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Letter of Comment No: 98  
File Reference: 1082-300  
Date Received: 12/01/03

Director of Technical Application and Implementation Issues  
Financial Accounting Standards Board  
401 Merritt 7  
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December 1, 2003

Ladies and Gentlemen:

**Re: File Reference No. 1082-300**

Thank you for the opportunity to express my views on the Board's proposed Interpretation *Consolidation of Variable Interest Entities – a modification of FASB Interpretation No. 46* (the "Exposure Draft").

I applaud the three Board members whose views are described in paragraphs A43 through A46 of the Exposure Draft. They have recognized the significant degree of confusion that exists among both preparers and auditors of financial statements regarding the calculation of expected losses and expected residual returns, which is the deciding factor in determining which variable interest holder must consolidate a variable interest entity ("VIE") in accordance with FASB Interpretation No. ("FIN") 46, *Consolidation of Variable Interest Entities*.

As a senior manager in the technical department of a large, international accounting firm, I have instructed at three separate firm-sponsored one-day training courses on FIN 46. I have also, in consultation with some of the top technical partners in the national office of our firm, responded to inquiries from practitioners in the field who, with their clients, are struggling to understand and apply the Interpretation to real-life fact patterns. This experience has indicated to me that even the most intelligent and experienced individuals both at clients and in our profession still do not understand how to apply much of the guidance in FIN 46 to all but the simplest of transaction structures within its scope, even after having studied the document intensively for more than ten months.

Because of significant uncertainties about various aspects of FIN 46, in particular as a result of the lack of guidance on the calculation of expected losses and expected residual returns, companies may be performing these calculations in a manner that is incomplete, inconsistent with the Board's intentions, and radically different from the approach taken by other companies. As a result, I believe a high risk exists that two companies could account for identical VIEs entirely differently. This outcome cannot be in the interest of the investing public. I therefore urge the Board to follow the recommendation of three of its members and defer the effective date of FIN 46 for all entities. To promote uniform application of FIN 46,

I recommend that the Board develop in-depth examples of the calculation of the expected losses and expected residual returns of all of the variable interest holders in a wide variety of transaction structures within the scope of FIN 46 based on real-life fact patterns.

I have included some comments below on specific points raised in the Exposure Draft. However, I would like to emphasize to the Board that I believe FIN 46 should be reconsidered in its entirety because, among other reasons, (1) it appears to be inconsistent with both the conceptual framework and Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, the standard it is meant to interpret, (2) it requires consolidation decisions based largely on information which, in my view, is neither reliable nor verifiable, and (3) in my opinion, it will neither reduce the number of abusive transactions it is intended to prevent nor will it succeed in bringing such transactions “on balance sheet,” as transaction engineers inevitably will develop new structures to circumvent its guidance. I understand other constituents have already raised these points to the Board, so I will not endeavor to argue them here in greater detail.

I believe that a model analogous to that being developed by the Emerging Issues Task Force in Issue 02-14, *Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means*, would be a more appropriate and conceptually sound approach to the consolidation question. Such a model might include two tests for determining whether a controlling financial interest exists: (1) Does the enterprise have a residual interest in the entity? and (2) Does the enterprise have unilateral decision making control? The model could be complemented with additional guidance on related parties in order to address the kinds of abuses that occurred at Enron.

Ultimately, to curb other abuses involving transactions typically housed in VIEs (e.g., leases, research and development arrangements, securitizations, etc.), I believe it would be more effective and more consistent with the conceptual framework to amend the literature governing these types of transactions than to try to capture them with consolidation guidance. This is the approach I recommend to the Board. Amendments to transaction literature can be crafted much more precisely than changes to the consolidation literature ever possibly could. They can be targeted specifically at the transactions perceived to be abusive. And they do not have the undesirable side-effect of changing the accounting for transactions and structures that are not abusive (such as joint ventures or partnerships with legitimate business operations and purposes) but get caught in the net of FIN 46 like dolphins in the hunt for tuna.

If the Board insists on holding to its model of consolidation under FIN 46, I suggest that it consider the following points arising from the Exposure Draft.

#### *Scope Exception for Certain Enterprises That Are Unable to Obtain Information*

I agree that there should be a scope exception for entities that are unable to obtain the information necessary to (1) determine whether an entity is a VIE, (2) determine whether the enterprise is the primary beneficiary (“PB”) of a VIE, or (3) consolidate the VIE, if it has determined it is in fact the PB. I disagree, however, that this scope exception should be limited to entities that were created before February 1, 2003. It seems to me that even in arrangements entered into after that date there will be legitimate business reasons (e.g., competitive harm reasons) for companies not to disclose the information necessary for other parties to make these determinations. Accordingly, I believe this scope exception should not depend on the date the entity was created. The conclusion that an enterprise should not

consolidate an entity in these circumstances seems entirely appropriate, on the basis that if it cannot obtain the information, it clearly does not have a controlling financial interest in the entity.

### *Other Scope Exceptions*

I agree with the Board's other proposed changes to the scope of FIN 46, and I also think that additional scope exceptions should be considered. For example, joint ventures are within the scope of FIN 46 as it is currently written. However, joint ventures are commonly understood to be entities that are subject to joint control.<sup>1</sup> Since no one party can have a controlling financial interest over such an entity, it would be inappropriate for any party to consolidate a joint venture. Accordingly, I recommend that joint ventures also be excluded from the scope of FIN 46.

### *Qualitative Considerations When Evaluating the Adequacy of Equity*

The Board has correctly observed in paragraph A20 of the Exposure Draft that the determination of whether an entity is a VIE under paragraph 5(a) of FIN 46 "frequently begins and ends with the quantitative assessment in paragraph 9(c)." However, I believe that the additional guidance in paragraph A21 of the Exposure Draft will not change that fact. The examples in paragraph A21 address only "black-and-white" cases and do not provide rigorous enough guidance to enable preparers and auditors to judge the wide variety of "gray" scenarios encountered in the business world. I recommend that the Board provide a more thorough discussion of the qualitative criteria for making judgments about when quantitative analysis is required and when it can be foregone.

### *Related Parties and De Facto Agency*

One common criticism of US GAAP is that the definitions of terms often differ from standard to standard. I agree with those who suggest that defined terms in US GAAP should have the same meaning throughout the entirety of US GAAP literature, and accordingly, I believe that the definition of a related party in FIN 46 should be the same as in FASB Statement No. 57, *Related Party Disclosures*. In my opinion, the Board has not sufficiently justified the expanded definition of related parties in FIN 46. For example, I disagree with the conclusion in paragraph A30 of the Exposure Draft that rights to approve the sale, transfer, or encumbrance of another party's interests in a VIE "suggest that the party is acting as an agent..." Business partners in a partnership frequently have approval rights so that they can ensure that they have a business partner whose interests are aligned with their own. Such rights have legitimate business reasons and do not, in my view, create any form of agency relationship.

Nevertheless, if the Board insists on maintaining its concept of *de facto* agency relationships in FIN 46, I recommend that it further clarify the circumstances under which one party should be judged to be able to constrain another party's ability to manage economic risks or realize economic rewards. The Board might cite the example from paragraph 30 in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, of a right of first refusal in connection with a *bona fide* offer from a third party as

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<sup>1</sup> The AICPA's Issues Paper "Joint Venture Accounting" dated July 17, 1979 describes a joint venture as "one of a class of entities generally described in the accounting literature as having certain common characteristics including, for example, owned by a small group of investors, operated for the benefit of the joint owners, and subject to joint control."

being a circumstance under which another party's ability to manage economic risks or realize economic rewards would not be constrained (if this is, in fact, the Board's conclusion).

*Determining the PB in a Related Party Group*

There are circumstances where all of the parties in a related party group are in the same exact business and no principal-agent relationships exist. Neither FIN 46 nor the Exposure Draft addresses the issue of which party in a related party group should consolidate the VIE under those circumstances. In my experience, these scenarios are not as infrequent as one might expect. I recommend that the Board provide additional guidance in the form of a "third-level tie-breaker" for these situations.

*Intercompany Eliminations*

The Board should clarify whether the proposed changes to paragraph 22 of FIN 46 mean that an intercompany profit elimination in inventory (or fixed assets) also should be attributed entirely to the PB. If that is in fact the Board's intent, it appears that such a requirement would be inconsistent with the guidance in paragraph 14 of Accounting Research Bulletin No. 51 that states that "[t]he elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests."

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Thank you for taking the time to consider my views. If you have questions or comments, do not hesitate to contact me.

Sincerely,

David B. Elsbree, Jr.