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Technical Director  
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Financial Accounting Standards Board  
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LETTER OF COMMENT NO. 19

PricewaterhouseCoopers appreciates the opportunity to comment on the FASB's Proposed Statements of Financial Accounting Standards, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140* (the proposed FAS 140 amendment) and *Amendments to FASB Interpretation No. 46(R)* (the proposed FIN 46(R) amendment).

Recent economic events have heightened the need for increased transparency of companies' risk exposures to off-balance sheet structures. We support the FASB's efforts to improve transparency and provide more relevant, timely, and reliable information to users of financial statements regarding transfers of financial assets and variable-interest entities (VIEs). We also recognize that the current accounting models that govern consolidations and transfers of financial assets could benefit from improvement.

The Board's proposal does not address several significant issues that arise in applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities – an interpretation of ARB No. 51* (FIN 46(R)). For example, we note in this letter some of the challenges that preparers face when applying the existing consolidation guidance. We are also concerned about the diversity that may occur in practice and other possible unintended consequences if all of the proposed amendments are adopted in their current form. We acknowledge, however, that the issues involved in the Board undertaking a comprehensive project to review all derecognition and consolidation guidance given current market conditions would require more time to address, and that there is a need to respond to constituent concerns associated with the current models on a timely basis. Accordingly, we support certain aspects of the Board's proposed amendments as a partial solution to improving the accounting and disclosure model in the short-term, as discussed below under Recommended Interim Steps.

We recommend that the Board refrain from making any other significant changes to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140) and FIN 46(R) on a piecemeal basis to address other practice issues. Our preference is that the Board address those issues as part of performing a comprehensive review of all derecognition and consolidation guidance and developing a single principles-based consolidation framework that can be consistently applied by all types of entities. Those efforts should be coordinated with the International Accounting Standards Board (IASB) to facilitate convergence and minimize the risk of creating significant new differences between International Financial Reporting Standards (IFRS) and US GAAP.

## *Recommended Interim Steps*

As a precursor to performing a comprehensive review of all derecognition and consolidation guidance, we recommend the Board undertake the following interim steps to amend FAS 140 and FIN 46(R).

- Eliminate the qualifying special-purpose entity concept and revise the related sale criteria as proposed. This should result in greater consistency in the application of FAS 140.
- Require reconsideration of an entity's primary beneficiary based on FIN 46(R)'s current qualitative assessment if significant events have occurred that were unanticipated at the prior assessment date. Those events could include changes to either the economics underlying the structure that were unexpected (e.g., losses that were unexpected), structural changes, or other verifiable market events. This approach should be more operational for companies to implement than an ongoing reconsideration and only result in changes in an entity's primary beneficiary primarily due to significant events. The Board should also clarify that implicit arrangements must be considered as part of this reconsideration.
- Adopt the enhanced disclosures proposed under FAS 140 and FIN 46(R) that will provide the transparency needed for these transactions and relationships.
- *Permit the captioning of assets and liabilities of certain consolidated securitization structures on the face of the company's balance sheet so that financial statement users can identify those assets and liabilities. This should be limited to situations in which the primary beneficiary of the VIE is a transferor of financial assets and the transfer qualifies as a sale under FAS 140, but the transferor was determined to be the entity's primary beneficiary. In these cases, due to the non-recourse nature of the securitization transaction, captioning will highlight to the financial statement user that the assets captioned are restricted to satisfying associated liabilities of the VIE. This could help mitigate the extent to which consolidation of these financial special-purpose entities (SPEs) might obfuscate core operations and related assets and liabilities to which a company is fully exposed.*

## *The Need for a Comprehensive Review of All Consolidation Guidance*

One of the primary reasons why we suggest a comprehensive review of all consolidation guidance is that different definitions of control currently exist throughout US GAAP. The proposed FIN 46(R) amendment introduces yet another control concept for determining whether a VIE should be consolidated. A consequence of such varying control definitions is reduced comparability among companies with economically similar relationships, and accounting results that may vary depending on how an entity is structured. For example, an entity can be structured as a VIE by merely funding the entity in a manner that causes it to be thinly capitalized or moving decision-making rights away from equity investors to contract holders by incorporating those rights into contracts.

There are other practice issues that have arisen in applying the existing FIN 46(R) guidance that are not addressed by the proposed FIN 46(R) amendment. For example, despite a significant amount of interpretive guidance, there continues to be a lack of consistency in determining what constitutes a variable interest, in determining the variability that an entity is designed to create and pass along to its interest holders, and in determining the primary beneficiary based on a quantitative analysis. In addition, the determination of whether an entity is a VIE is largely form-based, which may not always reflect the economics of transactions.

The Board's proposals will also increase the number of entities that are consolidated. However, we do not believe that consolidation in and of itself always provides greater transparency to financial statement users or achieves representational faithfulness. This is partly due to the binary nature (an "all or nothing" approach) of consolidation. Even if a company is only partially exposed to the

risks and rewards of ownership in an entity, the binary nature could result in all of the entity's assets and liabilities being recognized on the company's balance sheet. Further complicating matters is the inability to distinguish between the company's own operating assets and liabilities and those of the consolidated entity on the face of the balance sheet — potentially hindering a reader's ability to clearly understand the nature of core trends in operating assets and liabilities of the company. The multiple measurement attributes that co-exist in financial reporting can also negatively impact the representational faithfulness of amounts reported in consolidated financial statements. *For example, unless the company elects the fair value option, any impairment of the consolidated assets cannot be ascribed to the debt investors in the securitization vehicles despite being economically borne by them.*

These are some of the key reasons we recommend that the Board comprehensively reconsider the control concepts contained in all consolidation and derecognition guidance, and develop a single principles-based consolidation framework that can be consistently applied by all types of entities, not just those that are subject to FIN 46(R). As part of that reconsideration, we suggest that the linked-presentation concept be explored further as a means to mitigate the extent to which consolidation of SPEs might obfuscate core operations and related assets and liabilities to which a company is fully exposed. The revised framework should also be thoroughly field-tested and its *business and regulatory implications evaluated before being finalized.*

#### *Other Observations on the Proposed Amendments*

The proposed FIN 46(R) amendment requires the determination of the primary beneficiary based on a qualitative model that hinges on the concept of power and the ability to receive significant benefits or absorb significant losses. We believe that these concepts have merit and are a good starting point for a consolidation framework for all entities. However if the Board elects to pursue this model further, we recommend that the principles underlying the proposed qualitative model be developed further. In particular:

- The proposal requires that for an enterprise to have a controlling financial interest it must have the power to direct matters that most significantly impact the activities of the VIE. Although this determination may be straightforward when all powers rest with one party, it becomes much more challenging when those powers are shared among multiple parties. For SPEs or VIEs, many of the powers can take different forms — they could include the power to predetermine an entity's activities or decision-making, manage ongoing operations, or act in response to specific contingent events. Greater clarity concerning the principles that should be applied in assessing one power relative to another when determining which powers most significantly impact the VIE activities, would assist in the analysis.
- The proposal also indicates that for an enterprise to have a controlling financial interest it must have the right to receive benefits from the VIE or the obligation to absorb losses of the VIE, either of which could potentially be significant to the VIE. It appears that probability of outcomes is not a consideration when making that assessment. As a result, a minor senior fixed fee at inception potentially could be significant if the underlying assets in the VIE become worthless. Under the proposal, that remote possibility could cause consolidation of a VIE. *While we don't believe it is the Board's intent that the significance test be applied this way, without further clarity, companies could interpret it in this manner.*

Our responses to the specific questions contained in the Notice for Recipients, along with additional comments on the proposed amendments, are attached in the appendices to this letter. If the Board elects to continue with the current proposals, we recommend that the specific concerns related to the amendments that we have highlighted in the appendices and in this letter be considered.



We appreciate the opportunity to express our views on the proposed statements. If you have questions regarding our comments, please contact Thomas Barbieri at (973) 236-7227, Susan Cosper at (973) 236-5156, Jeff Naumann at (973) 236-7182, or Michael Gallagher at (973) 236-4328.

*Sincerely,*

*PricewaterhouseCoopers LLP*

**Exposure Draft**  
**Proposed Statement of Financial Accounting Standards**  
***Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140***

**1. Will the proposed Statement meet the project's objective to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about (a) a transfer of financial assets, (b) the effects of the transfer on its financial position, financial performance, and cash flows, and (c) a transferor's continuing involvement in transferred financial assets?**

- We believe that the proposed FAS 140 amendments represent improvements to the effective control model that was introduced in FAS 140. However, the control model under FAS 140 is inconsistent with the risks and rewards model in FIN 46(R), the control definition in the proposed FIN 46(R) amendment, and the voting interest model contained in Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51). This may cause user confusion because different accounting models applied to similar transactions may lead to different results. It also may increase complexity for preparers since there is no clear principle behind the definition of control.
- Under the proposed FAS 140 amendments, some transfers of financial assets to securitization vehicles will meet the sale criteria of FAS 140 because the transferor will not be deemed to have "effective control" of the assets, based on a legal determination regarding their status should the company ever file for bankruptcy. However, many of those transferors will be required to re-recognize those assets on their balance sheets through consolidation because they have the "controlling financial interest" in the securitization vehicle. Thus, the control concepts under the proposed FAS 140 model do not reconcile with the control concepts under the proposed FIN 46(R) model. We recommend that the Board revisit the derecognition guidance in FAS 140 in conjunction with a broader reconsideration of all consolidation guidance and develop a single principles-based consolidation framework that can be consistently applied by all entities, not just VIEs. The goal should be to provide guidance that contains broad, flexible principles that promote the exercise of professional judgment to achieve appropriate accounting that reflects the economics of transactions.

**2. Do you agree with the Board's decision to eliminate the qualifying SPE concept and to require that all securitization entities be evaluated for consolidation under applicable U.S. generally accepted accounting principles? If not, why?**

- We agree that the qualifying SPE model should be eliminated. That model was premised on the notion that many securitization entities operate with limited or no decision-making powers. In practice, however, this often is not the case. As a result, numerous practice issues have arisen, prompting amendments to FAS 140. Eliminating the model should reduce the number of practice issues in this area and the need for future amendments to clarify the application of the model.

**3. Certain financial statement users suggested that the Board adopt a no-continuing-involvement model (that is, if there is any continuing involvement, sale accounting would not be permitted). The Board decided to continue to permit derecognition of financial assets with continuing involvement as long as the conditions in paragraph 9 of Statement 140, as amended by this proposed Statement, are met, with the addition of enhanced disclosure requirements about a transferor's continuing involvement (see paragraph A28 of the proposed Statement). Do you agree with this decision? If not, why do you disagree**

**and what approach would you recommend to meet the needs of financial statement users for additional information on transferred financial assets?**

- We agree with the Board's decision to not support a no-continuing-involvement model. Such a model would be inconsistent with the overall economics of many financial asset transfers. Additionally, a no-continuing-involvement model is inconsistent with the fundamental financial components approach that was the basis for FAS 140 and its predecessor, FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. In the case of financial assets, we believe a financial components approach will result in accounting for transactions that more consistently reflects the underlying economics.

**4. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?**

- We recommend that the Board perform a robust field-test of the proposal, including evaluating its business and regulatory implications, and modify the standard as appropriate to address those implications. Without performing such a field test, it may be difficult for the Board to gain comfort that the proposal will not impose significant costs on preparers and other stakeholders that outweigh its perceived benefits.
- As it relates to disclosures, we generally support the changes contained in the proposed amendment. However, the proposed disclosures are quite extensive and certain of them could require companies to invest significant time and effort in gathering data, analyzing exposures, and preparing footnotes. Also, requiring the level of information contemplated by the proposed disclosures carries with it a potential cost, i.e., financial statements, weighted with this volume of information, can become less transparent and more cumbersome for financial statement users. To address the first issue, we recommend that the Board give special attention to the comments received from financial statement preparers and carefully consider the costs that they believe they will incur in developing the proposed disclosures. In making the case for requiring these disclosures, the Board and its constituents need to be confident that not only will the disclosures improve the relevance and reliability of financial reporting and provide incremental value to stakeholders, but they will do so at a reasonable and acceptable cost.

**5. The Board decided to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. A transfer of a portion of a financial asset as a sale is eligible for derecognition only for a pro rata portion that meets the definition of a participating interest. Do you agree with this decision? If not, why do you disagree? If you agree with the Board's decision to limit the portions of financial assets that are eligible for derecognition, do you agree with the definition of a participating interest? If not, what alternative definition do you recommend and why?**

- Although defining a portion of a financial asset that would be eligible for sale accounting could be beneficial, we do not agree with the Board's proposed definition because it may not result in accounting that reflects the economics of transactions. Our specific concerns include:
  - It is unclear to us why certain assets are not eligible for sale accounting under this definition. For example, the proposal does not articulate the principles behind why certain hybrid instruments with embedded derivatives that are not clearly and closely related are not eligible to be treated as participating interests. In certain cases, the cash flows from these instruments could be separated in a manner to comply with the participating interest definitions (other than the requirement in paragraph 8B(a)). Consider a debt security for which the interest rate is adjusted because of changes in response to

movements in the S&P index. Such a financial asset would be deemed to have an embedded derivative that is not clearly and closely related (i.e., the S&P indexation), but would appear eligible to be participated in by another holder (and meet all the other requirements of the definition of a derivative). Another example is a contingent call option held by the borrower that may not be considered clearly and closely related to a loan or a security issued. However, we also believe that there may be some cases where the embedded derivative that is not clearly and closely related would require "exercise" by the financial asset holder — this may not meet the definition of a participating interest because the decision to exercise would not allow for each participating interest holder to have the same rights associated with its exercise (e.g., convertible debt). It is unclear how decision-making rights attached to the transferred participating interests and retained interests could be separated to comply with criteria (b) and (c) of paragraph 8B. We suggest that the Board reconsider this requirement and better articulate the principle on which criterion (a) is based.

- The participating interest definition may not always result in accounting that reflects the economics of a transaction. Consider a factoring arrangement whereby a portion of a \$100 financial asset (a trade receivable) is legally transferred to a transferee and such portion represents a right to the first \$90 of cash flows from the trade receivable (i.e., the portion not sold is subordinate). Under paragraph 8B(c), such a transfer of a portion of a trade receivable would not qualify as a participating interest because of the subordination feature. However, the same economics could be achieved by transferring the entire \$100 financial asset, with the transferor accepting a receivable from the transferee, where the obligation for the transferee to pay depends on the performance of the trade receivable (i.e., the transferee is required to pay amounts collected from the trade receivable in excess of \$90). In essence, the transferor accepts a non-recourse collateral-dependent receivable from the transferee. The economic substance of the two transactions is the same, but they may result in different accounting.
- The principle behind excluding the cash flows allocated to servicing the asset is not fully described. In assessing whether cash flows are divided among the participating interests in proportion to their ownership, criterion (b) in paragraph 8B requires that all cash flows allocated to the servicer be excluded. Under this approach, however, the legal form of a participation agreement could alter the accounting. Consider an arrangement where the cash flows allocated to the servicer are subordinate to the transferor's and the transferee's participating interests. We believe that such subordination alters the rights to the cash flows of the underlying assets and as a result such an allocation should not meet the definition of a participating interest. Additionally, the servicing fee could be structured in a manner that subordinates the cash flows of the underlying asset while still meeting the definition of a participating interest. Consider a fact pattern where the servicer is allocated cash flows significantly in excess of adequate compensation and in a manner that is senior to the participating interests. This could result in the servicer subordinating cash flows allocated to the participating interest holder. We recommend that the Board require the servicing fee to represent a right that is comparable to the current market rate. We believe that servicing fees should be excluded only to the extent that they are not *significantly* in excess or *significantly* below adequate compensation rates for such servicing. In addition, we believe that cash flows from the underlying assets that are used to pay a market-based guarantee fee also should be excluded from this criterion.

**6. Paragraph 9(c) of Statement 140 and related interpretation guidance, as amended by this proposed Statement, require that the transferor (a) not maintain effective control over transferred financial assets to account for a transfer as a sale and (b) provide examples of effective control. The Board decided to incorporate many of the concepts from paragraph 9(b) of Statement 140 into paragraph 9(c), which results in the creation of the additional examples that are included in paragraph 9(c)(3) and 9(c)(4). Do you believe that paragraph**

9(c) of Statement 140 and the related implementation guidance, as amended by this proposed Statement, clearly explain how to determine if the transferor maintains effective control? If not, what additional guidance or examples are necessary? Do you believe that paragraph 9(c), as amended by this proposed Statement, is operational in its entirety in its current form? If not, what changes are necessary? Do you believe these additional examples of effective control in paragraphs 9(c)(3) and 9(c)(4) are operational in their current form? If not, what changes are necessary?

- We support the elimination of paragraph 9(b) because as currently written, it raises significant practice issues. We agree with the Board that, as a result of eliminating the qualifying SPE concept, the derecognition criteria in paragraph 9(b) required amendment to allow for the fact that restrictions on the ability of the transferee to pledge or exchange the transferred financial assets are often needed to enable the marketing of beneficial interests to investors.
- The example of effective control in paragraph 9(c)(3) could be further clarified. Paragraph 54D states: "Judgment also is required in assessing the significance of the benefit and whether the constraint provides the transferor with the ability to effectively control the transferred financial asset." This suggests that the significance of the benefit is relevant to the assessment under paragraph 9(c)(3). However, significance is not mentioned in paragraph 9(c)(3). The Board should consider clarifying whether the significance of the benefit should be assessed under paragraph 9(c)(3).
- We recommend that the proposal include guidance stating that even a restriction on the timing of transfer of a financial asset can be a constraint. Paragraph 29, which has been deleted in the proposal, stated that even a constraint that restricts the timing of transfer of the financial asset can be a restriction. We believe this clarification may be beneficial to retain.

**7. Certain financial statement users strongly recommended that the Board provide disclosure principles and require certain specific disclosures for both transferred financial assets treated as sales and those that are treated as secured borrowings. Do you agree that additional disclosures about transferred financial assets are necessary and operational? If not, what changes would you make to the requirements? Do you believe that the revisions to the disclosure requirements are sufficient? If not, what additional disclosures do you believe are necessary?**

- As discussed in our response letter to the proposed FASB Staff Position FAS 140-e and FIN 46(R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable-Interest Entities*, we support the inclusion of the principal objectives of the disclosures. They emphasize the need for companies to be flexible in meeting the disclosure objectives. They also provide for disclosures to be made that are not stipulated by the requirements if such disclosures would meet the principal objectives and provide useful information for financial statement users.
- In deciding whether to require disclosure of disaggregated or aggregated information, preparers should be permitted to exercise judgment to determine which information will be most helpful to financial statement users and will accomplish the principal objectives of the disclosures. The Board should consider including an example to demonstrate a reasonable application of the aggregation principle for continuing involvements in transfers of financial assets.
- The proposal requires consideration of implicit and explicit arrangements in providing quantitative and qualitative information about transfers of financial assets, when the transferor has continuing involvement in the assets. Such a disclosure could have adverse consequences for a company's legal strategy if the company is held to what it has previously disclosed in the financial statements based purely on hypothetical events. The Board's goal

of providing financial statement users with more transparent information needs to be weighed against the challenges of presenting that information in today's legal environment. The Board should also consider whether it will be feasible for preparers to predict implicit arrangements and their outcomes, and whether that information will be auditable.

**8. Appendix C includes significant amendments, primarily as a result of this proposed Statement, to related literature including (a) the FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, (b) certain Emerging Issues Task Force (EITF) Issues and Topics, and (c) certain AICPA Audit and Accounting Guides. Do you agree that the related literature, as amended, is consistent with the proposed amendments to Statement 140? If not, why do you disagree and what changes would you make?**

- A number of Q&As in the FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, would be deleted by the proposed amendment. Certain of these Q&As would appear to remain relevant under the proposed FAS 140 amendment and provide useful guidance, including numbers 52, 66, 76, 85, and 86. We recommend the Board reconsider these deletions. We also have the following comments:
  - Question 22: It is unclear what is meant by the phrase "The Board did not differentiate having the ability to exchange the transferred financial asset from pledging it as collateral."
  - Question 49: The second bullet under other examples of application of effective control principles is not correct if the call's strike price is at fair value — see paragraph 53 (the example says that if a call permits the transferor to reclaim all of the transferred financial assets from the transferee at any time; such call precludes sale accounting). To avoid misapplication of the Board's intent with the proposed guidance, it should be explicit in the body of the standard that in no event will a partial sale of an individual asset be permitted under this new guidance unless it meets the definition of a participating interest (i.e., sales would be recorded only if there is a transfer of individual or groups of financial assets in their entirety or of a participating interest).

**9. Due to differences in financial statement user needs and cost-benefit considerations, should any differences exist for recognition, measurement, disclosure, transition, or effective date for private companies? If yes, please articulate what differences should exist and the reasons for those differences.**

- No, we do not believe that any exceptions should be made for private entities in the proposed FAS 140 amendment. In our view, these principles should be applied similarly to private entities otherwise it would add unnecessary complexity to existing accounting standards. The proliferation of exceptions could result in private company accounting being less principles-based. That said, we acknowledge and support the benefit of providing differences in the transition, disclosures, and effective date requirements for private entities based on cost-benefit considerations. The Board should consider comments expressed by private entities in this regard.

**10. Other comments**

- Generally, FAS 140 requires that the ability to qualify for sale accounting is an ongoing test. However, condition (c) in paragraph 55 in the proposed FAS 140 amendment is an example of an inconsistency with that concept. This condition provides an exception to the transferor accounting for the regaining of control as a purchase of the transferred asset from the transferee when there has been a "change in market prices (for example, an increase in price that moves into-the-money a freestanding call on a non-readily-obtainable transferred



financial asset that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee)." We recommend that the Board address this inconsistency by removing condition (c) in paragraph 55 of the proposed amendment.

- Paragraph 27A of the proposed FAS 140 amendment states that "a legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested." We disagree with the inclusion of this sentence and the remainder of paragraph 27A on the basis that it might imply that a legal opinion is otherwise always required. In our view, the determination of whether a legal opinion is required is not something that an accounting standard should address. Rather, it should be left to the judgment of companies and their auditors as to what evidence is necessary to conclude that the criterion in paragraph 9(a) of FAS 140 has been met.
- Paragraph 53 in the proposed FAS 140 amendment includes the notion that the transferor is deemed to retain effective control over the transferred financial assets if the transferor has the right to reacquire those assets and also has a residual interest. This was premised on the fact that if the transferor holds all the residual interest, it could potentially overbid in an auction process for the sale of the transferred financial assets, and, as residual interest holder, would receive all those excess payments. However, this is less obvious when the transferor holds only a portion of the residual interest and therefore would be less likely to overbid since it would have to share any excess with other residual interest holders. For example, in a case where the transferor holds only 10 percent of the residual interest, 90 percent of the overbid amount would go to other residual interest holders. We recommend that paragraph 53 be amended to enable judgment to be applied in determining if a residual interest, with a right to reacquire the transferred financial assets, results in the transferor maintaining effective control over those financial assets.

**Exposure Draft**  
**Proposed Statement of Financial Accounting Standards**  
*Amendment to FASB Interpretation No. 46(R)*

**1. Will the proposed statement meet the project's objectives to improve financial reporting by enterprises involved with variable-interest entities and to provide more relevant and reliable information to users of financial statements?**

- Although we generally support the proposed disclosures, we do not believe that the accounting changes in the proposed FIN 46(R) amendment will necessarily improve financial reporting. As discussed further below, the proposed amendment does not address many of the challenges that are prevalent in the application of FIN 46(R). It also introduces a new control concept, which has inconsistencies with other existing control concepts, and adds complexity to financial reporting. We recommend that the Board refrain from making significant changes to consolidation standards on a piecemeal basis. Our preference is that the Board perform a comprehensive review of all derecognition and consolidation guidance and jointly develop a single principles-based consolidation framework, together with the IASB, that can be consistently applied by all types of entities.
- Examples of the practice issues not addressed by the proposed FIN 46(R) amendment, include:
  - FIN 46(R)'s guidance on determining whether an entity is a VIE is complex and has proven difficult to apply in practice. Additionally, many aspects of the guidance result in determinations that are form-based, which may not always reflect the economics of transactions.
  - Despite significant interpretive guidance, there continues to be a lack of consistency in determining variable interests and the variability that an entity is designed to create and pass along to its beneficial interest holders. For example, recently there was much debate on whether interest rate risk created variability for a money market mutual fund.
  - There are several bright line tests in FIN 46(R), such as for determining a variable interest in a specified asset, as well as for applying an element of the business scope exception. Such tests are not consistent with a principles-based framework and can reduce the extent to which professional judgment is applied.
- One of the primary reasons for suggesting a comprehensive review of all consolidation and derecognition guidance is due to the differing definitions of control that exist throughout US GAAP, such as those contained in FIN 46(R), ARB 51, and FAS 140. The proposed FIN 46(R) amendment introduces yet another control concept for determining whether a VIE should be consolidated, which may actually increase complexity and also create inconsistencies with the other existing control concepts. For example:
  - Under the proposal, the existence of substantive kick-out rights is not considered in determining control unless a single party has the unilateral ability to exercise those rights. This generally contradicts the approach taken under the voting interest model. As a result, the proposal may result in consolidation or non-consolidation of VIEs using different principles than those for determining consolidation for voting interest entities that have the same underlying economics. Not considering substantive kick-out rights also contradicts the approach in determining whether an entity is a VIE under paragraph 5b(1) of FIN 46(R).

- Under the proposal, there is also a need to consider implicit financial responsibility, a concept not contemplated in other consolidation guidance.

In addition, the current quantitative model for determining the primary beneficiary of a VIE, which does not consider power in determining control, would be retained in the proposed FIN 46(R) amendment. As a result, the proposal is inconsistent with other guidance in US GAAP because of differing definitions of control for entities subject to this guidance and may cause significant diversity in practice.

- The proposed FIN 46(R) amendment requires the determination of the primary beneficiary based on a qualitative model that hinges on the concept of power and the ability to receive significant benefits or absorb significant losses. We believe that these concepts have merit and are a good starting point for a consolidation framework for all entities. However, if the Board elects to pursue this model further, we recommend that the principles underlying the proposed qualitative model be developed further, as we explain in our answer to question 3 in this appendix. We also recommend that the Board perform a robust field-test of the proposed amendments to reduce the extent to which unintended consequences could result from applying the proposed guidance to certain structures.
- The Board's proposals will also increase the number of entities that are consolidated. However, as we explain in the cover letter, we do not believe that consolidation in and of itself always provides greater transparency to financial statement users or achieves representational faithfulness.

**2. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits to users of financial statements?**

- We recommend that the Board perform a robust field-test of the proposal, including evaluating its business and regulatory implications, and modify the standard as appropriate to address those implications. Without performing such a field test, it may be difficult for the Board to gain comfort that the proposal will not impose significant costs on preparers and other stakeholders that outweigh the proposal's perceived benefits.
- As it relates to disclosures, we generally support the changes contained in the proposed amendment. However, the proposed disclosures are quite extensive and certain of them could require companies to invest significant time and effort in gathering data, analyzing exposures, and preparing footnotes. Also, requiring the level of information contemplated by the proposed disclosures carries with it a potential cost, i.e., financial statements, weighted with this volume of information, can become less transparent and more cumbersome for financial statement users. To address the first issue, we recommend that the Board give special attention to the comments received from financial statement preparers and carefully consider the costs that they believe they will incur in developing the proposed disclosures. In making the case for requiring these disclosures, the Board and its constituents need to be confident that not only will the disclosures improve the relevance and reliability of financial reporting and provide incremental value to stakeholders, but they will do so at a reasonable and acceptable cost.

**3. The Board decided to adopt a more principles-based approach to determine the primary beneficiary of a variable interest entity. Do you believe the principles in paragraphs 14-14B of Interpretation 46(R), as amended by this proposed Statement, are sufficiently clear and operational?**

- We do not support the proposed consolidation model on the basis that it could add further complexity to current financial reporting. It would also likely cause significant changes while only representing an interim solution. However, as part of a comprehensive review of all *consolidation guidance conducted jointly with the IASB*, we would support a move toward a single principles-based consolidation framework that can be consistently applied by all entities based on a qualitative analysis.
- We do not believe the principles in paragraphs 14-14B are sufficiently clear and operational. If the Board chooses to pursue the proposed model, we have the following observations relating to those paragraphs and to related guidance:
  - The proposal requires that for an enterprise to have a controlling financial interest it must have the power to direct matters that most significantly impact the activities of the VIE. While this may be straightforward when all powers rest with one party, it becomes much more challenging when those powers are shared among multiple parties. The proposal is not clear as to the principle to be applied in assessing one power relative to another for the purpose of determining which powers most significantly impact the activities of a VIE.

One way to highlight this issue is by considering the different decision-making rights and/or predetermined decisions that exist in a franchisor/franchisee arrangement. In such arrangements, both the franchisor and the franchisee could be involved in making decisions and it is unclear which of those decisions would be regarded as significantly impacting the activities of the entity. The same issue arises in performing this analysis for financial structures when there are predetermined parameters. Consider an investment management structure where the investment manager is able to trade within parameters that are predetermined by the investors. It is unclear whether the predetermination rights of the investors or the prospective rights of the investment manager would be considered most significant.

FASB Staff Position FIN 46(R)-3, *Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46(R)*, was issued to provide guidance to assist in the determination of whether an entity such as a franchise is a VIE (not in the determination of the primary beneficiary). Its guidance places some emphasis on the level of absorption of expected losses or the right to expected residual returns in assessing whether equity investors have decision-making rights. In essence, a higher level of economic risk would imply that an enterprise has a corresponding higher level of decision-making that affects the success of the entity. It is unclear whether the Board agrees with this approach in making the assessment of the primary beneficiary under the proposed model.

Additionally, there is guidance in EITF Issue No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, and EITF Issue No. 04-5, *Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights*, addressing the determination of participating rights in assessing consolidation under the voting interest model. The definition of a participating right requires consideration of the decisions that would be made in the ordinary course of business. However, when assessing SPEs or VIEs, many of the powers can take different forms — they could

include the power to predetermine an entity's activities or decision-making, manage ongoing operations, or act in response to a specific contingent events. Greater clarity concerning the principles that should be applied in assessing one power relative to another when determining which powers most significantly impact the VIE activities, would assist in the analysis.

- The proposal also indicates that for an enterprise to have a controlling financial interest, it must have the right to receive benefits from the VIE or the obligation to absorb losses of the VIE, either of which could potentially be significant to the VIE. It appears that probability of outcomes is not a consideration in making the assessment under that criterion. As a result, a minor senior fixed fee at inception could potentially be significant if the underlying assets in the VIE become worthless. While we don't believe it is the Board's intent for significance to be applied this way, without further clarity companies could interpret it in this manner.
- In analyzing whether the right to receive benefits or absorb losses could potentially be significant, a company is required to consider its implicit and explicit financial responsibility to ensure that the entity operates as designed. In the basis for conclusions, the Board notes that implicit responsibility should consider actions that may be necessary to protect a company's reputation. This is another example where the new model moves further away from that applied to voting interest entities. Although we can understand why there may be a need to consider implicit financial responsibility in certain instances, we believe that further clarity is needed on how to apply this as a new concept, such as by providing a list of factors to consider in determining whether such responsibility exists. We also note that the need to consider implicit financial responsibility is included only in paragraph 14A(b). We believe that it could be equally relevant to consider in assessing powers and should be incorporated in paragraph 14A(a). It may also be possible to structure transactions with deep-in-the-money call options (which could potentially give the decision-making powers to holders); therefore, we believe that this influence notion should be incorporated in the proposal.
- In analyzing whether the right to receive benefits or absorb losses could potentially be significant, the proposed guidance requires that "significance" be measured with respect to the VIE. Although it may be easier to apply judgment in concluding whether direct economic/monetary benefits or losses from the VIE are significant to the VIE, it is unclear how benefits or losses that are not direct need to be assessed. Consequently, even if the benefit in question is structurally or operationally significant to the company, it can avoid consolidation under the proposed model if the benefit is not significant to the VIE. We suggest that the Board clarify that the "significance" of benefits or losses be interpreted more broadly so as to consider benefits or losses that are economically significant to the company.

**4. The Board concluded that it would be helpful to provide examples of the application of the principles in this proposed Statement. Do you believe that the examples in Appendix A clearly indicate how the principles in paragraphs 14-14B of Interpretation 46(R), as amended by this proposed Statement, would be applied? If not, please articulate what additional information or guidance is necessary, considering the basis for the Board's conclusions.**

- No, as further discussed in our response to question 3, we do not believe the examples clearly articulate how the principles in paragraph 14-14B would be applied. We believe that it may be more helpful to include only a few examples in appendix A that illustrate the range of judgments that may be necessary to apply the principles in paragraphs 14-14B. A franchisor/franchisee example may be useful to demonstrate how the model applies in situations where (1) each party has some significant rights to direct the activities of the entity and (2) no single party has the right to unilaterally control the entity.

**5. The proposed Statement retains the quantitative analysis for situations in which the enterprise cannot determine whether it is the primary beneficiary through the qualitative analysis in paragraph 14A of Interpretation 46(R), as amended by this proposed Statement. In Appendix A, each example either identified a primary beneficiary or concludes that no primary beneficiary exists through a qualitative analysis. The Board may consider removing the quantitative analysis for determining whether an enterprise is the primary beneficiary of a variable interest entity. Do you believe that the quantitative analysis is necessary based on the proposed amended guidance for determining the primary beneficiary? Do you believe that the quantitative analysis would be performed in many situations? Why or why not?**

- As further discussed in the cover letter, we do not believe the Board should introduce a new model for determining the primary beneficiary at this time. Our preference is that the Board perform a comprehensive review of all derecognition and consolidation guidance and develop a single principles-based consolidation framework for all entities, not just VIEs. That effort should be coordinated with the IASB. However, if the Board decides to pursue the current proposed model, we are not aware of situations where the quantitative analysis would be needed, provided that the principles underlying the qualitative analysis are sufficiently robust to enable a reporting enterprise to determine whether it is the primary beneficiary. As also previously discussed, we believe more clarity is needed on how to apply the principles for the new qualitative model.
- We also note that the quantitative and the qualitative models are based on inconsistent notions of control. The qualitative analysis is based on power to direct and right to receive significant benefits or absorb significant losses, whereas the quantitative model is based on the ability to absorb the majority of the expected losses or receive a majority of the expected residual returns. The application of these two models could result in different outcomes of who is the primary beneficiary, which would seem to highlight the need for a consistent approach in determining a controlling financial interest for all entities.

**6. For the reasons stated in paragraphs B6-B15 of this proposed Statement, the Board decided to require ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity. Do you agree with the Board's decision to require ongoing assessments? If not, please provide reasons (conceptual or otherwise) as to why you disagree with these requirements considering all of the proposed amendments in this proposed statement.**

- As previously discussed, we do not support the introduction of a new model for determining an entity's primary beneficiary. Rather, as an interim step, we believe that the Board should require reconsideration of an entity's primary beneficiary based on FIN 46(R)'s current qualitative assessment if significant events have occurred that were unanticipated at the prior assessment date. Those events could include changes to either the economics underlying the structure that were unexpected (e.g., losses that were unexpected), structural changes, or other verifiable market events. This approach should be more operational for companies to implement than an ongoing reconsideration and result in changes in an entity's primary beneficiary primarily due to significant events. The Board should also clarify that implicit arrangements must be considered as part of this reconsideration.
- We have concerns with the Board's proposal for ongoing reconsideration of an entity's status as either a voting interest entity or a VIE, in particular how interests in operating companies that are in financial distress may be impacted. This could have a significant impact on financial institutions and other financial services enterprises that provided financing to businesses. In many of these situations, those enterprises would no longer be able to elect the business scope exception under paragraph 4(h) of FIN 46(R) because their loan may



represent greater than half of the overall financial support of the entity as a result of operating losses. As a result, the enterprise would need to consider whether it is the primary beneficiary of the entity. In many cases, it may be readily apparent that the enterprise is not the primary beneficiary, but since the entity is a VIE, it would trigger all of the associated disclosure requirements.

**7. Do you believe that any exceptions to this proposed Statement should be made for private or not-for-profit entities? If so, please articulate the conceptual basis and reasons for the exceptions.**

*Private entities*

- We do not believe that any exceptions should be made for private entities in the proposed FIN 46(R) amendment. In our view, these principles should be applied similarly by private entities; otherwise, it would add unnecessary complexity to existing accounting standards. The proliferation of exceptions also could result in private companies accounting being less principles-based. That said, we acknowledge and support the benefit of providing differences in the transition, disclosure, and effective date requirements for private entities based on cost-benefit considerations. The Board should consider comments expressed by private entities in this regard.

*Not-for-profit organizations*

- We see no reason for removing the scope exception for not-for-profit organizations. Those organizations operate under a business model that is better suited to the voting-interest model for consolidation according to industry-specific guidance. We have noted no significant practice issues in not applying the FIN 46(R) consolidation model to these organizations.

**8. Financial statement users indicated that the information disclosed in accordance with Interpretation 46(R) about an enterprise's involvement or involvements with variable interest entities and the associated risks are often insufficient and untimely. Do you believe the disclosure requirements in this proposed Statement address these concerns?**

- As discussed in our response letter to the proposed FASB Staff Position FAS 140-e and FIN 46(R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable-Interest Entities*, we support the inclusion of the principal objectives of the disclosures. They emphasize the need for companies to be flexible in meeting the disclosure objectives. They also provide for disclosures to be made that are not stipulated by the requirements if such disclosures would meet the principal objectives and provide useful information for financial statement users. Although we support the Board's proposal to require companies to provide *additional disclosures about their involvement with VIEs*, we have the following observations:
  - In deciding whether to require disclosure of disaggregated or aggregated information, the Board should consider allowing preparers to exercise judgment to determine which information will be most helpful to financial statement users and will accomplish the principal objectives of the disclosures. Including an example to demonstrate a reasonable application of the aggregation principle for involvements with VIEs would be helpful.
  - The proposal will often subject transactions with VIEs to increased disclosures in comparison with similar transactions with other entity types. We suggest that the Board explore whether these differences in disclosures are justified and whether they will be understandable and decision-useful to financial statement users.
  - The proposal requires disclosure of significant assumptions and judgments made in determining whether an enterprise is a primary beneficiary and whether a different assumption or judgment could have reasonably been made that would result in a different

conclusion. Disclosure of significant assumptions and judgments that were not chosen for the preparation of the financial statements may not provide relevant information for financial statement users and is inconsistent with disclosures required for other *management judgments*.

- Determining (for the purpose of disclosure) the maximum and estimated exposure to loss will require significant judgment, and the estimated loss, despite management's best efforts, may differ significantly from the actual loss. This will likely raise questions about the reliability and usefulness of the disclosures, and may pose significant legal concerns for many companies. In addition, it is unclear how the estimated exposure to loss or a range of loss is to be determined.
- The proposed qualitative and quantitative disclosure on implicit arrangements could have adverse consequences for a company's legal strategy if the company is held to what it has previously disclosed in the financial statements based on purely hypothetical events. The Board's goal of providing financial statement users with more transparent information needs to be weighed against the challenges of presenting that information in today's legal environment. The Board should also consider whether it will be feasible for preparers of financial statements to predict implicit arrangements and their outcomes and whether that information will be auditable.

**9. Should the elements of a consolidated variable interest entity be required or permitted to be classified separately from other elements in an enterprise's financial statements?**

- Yes. We recommend that as an interim step, companies should be permitted to provide *captioning of assets and liabilities of certain consolidated securitization structures on the face of the balance sheet* so that financial statement users can identify those assets and liabilities. This should be limited to situations where the primary beneficiary of the VIE is a transferor of financial assets that qualifies for sale accounting under FAS 140, but was determined to be the entity's primary beneficiary. In these cases, due to the non-recourse nature of the securitization structure, captioning will highlight to the financial statement user that the assets captioned are restricted to satisfying associated liabilities of the VIE. This could help mitigate the extent to which consolidation of these financial SPEs might obfuscate core operations and related assets and liabilities to which a company is fully exposed.
- As part of a longer-term reconsideration of all consolidation and derecognition guidance, we believe that the Board should further explore the linked-presentation concept for financial SPEs to mitigate the extent to which consolidation of these entities will obfuscate core operations and related assets and liabilities to which a company is fully exposed. Linked-presentation will enable financial statement users to understand the extent to which assets have been set aside for obligations in securitization transactions by putting them separately on the face of the balance sheet. We share the Board's concern about extending linked-presentation to nonfinancial assets and liabilities.

**10. Other comments**

*Transition guidance*

- We do not believe that the basis for conclusions fully describes the Board's reason behind the choice of fair value measurement attribute for the transition guidance — specifically, why the Board elected not to follow similar transition provisions to FIN 46(R), but instead elected to measure all assets and liabilities at fair value on adoption. We are concerned that such an approach, while potentially making transition easier, may lead to unintended consequences and to confusion for financial statement users. Consider a company that consolidates an entity upon the adoption of the proposed FIN 46(R), and the fair value of the assets of the entity are more than the fair value of its liabilities and in each case, the values are less than

their principal amounts. In this case, after consolidation, the accretion of the liabilities up to their principal amount will cause a drain on earnings over time as the accretion of assets up to their principal amounts will be lower. It is also unclear why goodwill will be "flushed" through retained earnings upon adoption.

- Additionally, the Board should consider providing transition guidance regarding deconsolidation upon adoption of the proposal.
- Lastly, the Board should consider providing transition guidance regarding the treatment on the statement of cash flows of consolidation of an entity upon adoption, specifically with regard to the treatment of the increase in cash and cash equivalents upon consolidation or deconsolidation of a VIE upon adoption of the proposal.

*Related party guidance (Paragraph 17)*

- An additional qualitative factor has been added to paragraph 17 to consider when a related party group is determined to have the power to direct activities and receive significant benefits or absorb significant losses of a VIE. We suggest that the Board include a discussion surrounding this addition in the basis for conclusions to help preparers understand its application. For example, would the Board expect that primary beneficiary analyses under the existing paragraph 17 be reperformed as a result of the inclusion of the new factor? An example in the implementation guidance that explains the application of paragraph 17's principles would also be helpful.
- Since a controlling financial interest can also be determined pursuant to the related party guidance in paragraph 17, consider adding a reference to paragraph 17 in paragraph 14 after the reference to paragraphs 14A-14C.