Interpretation 46 to variable interests in variable interest entities in accordance with the effective date provisions of paragraph 27 of Interpretation 46, the guidance should be applied as a part of its adoption.