

January 20, 2005

Director, TA&I—FSP Financial Accounting Standards Board 401 Merritt 7 Norwalk, Connecticut 06856 Letter of Comment No: 4
File Reference: FSP46RB

We appreciate the opportunity to comment on the proposed FASB Staff Position No. FIN 46(R)-b, "Implicit Variable Interests Resulting from Related Party Relationships under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities." We are the task force authorized to comment on the proposed FSP on behalf of the Virginia Society of Certified Public Accountants. However, our comments are not intended to represent the views of all members of the Virginia Society of Certified Public Accountants.

We recognize that the proposed guidance would apply to financial statements of all entities that are not excluded from the scope of FIN 46(R) by its Paragraph 4. However, because of the practice backgrounds of most of the members of the Virginia Society of Certified Public Accountants, we only considered the effect the proposed guidance would have on financial statements of small and midsize nonpublic entities.

Paragraph 4 of the proposed FSP says in part, "Paragraph B10 of Interpretation 46(R) provides one example of an implicit variable interest." However, we believe FIN 46(R) does not establish the notion that a variable interest may be implicit. The word "implicit" appears only once in FIN 46(R). That is in the first sentence of Paragraph B10:

Guarantees of the value of the assets or liabilities of a variable interest entity, written put options on the assets of the entity, or similar obligations such as some liquidity commitments or agreements (explicit or implicit) to replace impaired assets held by the entity are variable interests if they protect holders of other interests from suffering losses.

The parenthetical phrase "explicit or implicit" modifies "agreements to replace impaired assets held by the entity." Therefore, the guidance in Paragraph B10 relevant to use of the word "implicit" says that explicit or implicit agreements to replace impaired assets held by the entity may be variable interests. That is different than saying that any agreement may be an implicit variable interest. We therefore believe the proposed FSP is

Director, TA&I—FSP January 20, 2005

changing FIN 46(R) by introducing the notion of implicit variable interests and believe this is a change that should be subjected to a broader exposure process than a proposed FSP.

Involvement is one of the conditions in Paragraph 5 of the proposed FSP that require consideration of whether there is an implicit variable interest. We assume, based on Footnote 12 of FIN 46(R), that this condition requires the existence of a pecuniary interest. We believe the proposed FSP should specifically state this.

We also believe the proposed FSP should only require consideration if, based on the facts and circumstances, there is significant involvement. For example, we believe an immaterial loan to or from an entity should not require consideration of whether there is an implicit variable interest.

Paragraph 5 of the proposed FSP prescribes two conditions that require consideration of the existence of an implicit variable interest—involvement that is not a variable interest and a related party that has a variable interest. Therefore, we assume that the mere existence of a related party relationship, that is, in the absence of a pecuniary interest, would not require consideration under Paragraph 5 of the proposed FSP.

However, language in the proposed FSP leads us to question whether there is some thought that the mere existence of a related party relationship may create an implicit variable interest. For example, the third paragraph of the example in the proposed FSP says, in the first sentence, that Manufacturing Company should consider whether the relationship between it and the owner creates an implicit variable interest. We strongly believe there should be no implication that a mere relationship could be viewed as an implicit variable interest.

In the example in the proposed FSP, the reporting entity—Manufacturing Company—has already applied Paragraph 5 of FIN 46(R) and determined that Leasing Company is a VIE. The next step for Manufacturing Company is to determine whether it has a variable interest in Leasing Company.

- a. If it does not have a variable interest in Leasing Company, Manufacturing Company is not required to include the consolidated financial results of Leasing Company in its financial statements. Based on the guidance in Paragraph 14 of FIN 46(R), consolidation is not required if the reporting entity does not have a variable interest in a VIE.
- b. If it has a variable interest in Leasing Company, Manufacturing Company should apply Paragraphs 16 and 17 of FIN 46(R) in determining whether it is the primary beneficiary of Leasing Company or whether the owner is the primary beneficiary.

The proposed FSP would not change our conclusion as to whether Manufacturing Company has a variable interest in Leasing Company. We believe a lease at market

terms should not be viewed as a means of absorbing variability, and the fact that it is a lease with a related party does not change that conclusion. If the lease were with an unrelated party, there would clearly be no consideration of whether to consolidate the lessor. We also cannot envision situations where a related party arrangement should be considered an implicit variable interest that would require a small or midsize nonpublic entity to consider consolidation.

Is the concern underlying application of the guidance in Paragraph 6 of the proposed FSP to the example in the proposed FSP that the owner would use assets of Manufacturing Company to settle losses of Leasing Company? If so, how could that possibility be assessed practically? For example, should there be consideration of the personal wealth of the owner or members of the owner's family? What would be the approach if the individual owns several operating entities? We therefore believe the notion of a related party relationship creating an implicit variable interest, or perhaps converting a pecuniary interest that is not explicitly a variable interest into an implicit variable interest, is impractical, at least for small and midsize nonpublic entities.

This leads to additional beliefs about FIN 46(R), which are larger than any specific concerns we have about the proposed FSP. We believe the FASB should remove small and midsize nonpublic entities from the scope of FIN 46(R). Based largely on seminars members of our task force have presented over the last several months, we believe there is no demonstrated need for applying the guidance in FIN 46(R) to the financial statements of small and midsize nonpublic entities. For example—

- a. It does not appear that financial institutions who provide financing in these arrangements have expressed an interest in requiring consolidation. Those institutions would most likely require consolidated statements to be accompanied by consolidating information that would enable them to separate information about the individual entities.
- b. The sinister arrangements that prompted the FASB to take on the project that resulted in the issuance of the Interpretation were not found in small and midsize nonpublic entities.

In addition, we believe requiring consolidation would impose a cost that does not provide a commensurate benefit. For example, in the typical related party leasing arrangement—

- a. The lessor either does not issue financial statements or else issues financial statements prepared on the income tax basis of accounting.
- b. The lessee's financial statements provide substantial disclosure of the related party arrangement.

Director, TA&I—FSP January 20, 2005

c. The same financial institution provides financing for the lessor, the lessee, and the majority equity holders and has access to financial information about all of those parties.

We also believe that requiring consolidation will significantly diminish the value the primary users of the financial statements of small and midsize nonpublic entities place on generally accepted accounting principles. We have already noticed some small and midsize nonpublic entities shifting from use of generally accepted accounting principles to the income tax basis of accounting in response to discussions of the potential impact of applying FIN 46(R), such as the need to renegotiate loan covenants. In addition, it is our understanding that FIN 46(R) (and FAS 150) prompted the AICPA to consider providing accounting guidance for nonpublic entities. Surely, two sources of accounting standards cannot be desirable.

While we strongly believe that small and midsize nonpublic entities should be excluded from the scope of FIN 46(R), we recognize the sensitivity of such a move and therefore recommend that the FASB extend the effective date of FIN 46(R) for these entities for an additional year to further study its impact. The related party lease provided as an example in the proposed FSP is common for small and midsize nonpublic entities. In the typical arrangement, the lessor is designed to stand on its own, and the leased property has no special features that would limit the lessor's ability to lease it to other tenants. In addition, typically the individuals who own most of the equity of the lessor control the lessor and would receive any expected residual returns and absorb any expected losses. For example—

- a. Those individuals could cause the lessor to sell the property and use the proceeds for other investments.
- b. Losses of the lessor cannot be enforced against the lessee.

We suspect that much of the frustration commonly expressed with the complexity of the Interpretation and the difficulty in deciding how to apply it is that accountants who work primarily with small and midsize nonpublic entities strongly believe that consolidation does not present economic substance but are unsure whether FIN 46(R) does or does not require consolidation.

We would be happy to discuss our comments in further detail or to help in any way we can with the project or your deliberations. Simply contact Stephen D. Holton, at 804-346-9595 or sholton@mdhltd.com, who will coordinate with other members of the task force. Thank you again for the opportunity to comment on the proposed FSP.

Stephen D. Holton, Chair

Accounting and Assurance Advisory Task Force