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Mr. Lawrence Smith
Director of Technical Application and
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Re: Proposed FASB Staff Positions on FASB Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*

Dear Mr. Smith,

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the following six proposed FASB Staff Positions (the "Proposed FSPs"), on FASB Interpretation No. 46 ("FIN 46" or "the Interpretation"), *Consolidation of Variable Interest Entities*:

- Treatment of fees paid to decision makers and guarantors in determining expected losses and expected residual returns of a variable interest entity under FIN 46
- Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13 of FIN 46
- Application of paragraph 5 of FIN 46 when variable interests in specified assets of a variable interest entity are not considered interests in the entity under paragraph 12 of FIN 46
- Calculation of expected losses under FIN 46
- Applicability of FIN 46 to entities subject to the AICPA Audit and Accounting Guide, Health Care Organizations
- Transition requirements for initial application of FIN 46

We generally support the conclusions reached in these Proposed FSPs and appreciate the Board's willingness to address implementation concerns on a timely basis. We believe that

the issuance of the Proposed FSPs will help clarify the Interpretation. However, we noted some concerns about the potential implications and possible interpretations of the concepts underlying the Proposed FSPs for your consideration.

Treatment of fees paid to decision makers and guarantors in determining expected losses and expected residual returns of a variable interest entity under FIN 46

Interaction of Proposed FSP with Paragraph 14 of the Interpretation

The Proposed FSP states that the determination of the primary beneficiary of a variable interest entity should first focus on whether there is one party that will absorb a majority of the expected losses, if they occur. It states that if there is a variable interest holder that will absorb a majority of the expected losses, if they occur, then that enterprise is the primary beneficiary and it is not necessary to compute expected residual returns. The draft wording in the Proposed FSP appears to confirm the FASB staff view that a literal reading of paragraph 14 of the Interpretation should be applied in practice to determine which enterprise is the primary beneficiary of a variable interest entity. Should this view prevail, we believe that certain variable interest entities will be restructured to achieve off-balance sheet treatment by identifying a single investor to invest in the vehicle to absorb a majority of the expected losses. In certain structures, the expected losses of the entity may be disproportionately small in relation to the expected residual returns. Such a literal view of paragraph 14, as implied by the Proposed FSP, results in a conclusion that consolidation is not required by the party that is entitled to the majority of the expected residual returns.

Consider a commercial paper conduit. We have observed, that these special-purpose entities, generally have expected losses that are disproportionately small when compared to expected residual returns. This is because total decision maker fees are part of expected residual returns, while the thought process underlying paragraph 12 of the Interpretation excludes certain risks assumed by others from the calculation of expected losses. More specifically, in determining the expected losses of the conduit, one must consider the effects of credit enhancement provided by the sellers of financial assets to the conduit. In the majority of structures, these credit enhancements, in the form of over collateralization or loss reserves, are variable interests in specified assets that represent less than half of the total fair value of the assets of the entity, and therefore are not deemed to be expected losses of the entity as described in paragraph 12 of the Interpretation. Thus, the financial assets in the commercial paper conduit, after taking into account the effects of the sellers' credit enhancement, are relatively risk free when determining the overall expected losses of the entity. As a result, the calculated expected losses of the entity are relatively small in relation to its asset size since the expected losses absorbed by the seller's credit enhancement are not included in the determination of expected losses of the entity.

The implications of applying the guidance in the Proposed FSP are that certain structures, including certain commercial paper conduits will not be consolidated by their sponsor. This is despite the fact that the equity investments will be far less than the historical 3% ownership requirement that accounting guidelines mandated prior to the Interpretation. More importantly, we believe the FASB staff's conclusions in this Proposed FSP, coupled with other guidance in the Interpretation, results in a rules-based calculation that will result in conclusions in certain circumstances that do not achieve the principle that the FASB wished to attain. Quite simply, we understand the principle articulated by the FASB to be that the party that has a "controlling financial interest" should consolidate. In the example presented above, we believe that application of this principle would require the sponsoring decision maker to consolidate. The FASB staff's conclusions would result in preparers and auditors being required to leave the commercial paper conduit off-balance sheet. The FASB staff's analysis does not consider other relevant factors such as whether the variability in the conduit's decision makers fees could result in such fees yielding amounts to the decision maker that would be less than the expected market return. We believe that the Proposed FSP should be changed to provide guidance that results in conclusions that are consistent with the Interpretation's principle. Specifically, we believe that an examination of the substance of the transaction, not its form, should be performed which would result in also considering aspects of the expected residual returns, since focusing only on expected losses when they are disproportionately small may not be useful when evaluating whether to consolidate. We urge the Board and the FASB staff to reconsider this Proposed FSP guidance and refocus on the FASB's underlying principle in the Interpretation.

Total Fees to Decision Maker

We understand the FASB staff's view that both the total fees paid to the entity's decision maker and to providers of guarantees of all or substantially all of the entity's assets or liabilities, or both should be included in the entity's expected residual returns. However, we believe that the FASB staff should clarify how the phrase "total fees" should be interpreted. We believe that "total fees" should be interpreted to include the fees that the decision maker or the guarantor is expected to return as of the consideration date. In other words, the decision maker and the guarantor fees should be determined under each CON 7 scenario (i.e., each estimated cash flow scenario) for the entity and that the present value of the probability weighted fees represents the total fees to be included in the expected residual returns of the entity. In addition, if it is the FASB staff's view that the calculation of expected residual returns does not include any variability in the fees to decision makers and guarantors, then we believe that the Proposed FSP should be clarified for that view.

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Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13 of FIN 46

We concur with the FASB staff's Proposed view that concludes that a silo only exists when the related claims against specified assets (or group of assets) are separate from the remainder of the variable interest entity. However, we are concerned that confusion exists with regards to the phrase "are essentially the only source of payment for specified liabilities or specified other interests" in paragraph 13 and its interaction with the last sentence in the response to the Proposed FSP which states "That condition does not exist if the interests in the specified assets and related claims cannot be reported separately without accounting allocations". We recognize that the FASB has been concerned and troubled by the alternative of having to perform allocations of a pro-rata portion of entity-wide interests in order to prepare financial statements of a silo. However, we believe from an operational perspective, that a materiality threshold should be applied when determining whether a silo exists, rather than solely basing this assessment on whether accounting allocations would need to exist to report the specified assets and related claims. We believe that if there is a relatively minor portion of the specified asset that is financed with equity that has claims against assets (other than the specified assets) in the variable interest entity, there in fact may be a silo.

In that regard, we suggest the following changes to the response (as indicated):

A specified group of assets of a variable interest entity and any related claims against those assets (including liabilities and equity interests) are treated as a separate variable interest entity only if ~~essentially all of the cash flows from the specified assets they are~~ effectively separate from the remainder of the entity pursuant to the guidance in paragraph 13. That condition does not exist if the interests in the specified assets and related claims cannot be reported separately without accounting allocations.

Application of paragraph 5 of FIN 46 when variable interests in specified assets of a variable interest entity are not considered interests in the entity under paragraph 12 of FIN 46

We agree with the FASB staff's conclusion that the phrase "expected losses of the entity" has the same meaning in paragraph 5 as it does in paragraph 12. We believe that the Proposed FSP should clarify that a variable interest in specified assets of a variable interest entity are considered variable interests in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets, or if the holder has another variable interest in the entity as a whole as described in paragraph 12 of FIN 46.

Calculation of expected losses under FIN 46

We appreciate the FASB staff's proposed comments which clarify that an entity that has no history of net losses and expects to be profitable could in fact be a variable interest entity. In addition, while we appreciate the FASB staff's efforts in providing an illustration of the calculation of expected losses, we are concerned that the example is too simplistic and does

not alert a preparer to the underlying complexities of the expected loss calculations. Specifically, the example should consider the following issues for inclusion:

- The example does not describe how one should perform an allocation of the expected losses of the entity to individual variable interest holders. Some believe that such an allocation may result in the total expected losses of each variable interest holder not agreeing with the total expected losses of the entity (as certain parties may have expected losses in scenarios whether other parties have expected residual returns). It is unclear as to whether the FASB staff believes that this is in fact the case, and if so, how one would reconcile the expected losses of each variable interest holder to the expected losses of the entity itself.
- The example does not clarify whether one should consider the possible credit losses from the party funding the residual value guarantee. We believe, based upon discussions we held with the FASB staff, that the party performing the expected loss calculation should include the effects credit losses that may result from unfunded commitments to the entity by other variable interest holders (other than the party under assessment itself). For example, we believe all variable interest holders (except the provider of the residual value guarantee) should consider the possible credit losses on the funding of the residual value guarantee. We encourage that the FASB staff clarify this point in the Proposed FSP.

Applicability of FIN 46 to entities subject to the AICPA Audit and Accounting Guide, Health Care Organizations

We generally support the conclusion reached in this Proposed FSP and believe that its issuance will help clarify the applicability of the scope exception in FIN 46 to not-for-profit health care entities. However, we believe the narrow scope of the proposed FSP leaves unaddressed two significant issues regarding the application of FIN 46 to not-for-profit organizations as noted below.

As you know, the use of off-balance sheet structures and other special-purpose entities is not limited to the for-profit arena. Some not-for-profit organizations (particularly those experiencing financial difficulties) may contemplate using arrangements involving related entities in an effort to achieve off-balance sheet treatment. Historically in assessing these structures for consolidation, many analogized to the guidance in EITFs and SEC staff announcements such as EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, and Topic D-14, *Transactions Involving Special Purpose Entities*. Although that guidance did not directly apply to not-for-profit organizations, no other guidance was available for similar transactions entered into by not-for-profit organizations. As you know, paragraph 4(a) of FIN 46 specifically excludes not-for-profit organizations subject to SoP 94-3 from its scope. In

addition, the consensuses/guidance in the EITFs and SEC staff announcements that previously were applied by analogy have been nullified. Since no other guidance exists that could be utilized in the determination of whether to consolidate in these circumstances, some believe that the guidance in FIN 46 or the prior guidance described above should or could be applied by analogy. We would appreciate if the FASB staff would consider commenting on whether they believe it would be appropriate to consider FIN 46 or other guidance, by analogy, in evaluating certain structures for consolidation since it is unclear whether analogizing to guidance which is not contemplated by the Interpretation's scope or by following nullified guidance would be appropriate.

In addition, since FIN 46 nullified the guidance in the EITF Issues and SEC staff announcements, it is not clear what guidance should be considered for structures created prior to the issuance of FIN 46 that relied on that guidance. Consequently, we believe that the Proposed FSP should be expanded to address this issue. If it is the FASB staff's view that EITF and SEC guidance could continue to be applied by analogy, the FASB staff consider commenting on the applicability for not-for-profits of the EITF Issues and Topics affected by FIN 46 in the same manner as was done for the Issues and Topics nullified by FASB Statement No. 141, *Business Combinations* when updating the EITF Abstracts. That is, the nullified EITF Issues and Topics could be annotated in the table of contents with a footnote indicating that the Issue or Topic was nullified by guidance that does not apply to not-for-profits; therefore, the issue has been retained within the volume (by implication, for the benefit of those not-for-profits).

Transition requirements for initial application of FIN 46

We concur with the FASB staff's conclusion that the transition requirements for initial application of FIN 46 should be made as of the date the enterprise became involved with the entity or at the latest reconsideration date if an event requiring reconsideration of the entity's status or the status of its variable interest holders has occurred. We also agree with the FASB staff's proposed accommodation that if at transition, an enterprise cannot obtain the information necessary to make the determination as of the appropriate date, the enterprise should make the determination as of the date on which FIN 46 is applied. However, we believe that the Proposed FSP should consider clarifying what is meant by the phrase "cannot obtain the information necessary". For example, we do not believe that this accommodation would allow an enterprise to elect to decide not to obtain the information necessary. Instead, we believe that an enterprise must rather perform appropriate care and due diligence in an effort to obtain the information before invoking this accommodation. In addition, if an enterprise does perform the evaluation as of the date on which FIN 46 is applied, we believe that the FASB staff should consider requiring entities to specifically disclose this fact in their financial statements.

If you should have any questions regarding our comments, please feel free to contact Thomas Barbieri at (973) 236-7227, Doug Tanner at (973) 236-7282, or Pamela Yanakopulos at (973) 236-5798.

Sincerely,

PricewaterhouseCoopers LLP