

Letter of Comment No: 58  
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Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
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**Re: File Reference No. 1082-300. Exposure Draft on Proposed Modifications of Interpretation No. 46 – Consolidation of Variable Interest Entities.**

**Specifically:**

- 1. Paragraph 16(d)(1) – Test to determine existence of related parties – those with constraints on ability to manage interest(s).**
- 2. Paragraph 17(b) – Test to determine which related party's activities are most closely associated.**

The opportunity to provide comments on the above noted Exposure Draft is appreciated. FIN 46 is particularly relevant for one of my clients. The FASB should be commended for its desire for increased transparency, its many open deliberations, and its willingness to modify FIN 46 to improve clarity and minimize interpretation risk faced by preparers. The new concepts introduced by FIN 46 have obviously raised a number of important questions and it is certainly worthwhile to support the FASB's efforts to provide additional interpretative guidance.

One of the important determinations that must be made in applying FIN 46 is whether a related group exists. Achieving some certainty on this matter early on in the process of applying FIN 46 is valuable in that it provides direction for the rest of the analysis, since the methodology used to determine the primary beneficiary when a related group exists appears to rely more on qualitative analysis, rather than on complex quantitative modeling of expected variability as would be the focus where no related group existed.

My client has VIE's where this matter is relevant and accordingly has spent considerable time and effort trying to interpret and apply paragraphs 16(d)(1) and 17(b) to determine whether a related group exists, and then which of the related parties is the primary beneficiary. It has become apparent that the interpretation and application of these provisions differs among preparers and their accounting advisors. Accordingly, I was asked to provide the FASB with comments on this matter. I trust you will find them insightful as you seek to amend FIN 46 and consider issuing further FSP's to provide additional clarity.

Please see Appendices I and II for comments relating to paragraphs 16(d)(1) and 17(b), respectively.

Thank you for your consideration. If you have any questions, or would like to discuss these matters, please do not hesitate to contact me at (416) 571-5036.

Respectfully,

Mark Nash, CA

**PARAGRAPH 16(d)(1) – DE FACTO AGENT TEST**

There appears to be some inconsistency between the proposed modified wording of paragraph 16(d) and paragraph A32 of the explanatory notes. Specifically, the modified language provides that a de facto agency relationship exists only if a right of prior approval could constrain the potential de facto agent's "ability to manage the economic risks or realize the economic rewards" [underlined emphasis mine]. This is consistent with the thirteenth point on page ii of the Summary section of the Exposure Draft. Therefore, it seems clear that if the ability to manage only one of risks or rewards is constrained, then a de facto agency relationship exists. However, paragraph A32 outlines an example that suggests that the ability to manage both the risks and rewards must be present for a de facto agency relationship to exist. In addition, paragraph A30 adds to the confusion since it refers to "and" in its first sentence and "or" in its last sentence.

As background, prior to the issuance of the Exposure Draft under consideration, my client engaged external legal counsel to review the agreements governing one of its VIE's to determine whether one of the parties could not "sell, transfer, or encumber its interests in the entity" without prior approval – i.e. the test in 16(d)(1). Counsel had particular difficulty interpreting and applying this test. Recently, they reviewed the relevant portion of the Exposure Draft and commented that, although the reference to a broader non-literal approach involving the use of judgment was helpful, in many ways their level of uncertainty has increased due to the confusion described above. This was particularly troubling.

I believe it is important to clarify this matter because as one applies the test in paragraph 16(d)(1), there is an inevitable attempt to align the words "sell, transfer" with "rewards", and to align the word "encumber" with "risks". Confusion results from not being able to reconcile the suggestion in paragraph A32 that all three of "sell, transfer, or encumber" must be constrained, with the proposed new words in paragraph 16(d)(1) – "risks or .....rewards" [underlined emphasis mine].

Such confusion could be mitigated by retaining the proposed new words in paragraph 16(d)(1) and modifying the example in paragraph A32 to suggest that any one of the three actions (or an action that is functionally equivalent) is sufficient for a de facto agency relationship to exist. This solution would, in my view, appropriately create a lower threshold of entry into the related party rules of FIN 46, which would be consistent with the anti-avoidance nature of such rules.

Alternatively, additional language could be drafted to modify paragraph 16(d)(1) to clarify that if a party is only constrained from doing one or two of the actions, then they are presumed not to be a de facto agent, unless some other significant aspect exists and use of judgment concludes that their ability to manage the risks or rewards associated with their interest(s) is constrained.

**PARAGRAPH 17(b) - WHICH RELATED PARTY'S ACTIVITIES ARE MOST CLOSELY ASSOCIATED WITH THE VIE?**

Where a related party group possesses the majority of expected variability, paragraph 17 of FIN 46 effectively provides that the primary beneficiary is that particular related party whose activities are most closely associated with the VIE in question. This is both the primary test, and the test required to overcome a presumption that the principal in an agency (or de facto agency) relationship is the primary beneficiary.

This test is difficult to apply since there has not been much guidance provided around the concepts inherent in the test and the intended indicators of "activities ...most closely associated". Below are questions that have arisen while attempting to apply the test to several VIE's under consideration. Please do not interpret them as a desire for all-inclusive prescriptive rules. Rather, I trust that the questions adequately convey the challenge faced when struggling with the words to understand the principles and intent behind them.

**Scope and Approach to Analysis – i.e. How to Construct Groups of Activities to Compare**

- (a) Is it appropriate to focus more on the word "activities" than "associated"?
- (b) Should all of the parties' (key) activities be considered, or only those activities with respect to the variable interest entity?
- (c) How, if at all, should "decision-maker" activities be incorporated into the analysis?

**Method of Comparison of Activities**

- (a) Are certain activities to be given relatively more weight than others?
- (b) Should "most closely associated" be interpreted as "most similar to the variable interest entity's activities", or "most crucial to the variable interest entity"? If the former, should the variable interest entity's activities represent only those actually undertaken by it, or also include those activities undertaken by others on its behalf (recognizing that the activities of variable interest entities differ from those of other entities in that many of the elements necessary for operation are contracted out)?
- (c) Modified FIN 46 makes it clear that quantitative, as well as qualitative, factors should also be considered. There are various ways one could interpret "quantitative". For example, size of relative:
  - expected loss
  - compensation for activities performed for the entity
  - number of activities performed for the entity.

Did the Board have any particular quantitative aspect in mind?

- (d) When a related group includes several homogeneous related parties (e.g. franchisees) and other non-homogenous related parties, would it be appropriate to aggregate the homogenous parties on some reasonable basis? In other words, is the more appropriate comparison between each particular homogeneous entity and each of the other related parties, or between an aggregated sub-group of all homogeneous related parties and each of the other related parties?