

Letter of Comment No: 45
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Ms. Suzanne Q. Bielstein, CPA
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: June 28, 2002 FASB Exposure Draft (ED) of a Proposed Interpretation of Financial Accounting Standards (File Reference No. 1082-200), *Consolidation of Certain Special-Purpose Entities (an Interpretation of ARB No. 51)*

Dear Ms. Bielstein:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the above-referenced ED and is providing the following comments for your consideration.

TIC's Overriding Concerns

TIC has two overriding concerns regarding the accounting provisions of the ED:

- (1) **Sufficient Equity at Risk Test:** The initial determination of whether-to-consolidate based on voting interests or the provisions of the ED is a basic element in its implementation. One of the factors considered is the determination of whether there is a sufficient amount of equity at risk. TIC believes that, in most instances, for closely held entities under common control, the equity of the owners is completely at risk. On that basis, TIC would conclude that consolidation would not be based on variable interests. TIC believes that Paragraph 9 should be revised to clarify this issue.
- (2) **Combined Financial Statements:** TIC recognizes that instances may exist where there is not a sufficient amount of equity at risk to evaluate special purpose entities (SPEs) based on voting interests. TIC requests that the FASB reconsider its conclusion on consolidation of SPEs and allow closely held entities under common control to combine financial statements of SPEs that do not meet the voting interest tests in paragraph 9.

Overall, TIC found the ED difficult to understand and interpret. TIC has heard similar comments from some of its constituents who say that the ED does not contain enough guidance to determine its applicability to their client base or enough examples to understand the mechanics of consolidation, such as accounting for minority interests and the annual inclusion/exclusion of SPEs.

TIC understands FASB's need to provide timely guidance to improve the accounting and disclosure standards for certain SPEs. However, before final guidance is issued, TIC believes FASB should review the effect this proposal will have on all of its constituents. Although this ED may solve some of the practice problems existing in the public company arena, TIC believes it will create significant implementation problems for a larger population of SPEs established by closely held entities under common control for legitimate purposes.

As stated in FASB Concepts Statement No.1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 34,

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

TIC believes, based on clients that exist in our own practices and discussions held with users of financial statements, that the consolidation requirements of the ED are not relevant to users of the financial statements of closely held entities under common control, and that it would be difficult to explain to our constituency, and costly and difficult to implement.

TIC requests the FASB defer application of the Interpretation for closely held entities under common control. TIC believes the deferral is necessary to allow adequate time for appropriate field tests to be conducted on these entities. TIC feels certain that the costs of this proposal will exceed its benefits and that it will prove to have little if any relevance for our constituents. Given the diversity of opinion on this issue and the scant research that is available for entities under common control, field tests are an essential part of due process for this ED.

In any event, TIC requests an extended, two-year implementation period for **all nonpublic entities** to allow sufficient time to gather relevant data and to educate financial statement preparers and users.

Furthermore, deferral or delayed implementation of the interpretation would have the added advantage of incorporating the benefits derived from the SEC's study of public company SPEs that was mandated as part of the Sarbanes-Oxley Act of 2002, Section 401(c). TIC believes the report on this study will be released after the FASB finalizes the interpretation on SPEs. TIC is concerned that the final interpretation may conflict with the findings of the Act's study on SPEs, necessitating further amendments to the FASB's standards.

In either case, however, TIC encourages the FASB to revise the ED to make it more relevant, comprehensive and understandable so that it may be consistently applied to all types of SPEs. Flowcharts and more examples specific to entities under common control would be useful.

This letter includes two attachments that are important to understanding TIC's views: (1) a section which expands the discussion on TIC's overriding concerns, and (2) a section which discusses other TIC concerns.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Candace Wright, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees

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OVERRIDING CONCERNS

TIC believes the guidance in the ED is not adequate for its scope. The ED purports to present interpretative accounting guidance for all SPEs. However, the ED appears to respond only to Enron's alleged abuses instead of providing guidance based on an understanding of all SPEs, including those that are established for legitimate purposes. The FASB has acknowledged in public forums that the interpretation will be applicable to certain entities under common control, but the draft never mentions these entities and never provides clear or relevant guidance for them. Entities under common control should be viewed as the "plain vanilla" SPEs. Interpretative guidance would be much more understandable if the accounting principles were presented for these entities first. Additional guidance for more complex SPE arrangements could then be provided in the latter part of the interpretation.

TIC has two main issues concerning the accounting provisions in the ED as they would be applied to closely held entities under common control. The first is that the ED does not provide enough guidance for entities under common control to determine whether there is sufficient equity at risk to avoid consolidation. TIC believes more guidance is needed in the final interpretation to understand how to apply the conditions in paragraph 9 of the ED to the various equity interests found in closely held commonly controlled entities.

For example, TIC is unsure how to interpret paragraph 9(b) of the ED, especially the first sentence:

The amount of the equity investment is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders.

TIC members interpreted this sentence differently. Some members argue the level of equity investment in the SPE to be largely irrelevant if a related party (defined under FASB Statement No. 57, *Related Party Disclosures*) provided financing or guarantees, while other TIC members believe the 10% threshold established in paragraph 12 would satisfy the test, even if the variable holders were related. Some TIC members believed variable interests could be aggregated; other members did not believe aggregation was allowed under the ED. TIC requests that FASB clarify some of these issues.

TIC also had difficulty interpreting an application example relating to paragraph 9c of the ED. Consolidation of an SPE based on voting interests would not be permitted if an equity owner in the SPE is not at risk of loss if the SPE's assets are insufficient to meet its obligations. In addition, the equity investment's return cannot be guaranteed directly or indirectly by any of the SPE's stakeholders. This condition must be met for the entire life of the SPE. Appendix A, paragraph A2, discusses a number of examples that, if present, would violate the condition in paragraph 9(c) and would thereby force the SPE to be evaluated for consolidation based on variable interests rather than on voting interests.

In the example in Appendix A, paragraph A2(c), a variable interest holder (other than the nominal owner) that guaranteed the SPE's debt or arranged another party to do so would

generally trigger the requirement to evaluate the SPE for consolidation based on variable interests. It is unclear whether footnote 10 is providing an exception to this rule and how such arrangements would be verified. Footnote 10 states:

However, guarantees and other arrangements that protect lenders to the SPE after the equity owner has suffered a total loss of its investment do not prevent the equity owner (or owners) from having the substantive risks of ownership.

TIC is uncertain whether the language in footnote 10 needs to be specified in the guarantee agreement for the exception to be considered effective. Since the equity owner is still at risk of losing its total investment; only the lender is protected. Therefore, the equity owner is deemed to have “substantive risks of ownership.” Assuming all other conditions in paragraph 9c are met, it would seem the SPE should be evaluated for consolidation based on voting interests (rather than variable interests).

The second issue arises if the SPE fails the tests in paragraph 9 and thereby must be considered for consolidation. TIC believes that closely held entities under common control should not be required to consolidate their financial statements. Rather, they should be allowed to combine them at historical cost. Combined financial statements are representationally faithful of the controlling financial interests in the entities, and are also the financial statement format preferred by financial statement users.

TIC’s constituency is comprised primarily of closely held commonly controlled substantive operating enterprises (SOEs) and SPEs that rarely have public investors. In many cases, the owner’s personal equity is at complete risk, and there are rarely the same incentives to mislead that appear to be present in public companies. The common owners control how the entities are configured and the nature of the transactions between the entities and can often change both factors relatively easily. Practitioners do not need further guidance to help them determine control with respect to these entities, and generally, TIC’s constituency has not experienced the practice problems with SPEs that have recently plagued certain public companies.

TIC has also found that consolidated financial statements would not serve the needs of our constituency’s financial statement users. Lenders and the owners themselves are the primary users of the financial statements of closely held entities under common control. TIC has spoken to some members of the banking community regarding this proposal and finds no support for it. In fact, bankers do not understand how the proposed presentation and disclosure standards will be relevant to their needs. They are often more interested in the separate financial statements of the related companies, not the combined picture. Therefore, consolidating these SPEs will not help lenders make more informed decisions.

In addition, the combination procedures in ARB No. 51 are simple and cost-effective to apply. Practitioners already know what to do to combine closely held entities under common control and do not believe consolidation would provide a more meaningful result.

Combined financial statements present clearly that control exists at a level **above** the **closely** held entities under common control—not with one of the combined entities. In contrast, consolidation implies that control is held by one of the entities in the consolidated group (the parent entity). The final interpretation should reinforce the difference between combination and consolidation—not obscure it.

OTHER TIC CONCERNS

TIC Concern No. 1-The stated objective of the ED, the need for guidance and the main accounting principles upon which the interpretation is based are not clearly articulated within the document and are insufficient to enable TIC's constituents to apply the guidance in practice.

This ED seems to represent a departure from principles-based standard setting. The ED launches into a series of rules without first clearly articulating the conceptual framework and the main principles upon which the ED is based. Neither the Summary nor the Introduction to the proposal clearly articulates the main objective of this ED or why the guidance was needed. This information is necessary to understand the direction and scope of the proposed interpretation and to consistently apply the guidance in actual practice situations.

TIC found that some of the key principles were placed in footnotes or in Appendix B, *Background Information and Basis for Conclusions*. Appendix B will not be reproduced in the *Current Text* or in the *Journal of Accountancy* and should not be the only place in the document where key principles are identified. TIC noted the following examples that may help the Board understand our point of view.

1. Paragraphs B2 through B5 could be merged into the Summary or Introduction of the final interpretation to increase understanding of the Board's intentions. Paragraph B2 describes some of the reasons for issuing the ED:

Some enterprises appear to have used SPEs to avoid reporting assets and liabilities for which they are responsible, to defer the reporting of losses that have already been incurred, or to report gains that are illusory.

2. Similarly, paragraph B3 provides a more specific statement of the objective of the interpretation than the existing Summary.

TIC Concern No. 2- Definitions used in the ED are either lacking or insufficient.

Definition of Special-Purpose Entity (SPE) – The ED does not explicitly define an SPE and does not distinguish “certain SPEs” from SPEs in general. Instead, the ED defines a substantive operating enterprise (SOE) by saying that it is *not* an SPE, and then briefly describes an SOE. The ED indirectly defines an SPE as the opposite of an SOE. New terminology should not be defined based on circular reasoning or negative definitions. Unclear definitions add to the confusion surrounding the ED and present troublesome issues regarding the meaning, intent and scope of the proposed interpretation, including a heightened risk of misinterpretation.

TIC appreciates the difficulty the FASB faces in defining SPEs, but TIC believes that a definition should be crafted. While TIC has not attempted to define an SPE, TIC has referred extensively to the definition of a **business** in paragraph 6 of EITF 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, in practice. Perhaps FASB should start with a rebuttable presumption that any entity that is **not** a business under EITF 98-3 would be considered an SPE.

At a minimum, TIC believes the SPE definition needs to be enhanced sufficiently to enable our constituency to apply the concepts to their practice situations. A common question asked of TIC is whether an individual's personal assets and liabilities (e.g., rental property and the debt thereon) that are used in connection with business activities could be considered an SPE under this ED. TIC believes the ED should explicitly state that an individual cannot be an SPE.

TIC believes the ED should present examples similar to those found in EITF 98-3. A flowchart may also be helpful.

Definition of Substantive Operating Enterprise (SOE) - TIC believes this definition should incorporate footnote 4 of the ED, so that the role that sufficient equity plays in the definition of an SOE is clearly understood. The Board should clarify whether the SOE's level of equity is a **deciding** factor in the definition.

TIC Concern No. 3 – Sources of equity investments for pre-existing SPEs and the meaning of indirect equity investments (paragraph 9(e))

One condition for evaluating an SPE for consolidation based on voting interests is paragraph 9(e) of the ED, which states the SPE cannot fund or finance its own equity interests, either directly or indirectly. Similarly, other parties with variable interests in the SPE are not permitted to supply equity or other financing either directly or indirectly. TIC notes many older entities that may qualify as SPEs under this ED might have difficulty determining the source of their equity investments, especially those SPEs without financial statement history. TIC requests that the transition guidance be changed to take this issue into account.

TIC also had difficulty determining what "indirectly" means among closely held entities under common control. TIC's constituency encounters a wide variety of transactions that may be considered indirect sources of equity interests. These include, **but are not limited to**:

- (1) Nonspecific entity loans to owner/officers, including those occurring prior to SPE formation;
- (2) Dividend or equity distributions (S or C corporation);
- (3) Gifting programs for estate planning.

TIC requests the FASB address these types of transactions in the final interpretation.

TIC Concern No. 4 – Lender as primary beneficiary with a 100% minority interest

Paragraph A3 contains a chart that identifies probable primary beneficiaries for a number of SPEs engaged in various activities. One of the examples discusses a SPE that leases real estate, production facilities or equipment to another entity. It further states:

If the lessee does not provide a residual value guarantee or make other arrangements that ensure that the value of the SPE's assets will be sufficient to meet its obligations at the end of the lease term, the lender to the SPE is the probable primary beneficiary.

Assuming the lender is not an equity owner in the SPE, the lender will have to recognize a 100% minority interest in consolidation. TIC does not understand how the minority interest would be presented or described in a manner that would not be misleading to the financial statement users. Initially, the consolidation would give the impression that the lender has full ownership of and access to the net assets of the SPE. The accompanying disclosures, which would show reductions for minority interest at a 100% amount, could potentially be missed or not understood. TIC requests that the Board re-examine this accounting to ensure it would achieve a result that would be representationally faithful.

TIC Concern No. 5 – Periodic Reconsideration of SPE consolidation not appropriate

Paragraph 14 of the ED requires that consolidation of an SPE be reassessed every reporting period. Based on the FASB's reassessment criteria, TIC is concerned that over the course of several years, some entities would consolidate an SPE in one year, deconsolidate it the next year and re-consolidate it shortly thereafter. This pattern would not only affect comparability over those years but would also add unnecessary complexity for financial statement users.

TIC believes that once consolidation is established between an SPE and a primary beneficiary, that presumption should remain in place unless specific factors have changed. This approach appears consistent with the FASB ED dated February 23, 1999, *Consolidated Financial Statements: Purpose and Policy* (File Reference No. 194-B) paragraph 16:

An entity shall review and assess all of the facts and circumstances surrounding its relationship with another entity whenever events or changes in circumstances suggest that control of that other entity may have been obtained or lost. (Emphasis added).

TIC Concern No. 6 – Fair market value of SPE upon initial adoption

Paragraph 26 of the ED requires that the individual assets, liabilities and noncontrolling interests of a pre-existing SPE be initially consolidated with a primary beneficiary at their fair values. This paragraph seems to be written with the presumption that the fair value of the SPE will *reduce* the consolidated equity of the primary beneficiary. While that may be the result where entities are “parking” off balance sheet debt, the presumption may not be true if the SPE has appreciated assets.

For example, some real estate SPEs may be required to consolidate with their primary beneficiaries. Under the ED, TIC believes the SPE holding the appreciated real estate would permit the primary beneficiary to record a substantial appreciation in the real estate even though the historical cost is substantially lower. This provision seems to permit the write-up of fixed assets in a manner that would conflict with APB Opinion No. 6, *Status of Accounting Research Bulletins*, paragraph 7, which states:

...property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity.

TIC believes predecessor basis is more appropriate and is consistent with paragraphs D11 and D12 of FASB Statement No. 141, *Business Combinations*, since no transaction has occurred with an unrelated third party.