

May 27, 2003

Mr. Larry Smith
Director, TA&I—FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith:

We appreciate the opportunity to provide comments on the Financial Accounting Standards Board staff's proposed FASB Staff Positions (FSPs) related to the implementation of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46 or the Interpretation). This letter and the following appendix contain our comments on the following six proposed FSPs:

1. Applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to entities subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*
2. Treatment of fees paid to decision makers and guarantors in determining expected losses and expected residual returns of a variable interest entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
3. Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
4. Application of paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, when variable interests in specified assets of a variable interest entity are not considered interests in the entity under paragraph 12 of Interpretation 46
5. Transition requirements for initial application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
6. Calculation of expected losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

In general, we believe that the guidance provided in the FSPs will assist in the application of FIN 46. However, we have specific comments on each draft FSP. We also believe that several critical interpretive questions remain that should be addressed by future FSPs or other means of communication the FASB deems appropriate. Our comments on the draft FSPs and some suggestions for additional topics we would like the staff to consider addressing in future FSPs are included in the appendix that follows.

In addition, we suggest that the FASB staff consider the following suggestions for making the format and presentation of FSP guidance more user-friendly and easier to catalog and retrieve:

- We suggest that the FASB staff create a logical numbering or other identification system for both the draft FSPs and final FSPs. The draft and final FSPs issued to date are identified by their title, which is determined by the topic covered. As the number of FSPs grows over time, it is likely to become more and more difficult to track and discern the

chronology of interpretations or to identify unique titles when multiple FSPs are issued on a single topic.

- We suggest that the FASB staff include, as a general rule, either background information or an illustrative example in each FSP. Background information and/or examples are extremely useful in conveying the context and implications of proposed guidance. This becomes even more important as time passes and persons not exposed to the process of developing an FSP seek to understand its application. For example, without context it is difficult to understand the objective of the Proposed FSP on “Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13.” That is, it is unclear whether that FSP is intended to address potential under-identification or over-identification of separate variable interest entities that otherwise would occur under FIN 46.

We hope that these comments are helpful. Should you have any questions, please feel free to contact Bob Uhl at 203-761-3705.

Sincerely,

Deloitte & Touche LLP

APPENDIX—Deloitte & Touche Comments on Draft FASB Staff Positions related to FIN 46, Consolidation of variable Interest Entities

1. Applicability of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, to entities subject to the AICPA Audit and Accounting Guide, Health Care Organizations

We support the clarification in the proposed FSP that all not-for-profit entities should be excluded from FIN 46 (unless such an entity is used to circumvent its requirements) if that was the Board's original intention. However, by not providing or referring to a definition of not-for-profit entities this FSP raises questions on what other not-for-profit entities may be included or excluded from this Interpretation. We note that FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, provides a definition of a "not-for-profit organization." If it is consistent with the Board's intent, we suggest that the FSP refer to this definition to ensure that there is a common understanding of the type of entities that qualify for the scope exception in FIN 46.

2. Treatment of fees paid to decision makers and guarantors in determining expected losses and expected residual returns of a variable interest entity under FASB Interpretation No. 46, Consolidation of Variable Interest Entities

We support the staff in seeking to clarify the words used in paragraph 8 of FIN 46 regarding the inclusion of decision maker and certain guarantee fees in the calculation of expected residual returns and expected losses. Further clarification as to what should be included in amounts identified as decision maker and guarantee fees also would be helpful. For example, a guarantee may be issued as a component of a larger transaction with no direct cash consideration paid to the guarantor. This might be the case when, for example, minimum lease payments are "reduced" to reflect the value of an embedded residual value guarantee provided by the lessee. Another example is a party agreeing to provide a guarantee (or serving as a decision maker) solely in exchange for an equity interest in the variable interest entity. In these examples there are no explicit cash flows associated with the decision maker or guarantee fees, and, in the case of the residual value guarantee, there is no explicit "exchange" of consideration for the guarantee.

We suggest that the staff clarify the following with respect to fees "paid" by the variable interest entity to decision makers or guarantors:

- Do such fees include non-cash consideration as well as cash consideration transferred to the decision maker or guarantor? For example, do such fees include consideration implicitly (as well as explicitly) provided through features embedded in other contractual terms or ownership (e.g., payment for guarantee fees provided through a reduction in cash inflows that otherwise would be associated with a lease or other contract)?
- Certain transactions have more than one decision maker based on different activities of the entity, however, FIN 46 refers to fees of "the decision maker" (singular). Does FIN 46 require selection of a single decision maker for purposes of the 8(c) calculation? Conversely, are fees to all decision makers included in the paragraph 8(c) amount?
- Are up-front fees paid to a decision maker included in the 8(c) amount? For example, the entity that is the decision maker may receive up front fees (such as structuring or finder's fees) at the transaction closing for services rendered up to that point or as a prepayment for services to be rendered in the future. Further, should fees received in prior periods continue to be included in the paragraph 8(c) amount upon a reconsideration event?
- In calculating the fees to be included as decision maker fees, should all fees paid to the decision maker be included, whether those fees are for services that involve decision making or not? In addition, are potential returns on other variable interests held by a decision maker included in the paragraph 8(c) amount? Should fees paid to affiliates of

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the decision maker for services provided by those affiliates be included in the paragraph 8(c) amount (even if they do not relate to decision making)?

- The proposed guidance does not specifically address the treatment of variable fees, for example a service fee tied to the performance of the entity. Phrasing the fees to be included in expected residual returns as the “probability weighted average present value of fees expected in all scenarios” would clarify the concept.
- We note that the wording used in the FSP and that in paragraph 8(d) of FIN 46 differs. That is, paragraph 8(d) refers to “. . . providers of guarantees of *the values of all or substantially all of the entity’s assets . . .*” (emphasis added), whereas the FSP refers to “. . . guarantee of substantially all of the entity’s assets . . .” We think the distinction is significant and suggest that the staff clarify the Board’s intent.

3. Reporting variable interests in specified assets of variable interest entities as separate variable interest entities under paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

We believe that guidance on the issue of when to treat a specified asset or group of assets as a separate variable interest entity (silo) is necessary. However, we are concerned that the way the proposed FSP is worded may lead to circumstances in which the result of applying FIN 46 is counterintuitive. The proposed guidance states that a specified group of assets is not effectively separate from the remainder of the entity if the specified assets and claims cannot be reported separately without accounting allocations. We believe this guidance provides a low threshold that is not necessarily consistent with the Board’s underlying objective as identified in paragraph C26 of the Interpretation. To prevent potential abuses, we suggest that the draft FSP be modified so that amounts subject to “accounting allocations” that are inconsequential or nonsubstantive would not be considered sufficient interests common to all the assets when applying the guidance in paragraph 13.

In addition, we believe siloing of assets and specific interests is appropriate when those assets are essentially the only source of payment for specified interests that are nonrecourse to the entity, even though there may be some accounting allocations for shared servicing costs of the entity and similar items. For example, an entity holds only leased assets and each of the assets are financed with separate 100% nonrecourse debt. If minimal servicing costs (for items such as payroll of common employees) paid from the return on all of the assets are allocated to each of the assets, the guidance in the proposed FSP, as currently written, could be interpreted literally to require the entity to be viewed as containing no silos.

4. Application of paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, when variable interests in specified assets of a variable interest entity are not considered interests in the entity under paragraph 12 of Interpretation 46

We support the staff in seeking to clarify that the expected losses that will be absorbed by guarantees or other variable interests (specific interests) in specified assets (i.e., assets that are not more than half of the total fair value of the entity’s assets) are not expected losses of the entity. It would be helpful to constituents to further illustrate through an example that the absorption of losses by these specified interests prior to losses being absorbed by the equity investment at risk would not cause the equity to lack the characteristic in paragraph 5(b)(2), (i.e., the equity at risk’s obligation to absorb the expected losses of the entity, if they occur) because these losses are not expected losses of the entity. We also understand this FSP to indicate that for two entities with the same assets, the entity with specific interests that absorb losses in specified assets will have less expected losses and may need less equity to meet the first condition of a voting interest entity (i.e., paragraph 5(a) of the interpretation) than an entity with no

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specific interests to absorb losses in specific assets. If this understanding is incorrect, the FSP should be clarified.

5. Transition requirements for initial application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

The proposed FSP states that “. . . if at transition an enterprise cannot obtain the information necessary to make the determinations as of the date the enterprise became involved with an entity or at the most recent reconsideration date, the enterprise should make the determinations as of the date on which Interpretation 46 is first applied.” However, the guidance does not further indicate how and as of which date a primary beneficiary should measure the assets, liabilities, and non-controlling interests of a variable interest entity that must be consolidated. If the information was not available at the inception of the investment in the entity (or at a reconsideration event, if applicable) to determine if the entity is a variable interest entity or the variable interest holder is the primary beneficiary, we believe it is inappropriate to presume that the entity was a variable interest entity and the variable interest holder was the primary beneficiary prior to the date the Interpretation is first applied. Therefore, we believe the FSP should also indicate that if the determinations are made on the date of initial application of the Interpretation because the necessary information as of the date of investment (or the date a reconsideration event occurred, if applicable) was not available, the primary beneficiary should measure the assets, liabilities and non-controlling interests of the variable interest entity at their fair values at the date the Interpretation is first applied.

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

We support the staff providing additional examples on expected loss calculations such as the one provided in the proposed FSP. We suggest that the staff clarify whether the example in the proposed FSP includes in the cash flow of the entity the interest paid to the debtholders since inclusion or exclusion of amounts deducted in determining net income or loss, but paid to potential variable interest holders is a critical to the application of paragraph 8. In addition, we encourage the staff to expand the use of examples generally. In particular, we have struggled with extrapolating the example provided in Appendix A of FIN 46 to real-life examples. An expanded illustration of the calculation of expected losses and expected residual returns, including illustrating the identification of the primary beneficiary from among multiple variable interests, would greatly reduce the costs associated with developing proprietary guidance and policies for the implementation of FIN 46, plus reduce the diversity in practice with respect to calculating the expected losses of the entity. Ideally an example (or set of examples) would include:

- Treatment of decision making and other fees for purposes of the expected loss and expected residual return calculations
- Appropriate time horizon over which to estimate cash flows when the variable interest entity does not have a specified life (e.g., the entity has a perpetual life)
- Treatment of non-cash consideration paid for decision making or guarantees
- Identification of the primary beneficiary from among multiple variable interests
- Illustration of a circumstance in which interests in specific assets are deemed not to be a variable interest in the entity as a whole under paragraph 12 (e.g., a guarantee on a minor amount of the assets).
- Illustration of the appropriate methods to use to determine the present value of (1) items included in net income on an accrual basis and (2) period to period fluctuations in the fair value of assets, whether or not included in net income currently.

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We also note that the illustrations of calculations of expected losses and expected residual returns in the Interpretation and those in the FSPs are all based on the methodology in Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. We have understood that an entity may use other methodologies for calculating expected losses, as long as those methodologies are “generally consistent with the concept of expected losses . . .” (paragraph C21 of FIN 46). An example would be a financial institution’s use of methodologies provided in regulatory capital adequacy guidelines. It would be helpful if an FSP made explicit whether the Concepts Statement No. 7 approach is required or whether other methodologies are acceptable.

7. Other potential FSPs

We also suggest that the staff consider addressing the following topics in future FSPs:

- Illustration of the acceptable method(s) for allocating expected losses and expected residual returns among the variable interest holders for determining which holder, if any, is the primary beneficiary. The acceptability of certain methods becomes an issue especially when there is a scenario in determining the entity’s expected variability that has a positive outcome for one variable interest holder while another variable interest holder has a negative outcome (sometimes referred to as “intramurals”). We have identified at least four methods for performing such allocation. The different methods can result in different variable interest holders being identified as the primary beneficiary. Thus, if all methods are acceptable, each variable interest holder could select the method that leads to its desired accounting. We would be pleased to discuss these methods with the FASB staff.
- How to identify a decision maker (for example, what attributes or characteristics should be considered) and how and when making decisions on behalf of others affects the determination. Specifically, if a hired manager of the entity can be fired without cause, is that party a decision maker and are fees paid to that party required to be additive in the expected residual return calculations?
- Whether reconsideration of variable interest entity status and primary beneficiary status is permitted or precluded in circumstances other than those specifically enumerated in paragraphs 7 and 15 of the Interpretation
- Application of paragraphs 9(a) and 9(b)—that is, an illustration of the circumstance in which an entity would be able to conclude that it has sufficient equity investment under each of those paragraphs
- Illustration of the meaning of the statement in paragraph 5(b) regarding “. . . substantially all of the entity’s activities (for example providing financing or buying assets) either involve or are conducted on behalf of an investor with disproportionately few voting rights.” In particular, we are unclear what the phrase “on behalf of” is intended to encompass.
- Are fees paid to service providers who are also equity holders considered reductions of such equity for purposes of determining the equity investment at risk?
- Illustration of the reference in paragraph 7(c) to “additional activities.” For example, are these activities the type that are significantly different from activities entered into in the normal course of business for the entity, or are they activities that increase the expected losses of the entity?