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The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants is pleased to offer comments on the FASB's June 28, 2002, exposure draft of a proposed FASB Interpretation, *Consolidation of Certain Special Purpose Entities*.

Overall

AcSEC supports the thrust of the Interpretation. However, AcSEC has a number of significant concerns about the proposal, as drafted, and believes that unless the Interpretation is clarified and additional implementation guidance is provided, the Interpretation will not improve current accounting for consolidation of special purpose entities (SPEs).

AcSEC is especially concerned that—

- The Interpretation does not provide a means for the reader to determine readily if an entity falls within the scope of the Interpretation. Clearer guidance on differentiating substantive operating enterprises (SOEs) from SPEs is needed. In addition, exempting entities that are consolidated by another enterprise without providing guidance as to the appropriateness of such consolidation could lead to unsound conclusions.
- How to determine the relative size of variable interests, a necessary step in identifying the primary beneficiary, is unclear. Implementation guidance, including examples, is needed to avoid diversity in practice, particularly because preparers will have to apply the Interpretation as soon as it is issued.
- The Interpretation needs significant clarification to assure that it is understandable and applied consistently by both preparers and auditors.

The remainder of this letter contains our specific suggestions and concerns about the exposure draft.

Definitions

1. The Interpretation should provide a clear starting point for determining whether an entity is within its scope. Such a starting point could be provided by defining an SPE, although AcSEC understands that defining an SPE could be unacceptably limiting. Alternatively, AcSEC suggests making more robust the definition in paragraph 7(a) of

what is not an SPE (that is, an SOE) and clarifying that an SPE is an entity that is not an SOE. If the Board decides to make more robust the definition of an SOE—

- A primary focus should be on whether the entity conducts a business. That focus should consider the indicators of a business provided in EITF Issue 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.”
- Paragraph 3 notes that a primary characteristic of an SPE is that it is not subject to control through voting interests but rather it is controlled by an enterprise through contractual agreements, governing documents, and so forth. The voting interests in an SPE are often meaningless because its decisions and activities are often set in those documents. If an SOE is not an SPE, then in contrast the nominal owner of the entity that is an SOE should have meaningful decision-making powers through its voting interests. The Board may wish to consider building this concept from paragraph 3 into the definition of an SOE.
- The definition of an SOE should not include “has employees” or “usually issues financial statements of its own.” Those conditions are not meaningful distinguishing characteristics because any entity can easily be made to have employees and issue financial statements.

2. Footnote 4 states that paragraph 9(b) (which requires an equity investment greater than or equal to the expected future losses of the SPE at all times during the SPE’s existence) is not intended to apply to enterprises that were previously considered SOEs that no longer have sufficient equity to finance their business activities because of operating losses. That concept should be added to the definition of an SOE and not relegated to a footnote. In addition, that concept should be expanded to be that once an entity is determined to be an SOE, it should always be considered an SOE unless its governing document or activities change (for example, the entity is no longer a business, or the owners no longer have meaningful decision-making powers).

Scope

1. AcSEC believes the exception provided in paragraph 8(c) should be eliminated. AcSEC is concerned that paragraph 8(c) will permit companies to “rent” their balance sheets to others that wish to avoid consolidating an SPE. For example, in exchange for a fee, an enterprise transfers assets and liabilities to an SPE whose nominal owner is an SOE that is otherwise unrelated to the enterprise. The transferor guarantees the SPE’s debt. The SPE’s governing document restricts the operations of the SPE, leaving the nominal owner (the SOE) with little decision-making power or risk. AcSEC would not support allowing the transferor to avoid consolidation of the SPE merely because the nominal owner is an SOE and it has decided to consolidate the SPE.

AcSEC also is concerned about the auditing implications of an accounting model for SPEs that depends on how another enterprise accounts for the SPE and, implicitly, whether that other enterprise’s accounting is correct.

AcSEC recognizes that eliminating the exception in paragraph 8(c) would lead, in some cases, to reporting of the same assets and liabilities in the consolidated financial

statements of two different and otherwise unrelated enterprises. AcSEC notes, however, that a reporting entity's financial statements generally present information based on the reporting entity's own circumstances and not based on the circumstances of other entities. Accordingly, AcSEC believes that whether an enterprise should consolidate an SPE should be based on the reporting enterprise's relationship with the SPE and not on another enterprise's relationship with the SPE.

However, if the Board decides to retain the exception in paragraph 8(c), the exception should be clarified. The Board should clarify that the nominal owner/SOE should have meaningful decision-making powers in order to consolidate the SPE. Further, if the Board thought that this exception would not apply to situations other than the one described in the example in the last sentence, the Board should consider narrowing paragraph 8(c) to only those situations described in the example.

In addition, AcSEC believes that some might conclude incorrectly that certain entities that were intended to qualify for the exception should be consolidated. For example, some might conclude that an SPE-type entity that is owned and controlled by an enterprise that is not required to prepare consolidated financial statements (such as some foreign entities) is not covered by the exception in paragraph 8(c) and that it should be consolidated by another enterprise merely because the owner does not prepare consolidated financial statements under U.S. GAAP. AcSEC recommends that the criteria be reworded to refer to an entity that would be consolidated with another entity under U.S. GAAP, rather than to merely refer to "subsidiary," "division," or "branch." Alternatively, the Interpretation could state specifically that no enterprise shall be deemed to be the primary beneficiary of an SPE merely because the nominal owner is not required to follow ARB 51 and FASB Statement No. 94.

Similarly, AcSEC is concerned that a party with a variable interest may be required to consolidate an SPE merely because the "true" owner is a natural person rather than a substantive operating enterprise.

2. AcSEC agrees with the exception provided in paragraph 8(b). Editorially, the Board should clarify in paragraph 8(b) that the employer should not consolidate employee benefit plans that it *accounts for* under FASB Statements No. 87, 106, or 112. In addition, the Board should clarify that rabbi trusts would continue to be consolidated by the employer if the conditions in EITF Issue. No. 97-14 are met.

3. Although AcSEC does not disagree with the exception provided in paragraph 8(a), AcSEC notes that exclusion of a qualifying SPE from the scope would create a conceptual inconsistency because the economic substance of some qualifying SPEs may be similar to the economic substance of SPEs that would be required to be consolidated under the Interpretation.

4. Not-for-profit organizations are not specifically within the scope of the Interpretation. It is unclear, however, whether the Board's intent is that not-for-profit organizations (NPOs) should not apply the Interpretation or whether the Board did not consider the

applicability of the Interpretation to NPOs. Because both SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and the Interpretation are derived from ARB 51, and because paragraph 1.09 of the NPO Guide permits NPOs to follow the guidance in FASB Interpretations that specifically exempt NPOs from their application (unless FASB Statement No. 116 or 117 or the NPO Guide provide different guidance), there could be confusion in practice if the Board's intent is not clarified.

Consolidation Based on Voting Interests

1. The introduction to the part of the Interpretation that addresses whether consolidation of an SPE should be based on voting interests (paragraph 9) refers to equity investments. It is unclear whether the Board intended for the investments to be equity in legal form. If legal form is not intended to be a requirement, the phrase "hold equity investments" should be changed to "hold voting interests." Otherwise, the requirement that the equity investment be equity in legal form should be made clear.

2. Paragraph 9(b) states, "...that means that the equity investment should be greater than or equal to the expected future losses of the SPE *at all times during the SPE's existence.*" (emphasis added). Paragraph 11 notes that the condition in paragraph 9(b) must be assessed continuously. It is unclear based on the wording of the excerpted sentence whether, if the condition is failed once (that is, the equity investment is less than expected future losses for a period), the condition can be met subsequently. A clarification indicating that the condition can be met subsequently would be to insert "remaining" before "existence" in the last sentence.

3. Paragraph 9(b) should be clarified to indicate that "expected future losses" means based on the assets and liabilities currently in the SPE. Enterprises should not have to anticipate possible losses from additional assets that may be transferred to the SPE in the future or additional interests that may be issued by the entity in the future.

4. Paragraph 9(b) of the Interpretation should permit point estimates of expected future losses as well as probability-weighted estimates, because it may be more practicable in some circumstances to develop a point estimate than a probability-weighted estimate. As the Board noted in FASB Statement No. 144, the preference expressed in Concepts Statement No. 7 for a probability-weighted approach is discussed in the context of developing estimates of future cash flows that provide the basis for an accounting measurement (fair value). Because estimates of future cash flows called for by paragraph 9(b) of the Interpretation do not provide the basis for an accounting measurement, AcSEC believes that the preference for a probability-weighted approach in Concepts Statement No. 7 need not be extended to those estimates.

5. It appears that the equity investment described in paragraph 9(e) could be financed with nonrecourse debt. If that is not the Board's intent, the point should be clarified.

6. AcSEC is concerned that the means for overcoming the presumption established in paragraph 12 may be abused, with the possible result that there may be less consolidation of SPEs once the Interpretation takes effect than exists currently. AcSEC was divided,

however, on whether the presumption should be retained or whether an investment equal to 10 percent of the SPE's total assets should be an absolute minimum. However, if the Board decides to retain the presumption, AcSEC believes that further clarification of what are acceptable comparable SOEs is necessary to avoid abuse. For example, would one business enterprise that has relatively little equity because of significant losses be an acceptable comparable? Is one comparable business enterprise sufficient to support overcoming the presumption?

7. In the third sentence of paragraph 12, insert "unrelated" before "businesses that are not SPEs."

Consolidation Based on Variable Interests

1. The Interpretation provides that, if consolidation is to be based on variable interests, the determination of the primary beneficiary should be based on the relative size of the variable interests (that is, a majority of the variable interests or a significant portion of the total variable interests that is significantly more than the variable interests held by any other party). However, there is relatively little guidance on how variable interests should be compared, particularly when the variable interests have different characteristics, as would be the case with debt, equity, and guarantees. For example, it is unclear whether an equity investment subject to first risk of loss should be given more weight than senior debt. AcSEC believes that implementation guidance, including examples, is needed to avoid diversity in practice.
2. The Board should clarify that the concepts in paragraphs 20 and 21 are generally applicable to paragraph 13(c). Otherwise, some may believe the criterion in paragraph 13(c) is to be assessed based solely on the amount of an investment. A reader-friendly way to do that would be to move the concepts in paragraphs 20 and 21 into paragraph 13.
3. Paragraph 14 states that the initial measurement of the assets, liabilities, and noncontrolling interests of the SPE shall be at fair value at the time the enterprise becomes the primary beneficiary, but it does not say what to do with the difference between the previous carrying amount of the interest in the SPE and the fair values of the SPE's assets, liabilities, and noncontrolling interests. The Interpretation should specify how the difference should be accounted for. In addition, the Board should monitor the Emerging Issues Task Force development of Issue 02-9, "Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold," to ensure that a consensus is not provided that may conflict with guidance to be issued by the Board. Further, AcSEC assumes that if an enterprise should cease consolidating an SPE, the difference between the carrying amount of the SPE's assets and of its liabilities and noncontrolling interests at that time should be the carrying amount of the investment. That also should be clarified.
4. In paragraphs 15(c) and (e), the phrase "A party that has a de facto agency relationship" should be changed to "A party that has a variable interest as a result of an agency relationship" to clarify that those paragraphs are not intended to capture random relationships. In addition, it is not clear what kinds of professional services or business

arrangements the Board is referring to in paragraph 15(e). Further clarification, potentially with one or more examples, would be helpful.

5. AcSEC believes the Board should add “Employees of the enterprise” as item “f” in paragraph 15.

6. We have presumed, because of the second sentence of the paragraph, that the guidance in paragraph 16 relates only to those situations described in paragraph 15. If that is correct, the first sentence of paragraph 16 (“An entity can have only one primary beneficiary”) should be moved ahead of paragraph 13 and should become the basis for a paragraph introducing the concepts in this section. In addition, it appears that paragraph 16 is intended to provide guidance on identifying the primary beneficiary when two or more parties hold variable interests in the same SPE, rather than overall concepts of the Interpretation. Accordingly, paragraph 16(a) should be modified to state “The party that is a substantive operating enterprise is the primary beneficiary.”

7. In paragraph 17, “an enterprise’s rights and obligations to” should be changed to “an enterprise’s variable interests pertaining to” so that consistent wording is used throughout the Interpretation. If the Board intends a concept different from variable interests, that concept should be elaborated. Further, the interrelationship between paragraph 17 and the concepts of paragraphs 22 and 23 is unclear. For example, paragraph 17 suggests that a seller of receivables to a typical multi-seller commercial paper conduit should consolidate its pro rata share of the conduit. However, applying the principles of paragraphs 22 and 23 would lead to the conclusion that the sponsoring bank would be the primary beneficiary. Further clarification of the interrelationship of those paragraphs with each other, with accompanying examples, is needed.

8. It would be helpful to have some discussion in the Interpretation of limitations on—

- The ability of the holder of a variable interest to obtain information. For example, assume that an SPE leases 10 assets. The SPE obtains residual value insurance for one of the assets from Entity A. Entity A may be able to determine only the cash flows for the insured asset, and not the cash flows of the SPE. What should Entity A do?
- The ability of a holder of a variable interest, and that entity’s auditor, to identify other holders of variable interests, especially if those other holders’ variable interests result from other than equity interests in the SPE.
- The ability of the holder of a variable interest to know how other holders of variable interests are assessing their interests (for example, the cash flow estimates they are using) and how they are accounting for their variable interests.
- An entity’s responsibility if it and another holder of variable interests reach different conclusions as to who is the primary beneficiary. Perhaps that could be accomplished by expanding footnote 5 and bringing it up into the text.

Identifying and Comparing Variable Interests

1. The concept of variable interests providing support to the SPE “and through which the providers gain or lose from activities and events that change the value of the SPE’s

assets and liabilities” in paragraph 7(b) should be carried to paragraph 18. Otherwise, there may be confusion as to whether a risk of loss as a result of a contingent obligation that is unrelated to providing support (for example, a lawsuit over intellectual property rights brought against the enterprise by an SPE created to facilitate research and development) is a variable interest.

2. Some of the descriptions in paragraph 18 (a)–(j) of ways in which variable interests can arise do not bring the concept to life. For example, “leases with contingent lease payments or residual value guarantees” would be a clearer description than “leases.” The Board should review the descriptions for clarity and understandability.
3. The guidance in the second sentence of paragraph 19 is unclear and seems unnecessary. The second sentence of paragraph 19 should be deleted because:
 - What is relevant is whether the fee is at arm’s length. (Whether the fee is fixed or variable is irrelevant.)
 - The criterion should be whether there is an investment at risk regardless of whether the fee is fixed or variable.
4. Clarify in the first sentence of paragraph 19 that a fee may include other interests as well as cash, and delete the third sentence of the paragraph.

SPEs That Hold Certain Financial Assets

1. It would be helpful if the paragraphs of FASB Statement No. 140 that are referred to in paragraph 22 were reproduced in an appendix to the Interpretation.
2. In paragraph 23(a), “and sell assets” should be changed to “or sell assets” and “gains, and losses” should be changed to “gains, or losses.”

Disclosures

1. The rationale for the disclosure required by paragraph 25 is not apparent to AcSEC. If the Board decides to retain this disclosure requirement, the Board’s rationale should be provided in the Basis for Conclusions.
2. The phrase “In addition to any disclosures that may be required by other standards” should be added to paragraph 25.

Transition

1. AcSEC believes that individual assets, liabilities, and noncontrolling equity interests of an SPE that is consolidated as a result of the application of the Interpretation should initially be recognized at historical cost rather than at fair value. That should be accomplished through a cumulative catch-up adjustment, not by restatement. AcSEC supports an alternative to use fair value if it is impracticable to obtain the historical cost.
2. It is unclear to AcSEC how one would accomplish the pro forma disclosures required by paragraph 27 if transition were at fair value.

Other Matters

1. The Interpretation should provide additional guidance on whether investment companies, including separate accounts, are included in the scope of the Interpretation. It may be unclear how investment companies should apply the Interpretation’s consolidation guidance in the light of the guidance in paragraph 7.04 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, which precludes consolidation by an investment company of a non-investment company investee, and SEC regulation S-X rule 6-03(c)(1), which precludes consolidation by a registered investment company of a non-investment company investee.

2. AcSEC believes the understandability of the Interpretation and consistency in its application would be improved if the Interpretation included a decision-process flowchart.

3. If the Board does not define an SPE, it should consider changing the title of the Interpretation to “Consolidation of Entities That Are Not Substantive Operating Enterprises.”

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We appreciate the opportunity to comment on the proposed Interpretation. Representatives of AcSEC would be pleased to discuss our comments with the Board members or staff.

Sincerely,

Mark V. Sever, Chair
Accounting Standards Executive Committee

Robert Uhl, Chair
Guarantees/SPEs Task Force

cc: Accounting Standards Executive Committee
Guarantees/SPEs Task Force