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Exposure Draft of a Proposed FASB Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46* (File Reference No. 1082-300)

Dear Mr. Smith:

We appreciate the opportunity to comment on the exposure draft of the FASB's proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46* (the proposed Interpretation or the ED). We support the Board's ongoing efforts to modify and provide interpretive guidance to FIN 46 and offer our specific comments on the provisions of the proposed Interpretation (paragraph references are to the modified paragraphs of FIN 46).

Scope Exceptions

We believe the proposed new scope exceptions are consistent with the Board's intent. In addition, there are other entities that we understand the Board intended to exclude from the scope of FIN 46. Assuming that is the Board's intent, we believe it would be helpful to constituents for the Board to explicitly identify those entities in paragraph 4 of the Interpretation. They are as follows:

- **Governmental entities**. We understand that the Board intended to exclude governmental entities from the scope of FIN 46 in the same manner as not-for-profit organizations are excluded from the Interpretation's scope in paragraph 4(a) (i.e., governmental entities should not consolidate other entities or be consolidated in accordance with the requirements of FIN 46). We believe governmental entities should include municipal authorities and other "financing conduits" used to issue tax exempt or government-sponsored debt.

- **Employee benefit plans**. We understand that the Board did not intend to change the accounting requirements of the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, which generally requires plan investments to be carried at fair value. If our understanding is correct, we believe it would be helpful to clarify paragraph 4(b) to indicate that employee benefit plans are not required to potentially consolidate *plan investments* under the requirements of FIN 46, and *parties other than the employer* (e.g., an administrator of a multi-employer plan) are not required to potentially consolidate the *plan* under the provisions of FIN 46. (Currently the scope exception for employee benefit plans in paragraph 4(b) only addresses whether the *plan* should be consolidated by the *employer* under the requirements of FIN 46.)

There are certain aspects of the new scope exceptions in the proposed Interpretation that we found unclear. They are as follows:

- **Information out – paragraph 4(g)**.
  (1) Because the conditions in paragraph 4(g) are objectively determinable, we do not understand the need for the statement that the "inability to obtain the necessary information is expected to be *infrequent*, especially if the enterprise was involved in the creation of the entity." Does the Board intend that the characteristics should not apply in certain circumstances, leading to the statement regarding the frequency in which those circumstances will be present?

  (2) Does the Board intend for an enterprise with an interest in an entity that qualifies for the paragraph 4(g) scope exception to be required to continue to make efforts to obtain the necessary information if the enterprise has been denied access to that information on the basis that it has no legal right to obtain it? The draft language used in connection with the proposed paragraph 4(g) scope exception would require such enterprises to continue to make efforts to obtain the information even if they have no legal right to obtain it and have already been denied access to it. However, we are not sure what those efforts would comprise.

- **Certain trusts – paragraph 4(h)**. It is unclear with respect to this proposed new scope exception what arrangements would qualify as arrangements that are "similar to mutual funds in the form of trusts and trusts of bank trust departments that are organized and operated in a manner consistent with customary existing practices." For example, would this scope exception apply to employee benefit plans? Those plans have characteristics that are very similar to the foregoing description. If so, that would resolve the issue of consolidation of employee benefit plans discussed above (the issue of consolidation of plan investments would still need to be resolved). We believe that constituents would find this scope exception to be more operational if the

- Board described the characteristics of the vehicles that it intends to exempt. We believe those characteristics should include at a minimum vehicles that are created solely pursuant to legal statute and in which the "owners" or "beneficiaries" of the vehicle for tax purposes are parties other than the asset manager, and vehicles with minimal variability that can be influenced by the asset manager due to contractual, legal, or regulatory restrictions. For example, if the asset manager of an investment trust can only invest in debt securities that are rated AA (or Aa) or higher, there is only minimal variability that can be influenced by the manager because its discretion in selecting investments has been significantly limited relative to the broader population of investments (including equities, other investment and noninvestment grade debt, etc.). Without further "characteristics-based" guidance it is unclear whether an entity such as a CDO represents a similar arrangement to a mutual fund in the form of a trust.

Scope

- **Paragraphs 5(a) and 9A**. We found the changes that refer to qualitative considerations require more clarification. Paragraph 9 and paragraph C24 in the basis for conclusions currently require qualitative considerations to be evaluated *before* performing an expected loss calculation. As a result, the changes to paragraph 5(a) raise the question of whether it is optional for an entity to be a VIE (i.e., even if the expected loss calculation indicates that equity is sufficient, could the entity conclude it is a VIE simply because it has not obtained financing without providing additional subordinated financial support?). We did not believe that the Board intended for entities to be able to "opt into" FIN 46. The guidance in paragraph C21 of the Interpretation, which discusses the fact that lenders often require more subordinated financial support than is necessary given the level of equity that an entity has, seems to support this idea. We found the language about consideration of qualitative factors more helpful in relation to the primary beneficiary determination than in relation to the determination of whether an entity is a VIE.

- **Paragraph 5(a)(3)**. We understand that the Board looked to the guidance in EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," in developing the requirement with respect to amounts provided to equity investors through fees. We believe the Board should indicate in the proposed Interpretation the source of this requirement because constituents have been confused about how to apply it. The Board should specifically address whether certain types of fees are acceptable while others are not.

- **Paragraph 5(b)(1).** The Board should consider providing additional guidance to help reconcile the provisions of EITF Issue No. 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," regarding participating rights and the notion that the Board has set forth in this paragraph requiring that equity participants have the ability to make decisions about the entity's activities. We believe it is preferable for the Board to follow the guidance in Issue 96-16 with respect to participating and protective rights in identifying those situations where the equity group has the ability to make decisions regarding the entity's activities. Specifically, we believe it would be helpful for the Board to indicate in the footnote to paragraph 5(b) that the equity at risk does not have the characteristic of a controlling financial interest if interests other than the equity investment at risk have participating rights as defined in Issue 96-16. That would be consistent with (and clarify) the observation in footnote 3.

Triggering Events

- **Paragraphs 7 and 15.** We are concerned that the proposed changes to these paragraphs, specifically the reference to changes in the design of the entity or ownership of interests in the entity, could suggest that the triggering events are exactly the same for both evaluations. We do not believe that should be the case. In particular, we believe that events that require a reconsideration of whether the entity is a VIE would also require a reconsideration of what party is the entity's primary beneficiary, but that events that require a reconsideration of what party is a VIE's primary beneficiary would not necessarily require a reconsideration of whether the entity is a VIE. For example, a mere change of ownership of interests in the entity would not necessarily indicate that there has been a change in the design of the entity that would cause it to be a VIE (or not to be a VIE).

- **Paragraphs 7 and A25.** We are not sure from the proposed changes to paragraph 7 (as further explained in paragraph A25) how the FASB intends for the reconsideration guidance to be applied to troubled debt restructurings. For example, if a lender accepts stock warrants as part of a troubled debt restructuring and otherwise simply "forgives" certain payments that were previously not made by a debtor, does that cause a change in whether the entity is a VIE or what party is the entity's primary beneficiary? An example would be helpful to better understand the Board's intent with the language in paragraph A25 that to conclude that "the level of subordinated financial support provided to the entity" has not been modified the lender's exposure to the entity's expected losses must be "essentially the same immediately before and

immediately after the restructuring," and the characteristics of the equity must not have been changed "by providing the lender with new voting rights."

Expected Losses and Expected Residual Returns

We are not sure in certain situations how to apply the revised language replacing paragraph 8(a) and 8(b). For example, in commercial paper conduits there are often short-term assets, even shorter-term liabilities (e.g., commercial paper) and derivative instruments that may be longer-term than either the assets or the liabilities. Does the Board intend for a different evaluation to be performed for each variable interest, or should the evaluation be based on the duration of the longest-term variable interest, or on the duration of the assets available to satisfy variable interests? Other revolving or operating structures raise the same questions. For example, in an operating joint venture these questions would arise with respect to variable interests such as debt, equity, leases, derivatives, and forward purchase contracts. How should this guidance apply to cancelable contracts or derivatives that are used for hedging purposes? Should it be assumed that derivatives will be rolled over if that is the hedging strategy (and if so, is it appropriate to assume that the replacement derivative will be identical to the original)? How does long-term variability of variable interests relate to the fair value of the entity's assets? The Board also may want to consider addressing how the guidance in paragraphs B11-B12 should be applied in relation to the revised paragraph 8 requirements (e.g., the treatment of tax credits in an affordable housing partnership).

Related Parties

- **Paragraphs 16(d) and A32**. Does the Board intend that a de facto agent relationship would not be deemed to exist if there is a contractual provision that the restricting party's approval cannot be unreasonably withheld? It would be helpful for the Board to explicitly address this point as well as the linkage between this guidance in FIN 46 and the guidance in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, regarding a transferee's ability to pledge or exchange transferred financial assets.

- **Paragraphs 17 and A35**. Paragraph A35 states that the "presumption [that the principal or de facto principal in a related party group is the primary beneficiary] is not appropriate, for example, if one party in the related party group has a direct agency relationship with two or more parties within the group." Paragraph A35 goes on to state that the revised guidance in paragraph 17 "will put more emphasis on the need to make reasonable judgments in those circumstances." We believe the revised

guidance in paragraph 17 is an improvement, but are concerned that it may not adequately address situations such as the following:

> Company A (a non-VIE financial services company) creates Company B (a VIE investment company) and holds 100 percent of the equity and debt interests in Company B. Company B does not issue any other interests other than those issued to Company A. Company C (a non-VIE investment management company), a majority-owned and controlled subsidiary of Company A is appointed by Company A as the investment manager of Company B. Due to legal requirements in the country in which Company B is domiciled with respect to B's corporate structure, Company C cannot be removed as investment manager by a vote of B's shareholders. Company B and Company C provide separate financial statements to various stakeholders.

In the above fact pattern (and similar circumstances), we believe that Company A should be deemed to be the primary beneficiary because Company B and Company C are under common control of Company A. We believe the Board should consider further clarifying paragraph 17 or adding an overriding tiebreaker that parties in a related party group that are directly controlled by another party in the group cannot be deemed to be the primary beneficiary or that in such circumstances a party other than the one whose activities are most closely associated with the VIE's or other than the principal in an agency or de facto agency relationship may be the primary beneficiary. We also believe the Board needs to consider adding a tiebreaker to address situations where none of the related parties' activities are most closely associated with the VIE's and none of the related parties is a principal or de facto principal. In such circumstances we recommend that the Board require the party with the largest share of expected losses (within the related party group) to consolidate the VIE.

Initial Consolidation of a VIE

We believe it would be helpful for the Board to clarify in paragraph 21 that consolidation of a VIE is not the same as consolidation of a voting interest entity in a business combination. In particular, we have noted confusion in practice regarding initial measurement of the assets, liabilities, and noncontrolling interests of a VIE (i.e., at full fair value) versus the measurement requirements in an acquisition of a voting interest entity (i.e., at carryover basis to the extent of noncontrolling interests) under the business combinations literature.

Accounting Subsequent to Consolidation of a VIE

We believe that constituents are seeking guidance from the Board or Staff on the issue of attribution of profits and losses when there are no minority interests in a consolidated VIE even though there are variable interest holders other than the primary beneficiary (e.g., in case of consolidation by a party, such as an asset manager, that does not own any equity interests where other parties own variable interests other than equity, such as beneficial interests). In addition, it would be helpful for the Board to comment on the issue of adoption of accounting policies when the VIE previously did not issue financial statements. This issue arises with respect to hedge accounting policies and classification of investment securities under the requirements of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, among other areas. We also believe it would be helpful for the Board to incorporate in the proposed Interpretation its informal guidance that consolidation of a VIE lessor by a lessee does not impact leveraged lease accounting by the equity investor(s) in the VIE.

Other Suggestions

We believe it would be helpful to constituents for the Board to issue an Interpretation that codifies all of the guidance issued on FIN 46 (similar to what the Board did when it replaced FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with Statement 140). The codification will help to ensure that a substantial body of interpretive and clarifying guidance is not inadvertently overlooked by preparers, and will also make that guidance more readily retrievable.

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If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Kimber Bascom at (212) 909-5664.

Very truly yours,

KPMG LLP