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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
File Reference No. 1082-200
Financial Accounting Standards Board
401 Merritt 7
Norwalk. Connecticut 06856-5116

Letter of Comment No: 106 File Reference: 1082-200 Date Received: 08/30/0

Re: Comments on the Proposed Interpretation, Consolidation of Certain Special Purpose
Entities

Dear Ms. Bielstein:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the exposure draft of the proposed interpretation *Consolidation of Certain Special-Purpose Entities* (the "interpretation").

We support the Board's efforts to develop guidance regarding consolidation of special purpose entities (SPEs). In our view, controlling financial interest should be the basic principle by which one entity should be required to consolidate another. An entity that has a controlling financial interest in an SPE should consolidate the SPE. However, we agree with the Board that a controlling financial interest can be established through means other than voting interests. In that regard, the risks and rewards framework utilized in the interpretation should be useful in making an overall assessment of whether an SPE that is not controlled by voting interests should be consolidated.

We support the Board's efforts to complete this project as quickly as possible, consistent with the need for substantive due process. However, we have concerns about the interpretation that we believe the Board should address before issuing a final interpretation. Our concerns are detailed herein.

General Observations

As we have noted in previous communications with the Board, and have publicly stated in many different forums, we support the issuance of principle-based accounting standards. When the project first commenced, a model based upon principles was developed; however,

during the deliberation process many compromises were made in the interpretation that cause the current draft to effectively depart from some of the principles the Board originally established. Those compromises have increased the complexity of the document, resulting in a standard that is unwieldy, confusing and difficult to apply. In the remainder of this letter, we have indicated the principles that we believe should be operative in the interpretation, the provisions of the interpretation that we believe conflict with those principles, and our recommendations to remedy the conflicts.

We support the principle that the identification of a primary beneficiary should be used as the basis for determining whether an entity should consolidate an SPE. However, while the interpretation implicitly calls for an analysis based upon substance, we believe that it should explicitly state that the evaluation and analysis as to whether there is a primary beneficiary and who that might be should be based upon the substance and not the form of a particular transaction and should consider all the relevant facts and circumstances.

In recent years there has been a dramatic increase in the sophistication of the capital markets. New transactions and structures are being designed each day that put stress on established standards for accounting for those structures. We believe that the interpretation has the potential to improve financial reporting. However, it is certain that the world's capital markets will continue to evolve and that new structures and transactions will continue to emerge. In recognition of this fact, we recommend that the Board revisit the interpretation in two years and assess its effectiveness and its impact upon financial reporting. In the event that new structures or transactions emerge for which the interpretation provides inadequate guidance, or the guidance otherwise does not appear to be achieving the Board's objectives in issuing the interpretation, we recommend that the Board commit to either reconsider it or provide implementation guidance as needed.

In several parts of the document, the inclusion of detailed examples would go a long way toward making the interpretation more understandable and facilitating its implementation. Several examples were included in earlier working drafts of the interpretation and we recommend that they be reinstated and expanded where appropriate to illustrate application of the interpretation to common practical situations.

Scope

The interpretation would apply to any business enterprise that has involvement with an SPE, but we believe an SPE is not clearly defined in the document. Paragraph 2 lists some characteristics that may be present in SPEs, but acknowledges that entities that are not SPEs can have those same characteristics. Applying paragraph 7a, one would attempt to identify SPEs by determining whether the entity falls outside of the definition in that paragraph. We find that approach equally unhelpful because the term SPE is used in the definition of "substantive operating enterprise (SOE)." In short, the lack of a concrete definition of an SPE

creates questions about which types of entities are SPEs and would be within the scope of the document.

We believe that the scope language would be clearer, more concise, easier to apply, and more in keeping with a principle-based approach if it focused broadly on whether an entity is one for which voting equity interests do not give the holders a controlling financial interest (regardless of the percentage owned), rather than on whether an entity is an SPE for which voting equity interests do not give the holders a controlling financial interest. The interpretation provides a general framework for consolidation of SPEs in which the voting equity interests do not give the holders a controlling financial interest regardless of the percentage owned. In principle, that general framework could be applied to any entity that has that distinguishing characteristic, whether or not the entity possesses the other characteristics of an SPE discussed in paragraph 2 or can be identified by virtue of falling outside of paragraph 7a. Accordingly, that framework could be applied to any business enterprise that has involvement with an entity for which voting equity interests do not give the holders a controlling financial interest regardless of the percentage owned. On that basis, defining an SPE would seem to become less relevant. We recommend that the Board consider this as a way to reduce confusion over the definition of an SPE, whether an entity has the characteristics of an SPE, and whether the entity falls within the scope of the document.

In conjunction with that approach, we believe that it is important for the Board to acknowledge that one of the key objectives of the interpretation is to define the term controlling financial interest in the context of such an entity, recognizing that such an interest might be achieved through contractual relationships or other means and not just by holding a majority financial interest in the SPE. The Board should make it clear that a controlling financial interest can be established by obtaining the substantial risks and rewards related to an entity even without any explicit control mechanism. This would be the case, for example, if all major decisions have been predetermined by the establishing documents. Further, we recommend that the Board acknowledge that the interpretation does not address the various means through which a controlling financial interest can be achieved in an entity that is not within the scope of the document, and that the Board intends to address those situations as part of its major project on consolidation policy.

We also recommend that the Board consider revising the definition of an SOE. In our view, an SOE would be an entity whose equity voting interest gives the holder a controlling financial interest, and the definition could be more simply expressed in that manner. In other words, an SOE is not subject to consolidation under the provisions of this interpretation because an SOE is controlled by its voting equity interests as a group. SOEs are subject to consolidation under the provisions of Accounting Research Bulletin No. 51 (ARB 51), Consolidated Financial Statements, and FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries. Additionally, the term SOE may not accurately describe all entities whose voting equity interests give the holders as a group a controlling financial interest. A term such as

"substantive enterprise" might be less restrictive and capture the intended distinction more accurately.

We do not understand the rationale for paragraph 8c of the interpretation. That paragraph states that no enterprise shall be deemed to be the primary beneficiary of a subsidiary, division, department, branch, or other portion of an SOE even if it is otherwise similar to an SPE. The only acceptable rationale for consolidation in GAAP today is the existence of a controlling financial interest. This interpretation would clarify that a controlling financial interest can be established through means other than a voting interest. By definition, there can only be one controlling financial interest in an enterprise. If the voting interest holders as a group have a controlling financial interest in a subsidiary, division, department branch or other portion of an enterprise, then the voting interest holders should evaluate whether any one voting interest holder has a controlling financial interest as the term is used in ARB 51. If, however, the voting equity interests in the enterprise do not give the holders a controlling financial interest, then the enterprise may be subject to consolidation by another variable interest holder in accordance with the interpretation. It seems to us that in either case, paragraph 8c would not be operative. There is no basis in GAAP for an entity to elect to consolidate another entity (or a division, department or branch) that it does not effectively control; therefore we do not understand the need for paragraph 8c. We recommend that it be deleted, as we believe that the other provisions of the interpretation should be applied to any entity for which the voting equity interests do not give the holders a controlling financial interest regardless of the percentage owned. If the Board elects to retain paragraph 8c, we recommend the guidance be expanded to explain the basis on which an entity would consolidate or otherwise include in its financial statements entities or assets that it does not control. Further, the basis for conclusions should be expanded to explain when this paragraph would be operative.

Consolidation Based on Voting Interests

The heading of this section does not appropriately capture the concepts expressed in the section. In order for an entity to be evaluated for consolidation under the interpretation, that entity must possess the characteristic that its voting equity interests do not give the holders as a group a controlling financial interest. Additionally, paragraph 9a confirms that this section would be operative even when, because of predetermined decisions, the voting interest holders may have very little decision-making authority. Therefore, it appears that the principle contained in this section is that, under certain circumstances, the holder of a majority of the residual equity interests of an SPE should consolidate it even if that holder has no substantive decision making power on an ongoing basis. If this is correct, the phrase "Consolidation Based on Voting Interests" seems an inappropriate description. Instead, it would be more appropriate to label this section "Consolidation Based on Residual Equity Interests." That title appears to better capture the notions embedded in these paragraphs.

Paragraph 9 focuses on the equity investments of one or more parties. If an interest in an SPE meets all of the conditions in paragraph 9 to be considered an independent equity interest, we believe the interest might not have to be equity in legal form. For example, it may be possible to structure an indexed debt security so that its characteristics are identical to those of legal form equity and it meets each of the conditions in paragraph 9. To accomplish this structure, the debt would have to be subordinate to all equity of the entity as well as all other liabilities currently existing or incurred in the future. In addition, the debt would have no creditor rights (e.g., to force bankruptcy) or legal claim on the assets. In effect, the debt would be debt in name only but would be residual equity in all substantive respects. We recommend that the interpretation acknowledge this possible structure, and provide that the criteria in paragraph 9 are operative regardless of the legal form of the equity interest.

We believe that an equity interest that is held by an employee, director, or similar related party of a variable interest holder is in substance financed by the variable interest holder and therefore does not meet the test in paragraph 9e. Since this type of arrangement has been the subject of some highly visible abuses in the recent past, we recommend that the Board consider making explicit reference to it in the interpretation.

We find the guidance on how to overcome the presumption in paragraph 12 that an investment should be equal to at least 10 percent of the SPE's total assets to be confusing and difficult to apply. Paragraph 12 requires preparers to compare the equity of an SPE to the equity of an SOE that engages in similar transactions with similar risks in order to demonstrate that the 10 percent investment presumption can be overcome. We believe that comparison to be a hypothetical exercise. SPEs typically serve a single special purpose and have concentrated risks. SOEs typically have diversified risks. This important distinction has a profound effect on the level of capital needed to finance operations. Accordingly, in most cases it would be very difficult, if not impossible, to find an SOE that engages in similar transactions with similar risks as the SPE. We believe that the determining factor in whether an equity investment is sufficient should be whether that investment is large enough to absorb the expected future losses of the SPE at all times during the SPE's existence. That should be the basis for overcoming the 10 percent presumption. We recommend that the Board adopt this approach in lieu of the requirement in paragraphs 11 and 12 to assess the investment against comparable SOEs. In addition, the Board should provide examples of possible indicators of the amount of equity that would be considered adequate. One possible indicator, for example, might be the investment necessary (the unrated piece) such that a nationally recognized rating agency would rate the senior obligations as investment grade.

Consolidation Based on Variable Interests

Under the guidance in the first sentence of paragraph 14 and in footnote 5, an entity would not be required to conduct an exhaustive search for information about the actions of other unrelated parties. Read literally, there would be no responsibility on the part of any party to

get the information necessary to properly apply the interpretation and determine whether that entity must consolidate the SPE. Some may argue that obtaining the necessary information will be too difficult and too costly, and we believe the Board should be sensitive to those concerns. However, the Board also should be concerned that those provisions could be used to avoid obtaining information that would compel an entity to consolidate. In order to strike the proper balance, we recommend that the Board consider establishing a presumption that an entity that holds a certain percentage of the variable interests of an SPE (for example, 20 percent) is the primary beneficiary. That presumption could be overcome by evidence that the variable interest is not significantly more than the variable interests held by any other unrelated party. If an entity holds a percentage of the variable interests below the threshold percentage, footnote 5 should be operative.

Paragraph 15 addresses *de facto* agency relationships but does not address formal agency relationships. If a party has a *de facto* agency relationship with the enterprise, its variable interests are treated as the enterprise's own interests. It logically follows that the same treatment should apply if the party has a *formal* agency relationship with the enterprise. It would therefore seem that this guidance should cover any party that has an agency relationship with an enterprise, whether or not *de facto*, for the purpose of determining the primary beneficiary.

Paragraph 15e, regarding a *de facto* agency relationship as a result of significant amounts of professional services, lacks clarity. For example, it is not clear why a law firm that has a variable interest in an SPE and also provides professional services to another variable interest holder would be considered to be in a *de facto* agency relationship with the other variable interest holder. Perhaps the relative value of the interest in the SPE compared to the professional service arrangement could create such a *de facto* agency relationship. In any event, we recommend that the Board consider including examples of such a circumstance to illustrate the intended application of this provision.

We found the language in paragraph 17 regarding multi-seller/lease conduits to be confusing. We recommend that the Board consider providing additional guidance regarding separation of silo SPEs. In earlier working drafts of the interpretation, the Board indicated that multi-seller/lease conduits should be separated into silos for each individual transferor or lessee that is in the same position as if they were involved in a single-entity SPE. In addition, EITF Issue No. 96-21 (EITF 96-21), Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities, contains useful guidance in this regard. We believe the interpretation should explicitly incorporate the concepts in question 1 of EITF 96-21 by making it clear that where both the assets and the liabilities are isolated within a larger entity through the use of debt that has recourse only to the specific assets, that arrangement would automatically establish a silo SPE. The interpretation could then go on to describe the concept in paragraph 17, which applies when the entity's creditors have recourse to other assets of the

entity but the transferors or lessees of the assets do not have a substantive direct or indirect interest in the other assets of the entity.

The interpretation is also unclear as to the interaction of paragraphs 22 and 23 and paragraph 17. It is unclear whether paragraph 17 should be applied to a multi-seller conduit first or whether an SPE that meets paragraph 22 should be evaluated solely under paragraph 23 without regard for whether interests in the SPE meet the provisions of paragraph 17.

Identifying and Comparing Variable Interests

In the second sentence in paragraph 19, the provision about a significant incremental investment made by the service provider in its own business should be clarified. We believe that an incremental investment in an enterprise's business that is not particularly unique and that has alternative uses for the enterprise (and therefore is recoverable without regard to the investment in the SPE) should not be considered in determining whether the enterprise has a variable interest.

Paragraph 19 also should clarify that a "sweep" arrangement, where a service provider is entitled to the residual cash flows of an SPE after all contractual cash flows have been paid, cannot be considered a market-based fee and therefore must be considered a variable interest.

Paragraphs 20 and 21 discuss the method for determining who is the primary beneficiary by comparing variable interests, but focus exclusively on expected losses and do not discuss potential gain. At a minimum, those paragraphs should state that variable interests that are exposed to the greatest expected losses would typically be expected to have the greatest potential reward as well. Thus, where a party has significant upside potential, but appears to have minimal downside risk, that party would need to be examined carefully because it is likely that it also has significant downside risk even though that appears not to be the case. A different conclusion might be indicative of an error in estimating expected losses.

We also believe that the paragraphs 20 and 21 "tiebreaker" provisions needlessly contribute to the complexity of the interpretation. Expected losses calculated in accordance with CON 7 inherently incorporate any subordination of one party's interests to another party's interest. If a calculation results in two parties with similar expected future losses, it would be inappropriate to further consider the subordination. If the subordination is substantive (i.e., there exists the possibility that the subordinated party could lose while the senior party does not), then the subordinated party's losses will be given more weight automatically in a probability-weighted analysis. Along the same lines, if two parties have similar expected future losses, it should be irrelevant which party is exposed to the dominant risk. Moreover, the tiebreaker provisions are inconsistent with the interpretation's stated principle that the primary beneficiary is the party that holds a majority of the variable interests in the SPE or a significant portion of the total variable interests that is significantly more than the variable

interest held by any other party. Accordingly, we recommend that the tiebreaker provisions be deleted.

SPEs That Hold Certain Financial Assets

We agree with the Board's observation in paragraph B20 that the appropriate application of the provisions of the interpretation would not result in consolidation of SPEs that effectively disperse risks. However, we are not convinced that there is benefit to establishing another model for financial SPEs that differs from the model for non-financial SPEs, if the SPE effectively disperses risks. Notwithstanding our view, if the Board elects to go forward with the distinction, we encourage consideration of the following comments.

We believe that the definition of a financial SPE in paragraph 22 will exclude many SPEs that should be evaluated as financial SPEs. In our view, the definition of a financial SPE should be expanded to include any SPE that holds only financial assets, as the term is defined in FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. That definition would allow a financial SPE to hold derivative instruments and equity instruments as well as other financial assets. It is also simpler than the definition in the proposed interpretation, and we recommend that the Board adopt it for financial SPEs.

In addition, we believe that the criteria in paragraph 23 for determining the primary beneficiary are needlessly complex. We recommend that the paragraph be changed to conform to the principle that the only basis for consolidating an SPE is the existence of a controlling financial interest. In order to have a controlling financial interest in a financial SPE, an entity must have the substantive ability to direct the sale, purchase, origination, or exchange of assets for the SPE (controlling) and the entity must have a variable interest in the SPE (financial interest). In cases where more than one entity has both the ability to manage assets for the SPE and a variable interest in the SPE, each entity should look to conditions (b) and (c) in paragraph 13 to determine the primary beneficiary. We find this approach to be less complex and easier to apply than the interpretation, and one that is more consistent with the basic control principle.

One benefit of this simplified approach is in the application of the interpretation to investment companies. Certain investment companies - for example, bank collective funds - do not have voting interests and thus could fall under the scope of the ED as drafted, thereby requiring consolidation by a "primary beneficiary" on the basis of variable interests even though the beneficiary has no ability to manage the fund's assets. Similarly, an investment company may acquire interests in financial SPEs (for example, tranches of asset-backed securities or interests in other investment funds) managed by other entities that could cause the investment company to be deemed a "primary beneficiary" for consolidation purposes, even though, once again, it has no ability to manage the SPE's assets. In these cases, it appears that application of the

variable interest model to those entities will produce illogical results, causing passive investors to consolidate. Under the simplified approach that we have advocated, an entity that both manages the assets of a fund and retains a variable interest in it would be required to consolidate the fund. A passive investor with no control over the fund's assets would not be required to consolidate, regardless of its variable interest in the fund.

Notwithstanding our comments above, it appears that any entity that meets the condition in paragraph 23b would also, by reference to the guidance in paragraph 19, meet the condition in paragraph 23c because an entity that provides the services described in paragraph 23b (i.e., a guarantee, backup lending, other form of liquidity, credit, or asset support) could be required to transfer assets or issue its own equity or debt instruments. In that case, we believe that entity would be receiving a fee that could not be market-based under the guidance in paragraph 19. We recommend that paragraph 23 be modified to indicate that an entity that meets the condition in 23b, or an entity that meets the conditions in both paragraphs 23a and 23c, is considered to provide significant financial support through a variable interest.

Transition

Paragraph 26 provides that SPEs that are consolidated for the first time as a result of application of the interpretation should be recorded at fair value. Earlier drafts provided that the individual assets, liabilities, and non-controlling equity of such an SPE should be recorded at the amounts that would have been recorded if the SPE had been consolidated since inception, unless impracticable. We believe the latter method would facilitate ease of implementation in circumstances where fair value amounts might be difficult or costly to obtain. Although offering such a choice will potentially reduce comparability between entities, we believe that will be an unavoidable consequence of applying the interpretation regardless of the transition method offered in the final interpretation. Therefore, we recommend that the Board permit preparers to elect either method of adoption on cost/benefit grounds. Whichever method a preparer chooses, however, should be applied to all of its SPEs.

Other

We recognize that the Board wants to issue timely guidance and we firmly support that objective. However, we believe that the interpretation will require many entities to consolidate SPEs not previously consolidated. In those circumstances, we foresee many questions arising concerning the accounting for gains or losses of an SPE that economically will never be borne by the entity required to consolidate it. Accordingly, we recommend that the Board consider adding a follow-on project to its agenda to address the accounting subsequent to initial consolidation for entities that consolidate SPEs.

We appreciate the opportunity to express our views in this letter. We would like to participate in the Board's roundtable discussion of the interpretation on September 30, 2002. In the interim, if you have any questions regarding our comments, please feel free to contact James F. Harrington at (973) 236-7203, Kenneth E. Dakdduk at (973) 236-7239, or Randall J. Vitray at (973) 236-7223.

Sincerely,

PricewaterhouseCoopers LLP