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Ms Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 Norwalk CT USA

File ref: 1082-200

03 September 2002

#### Dear Suzanne

# Proposed Interpretation - Consolidation of Certain Special-Purpose Entities

I write as Technical Director of the UK Accounting Standards Board (ASB) to offer staff comments on the above proposal.

## International background

Over the ten years to 1995, the ASB and its predecessor devoted considerable efforts to developing a standard to ensure that transactions with SPEs and others were accounted for in accordance with their substance and not allowed to become a means of artificially removing assets and liabilities from a reporting entity's balance sheet. We therefore welcome the FASB's current moves to deal with that part of the problem not covered by FAS 140 and we recognise in these proposals a number of the issues that we ourselves have had to address. I attach at Appendix 1 a copy of a letter sent by our Chairman to Mr Jenkins when we received an outline of the FASB's approach earlier this year.

During 2002 the FASB and ASB have participated with other standard setters in discussions to assist the IASB in developing an international project that would apply the same principles based on control both to normal consolidations and to SPEs. It is acknowledged that the absence of the exercise of day to day control in many SPEs calls for the development of the implications of predetermined control. This, in turn, would involve identifying the risks and benefits attaching to a reporting entity as a result of its relationship to an SPE. We appreciate that the FASB's proposed Interpretation has had to be framed in

the context of the existing standards for consolidations and for the transfer of financial assets (ARB 51 and FAS 140 respectively) without amending either. We very much hope, however, that nothing done at this stage will impede the development both at the FASB and the IASB of an integrated, control-based, international approach to resolving the issues of consolidation, SPEs and the recognition and derecognition of assets and liabilities.

### Specific concerns

### Structure of the Interpretation

In dealing with a field of activity in which financial innovation is rife, it is particularly important to give precedence to the guiding principles of a pronouncement and to show how they provide the starting point for any detailed rules that are then enunciated. Notwithstanding the clear explanations given in the Introduction and Basis for Conclusions, the Interpretation would, in our view, be stronger if the key objective – the identification and recognition of the reporting entity's assets and liabilities – could be set out at the start of the main text. Appendix 2 illustrates, by way of extracts from our own standard, a few principles that we have found useful in building a supporting framework for the detailed requirements that we have in this field.

### The role of financial support

The Interpretation proposes two criteria as necessary for determining that an enterprise is the primary beneficiary of an SPE and should consolidate it: the provision of significant financial support and possession of the largest portion of variable interests. Some of the guidance given for these (for example para 21) seems to us unduly mechanistic and we would have thought that it would be more effective to stress that the criteria need to be understood in the context of an assessment of the overall commercial effect of the arrangements and the relative risks and benefits to which each party is exposed.

The role of financial support, in particular, needs to be explained in that wider context as it is not intuitively obvious that the provision of financial support of itself forms part of the control of one entity by an other. Entities are usually able to raise finance at some price without giving up the essential control of the shareholders, even if debt covenants restrict in some ways the choice of operating or financial policies. The role of the provider of financial support may therefore best be understood in the general context of assessing the relative risks and returns to the entities with interests in the SPE. In particular, the rate of return provided relative to the benefit apparently obtained and the arrangements for the interest to be terminated or transferred would be relevant considerations.

The text as drafted gives greatest weight to downside risk and first dollar exposure (see paragraphs 20 and 21). We are concerned lest such an emphasis

could lead to consolidation by, for example, insurers or, worse, the creation of artificial "first-loss" structures to avoid consolidation by the true primary beneficiary. In setting up the arrangements, the parties will have given weight to the possibilities of benefit as well as risk and in some cases the expectation of benefit may provide a more appropriate basis for identifying the primary beneficiary.

### Largest variable interest

The notion of the largest variable interest falls well short of control and would be difficult to fit into a future integrated approach covering both consolidation and SPEs. It may be that multiple variable interests are normally an indication of dispersion of risk.

Subsidiary of a substantive operating enterprise

Presumably the prohibition against consolidating the subsidiary of a substantive operating enterprise would drop away in a future integrated regime. Nevertheless, at present it seems to open up a significant avenue for avoiding the application of the Interpretation by arranging for a large financial institution to 'warehouse' assets and liabilities that a reporting entity wishes to keep off its balance sheet.

#### Conclusion

As we have stated above, we strongly advocate an integrated approach to consolidations and SPEs based on the principle that, for accountability, one entity's control of another should be reflected by its consolidation of the controlled entity. This is consistent with the way that an entity's control of future economic benefits is reflected by its recognition of assets. We hope that, once an acceptable short-term solution addressing the consolidation of SPEs is in place, the FASB will join with us in working with the IASB to develop a universal control-based model that is conceptually sound and effective in practice.

Sincerely

Allan V C Cook Technical Director

#### Appendix 1

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Mr Edmund Jenkins Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut CT06856-5116 United States of America

25 March 2002

Dear Ed

FASAC papers: Summary of Tentative Decisions 'Entities that Lack Sufficient Independent Economic Substance'

We were very interested to see the papers you sent to FASAC, in particular Attachment D where you summarise the FASB's tentative decisions on entities that lack sufficient independent economic substance.

As you will appreciate, we are very supportive of an approach that is based on the exercise of professional judgement as informed by the various principles set out in your paper. I can confirm that, since the introduction of the equivalent UK standard in 1994, many of the principles have played a significant part in the analysis of off-balance sheet arrangements and in discouraging the use of financial engineering for cosmetic financial reporting purposes. In the UK we have not found it necessary to specify a minimum level of equity holding by outsiders.

As you will have seen, we are currently working on international guidance on consolidation. The model we are proposing is based on control and has many similarities to the model described in your 'Tentative Decisions' paper. We are, however, hoping to develop a universal control-based model that applies equally to classic consolidation issues and to Special Purpose Entities (SPEs). An advantage to such an approach would be that it avoids making decisions about when an SPE exists as the basis for applying additional requirements.

We look forward to discussing this further with you at the IASB meeting in May when a paper on consolidation is planned for discussion.

Yours sincerely

Mary Keegan Chairman

### Appendix 2

## Extracts from FRS 5 'Reporting the Substance of Transactions'

#### The substance of transactions

A reporting entity's financial statements should report the substance of the transactions into which it has entered. In determining the substance of a transaction, all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole.

### **QUASI-SUBSIDIARIES**

## Identification of quasi-subsidiaries

- 32 In determining whether another entity (a 'vehicle') gives rise to benefits for the reporting entity that are in substance no different from those that would arise were the vehicle a subsidiary, regard should be had to the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them.
- 33 In determining whether the reporting entity controls a vehicle regard should be had to who, in practice, directs the financial and operating policies of the vehicle. The ability to prevent others from directing those policies is evidence of control, as is the ability to prevent others from enjoying the benefits arising from the vehicle's net assets.
- Where the financial and operating policies of a vehicle are in substance predetermined, contractually or otherwise, the party possessing control will be the one that gains the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them.