

Letter of Comment No: 5
File Reference: FSPFIN46-F

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December 15, 2003

Mr. Lawrence Smith
Director of Technical Application and
Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: Proposed FASB Staff Position FIN 46-f, 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, Consolidation of Variable Interest Entities

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the Proposed FASB Staff Position No. FIN 46-f (the "Proposed FSP"), 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, Consolidation of Variable Interest Entities. We agree that a clarification of how paragraph 5(b)(1) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities ("FIN 46") should be interpreted will be useful and will help ensure a consistent application of FIN 46.

We understand the Board's underlying principle regarding the application of paragraph 5(b)(1) is to identify those entities where the group of holders of the equity investment at risk (the "equity group") does not control the entity rendering the application of the traditional consolidation model based on a majority voting interests to be ineffective. We do not believe the approach outlined in the Proposed FSP is consistent with that principle. We have concerns that the approach outlined in the Proposed FSP provides broad guidance in an attempt to address a narrow issue (i.e., franchise arrangements). We believe that a simpler and more operational model already exists in evaluating whether or not equity investors control an entity. We believe this model is understood by practice and do not see a need to develop a

new model for this purpose. Accordingly, we believe a different approach should be applied in the application of paragraph 5(b)(1) as described below.

The Proposed FSP states that when the equity group does not have all of the voting or similar rights of a controlling financial interest, emphasis should be placed on the ability of the equity group to make decisions that have a significant impact on the success of the entity as well as the extent to which the equity group absorbs expected losses and receives expected residual returns of the entity. The Proposed FSP suggests that the key consideration in the analysis of whether the equity group lacks the characteristic in 5(b)(1) is whether or not the equity group has the ability to make decisions that may have a "significant impact on the success of the entity."

We believe it was the Board's intent that when determining whether an entity should be evaluated under a voting interest model (ARB 51) or the variable interest entity (VIE) model (FIN 46), the goal of paragraph 5(b)(1) should be to identify those entities where the equity group does not have control of the entity. Merely concluding that the equity group has the "ability to make decisions that significantly impact the success of the entity" does not, to us, seem consistent with the Board's underlying principle and therefore should be insufficient to conclude that the entity is a voting interest entity.

The objective of paragraph 5 of FIN 46 should be to identify entities where a consolidation model based on the traditional interpretation of a controlling financial interest - a majority voting interest - is "irrelevant". We believe it is counterintuitive to reach a conclusion that when the equity group does not have the controlling financial interest, the entity can still be evaluated for consolidation under the voting interest model of ARB 51. The Exposure Draft for the proposed modification to FIN 46 (ED) states in footnote "†" that the objective of paragraph 5(b) is to "identify as variable interest entities those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest." Paragraph A15 of the ED also states "Paragraph 5(b) of Interpretation 46 describes the characteristics of a controlling financial interest. If the rights and obligations of the total equity investment at risk lack any of those characteristics [emphasis added], then the ownership of a majority of the equity investment at risk would not provide all the characteristics of a controlling financial interest and would not be an appropriate basis for consolidating the entity." Therefore, we believe that the equity group only has the characteristics of a controlling financial interest if in fact it controls the entity.

The Proposed FSP suggests that the equity group would be less likely to give up the rights to control the entity as their equity increases relative to the entity's expected losses. This view appears inconsistent with paragraph C19 of the Basis for Conclusions of FIN 46, which states "Because the equity investors in an enterprise other than a variable interest entity generally absorb losses first, they can be expected to resist arrangements that give other parties the ability to significantly increase their risk or reduce their benefits." The Proposed FSP seems to contradict this notion, and suggests that the amount of the equity investment at risk is the determining factor in evaluating condition of 5(b)(1).

We believe an appropriate application of paragraph 5(b)(1) of FIN 46 is to determine whether a party outside the equity group possesses substantive decision-making or participating rights as those rights are contemplated in EITF 96-16 (EITF 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. If the equity group does not control the entity, it should be evaluated under the FIN 46 model. EITF 96-16 is an established model that is understood by practice and would be a useful tool. EITF 96-16 states, in part, that "The Task Force agreed that the assessment of whether the rights of a minority shareholder should overcome the presumption of consolidation by the investor with a majority voting interest in its investee is a matter of judgment that depends on facts and circumstances. The Task Force further agreed that the framework in which such facts and circumstances are judged should be based on whether the minority rights, individually or in the aggregate, provide for the minority shareholder to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business." Effective participation means the ability to block significant decisions proposed by the investor who has a majority voting interest." We believe that most practitioners had been interpreting 5(b)(1) consistent with this view and that the model proposed in this Proposed FSP would be a significant change in practice.

In addition, while the Proposed FSP places emphasis on the extent to which the equity group absorbs expected losses and receives expected residual returns of the entity, we do not believe that the mere obligation to absorb the expected losses or the right to receive expected residual returns should be determinative as to whether the equity investors at risk directly or indirectly have the ability to make decisions about an entity's activities through voting rights or similar rights. We believe that the requirements of paragraphs 5(a), 5(b)(2) and 5(b)(3) of FIN 46 arc separate and distinct requirements in the evaluation of whether the entity is a variable interest entity or a voting interest entity.

With regards to franchises and similar arrangements, we are sympathetic to a conclusion that the rights of many franchisors should not cause the equity group to lack the characteristic of 5(b)(1) of FIN 46. We believe that many of the rights typically held by a franchisor are protective of the franchisor's brand, and not participating rights in the business of the franchisee. However, we do believe that in certain fact patterns, substantive participating rights are retained by the franchisor and that in those fact patterns, those entities should be evaluated as VIEs. Even in cases where the franchisee is a VIE, if the franchisee is adequately capitalized and the franchisor did not provide the majority of the subordinated financial support, we do not believe the franchisor would normally be the primary beneficiary. Accordingly, as a solution to the franchise issue, we suggest the Board exempt franchise agreements, as they recently proposed for operating joint ventures that meet the definition of a business from the scope of FIN 46 unless certain criteria are met. In this connection, we

<sup>&</sup>lt;sup>1</sup> As we currently understand, under the proposed modification to the ED, an operating joint venture that meets the definition of a business would be exempted from FIN 46 unless it meets one the following characteristics: substantially all of the activities involve, are conducted on behalf or are primarily for the benefit of the reporting

would not conclude that substantially all the activities involve, conducted on behalf of, or are primarily for the benefit of the franchisor, unless there are clear indicators that the activities are conducted on their behalf (e.g., the franchisee is required to purchased substantially all of its supplies from the franchisor, or the franchisee is a de facto agent of the franchisor).

If our view regarding the evaluation of the analysis under paragraph 5(b)(1) is accepted by the Board, the franchise example in the exhibit should clarify which rights are protective versus participating and how the evaluation should be performed. We have revised the franchise example in the exhibit to assist in that evaluation.

If the Board decides to retain the current approach, we have the following suggestions to improve the guidance in the Proposed FSP:

- The Proposed FSP establishes a model which lacks clarity with regard to the degree of decision-making that the equity group should hold to satisfy the characteristic in FIN 46, paragraph 5(b)(1). In that regard, we believe that further guidance must be provided regarding Board's underlying thought process regarding the extent of decision-making that the equity group must have in order to satisfy the conditions in FIN 46, paragraph 5(b)(1). We suggest that the Board provide more examples of the application of the proposed guidance, perhaps including leasing vehicles, outsourced supply arrangements, and management contracts that provide for important decision-making responsibility.
- The Proposed FSP should provide guidance regarding whether the presence of substantive "kick-out rights" should be applied in the application of paragraph 5(b)(1) when the equity group has ceded certain decision making rights to other parties. Specifically, does the ability of the equity group to remove those parties (the decision makers) affect the analysis under paragraph 5(b)(1). For example, should entities look to the guidance in the recently issued FSP 46-7, Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FIN 46?
- It would be useful to clarify the term "equity group," as used in the Proposed FSP. We
  believe that the intent was to include only equity that is "at risk" as defined under
  paragraph 5(a) in the analysis of paragraph 5(b)(1).
- The example provided in exhibit of the Proposed FSP utilizes the phrase "significantly influence the fair value of the franchise". It is unclear whether this notion is consistent with the notion described in the forepart of the Proposed FSP which focuses on the ability of the equity group to "significantly impact the success of the entity". We believe that further clarification is necessary to address whether these concepts are meant to be similar.

enterprise, or the reporting enterprise and its related parties provide more than 50% of the equity, subordinated debt or other form of subordinated financial support to the entity.

We appreciate the opportunity to express our views in this letter. If you should have any questions regarding our comments, please feel free to contact Doug Tanner at (973) 236-7282 or Thomas Barbieri at (973) 236-7227.

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Sincerely,

PricewaterhouseCoopers LLP

#### Exhibit

Some constituents have questioned whether the decision-making authority of a franchisor in a franchise arrangement results in the equity group of the entity that holds the franchisee (the "Franchisee") lacking the characteristic in paragraph 5(b)(1) such that all franchises are variable interest entities. The determination of whether the Franchisee lacks the characteristic in paragraph 5(b)(1) can be difficult, since many franchise arrangements provide franchisors with rights with respect to the operations of the franchise, the level of which varies depending on the arrangement. The franchisor is licensing its brand to the Franchisee for a specified period of time and therefore is likely to retain rights that ensure that quality and consistency associated with the franchisor's brand are maintained. Many of those rights are designed to protect the franchisor's brand, while others provide the franchisor rights to participate in the day to day operations of the Franchisee. As a result, the analysis to determine if the Franchisee lacks the characteristic of paragraph 5(b)(1) is unique.

The assessment as to whether the Franchisee lacks the characteristic in paragraph 5(b)(1) should focus on whether the equity group (the equity owners of the Franchisee who are considered at risk under paragraph 5(a)) controls the entity. If the equity owners of the Franchisee do not control the Franchisee, the evaluation under the voting control model of ARB 51 would not be appropriate. The Franchisee's ability to choose its suppliers, its employees, and to price its products or services are illustrations of situations indicative of control. In other words, participating rights have not been retained by the franchisor. In cases where the franchisor holds substantive participating rights via the franchise agreement, the Franchisee would lack the characteristic in paragraph 5(b)(1) and the entity would be a variable interest entity. EITF 96-16 should be used by analogy and each right granted the franchisor should be evaluated to determine whether that right would represent a substantive participating right, which could result in the Franchisee lacking the characteristic of paragraph 5(b)(1) or a right that protects the franchisor's brand which would typically not result in the Franchisee lacking that characteristic. For example, a Franchisee agreement may allow the franchisor the following rights (not intended to be all inclusive):

- The right to approve the location of the retail facility or geographic area in which the franchisee is permitted to operate. In many cases the franchiser and the Franchisee agree to a location as part of the initial sale of the franchise to the Franchisee. Merely agreeing to the initial location as part of such sale would not be viewed as a participating right. However, other situations where such right is associated with an area development agreement where the franchisor retains the right to approve each future location and such right is substantial, it may be a participating right.
- The right to require equipment signs, menuboards, supplies, and other items necessary
  in connection with adding new approved products to be acquired, installed, and

utilized at the retail facility consistent with franchisor requirements. These rights normally represent protective rights because they protect and ensure quality of the brand. However, if the franchisor requires the Franchisee to purchase substantially all of its major supplies, signs, equipment etc. from the franchisor or its related parties, such right would likely be a participating right or may be an indication that substantially all of the activities of the Franchisee are conducted on behalf of the franchisor. A careful analysis of each of these provisions would be necessary to determine if such rights are protective or participating in nature.

- The rights to approve the products that may be sold at the retail facility. The ability of
  the franchisor to approve the products that may be sold is normally important to ensure
  brand quality and would likely be considered protective.
- The rights to approve suppliers for purchases of advertising materials, training materials, uniforms, packaging, computer hardware, and insurance. Typically, these rights are established to ensure consistent brand quality and would therefore protective rights. However, the requirement to acquire substantially all such items from the franchisor or its related parties may be participating rights or may be an indication that substantially all of the activities of the Franchisee are conducted on behalf of the franchisor.
- The right to approve the franchisee's marketing plan. Joint and/or cooperative marketing arrangements are common and are critical to advertisement of the brand. Therefore, these rights are often protective in nature and the franchisor's control over national or regional cooperative advertising campaigns normally would normally not be considered a participating right which would cause the Franchisee to lack the characteristic of paragraph 5(b)(1). In addition, approval of the content of a local campaign would likely not be considered a participating right.
- The right to approve a sale of the franchise. Such rights would normally not be cause the Franchisee to lack the characteristic of paragraph 5(b)(1). However, if such right would represent a de facto agency relationship under paragraph 16(d)(1), then it would represent a participating right.