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FSP FIN 46-e

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October 7, 2003

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**Proposed FASB Staff Position No. FIN 46-e, Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Interests Held by a Public Entity (FSP FIN 46-e)**

Dear Mr. Smith:

We support the deferral proposed in the above referenced document. However, we also believe that consolidation guidance of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, (FIN 46) in its entirety, warrants deferral.<sup>1</sup> We are aware that the Board debated and rejected this suggestion at its meeting on September 17, 2003. The Board's concerns are very real – many of the Board's most important constituents insist on timely accounting guidance that they believe will prevent the recurrence of recent, well publicized accounting abuses that involved the use of off-balance sheet special-purpose entities.

Our recommendation is based on the following broad concerns:

- 1. FIN 46 introduces new concepts that significantly challenge the resources of preparers and their independent auditors.*

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<sup>1</sup> We do not recommend deferring the disclosure provisions of the Interpretation.

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2. *The guidance does not always produce, from our perspective, relevant consolidation outcomes, raising legitimate questions about the Interpretation as a conceptual basis for consolidation.*
3. *Too many detailed implementation issues remain unresolved.*

Each of these points is explored in greater detail in Appendix A of this letter. Appendix B lists other comments we have on FSP FIN 46-c as proposed.

We thought long and hard before deciding to make this recommendation. First, we agree with the Board's assessment that pre-Fin 46 consolidation guidance for special-purpose entities<sup>2</sup> was incomplete, fragmented, and arbitrary. Second, FIN 46 represents an extraordinary effort by the Board and the Staff to provide a timely and conceptual resolution to the long-standing conundrum of when a special-purpose entity should be consolidated.

Yet we believe that the required approach is so new and untested, that the FASB should defer FIN 46's effective date. Based on our experiences to date, we are concerned that if financial statement preparers and auditors were to implement the provisions of FIN 46 at this time, the results would not align well with two tenets of the conceptual framework – (a) reliability, and (b) comparability and consistency. During the deferral period, the Staff, working with its constituents, should comprehensively review and understand implementation issues, with the goal of providing far more examples and implementation guidance (this deals with concerns 1 and 3 above). We also believe this would provide the FASB an opportunity to revisit the underpinning concepts of FIN 46 and whether it consistently produces relevant consolidation results (concern 2 above).

How long should the deferral extend? This is a difficult judgment to make. We believe that the first priority is for the Staff to establish a realistic timeframe for dealing with the above-mentioned issues. Our preliminary instinct tells us that accomplishing these tasks would result in a deferral beyond December 31, 2003.

Should you have any questions regarding our response, please contact Bob Uhl at (203) 761-3705 or Jim Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche LLP

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<sup>2</sup> We recognize that FIN 46 does not distinguish between special-purpose entities and other entities – however, the issue leading to FIN 46 was primarily concerned with special-purpose entities.

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## Appendix A Proposed FASB Staff Position No. FIN 46-e

As summarized in our cover letter, we believe that there are a number of areas of broad concern that warrant a general deferral of FIN 46's effective date – both for variable interest entities (VIEs) that hold financial and non-financial assets. Our primary concerns are as follows:

*FIN 46 introduces new and complex concepts that significantly challenge the resources of preparers and their independent auditors.*

This point doesn't address the many implementation questions that need to be answered – instead, it addresses the basic skill sets required to comply with and audit the Interpretation's provisions.<sup>3</sup> We believe that this circumstance makes it likely that FIN 46 – even when applied with the best of intentions – will result in an unacceptably high risk of financial reports that subsequently need to be restated. This is especially true when FIN 46 is initially adopted because preparers need to apply the provisions of FIN 46 to all existing entities, not just for new transactions. Thus the efforts and resources needed to implement the Interpretation and the risks of improper or inconsistent application are magnified. The initial application is also very important because it sets the base for ongoing subsequent application, making it especially critical that appropriate time and resources are devoted to ensure that initial application is done appropriately and consistently.

A *meaningful* calculation of expected cash flow variability requires skills that transcend the training and background of many people involved in the preparation and auditing of general-purpose financial statements. What is the proper basis for assigning probabilities? How should historical trends be considered? Should only observable data be used to support assertions, especially forward based assumptions? We acknowledge that FIN 46 techniques are used by quantitative analysts at Wall Street Firms and select valuation experts. We believe that the resources of these groups are not adequate to deal with the broad array of entities that are struggling with the fundamental concepts. Unlike FAS 133's impact, which also involved complex and novel financial calculations, FIN 46 touches on all but the most simply structured corporate entities.

*The guidance does not always produce, from our perspective, relevant consolidation outcomes, raising legitimate questions about the Interpretation as a conceptual basis for consolidation.*

In other comment letters we expressed our concern that FIN 46's bias towards consolidation by decision makers can produce anomalous results – a consolidated entity

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<sup>3</sup> We understand that it will not be necessary to do an expected variability analysis in cases where the variable interest is insignificant and also in instances where a general understanding of the structure makes clear that a particular party could not be the primary beneficiary.

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reporting assets for which it has no risk and liabilities for which it has no obligation.<sup>4</sup> The reverse is true as well. In these cases, a variable interest holder concludes it is not a primary beneficiary in spite of substantial and ongoing exposure to risk. In neither case, is it clear that financial statement users are well served. We wonder whether these anomalies suggest that an expected variability analysis, while conceptually suited to determining fair value, is not as useful a tool for analyzing (i) implicit control or (ii) substantive exposure to risk and reward. Another possibility is that perhaps the internal logic of FIN 46 could be improved. As we read the interpretation (and ignoring its treatment of QSPEs) it appears to follow the following logic:

1. If an entity is a voting interest entity, conventional consolidation guidance suffices (for the time being),
2. If an entity is a VIE, control is difficult to discern.
3. Control should be inferred from an economic analysis of risks and rewards.

One set of logic we have been considering (we have not finalized this notion) is described in the following sequence:

1. If an entity is a voting interest entity, conventional consolidation guidance suffices (for the time being),
2. If an entity is a VIE, identified factors [to be determined] should be analyzed to determine if control is difficult to discern. When control is not difficult to discern, conventional consolidation guidance would suffice. "Devices" such as a significant investment at risk without a corresponding ability to exercise control or influence might be a factor that indicates that control is difficult to discern.
3. When control is difficult to discern, control might have to be inferred from an economic analysis of risk and reward, with risk outweighing reward. The absence of a significant out-of-pocket investment at risk (including potential losses from guarantees and similar arrangements) would generally limit the potential parent's need to consolidate.

*Too many detailed implementation issues remain unresolved.*

In our first review on the document that led to FIN 46 we had the following comment:

We believe it is necessary to explain more fully the concept and to illustrate the mechanics [of the expected variability calculation], particularly in situations

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<sup>4</sup> Certain securitization transactions and common trust operations of banks illustrate aspects of this point.

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where there are multiple risks and rewards and where there is an interdependency of different risks and rewards.

This concern continues – and we note that it applies to VIEs that hold financial assets as well as non-financial assets. Below we list some of the more significant issues that we struggle with that have not been otherwise identified to FASB in our FIN 46 comment letters.

- We have internal debates on what really constitutes a variable interest, struggling, for example, with floating rate assets, vanilla interest rate or currency derivatives, etc.
- With disturbing frequency, we identify VIEs that appear to be entirely comprised of variable interests and worry that the corollary conclusion – that the entity has no expected losses or residual benefits and hence no primary beneficiary – is understandable or indeed whether it is appropriate.
- On the other hand, we have encountered situations where trivial risk exposure becomes the consolidation factor because variable interest holders share the substantive risks and rewards. We wonder whether these instances represent a case of “the tail wagging the dog.”
- Constituents (including ourselves) have developed a variety of methods to calculate expected variability and allocate this variability to variable interest holders. Disturbingly, the methods fail to identify the same primary beneficiary even when the methods incorporate identical assumptions and estimates about the timing and amount of the expected cash flows.
- The interaction between FIN 46 and other accounting literature applicable to business combinations, hedging activities (as described in DIG Issue No. G24), financial instruments with characteristics of both liabilities and equity, and others is complex. A deferral would allow the staff and its constituents appropriate time to consider the ramifications of these interactions.

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**Appendix B**  
**Proposed FASB Staff Position No. FIN 46-e**

Should the Board elect not to defer FIN 46 in its entirety, we support a deferral for those VIEs whose predominant holdings are non-financial.

However, we question whether the approximate three month deferral is long enough. The proposed FSP does not indicate why the Staff is making the recommendation – is it due to a late recognition by some preparers of the impact of FIN 46 on a variety of a VIE entities, identification of unique implementation problems associated with these entities, or a combination of both? To the extent the deferral results in whole or in part from unique implementation issues, we are concerned that too short a deferral could lead to a need for additional time.

We also urge the Board to permit a deferral for all VIEs that hold predominantly nonfinancial assets, regardless of when the interest was acquired or whether a variable interest holder has completed its assessment (conditions 1 and 4). The unresolved implementation issues cited in our cover letter, among others, illustrate the difficulties that variable interest holders continue to face in applying FIN 46. The February 1, 2003 cutoff assumes that a variable interest holder could, upon issuance of FIN 46, understand all of the broad and complex ramifications of the Interpretation. In addition, we do not understand why the deferral of FIN 46 should exclude entities that have put forth their best efforts in implementing FIN 46 but have not reported such results when additional interpretations of FIN 46 between now and the end of the deferral period may challenge their conclusions.

Finally, we do not believe that the Proposed FSP's requirement to disclose the reason for the delay in application of FIN 46 will result in the disclosure of information that is relevant to users of the financial statements.