

February 14, 2012

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

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The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its perspective on the Proposed Accounting Standards Update (ASU), *Principal versus Agent Analysis*. The Committee is a voluntary group of CPAs from public practice, industry and education. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. The organization and operating procedures of the Committee are outlined in Appendix A to this letter.

We appreciate the Board's efforts and are supportive of the goals to address inconsistency in the current consolidation guidance, promote financial reporting that is consistent with the principles of the consolidation guidance in U.S. GAAP, and advance convergence between U.S. and international accounting standards.

While we believe that the Board's proposal would address certain implementation issues associated with the current variable interest entity model, we are concerned that in developing this proposed guidance, the Board has started with a desired outcome and has crafted guidance intended to promote that outcome versus starting with a sound principle and building a framework around that principle. It appears to us that starting with a desired outcome could result in guidance that is more susceptible to unintended consequences and structuring opportunities. Accordingly, we encourage the Board to consider whether the consolidation principle is clearly articulated in the *FASB Accounting Standards Codification*® (ASC or Codification). In our view, the proposed guidance would not change the consolidation principle, although application of current guidance by certain entities, including investment fund managers, would appear to result in outcomes that are contrary to the principle.

Furthermore, we are concerned that the proposed amendments, which appear to be directed at alleviating implementation issues for investment fund managers, could have a significant impact on consolidation evaluations for entities outside the investment fund manager industry. For example, it is unclear to us whether the proposed guidance would impact how a manufacturing entity that has entered into a related party lease for its production facility would evaluate that arrangement under the amended consolidation guidance. It is also unclear whether the proposed guidance might change the outcome of that evaluation from the current conclusion reached after implementing the guidance in FASB Statement 167, *Amendments to FASB Interpretation No.* 46(R). We encourage the Board to consider the impact these changes might have on non-investment fund manager entities and to add examples illustrating consolidation evaluations for such entities under the proposed model.

1. When determining whether a decision maker is a principal or an agent, the proposed amendments require the analysis to consider the decision maker's overall relationship with the entity and the

other parties involved with the entity. This analysis would be based on a qualitative assessment. Do you agree with this approach? If not, why?

We agree with this approach, but are concerned that the proposed changes are brought about by a desired accounting result as opposed to an effort to provide application guidance for a consolidation principle. Because the Board expects the proposed guidance to address the unintended consequences of applying the guidance in Statement 167 for investment fund managers, which had been temporarily addressed through an indefinite deferral, we believe that the principle underlying the consolidation guidance in Statement 167 remains the same, but that rules regarding its application to certain scenarios would be introduced to produce desired outcomes.

We recognize that these desired outcomes, which we believe include non-consolidation of investment funds by investment fund managers acting in an agent capacity on behalf of the fund's investors, are likely appropriate, but we believe the Board should better explain why these outcomes are not reached under the current guidance and whether this indicates a deeper issue with the consolidation guidance.

Additionally, we are concerned that the proposed approach could impact consolidation evaluations for entities in other industries. We encourage the Board to examine a range of scenarios requiring a variable interest entity evaluation not involving an investment fund manager under the proposed model to identify potential implementation issues. Additionally, it is our view that the proposed guidance should include examples of how the proposed model would be applied by non-investment fund manager entities.

- 2. The evaluation of a decision maker's capacity would consider the following factors:
 - a. The rights held by other parties
 - b. The compensation to which the decision maker is entitled in accordance with its compensation agreement(s)
 - c. The decision maker's exposure to variability of returns from other interests that it holds in the entity.

Are the proposed factors for assessing whether a decision maker is a principal or an agent appropriate and operational? If not, why? Are there any other factors that the Board should consider in this analysis?

We believe that the proposed factors are appropriate and operational. We are not aware of any other factors that the Board should consider in this analysis.

3. The proposed Update would require judgment in determining how to weigh each factor in the overall principal versus agent analysis. Do you agree that the proposed amendments, including the related implementation guidance and illustrative examples, will result in consistent conclusions? If not, what changes do you recommend?

We are unclear whether the proposed amendments would result in consistent conclusions. Although the process of weighing the factors in the principle and agent analysis would involve judgment, we believe that additional implementation guidance would be helpful to provide guidelines for weighing various factors and would improve the consistency of conclusions reached under the proposed model. The proposed examples could provide additional guidance to help a preparer determine how much economic exposure would overcome rights held by other parties in reaching the decision to consolidate a fund, or vice versa.

4. Should substantive kick-out and participating rights held by multiple unrelated parties be considered when evaluating whether a reporting entity should consolidate another entity? If so, do you agree that when those rights are held by multiple unrelated parties, they should not in and of themselves be determinative? If not, why? Are the guidance and implementation examples illustrating how a reporting entity should consider rights held by multiple unrelated parties in its analysis sufficiently clear and operational?

In our view, substantive kick-out rights and participating rights should be considered when evaluating whether a reporting entity should consolidate another entity, and we agree that when those rights are held by multiple unrelated parties, they should not in and of themselves be determinative. We believe that the guidance and implementation examples in this area are sufficiently clear and operational.

5. The proposed Update would not include a criterion focusing on the level of seniority of a decision maker's fees when evaluating the decision maker's capacity. Do you agree that the seniority of the fee relative to the entity's other operating liabilities that arise in the normal course of the entity's activities should not be solely determinative of a decision maker's capacity? If not, why?

We agree that the seniority of a decision maker's fee relative to the entity's other operating liabilities that arise in the normal course of the entity's activities should not be solely determinative of the decision maker's capacity. However, we do believe that the seniority of a fee should be considered as part of the analysis of the decision maker's capacity. We believe that this factor would be considered under the proposed guidance in ASC 810-10-25-39J(b), which would require a decision maker to consider whether its compensation agreement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated on an arm's-length basis.

6. The evaluation of a decision maker's capacity places more emphasis on the decision maker's exposure to negative returns (for example, an equity interest or guarantee) than interests that only expose the decision maker to positive returns. When performing the principal versus agent analysis, should the assessment differentiate between interests that expose a decision maker to negative returns (or both negative and positive returns) from interests that expose the decision maker only to positive returns? If not, why?

We agree that the principal versus agent analysis should differentiate between interests that expose a decision maker to negative returns (or both negative and positive returns) from interests that expose the decision maker only to positive returns. In our view, there is a fundamental difference between an arrangement where a counterparty is exposed to negative returns versus one where a counterparty is protected from losses, and we believe that this distinction should be considered in determining a decision maker's capacity in an a contractual arrangement.

However, we believe that the proposed guidance could be strengthened by illustrating scenarios where an entity appears to lack exposure to negative returns, but in fact does have some downside risk. For example, a fund manager might agree to forgo an upfront fee in exchange for compensation based on reaching certain performance targets. If those targets are not met, the fund manager would not be compensated for managing the fund and would therefore incur a loss relative to the compensation a third party manager would expect to receive for similar services. We believe this scenario illustrates exposure to negative returns that might not be consistently identified under the proposed model.

7. A reporting entity would be required to evaluate whether there has been a change in the decision maker's capacity by considering whether there has been a change in the purpose and design of the entity. For example, the purpose and design of the entity may change if the entity issues additional equity investment that is at risk to the decision maker. Do you agree with this proposed requirement? If not, please specify when this relationship should be reassessed and why.

We agree with the proposed requirement for a reporting entity to evaluate whether there has been a change in the purpose and design of an entity as part of its evaluation of a decision maker's capacity.

8. The Board decided to include the principal versus agent assessment as a separate analysis within the overall consolidation assessment, rather than replacing the current guidance for evaluating whether a decision-making arrangement is a variable interest (and accordingly, a principal) with the revised principal versus agent analysis. The Board believes that if an entity's fee arrangement does not meet the definition of a variable interest (for example, a nominal performance-based fee), the decision maker should not be required to continue the consolidation assessment. Do you agree? If not, why?

We agree with the Board's decision to include the principal versus agent assessment as a separate analysis within the overall consolidation assessment. However, we encourage the Board to consider whether the proposed principal versus agent guidance is consistent with existing principal versus agent guidance related to revenue recognition and debt modifications and extinguishments.

9. The Board expects the proposed principal versus agent guidance may affect the consolidation conclusions for entities that are consolidated as a result of the decision maker having a subordinated fee arrangement (for example, collateralized debt obligations). However, the Board does not otherwise expect the proposed amendments to significantly affect the consolidation conclusions for securitization entities, asset-backed financing entities, and entities formerly classified as qualifying special-purpose entities. Do you agree? If not, why?

We agree, but recognize that there may be unintended consequences of the proposed guidance, similar to those that prompted the indefinite deferral for investment managers under the guidance in FASB Accounting Standards Update (ASU) 2010-10, *Amendments for Certain Investment Funds*.

10. Update 2010-10 was issued to address concerns that some believe that the consolidation requirements resulting from Statement 167 would have required certain funds (for example, money market funds that are required to comply with or operate in accordance with

requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940) to be consolidated by investment managers. The amendments in this proposed Update would rescind the indefinite deferral in Update 2010-10 and would require money market funds to be evaluated for consolidation under the revised guidance. The Board does not intend the application of the proposed Update to result in money market funds being consolidated. Do you agree that the application of the proposed Update will meet this objective? If not, why and what amendments would you recommend to address this issue?

It is unclear to us, based on the proposed examples, whether an evaluation under the proposed guidance would result in consistent conclusions that fund managers would not consolidate money market funds. The proposed examples do not appear to address some of the unique characteristics of money market funds that might impact the consolidation conclusion under the proposed model. For example, a money market fund manager would likely suffer significant reputational damage if its fund breaks the buck, and this risk might implicitly indicate that the fund manager has sufficient downside exposure to warrant a conclusion that it is using its decision making power in a principal capacity. In the interest of ensuring that the desired outcome is achieved, we believe the Board should include a money market fund manager example in the proposed implementation guidance.

11. For purposes of applying the proposed principal versus agent guidance, the proposed amendments would require a reporting entity to include the decision maker's direct and indirect interests held in an entity through its related parties. Do you agree with the requirement that a decision maker should include its proportionate indirect interest held through its related parties for purposes of applying the principal versus agent analysis? Why or why not?

We agree with the proposed requirement that a decision maker should include its proportionate indirect interest held through its related parties for purposes of applying the principal versus agent analysis. In our view, this requirement would limit entities' ability to structure arrangements that would allow them to circumvent the principle of the consolidation guidance.

However, we believe that judgment is necessary as part of this process. In the Board's example, a reporting entity with a 40 percent interest in a related party that in turn has a 60 percent interest in the entity being evaluated would conclude that it has a 24 percent indirect interest in the entity being evaluated for purposes of determining whether it uses its decision making capacity as a principal or agent. We believe it is useful to consider a variation on this scenario in which the reporting entity has a 60 percent interest in a related party that in turn has a 40 percent interest in the entity being evaluated. The proposed guidance appears to indicate that this evaluation would yield the same conclusion that the reporting entity has a 24 percent indirect interest. However, on account of the reporting entity's majority interest in the related party, it appears that it could have more power to direct the activities of the entity being evaluated under the latter scenario than the former. We believe the Board should clarify whether this aspect of the evaluation is intended to simply consist of a calculation, or whether additional factors should be considered.

12. The amendments in this proposed Update would require a general partner to evaluate its relationship with a limited partnership (or similar entity) by applying the same principal versus agent analysis required for evaluating variable interest entities to determine whether it controls the limited partnership. Do you agree that the evaluation of whether a general

partner should consolidate a partnership should be based on whether the general partner is using its decision-making authority as a principal or an agent?

We agree that the evaluation of whether a general partner should consolidate a partnership should be based on whether it is using its decision making authority as a principal or an agent. We support the resulting consistency between the variable and voting interest entity consolidation guidance.

13. Do you agree with the proposed transition requirements in paragraph 810-10-65-4? If not, how would you propose to amend those requirements, and why? Please provide an estimate of how long it would reasonably take to implement the proposed requirements.

We agree with the proposed transition requirements, but are unable to estimate how long it would reasonably take to implement the proposed requirements. Clearly, the time needed to implement the proposed guidance would vary depending on whether an entity had previously evaluated a variable interest under the consolidation guidance. The effort required to implement the proposed guidance for entities in the scope of the indefinite deferral under the guidance in ASU 2010-10 could be significant.

14. Should early adoption be permitted? If not, why?

We do not believe that early adoption should be permitted. We believe that entities significantly impacted by the proposed guidance would benefit from the development of interpretive guidance by industry groups, audit firms, and others during the period from the date the final standard is published until it becomes effective. In our view, prohibiting early adoption would enhance consistency in application of the proposed guidance.

15. Should the amendments in this proposed Update be different for nonpublic entities (private companies or not-for-profit organizations)? If the amendments in this proposed Update should be applied differently to nonpublic entities, please provide a rationale for why.

We do not believe that the proposed amendments should be different for nonpublic entities. We believe that a significant proportion of the entities impacted by the proposed guidance (investment fund managers) are nonpublic, and that scoping nonpublic entities out of the proposed guidance would warrant a re-examination of this project's objective.

We appreciate the opportunity to offer our comments.

Sincerely,

Jeffery P. Watson, CPA

Chair, Accounting Principles Committee

Scott G. Lehman, CPA

Vice-chair, Accounting Principles Committee

APPENDIX A ACCOUNTING PRINCIPLES COMMITTEE ORGANIZATION AND OPERATING PROCEDURES 2011-2012

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

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