May 22, 2003

Director, Technical Application and
Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Re: Proposed FASB Staff Position

We are pleased to respond to the Proposed FSP, Calculation of expected losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (the "Proposed FSP").

We agree that the conclusion in the Proposed FSP that expected losses include the negative variability in net income and changes in fair value, if excluded from net income, is consistent with the guidance in paragraph 8 of Interpretation No. 46. However, we are concerned that the requirement to determine the sufficiency of an equity investment by considering a lack of expected appreciation in the value of an asset as a "loss," as illustrated in the Proposed FSP, is a concept that may not have been clearly understood by constituents at the time the final Interpretation was issued. Further, we believe this requirement may have the unintended consequence of expanding the population of entities that will be deemed to be variable interest entities. The example in the Proposed FSP highlights that an equity investment of less than $25 million would be considered insufficient for purposes of applying paragraph 5a, not because of the potential for a decline in the fair value of the real estate asset that would expose lenders or other variable interest holders to risk of loss, but because of the potential that the fair value of the real estate asset may not appreciate over the lease term. Based on the clarification in the Proposed FSP, we believe many more entities will be deemed to have insufficient equity and therefore be considered variable interest entities (unless one of the conditions in paragraph 9 is met) as most business enterprises, by design, are not capitalized on the basis of being able to absorb potential "opportunity costs." We are not sure that result is what the Board intended when it undertook this project.

We believe the final FSP should be revised to exclude the discussion about the lessee guarantee of the fair value of the leased asset at the end of the lease term as that fact is not pertinent to the example and detracts from the Proposed FSP's purpose of explaining that "expected losses" does not just refer to loss of principal. Because of the residual value guarantee, the equity investors would not be exposed to the losses of the entity. As such, the entity would be a variable interest entity under the guidance in paragraph 5b(2). See Attachment I for a marked copy of the Proposed FSP identifying those facts that are not relevant to the issue being addressed.

We also believe the example should present separately cash flows (lease payments received less debt service and return to equity holders) and appreciation or depreciation in the value of the office building as those elements of the total return of the entity are likely to have different probabilities of occurring. In addition, we question whether the assumption in footnote 1 of the example that Company X would determine the expected change in the fair value of the office building on an annual basis for purposes of this analysis is realistic since the change in fair value is only realized when the asset is sold. As such, we believe the change in fair value of the asset should be included, but as of the point in time the lessor expects to sell the asset (presumed to be the end of the lease term in the illustration in the Proposed FSP). Lastly, it may be helpful to add a conclusion to the example indicating that an equity investment of less than $25,003 would not be considered sufficient to absorb expected losses and would result in treating the entity as a variable interest entity.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to Joe Graziano at (732) 516-5560, or Jeff Ellis at (312) 602-8991.

Very truly yours,

Grant Thornton LLP

Attachment I

Proposed FSP—Calculation of expected losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities.*

(Comment Deadline: May 26, 2003)

Q— Can an entity that has no history of net losses and expects to continue to be profitable in the foreseeable future be a variable interest entity?

A—Yes, an entity that expects to be profitable can have expected losses. The term *expected losses*, as used in Interpretation 46, does not refer to the net loss an entity may report in its income statement prepared in accordance with generally accepted accounting principles.

The calculation of *expected losses* is described in paragraph 8 and illustrated in Appendix A of Interpretation 46. Paragraph 8 requires that the outcomes used to calculate expected losses include the expected unfavorable variability in the entity's net income or loss and expected unfavorable variability in the fair value of the entity's assets, if it is not included in the net income or loss.

The following example illustrates the calculation of *expected losses*:

1. On January 1, 2004, Company X is formed to purchase a building~~, 95 percent of which is~~ financed by debt and ~~5 percent by~~ equity. The lenders will have recourse only to the building in the event that Company X does not make the required debt payments.

2. On the same day, Company Y enters into a five-year market-rate lease for the building ~~that includes a guarantee of a portion of the building's residual value~~. The present value of the minimum lease payments~~, including the residual value guarantee,~~ is less that 90 percent of the fair value of the building.

3. There are no other interests in Company X.

4. The appropriate discount rate is assumed to be 5 percent.

5. In accordance with paragraph 8, the estimated annual outcomes used in the example include Company X's estimated net income or net loss and the estimated changes in the fair value of its assets not reflected in net income or loss. ~~The guarantee is a variable interest in the entity because it relates to more than half of the entity's assets. Therefore, losses absorbed by the residual value guarantee are losses of the entity and are included in the outcomes used to calculate losses.~~ For simplicity, the estimated outcomes, which include both cash flows and changes in the fair value of Company X's assets, and related probabilities are assumed to be the same each year of the five-year lease, and at the end of the lease, the carrying value of the building is assumed to be its fair value.

Table 1 shows the January 1, 2004, calculation of the expected outcome at the inception of the variable interest created by the lease. The fair value of the expected outcome is assumed to be equal to the sum of the present values of probability- weighted estimated annual outcomes for the five-year lease term~~, excluding the effects of the residual value guarantee~~. Any variation in estimated outcomes, as compared to the expected outcome, represents a change to the value of the entity or variable interest from the calculation-date value.

Table 1
(Amounts in Thousands)

Estimated Annual Outcomes[1]	Probability	Expected Annual Outcome	Fair Value of Expected Five-Year Outcomes[2]
$(10,000)	5.0%	$ (500)	$(2,165)
(5,000)	10.0%	(500)	(2,165)
0	20.0%	0	0
10,000	50.0%	5,000	21,648
50,000	15.0%	7,500	32,471
	100.0%	$11,500	$49,789

[1] Estimated outcomes include both estimated cash flows and changes in the fair value of Company X's assets.

[2] The fair value is assumed to be the sum of the present values of the expected outcomes for each year of the five-year period. Because of the simplifying assumption that the annual estimated outcomes and probabilities are the same for each year of the five-year period, the expected annual outcomes are treated as level annuities in the present value calculations to determine the fair value of the five-year expected outcomes.

Table 2 shows the calculation of *expected losses* as the negative variability from the fair value of the expected outcome. Note that the estimated annual outcomes of $0 and $10,000 contribute to expected losses although neither amount is negative. To the extent that an estimated outcome, although positive, is less than the expected outcome, the company will lose value in relation to its value based on the expected outcome. Table 2 illustrates the calculation of this *expected loss* as the fair value of the probability-weighted negative variations from the expected outcome. *Expected losses* include all such negative variations.

Table 2
(Amounts in Thousands)

Estimated Annual Outcomes	Present Value of Estimated Five-Year Outcomes	Fair Value of Expected Five-Year Outcomes	Positive (Negative) Variation from Expected Value	Probability	Expected Losses	Residual Returns
$(10,000)	$(43,294)	$49,789	$(93,083)	5.0%	$(4,654)	
(5,000)	(21,648)	$49,789	(71,437)	10.0%	(7,144)	
0	0	$49,789	(49,789)	20.0%	(9,958)	
10,000	43,294	$49,789	(6,495)	50.0%	(3,247)	
50,000	216,473	$49,789	166,684	15.0%		$25,003
				100.0%	$(25,003)	$25,003

[3] Because of the simplifying assumption that the annual estimated outcomes are the same for each year of the five-year period, the estimated annual outcomes are treated as level annuities in the calculation of the present value of estimated five-year outcomes.

Negative variations can occur without having a net loss reflected in any of the estimated outcomes. Consequently, a profitable entity will have *expected losses* which must be considered in evaluating the sufficiency of equity-at-risk under paragraph 9c of Interpretation 46.