

Letter of Comment No: 126 File Reference: 1082-200 Date Received: 09/09/02

September 06, 2002

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1082-200 – Exposure Draft – Proposed Interpretation of ARB No. 51 on Consolidation of Certain Special Purpose Entities.

Dear Ms. Bielstein:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)¹ is pleased to comment on the Financial Accounting Standards Board's (FASB) Exposure Draft, Proposed Interpretation – Consolidation of Certain Special Purpose Entities. The FAPC is a standing committee of AIMR charged with maintaining liaison with standard setters who develop financial accounting standards and regulate financial statement disclosures and responding to new regulatory initiatives. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

General Comments

The FAPC strongly believes that the FASB should NOT issue this Exposure Draft (ED) because it neither achieves the stated objective to improve financial reporting by enterprises involved with special purpose entities (SPEs) nor improves overall financial reporting for consolidations. The committee strongly believes that the Board should develop a comprehensive standard for consolidated financial statements. Please refer to our specific comments below as they relate to this ED.

¹ With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, the Association for Investment Management and Research® is a non-profit professional organization of 59,000 financial analysts, portfolio managers, and other investment professionals in 107 countries of which 44,800 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 117 affiliated societies and chapters in 29 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program, which had more than 100,000 candidates from 143 nations enrolled for the June 2002 exam.

The committee's position on consolidation policy has not changed in over a decade. In *Financial Reporting in the 1990s and Beyond*, we stated, that failure to consolidate results in a "loss of detailed information about an economic enterprise's constituent corporate entity components". In a letter in 1995 we stated, that consolidation should employ an "enterprise approach in which all assets and liabilities of a partially-owned subsidiary are recorded at their fair value" and that the accounting "should reflect economic reality to the extent possible".

An important element that must be considered in establishing consolidation policy is the level of operational integration between two entities. We contend that in those cases in which the operations of the parent and a subsidiary are very closely linked, they should be consolidated. In applying this principle to QSPEs, retailers should be required to consolidate their finance or credit card subsidiaries and securitization conduits.

We are alarmed by the near-total absence of disclosure requirements in this ED. As has become increasingly clear in recent months, investors and other users of financial statements need full, complete, and transparent disclosure of the nature of a company's operations in order to be able to adequately assess the nature of the company's potential risks and rewards.

Specific Comments

Scope of the Project

The committee is very troubled by the approach that the FASB has taken in creating multiple, conceptually unrelated approaches to accounting for subsidiaries. If this ED were issued then we would have a proliferation of rules including a QSPE method, the ARB 51 approach, and the SPE method with variants.

The rationale for the proposed QSPE method is that the vehicle allows the parent company to disperse risk. However, we believe that the method may encourage companies to concentrate risk instead, and permit the retention of substantive risk by the transferor. The reason is that the method allows a company to securitize assets, retain the associated economic risk, and remove the assets from the balance sheet.

Some members of the FAPC have observed an increase in the number of non-public companies, which are substantive operating entities (SOE) that are willing to "rent" their balance sheets and consolidate SPEs as part of an arrangement. We are concerned that this proposal may exacerbate the problem. Since the ED does not address derecognition issues, we believe that "voluntary" consolidation by a SOE will limit the disclosure provided to investors, contrary to the objective of this ED.

The ED should clarify both consolidation and deconsolidation (derecognition) policy. If an entity is already consolidated by a SOE, the SOE should be required to evaluate whether it is appropriate for it to continue consolidation. We believe that this assessment is essential in that

the proposed rules will result in some SPEs going in and out of consolidation by an entity depending on its assessments of risk of losses.

Consolidation Based on Voting Interests

In paragraph 9(b), the ED specifies that the amount of the equity investment be "sufficient to allow the SPE to finance its activities without relying on financial support from the variable interest holders." However, in Paragraph 11, the ED states that a minimum equity level may be established by comparison to industry practice, thus overriding, the economic criterion in paragraph 9(b). The committee believes that this could result in even less equity than is required today.

A further test of sufficiency is outlined in paragraph 12. The FASB's bright line requirement of 10% outside equity appears to be too broad for general application. In principle, the FAPC believes that the amount of required unrelated (that is, other than a sponsor or primary beneficiary) equity should be based upon an economic and risk-based analysis of the level of equity needed for the SPE to independently access capital markets to finance its operations and to operate as an independent, economically viable, entity. The risk-based approach (economic model) does not eliminate subjectivity from the assessment of sufficiency of equity capitalization, but it is defensible both from a practical and theoretical standpoint. We believe that companies will always be able to find comparables to make the case for an override.

Consolidation Based on Variable Interest

We are concerned that application of the variable interest analyses will result in SPEs being consolidated in one period and not in another. Current practice permits companies that obtain a controlling interest in an investment previously reported under the equity method to consolidate the results as of the beginning of the year. With both of these methods being applied, we question whether investors will be able to determine what economic events resulted in a change in the consolidated entity.

We note that some are recommending that the assessment of consolidation based on variable interests be performed based on who holds a majority of the variable interests. We do not believe that identifying the controlling party based on a majority of rights—whether voting interests or variable interests—has provided investors with the best information in the past, and we would not support the assessment of the controlling party based on a majority of variable interests' analysis.

Definition of an SPE

The FASB does not define what a SPE is. However, the FASB states that a substantive operating entity (SOE) is not a SPE. We recommend that a definition be developed that identifies the distinguishing characteristics of a SOE. EITF Issue No. 98-3 may be a useful starting point with its focus on what is a business, although we are reluctant to place the full weight on this definition because it was not developed for this purpose.

As stated previously, the FAPC believes that any unrelated equity requirement should be based upon an economic and risk-based analysis of the level of equity needed for the SPE to obtain independent financing and function as an independent operating entity. That said, in the interim, we would support a specified minimum equity funding requirement for a SOE in addition to the economic risk analysis. We recommend that this equity be provided by independent third parties and be required to be in common shares. The use of subordinated debt should not be allowed even if it serves the same economic purpose and is subordinated to all other interests in the SPE.

Disclosures

We do not believe that the existing standards or this ED provide a substantive basis for accounting for SPEs. Furthermore, neither the existing standards nor this ED adequately addresses the required level of disclosures that would enhance transparency to investors. We believe that a better alternative, while the board works on trying to develop a standard on consolidation, is to provide disclosures that are clear and specific to the entity and should not simply be a restatement of the transaction's legal terms. Considering that the ED does not clearly define SPEs as noted in the previous section, we propose that for the purpose of disclosure the term SPE should include all other entities to which assets, contractual agreements and/or risks are transferred. The following elements, we believe, will enhance disclosure:

- Full and clear description of the extent of an entity's reliance on SPEs (Other entities to which assets, contractual agreements and/or risks have been transferred)
- Business purpose for creation and continued operation of the SPE
- The economic substance of the SPE
- Key terms and conditions of any commitments
- Potential risk exposure to transferor resulting from such arrangements that is not reflected
 on the face of the financial statement

Concluding Remarks

Respectfully yours

The Financial Accounting Policy Committee appreciates the opportunity to express its views on the Board's proposed interpretation: Consolidation of Certain Special Purpose Entities. If the Board or staff have questions or seek amplification of our views, please contact Nazir Rahemtulla at 1-434-951-5337 or at nazir.rahemtulla@aimr.org. We would be pleased to answer any questions or provide additional information you might request.

respectivity yours,	
/s/ Ashwinpaul C. Sondhi	/s/ Nazir S. Rahemtulla
Ashwinpaul C. Sondhi, Ph.D.	Nazir S. Rahemtulla, CFA
Chair, Financial Accounting Policy Committee	Associate, Advocacy AIMR

cc: AIMR Advocacy Distribution List
Patricia Doran Walters, Senior Vice-President
Professional Standards & Advocacy
Rebecca Todd McEnally, Vice-President, Advocacy