



November 17, 2008

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference No. 1620-100

Dear Mr. Golden:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (the "FASB" or "Board") Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Amendments to FASB Interpretation No. 46(R)* (the "Exposure Draft"). Huron Consulting Group helps clients address accounting issues arising from complex business transactions, as well as issues that arise in litigation, disputes and investigations. Huron provides services to a wide variety of organizations, including Fortune 500 companies, medium-sized businesses, leading academic institutions, healthcare organizations, and the law firms that represent these various organizations.

While we agree that the model in FASB Interpretation No. 46 (revised December 2006), Consolidation of Variable Interest Entities ("FIN 46R"), should be improved, we do not believe that the Exposure Draft represents a substantial enough improvement to justify the increased costs companies will incur to comply with it. We agree with the Board's decision to eliminate the scope exception for qualifying special purpose entities ("QSPEs"), but we disagree with many of the other proposed changes. Further, we are concerned about whether the principal change – the requirement that a reporting enterprise assess qualitatively whether it is the primary beneficiary of a variable interest entity – is operational.

Other than amending FIN 46R's scope, we do not believe the Board should finalize the Exposure Draft. Rather, we believe the Board should work with the International Accounting Standards Board ("IASB") to issue a converged standard on consolidation. While we understand the Securities & Exchange Commission ("SEC") expects the Board to improve FIN 46R, we believe eliminating the QSPE scope exception represents a substantial improvement. We do not believe the SEC would take unilateral action (and we would encourage them not to take action) as long as the Board is working diligently towards the issuance of a high quality, converged standard, particularly given the current project timeline for both projects. The Exposure Draft, if finalized as is, will not apply to a calendar year company until January 1, 2010. The IASB expects to issue an exposure



draft of its proposed statement before the end of 2008 and a final standard in the second half of 2009. In addition, the issuance of FASB Staff Position No. 140-e and FIN 46(R)-e, Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities, with its enhanced disclosures, should lessen the urgency to amend FIN 46R. Although we understand the FASB staff and IASB staff will attempt to eliminate differences in the results obtained by applying the different proposed models, we think it would be preferable to wait for a converged model so that companies do not have a second potential change in consolidation guidance applicable to variable interest (structured) entities.

If the Board decides to proceed with the Exposure Draft along the lines proposed (beyond amending the scope), we have the following comments and suggestions.

Consolidation Based on Variable Interests

We agree with the FASB's decision to require a reporting enterprise to perform a qualitative assessment to determine whether it is the primary beneficiary, and we generally agree with the focus on determining whether the reporting enterprise has the power to direct the activities of the variable interest entity. However, we are concerned with two aspects of the characteristics of a controlling financial interest the Board proposes in paragraph 14A.

First, we believe it may be difficult to distinguish between actions taken by a company in fulfilling its fiduciary obligation to holders of the entity's variable interests and actions taken by that company to enhance its own return. As an example, a company that services financial assets for a group of investors is obligated to take certain actions (or refrain from taking certain actions) to provide a return to the investors. The company receives a fee if the performance of the assets exceeds a specified threshold. While the company has an incentive to act in a way that will maximize its return, it also has an obligation to act in a manner that is in the best interests of investors. Our reading of the Exposure Draft leads us to conclude that the company is the primary beneficiary if it has discretion over the management of the financial assets, even if it is constrained by its fiduciary responsibility. Is our understanding correct? If so, we are not sure how that approach is consistent with the approach in the IASB staff draft of the consolidation exposure draft discussed at the October 20, 2008 FASB/IASB meeting. Even when a company has a dual role (as principal and agent) in an entity, the IASB approach recognizes that there may be limitations on the company's ability to control the entity.

Second, we do not believe the use of the "potentially significant" threshold is appropriate for making a consolidation decision because it could result in consolidation by a variable interest holder that has significantly more exposure to losses from the assets of the variable interest entity than other variable interest holders, but those losses occur only in remote circumstances. We are not sure how helpful users will find financial statements that include billions of dollars of assets and liabilities because the reporting enterprise has potential exposure to significant losses arising from remote events. We believe consolidation would be more meaningful if the losses to which the company is exposed



have a higher probability of occurring. Therefore, we support an approach that looks qualitatively at probability-weighted losses and requires consolidation when the variable interests held by a company expose it to a majority of the probability-weighted losses (or returns, if no variable interest holder has a majority of the losses).

If the Board decides to retain paragraph 14A as proposed, we believe it should:

- Add guidance similar to that in paragraph B15 of the IASB staff draft (Agenda Paper 3A discussed at the October 20, 2008 FASB/IASB meeting) allowing a variable interest holder with a dual role as principal and agent to demonstrate that it is obligated to act in the best interests of other parties involved with the variable interest entity.
- Provide guidance on what you intend by the "power to direct" the activities of a variable interest entity. Does it mean that a company has the unilateral right to do whatever it wants and for its own benefit? What effect do contractual limitations have on a company's assessment of whether it has the "power to direct" the activities of another entity? Would a contract that limits a manager's authority to make investments within pre-defined criteria preclude the manager from having the power to direct the entity? We believe the Board should provide application guidance similar to that included in paragraphs 10 through 27 of IASB staff draft (Agenda Paper 3A discussed at the October 20, 2008 FASB/IASB meeting) so that preparers and auditors will have a basis for applying the guidance in the revised FIN 46R beyond the examples in the Exposure Draft.
- Clarify the application of the "most significantly impact" criterion in paragraph I4A. If a variable interest entity is exposed to credit risk, foreign currency risk, and interest rate risk and the exposure to credit risk is slightly more significant than the exposure to other risks, does the company that has the power to direct matters that affect credit risk meet the criterion in that paragraph?

Relevance of Entity's Design

We are not sure if this was the Board's intent, but it appears to us that the addition of the phrase "or as a result of changes in facts and circumstances" to paragraph 5 of FIN 46R and the deletion of the second sentence in footnote 5 effectively renders the "by design" guidance moot. If the Board no longer believes the design of the entity is a factor to consider in deciding whether it is a variable interest entity, we recommend deleting the reference to "by design" rather than adding the proposed wording.

Substantive Kick-Out Rights

We disagree with the Board's decision that a variable interest holder should not consider kick-out rights held by other variable interest holders in deciding whether it has the power to direct the activities of the variable interest entity, unless a single variable interest holder has the right. As the Board acknowledges in paragraph B26, its decision is inconsistent with the guidance in EITF Issue 04-5, "Determining Whether a General



Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights."

We do not believe the fact that investors rarely, if ever, exercise their right to replace the manager provides an adequate conceptual basis for concluding that a reporting enterprise should ignore the existence of those rights. The fact that investors hold kick-out rights provides a constraint on the manager's activities that otherwise would not exist. We also do not believe there is any conceptual basis for requiring different accounting because a variable interest entity is highly structured. We do not see how basing the consideration of kick-out rights on whether the entity is a variable interest entity or not represents an improvement in financial reporting.

We also do not believe the possibility that a company might structure a transaction to include kick-out rights in order to avoid consolidation is sufficient reason to ignore those rights, assuming they meet the criteria in Issue 04-5. By structuring the transaction to include the kick-out rights, a company has altered the economics of the arrangement. To require a company to ignore a significant provision that could affect the economics does not make sense to us.

Because of the Board's decision on kick-out rights, we believe there will be cases where a company would not consolidate an entity under the voting interest model, contrary to the views expressed in paragraph B12 of the Exposure Draft. If a variable interest entity subsequently qualifies as a voting interest entity, the primary beneficiary would consider kick-out rights not held by a single party in deciding whether it controls the entity.

Reconsideration Events

We do not agree with the proposed elimination of paragraphs 7 and 15 of FIN 46R. We believe the result of deleting those paragraphs is that a company will be required to reassess at least quarterly whether an entity is a variable interest entity and whether it is the primary beneficiary. We do not believe the Board has made a clear case that the benefit to financial reporting will offset the cost to companies to go through that exercise every reporting period. While the ability of a company to analyze qualitatively whether it is the primary beneficiary will likely be less difficult than a quantitative analysis, we believe that analysis is significant more involved, and the effort required is significantly greater, than the effort required by a company to assess whether it should consolidate a voting interest entity. The increased effort required for a company to assess whether the entity is a variable interest entity and whether it is the primary beneficiary is due, in part, to the broader population of entities within FIN 46R's scope.

If the Board decides that companies should continually assess whether they are the primary beneficiary of a variable interest entity, we strongly encourage it to retain the guidance in paragraph 7 of FIN 46R. If the principal issue driving the elimination of paragraph 7 of FIN 46R relates to structured investment vehicles and similar entities that incurred losses significantly in excess of what models suggested they would incur, we suggest requiring reconsideration of the entity's status if it incurs losses in excess of



expected losses. We do not believe that change would impair the quality of the financial information a company provides to users.

Disclosures

Proposed paragraph 22C of FIN 46R refers to an enterprise that is a "sponsor" of a variable interest entity. Outside of a speech in December 2000 by Dominick Ragone, a Professional Accounting Fellow in the Office of the Chief Accountant of the SEC, we are unaware of a definition of "sponsor" in the accounting literature. Therefore, we recommend the Board include guidance in FIN 46R on when an enterprise is the sponsor. The aforementioned speech identified several qualitative and quantitative factors that may be helpful in determining if a company is the sponsor of an entity, but we are not sure if those factors are consistent with Board's views.

Implementation Guidance

We think the examples would be improved if they highlighted differences between the result obtained using the qualitative analysis and the result that would have been obtained using the quantitative analysis. It seems to us that both approaches would achieve the same answer in many of the examples. Those examples do not provide an incremental benefit.

Example 1

- How did the Board reach its conclusion that the Transferor has the power to direct the activities of the entity? The Transferor does not have the power to direct any activities until an event of default occurs. We think it would be helpful if the Board could explain how the Transferor has the power to direct the entity's activities at a time when no loans are in default.
- What effect do limitations on the Transferor's ability to service defaulted loans have on the qualitative analysis? For example, if the Transferor is required to service defaulted loans in order to minimize potential losses to bondholders, does it still have the power to direct the entity's activities? Or is it then simply acting as an agent of the bondholders? As noted earlier, we think the Board should provide guidance on how to apply the proposed model when an enterprise has dual roles.
- How did the Board conclude that the power to service defaulted loans has the most significant impact on the entity's activities? If the Transferor does not expect defaults to be significant, won't interest income from performing loans have a greater impact on the entity's economic performance than losses and recoveries on loans in default? In Example 1, the expected level of defaults could not significantly exceed the equity tranche and still have an investment-grade rating on the bonds.

Example 2

• How did the Board conclude that the Manager has the obligation to absorb losses that could potentially be significant to the entity? The Manager has an equity investment



- equal to 35% of \$4, or 1.4% of the entity's total capitalization. We are not sure how the potential loss of even the entire interest qualifies as significant to the variable interest entity.
- How likely does it have to be that the Manager will receive a performance fee that is significant to the variable interest entity? Given the facts, it seems that the Manager's ability to generate a significant performance fee is significantly constrained. It has to maintain an average portfolio rating of B-plus or higher (which raises a question as to how the senior debt is AAA-rated and the subordinated debt is BB-rated when the debt equals 96% of the entity's total capitalization), which limits the risks it can take. If the likelihood that the Manager will generate a significant performance fee is remote (for example, less than 5%), would that affect the results of the qualitative analysis?

Example 3

- How could the transaction have been marketed to potential debt investors as
 providing exposure to credit risk? The debt issued by the entity was AAA-rated,
 which presumably means there is no exposure to credit risk.
- Doesn't the investment management agreement place a constraint on the Sponsor's power to direct the activities of the entity? If the Sponsor has a fiduciary obligation to the entity's investors, its activities are limited. We believe the Board should discuss the impact of any such constraints or obligations on the assessment of control.
- Since reputation risk will likely always be a concern to entities in the public eye, is the Board suggesting that if reputation risk exists, a company will always have an implicit financial responsibility no matter how clear it made the risks of an investment to the entity's investors? Why did the entity conclude it had reputation risk in the example? Concluding that an entity has reputation risk without discussing why it might reach that conclusion is not helpful. We note that a number of financial institutions stepped in to rescue structured investment vehicles early in the credit crisis, however, that was not a universal reaction. Sponsors allowed a number of structured investment vehicles to collapse. Does that imply that those sponsors cared less about their reputations than the ones that stepped in to rescue investors?

Example 4

• Other than making decisions about the tenor and other features of the short-term debt issued by the entity, how are the factors in paragraph A49 evidence of control by the Sponsor, at least on an ongoing basis? While the Sponsor may have approved the assets the entity purchased, it had limits on its power. Achieving a AAA-rating for debt that comprised 98% of the entity's total capitalization created practical constraints on the Sponsor's ability to select assets. Further, however significant that power was, it was only effective at the date the transaction closed. The Sponsor has no right to trade assets subsequently. Similarly, monitoring the assets and ensuring compliance with the entity's credit and investment policies do not seem like matters that significantly impact the entity's activities. If our assessment is incorrect, we



believe the Board should explain how those activities contribute to the Sponsor's power to direct the entity's activities.

Example 5

- In order to determine that the power to direct activities related to credit risk gives the Guarantor control, wouldn't you have to first determine what portion of the risks to which the variable interest entity is exposed relate to credit risk? If credit risk is a minor portion of the total risk to which the entity is exposed, would the party with the power to direct activities related to credit risk still be the primary beneficiary? It does not seem as though the Guarantor could be the primary beneficiary in that situation because credit risk does not significantly impact the entity's operating performance.
- We agree with the conclusion on this example that the Guarantor is the primary beneficiary, but we come to that conclusion because the Guarantor will absorb all of the entity's expected losses (a quantitative analysis).

Example 7

- Would the analysis change if the lease agreement limited the lessee's use of the property and obligated the lessee to meet established maintenance standards? Based on our experience, real estate leases generally limit the lessee's ability to change the type of business it operates in the leased premises and provides for inspections to ensure the lessee is maintaining the property. We don't view the lessee's operation and maintenance of the property as "power" to direct the entity's activities, but an obligation to perform in accordance with the lease terms. Does that make a difference?
- How does the Board conclude that anyone directs the activities of the entity? The lease agreement establishes the rights of both parties. Beyond ownership of a building, the entity has no activities to direct.

Other Comments

<u>Primary Beneficiary Designation</u> – We found the discussion in paragraph B19 of the Exposure Draft confusing. The Board notes that users "were particularly concerned that the quantitative analysis would not capture situations in which enterprises involved with a variable interest entity provided financial support, including credit and liquidity, to entities and that this support represented an implicit arrangement (such as a guarantee)." We believe companies that provided liquidity and credit support (which we have found to be explicit arrangements) considered the expected losses they would absorb through those arrangements, so we are not sure why exactly users had a concern.

We are also unsure of the basis for the comment that "the quantitative analysis sometimes contained overly optimistic assumptions about the entity's performance." If the Board is referring to the fact that most companies did not foresee the credit crisis and therefore would have assigned low probabilities to scenarios assuming implosion of the credit markets, we are not sure we agree with characterizing those assumptions as "overly



optimistic." If the Board does not have evidence that companies used assumptions that were overly optimistic at the time they determined whether they were the primary beneficiary, we suggest it avoid making comments that might be misconstrued as supporting a view that companies issued financial statements that potentially were materially misstated.

Similarly, paragraph A20 of the Exposure Draft notes that "[s]ome Board members asserted that the predominant issues may ... be attributed ... to the quality of the inputs into the analysis, including the use of overly optimistic assumptions that did not contemplate all the relevant risks." Again, unless the Board has evidence that companies misapplied GAAP, we believe it should refrain from making comments that imply that they did. The Board offers no support for its view that companies used "overly optimistic assumptions" in making the quantitative assessment required under FIN 46R. If there is evidence that companies used overly optimistic assumptions, we suggest the Board cite those circumstances and explain why it believes the assumptions were overly optimistic.

We recommend deleting comments like those discussed above as they serve no useful purpose. We suspect the Board is not happy with the quantitative assessment under FIN 46R. Rather than casting doubt on the quality of financial information issued by companies that did not consolidate variable interest entities that subsequently incurred losses significantly in excess of the losses that the companies expected to occur, we believe the Board should just state that it was not happy with the results of the quantitative analysis and replace it.

Variable interests in specified assets of a variable interest entity – We believe the Board should amend the guidance in paragraph 12 of FIN 46R. Although the guidance in that paragraph is relevant to determining the expected losses of a variable interest entity for purposes of identifying the primary beneficiary through a quantitative assessment and therefore will likely be less significant in assessments made subsequent to the effective date of the amended FIN 46R, we believe paragraph 12 leads to illogical results. When a quantitative assessment applies, we believe the guidance in paragraph 12 often results in consolidation by a party that has less exposure to expected losses than other parties involved with the entity. This is particularly the case with securitization arrangements where many transferors sell receivables to a master trust and retain a subordinated interest in the receivables that protects investors in the master trust against losses. We believe there is no conceptual basis to ignore the expected losses a transferor will absorb in identifying the primary beneficiary of a variable interest entity. We believe the Board's decision to exclude losses absorbed by transferors from the entity's expected losses (at least, when the assets transferred were not more that 50% of the entity's total assets) may be partly responsible for the advent of "first-loss notes" as a means of allowing the sponsor to avoid consolidating the trust.

* * * * *



We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct any questions or comments to Jeff Ellis at 312-880-3019.

Sincerely,

/s/ Jeffrey H. Ellis

Jeffrey H. Ellis Managing Director