Comment letter on Proposed Statement of Financial Accounting Standards; Amendments to FASB Interpretation No. 46(R).

File Reference No. 1620-100

Technical Director
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LETTER OF COMMENT NO. 24

Dear Sir/Madam,
Thank you for providing the opportunity to comment on the proposed changes to FIN 46(R).

While I have some reservations about certain aspects of the proposal, I congratulate the Staff and the Board for taking a pragmatic approach to rule setting in relation to the specific form of off-balance sheet financing FIN 46(R) addresses, rather than paying excessive attention to the definitions of assets in the Conceptual Framework, specifically Statement of Financial Accounting Concepts No. 6. The main issue should not be the internal logic of the Framework, but the production of accounting rules that assist users when making investment decisions. *Obviously, this is not a novel thought, as far back as 1942 the SEC warned of* losing focus on the main issue, that is, 'whether the financial statements performed the function of enlightenment, which is their only reason for existence' (Alexander & Jermakowicz, 2006 p133).

There are two parts to the attachment. In the first part I respond to the questions the Board set in the Exposure Draft. In the second part I show how an alternative approach to rule setting in this area could work.

If you have any comments or questions about my suggestions, please feel free to contact me.

Yours Sincerely,

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Attachment

Part A
Responses to questions

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?

I am not sure. In general, I expect the proposed Statement will have a positive impact on reducing this form of off-balance sheet financing (OBF) as the proposed Statement has closed off some loopholes but may have opened others, particularly through the two-part test required in paragraph 14A to identity the primary beneficiary.

I am particularly concerned about the ability of entities to cherry pick who the primary beneficiary will be. Paragraph 14 A(a) of the proposed Statement requires the identification of the entity which has the power 'to most significantly impact the activities of a variable interest entity'. The proposed Statement also requires entities to reconsider who the primary beneficiary is during each year as circumstances change. I expect that entities which seek to avoid consolidating their variable interest entities will exploit the loopholes this test provides so they can avoid being identified as the party with the most significant impact on the variable interest entity. This is easy to achieve.

A Variable Interest Entity (VIE) may distribute responsibility for the operating, financing and investing decisions between a number of parties, without necessarily giving rise to a joint venture. This will increase the difficulty of identifying the party with the most significant impact on the VIE. At one point in the economic cycle it is arguable that operating and investing decisions are the most important. In the current credit crisis, it is arguable that financing decisions are the most important. If the VIE can't get finance, it will go into bankruptcy, along with other entities in the same predicament.

These issues can also arise on an intra-annual basis. If the financing for the VIE is done on a short term basis, for example, using 3 month notes, refinancing will happen 4 times a year. Investment decisions may also be made on an annual or half yearly basis. Operating decisions obviously will happen all the time. How is an auditor or an entity to decide which of these activities is the most significant? I suspect each of the parties will say the other parties to the VIE have the most significant power. This also raises the issue of how to account for a VIE if different parties are identified as having the most significant power at various times in a given year.

Is it likely that these sorts of issues will emerge? Given the amount of energy that many managers have spent keeping material off the balance sheet in the past, I strongly expect that a substantial number of managers would enter this sort of structure with an obliging hedge fund, private equity firm or some other non-reporting entity, who, for a fee would agree to become the party with the power to most significantly impact the activities of the VIE. Of course, whether these non-reporting entities consolidate their VIEs is beyond the purview of the standard setters. However, it is strongly arguable that standard setters should ensure that the decision-making ability of users who invest in reporting entities is not compromised because these entities are able exploit a structural weakness in the accounting rules and so continue to engage in this well known form of off-balance sheet financing.

I suggest the Board adopt an alternative approach when trying to identify whether a VIE should be consolidated. In brief, as I argue below, this approach involves analysing whether a reporting entity is able to achieve the same outcome (excluding off-balance sheet financing) without the use of a VIE, as it is able to obtain by using the VIE. If the VIE does not provide incremental benefits to the reporting entity (off-balance sheet financing is deemed not to be an incremental benefit), the VIE would be deemed to be an off-balance sheet financing vehicle and should be consolidated into the reports of the relevant reporting entity. This test is more likely to close off the loophole available to reporting entities who could use non-reporting entities to avoid the requirements of paragraph 14A and as I show below, can be used for other situations where VIEs are used.

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?

I cannot comment on the costs to the preparers. However, I suggest there is significant disquiet in the public and in various legislatures about accounting rules which facilitate the promotion of contrived transactions that are designed to or have as their consequence the obfuscation of information from users. The major cost that I am concerned about, as an accounting academic, is the disrepute these rules continue to bring upon our profession.

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?

The principles are clear and operational. My concern is that they are easy to manipulate and avoid, as my comments to Question 1 indicate.

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.

I found the examples in Appendix A useful to understand the principles in this proposed Statement. However, they are simplistic and all have equity levels less than 10%. If the Board is going to retain the 10% equity test in paragraphs 9 and 10 of the proposed Statement, it may be useful to give an example where a VIE has more than 10% equity and show why this is a classified as a VIE. Alternatively, I suggest you remove reference to the 10% equity level in paragraphs 9 and 10. (See my response to Question 5.)

5. This proposed Statement retains the quantitative analysis for situations in which an 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 identifies 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?

I am less concerned about the quantitative analysis in paragraph 14C of the proposed Statement than I am about certain quantitative material in paragraphs 9 and 10 of that document.

The wording in the proposed Statement clearly shows the quantitative test in paragraph 14C will only apply if the qualitative tests in paragraph 14A do not identify the primary beneficiary. I would only remove the quantitative test if there is evidence or concern that companies can use instruments like Expected Loss Notes (Bens & Monahan, 2007) to avoid the requirements of the proposed Statement.

The use of the following text in paragraph 9 of the proposed Statement is much more concerning.

> An equity investment at risk of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient.

I am worried that entities will use this as a bright line test, even though it is not meant to be used this way. The notorious 3 percent test in EITF 90-15 was adopted as a bright line test and there is some evidence that the 10 percent test in FIN 46(R) has been used as a bright line test too, even though neither figure was meant to be used that way.

I think it is time to get rid of this test, especially if the Board wants to move to a more principles based system of accounting rules. Given the extensive qualitative tests given in paragraphs 9 and 10, I see no need at all for the quantitative test of 10 percent.

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.

I agree with the Board's argument.

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.

I can't think of any reason for this sort of exemption.

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 those concerns?

The proposed disclosures are good. I note that even if an entity is not the primary beneficiary, it must make extensive disclosures about its exposures to the VIE.

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?

I can't think why they should be.

Part B
<u>Alternative approach</u>

I suggest the Board abandon the current approach where it seems to be incessantly modifying accounting rules in a constant game of catch up because certain entities use a 'show me where it says I can't do this approach' to the rules and keep pushing them to the limit, requiring new rules and guidance for contrived transactions and corporate structures that are basically designed to impede transparent reporting (Herz, 2005).

Instead, I suggest the Board adopt an alternative test which would require reporting entities to prove to their auditors and regulators that the use of an interposed entity, or VIE provides incremental benefits to the relevant reporting entity (the organizer, transferor, manager or sponsor of the entity), that would not otherwise be available to the reporting entity. This reverses the onus of proof onto those entities that wish to make use of interposed entities as they would need to convince auditors and regulators that the interposed entity (IE) is not simply a vehicle to facilitate off-balance sheet financing. This test would also reduce the scope for game playing about who is the party who can most significantly influence the activities of the IE.

An interposed entity is any structure that an entity places between itself and potential investors. For example, a company could issue debt or equity instruments to third parties itself, or it could create an IE to issue these instruments to the same parties.

I use the broader term 'interposed entity' rather than the more restrictive term 'variable interest entity' as managers can structure interposed entities to avoid the definition of a VIE, and so avoid the consequences of complying with FIN 46(R). An interposed entity could be a VIE or some other entity that is used to achieve an off balance sheet financing advantage.

Of course, being able to use an interposed entity as an off-balance sheet financing (OBF) vehicle would not be deemed to be an incremental benefit, as the decision usefulness of the

General Purpose Financial Reports would be reduced, leading to increased search costs by users seeking to understand the risks and benefits of their investment in the reporting entity.

This approach can be demonstrated using the examples in Appendix A to the proposed Statement. Please note that the alternative test I am suggesting and the tests used in the proposed Statement yield the same result in all of the 9 examples, except for Example 5. In addition, for the sake of clarity of expression, I refer to the benefits the interposed entities provide, rather than the 'purpose' of the interposed entities (the term used in Appendix A and paragraph 14A of the proposed Statement). It is arguable that 'benefit' is closely related to 'purpose' in that an entity's purpose in creating an IE will be to achieve certain benefits.

Example 1

In this case, the Transferor transferred some assets to an interposed entity, which issued debt instruments to third parties and sold some equity instruments to the Transferor, to pay for these assets. The IE funded the interest on its debt instruments through the revenues it collected on the assets it acquired from the Transferor. The Transferor retains administrative responsibility for collecting the cash flows on the assets it transferred to the IE and is paid a fee for this service.

Analysis

The proposed Statement states the 'primary purposes for which the entity was created were to (1) provide liquidity to the Transferor to originate additional loans and (2) provide investors with the ability to invest in a pool of commercial mortgage loans' (p 17).

Using the alternative test, the issue should be whether the IE provides benefits that the Transferor would not have had, but for the IE. The benefits the IE provides to the Transferor, identified in the paragraph above (increased liquidity and investment opportunities) would be achieved if the Transferor simply issued debt instruments to the market in its own name, secured over the specific assets in question and stated that it would meet any shortfall up to a given amount (the same amount as the equity it bought in the IE).

The use of the IE does not provide the Transferor with any incremental advantage it could not have obtained if it undertook the transactions itself. The only advantage the IE offers the Transferor is the removal of the assets from its books. This advantage would not be achieved if the Transferor issued the debt instruments in its own name. In this case the IE is simply an OBF vehicle and should be consolidated into the reports of the Transferor.

Example 2

In this example an entity (the Manager) created an IE to issue high quality debt instruments to the market then used these proceeds to buy other instruments with a lower credit rating which presumably offered a higher rate of return. This difference in interest will generate the profits for the interposed entity. The IE is funded 96 percent by debt and 4 percent by equity. The Manager holds 35 percent of the equity, the remaining 65 percent being held by third parties. The rights of the third party equity holders are limited to administrative matters. The Manager is paid a base fee as well as a performance fee. The Manager is responsible for the first dollar of losses of the interposed entity.

Analysis

The purposes of this interposed entity are basically the same as for Example 1, according to the authors of the proposed Statement.

Using the alternative test, it is clear that the Manager would have achieved the same purposes if it had issued the debt and bought the various instruments itself. The instruments it issues can be secured over the specific assets they were used to fund (as would be the case if the IE was used). The Manager can guarantee it will absorb a given amount of losses (the same as it is exposed to with the IE). Therefore the interposed entity does not provide an incremental benefit to the Manager. The only advantage the IE provides is the ability to keep the liabilities (debt that was issued) and the assets that it acquired off the Manager's balance sheet.

Similar logic applies to Examples 3, 4, 6 and 9 of the proposed Statement, as these examples are basically variants of Example 2. In all these examples the only advantage the IE provides the Sponsor, Manager, Transferor, Manufacturer etc is the ability to keep assets and/or liabilities off the balance sheet. In all these examples the Sponsor, Manager or Manufacturer would be able to achieve the same result of financing their specific transactions without using an IE. For example, in Example 9 the Manufacturer could just as easily have borrowed the funds itself and provided the same guarantee as was provided when the IE borrowed the funds. The only advantage the IE provided the Manufacturer was the ability to keep the loan liability and its associated assets off the Manufacturer's balance sheet.

Example 5

This time an entity (the Transferor) created an IE which in turn issued certain instruments to the public. The IE used these proceeds to buy assets (mortgage loans) from the Transferor. The IE also entered into a guarantee facility whereby the Guarantor (a third party) contracted to absorb 100 percent of the losses that may arise on the IE's assets. The Transferor underwrote the assets that the IE acquired and retained certain administrative responsibilities such as collecting the mortgage payments due on the loans and managing defaults, for which it is paid a fee.

Analysis

The proposed Statement identifies the following points in relation to the design and purpose of the IE.

a. The primary purposes for which the entity was created were to (1) provide investors with the ability to invest in a pool of residential mortgage loans with a third-party guarantee for 100 percent of the principal and interest payments due on the mortgage loans in the entity, (2) provide the Transferor to the entity with access to liquidity and an ongoing servicing fee, and (3) generate fees for the Guarantor.

b. The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the Guarantor and prepayment risk associated with the underlying assets of the entity.

c. The principal risks to which the entity is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate. The credit risk of the underlying assets and the risk of fluctuations in the value of the underlying real estate are fully absorbed by the Guarantor.

Applying the alternative test, it is clear that the Transferor could have issued the debt instruments to the public itself, secured over the same mortgages it transferred to the IE. The Transferor could also have entered into the same sort of insurance contract with the Guarantor that the IE entered into. The only advantage the IE provides to the Transferor is the ability to keep certain assets and liabilities off the balance sheet. The IE does not generate any incremental advantages for the Transferor that the Transferor is unable to generate for itself.

This example also illustrates a major problem with the proposed Statement; it offers too much scope for interpretation. In Example 5 the Board concluded that the Guarantor is able to make the decisions that most significantly impact the activities of the IE, in this case the performance of the underlying assets (the mortgages). However, the Guarantor only has a reactive role, in that it becomes involved if mortgagees risk defaulting on the loans. It is arguable that the Transferor is the party that is able to make the decisions that most significantly impact the activities of the IE, as this is the entity that originally made the loans to the mortgagees and the performance of these loans will be primarily affected by the lending criteria used by the Transferor. For example, one would expect the performance of NINJA mortgages to be worse than mortgages made to borrowers with better debt servicing capacity.

The Board's finding that the Guarantor is the entity that should consolidate the IE is troubling, given that the Guarantor is doing little more than providing insurance, and possibly acting as a kind of trustee in that it has the ability to act in the best interests of the IE's debt holders if the mortgagees look like defaulting. It seems strange that an insurance contract would allow an entity to derecognise the insured assets and liabilities associated with them due to a reactive ability of the insurance company (Guarantor) to mitigate against certain events and to absorb losses. My home insurance policy contains certain restrictions on the activities I can undertake in the house. For example, I am not allowed to carry on a business at home or make unauthorized additions/modifications to the structure. If I obey these rules, and others, the insurance company is liable to compensate me for losses I sustain if my house is damaged. I can't see why I would not have an asset (the house) just because of the restrictions the insurance contract places on me and the potential liability the insurer is exposed to.

Example 7

In this example an IE is set up between a lessor and a lessee. The IE issued debt in itself, backed by the receivables it will make from leasing an asset to the lessee. This asset is acquired from the lessor. It appears the lessee has to guarantee substantially all the residual value of the leased asset. If it chooses to, at the end of the lease the lessee is able to sell the asset in the market and keep any excess above the guaranteed residual it owes the lessor. The proposed Statement indicates that the lessee is able to classify the lease as an operating lease and the lessor is able to classify it as a direct finance lease.

Analysis

To be honest, it is not clear to me how the lessee can classify this contract as an operating lease, given the wording of paragraph 60, SFAS 13.

> 60. The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases.

The wording in Example 7 seems to indicate that the lessee faces substantially all the benefits and risks incidental to ownership of this asset (see paragraphs A81, A82 and A86). If this were the case, the lease would normally be treated as a financing lease in the books of the lessee. However, I have to admit my ignorance of the finer points of lease accounting in America and accept the Board's findings regarding the way the lessee classifies this lease.

The Board concludes that the proposed changes to FIN 46(R) will lead to the IE being consolidated in the books of the lessee. It will be interesting to see whether this conclusion would apply to other types of operating leases, especially those where the lessor faces risks and benefits that could potentially be significant to the IE. These risks would arise if the lessee does not guarantee a substantial amount of the residual value of a leased asset.
It is unclear to me how the proposed rule will change the current accounting outcome for direct finance leases and operating leases.

Using the alternative rule, it appears the IE does not provide any advantages to the lessor or the lessee that they would not be able to achieve if they transacted directly, rather than through the IE. The lessor could issue debt instruments, secured over the same asset that was acquired by the IE. The lessee would then lease the asset under the same terms it contracted with the IE. The interposed entity does not appear to provide any incremental advantage to either party.

I agree that the lessee should consolidate the IE if the lease is classified as an operating lease. This will show more clearly the risks and benefits investors in the lessee are exposed to, compared to the current opaque disclosures required for operating leases. If the lease was classified as a direct financing lease by the lessee, consolidating the IE should not have a major impact on the financial reports compared to current practice.

Example 8
This example relates to a joint venture where two parties each have 50 percent of the votes and 50 percent of the seats on the board in a jointly controlled IE that was set up to acquire and run a hotel. One party to the venture is a professional hotel manager, the other is an investment company. Both parties have clearly delineated responsibilities in running and financing the hotel. Any matters relating to the hotel that cannot be resolved or agreed upon must be resolved through a third-party arbitration process.

Analysis
The Board stated that 'the primary purpose for which the variable interest entity was created was to provide Company A and Company B with the ability to invest in and operate a hotel' (p 36). The Board then concluded that neither party would consolidate the IE.

This conclusion seems sensible as the transaction is a simple Joint Venture that allows both parties to build their businesses and reap the benefits as equity partners. The IE provides incremental benefits to the parties (excluding OBF) which they would not have been able to obtain otherwise.

It is not easy to see how an alternative structure would facilitate the needs of both parties. For example, the debt issuance and share IPO would be complicated without a legal entity if the parties decided to set up the transaction as a jointly controlled asset. One of the parties would need to issue the debt to the market, perhaps with a guarantee from the other party that it would guarantee 50 percent of the loan. Similar complexities arise in relation to the IPO For example, which party would issue the shares? How would the share returns be quarantined to the hotel and not subject to the returns of the issuing party's other assets?

Alternatively, if one of the parties bought the hotel outright and brought in the other party on a fee for service basis, the advantages of reduced agency costs achieved by making the parties equity partners would be lost.

References

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Herz, R. H. (2005). Paper presented at the 2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments.