December 1, 2003

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

File Reference No. 1082-300

Dear Sir:

The Financial Reporting Committee (FRC) of the Institute of Management Accountants appreciates the opportunity to share its views on the Exposure Draft of the Proposed Interpretation, Consolidation of Variable Interest Entities — a modification of FASB Interpretation No. 46 (the ED). We support the FASB in its efforts to improve financial reporting for arrangements involving special-purpose entities (SPEs) and to preclude off-balance-sheet treatment for abusive transactions structured using SPEs. However, we have a number of significant concerns that we would like to share with the Board. In an effort to directly address the two most critical issues with Interpretation 46, we have summarized all other comments related to the ED and implementation/interpretive issues in Appendix A, and provided more detailed explanations in Appendix B. This cover letter focuses exclusively on issues related to the scope of Interpretation 46 and its effective date.

As a preface to our comments, we wish to observe that over the past two years, rigorous application of accounting standards has evolved into a paramount management objective. Like other representational organizations involved in financial reporting, we applaud this change and believe that it has had a strong, positive effect on our capital markets and investor confidence. However, in the current environment the misapplication of accounting standards, whether intentional or accidental, tends to be front-page news. With the jaundiced perspective of the news media, it is always possible to cast even honest mistakes in a sinister light and have it stick, unchallenged. The magnitude of the issues and their attendant consequences become more severe when the accounting issue involves off-balance sheet arrangements. It is from that perspective that we frame our overall comments and we hope that the Board will accept them in the constructive manner in which they are intended.
In this environment, we believe that it is critically important that the requirements of Interpretation 46, inclusive of supplemental guidance in the ED and all FSPs (issued, proposed, and contemplated), are sufficiently clear that preparers and auditors know with a high degree of certainty which entities are within its scope and that they are provided with sufficient time for preparers and auditors to read, understand and comply with the requirements of Interpretation 46 as they relate to each of these entities. The credibility of financial reports will be strained yet again, if adoption of the modified interpretation is followed by restatements each quarter by companies who, despite their best efforts, failed to get it right.

Almost since the date of its issuance, preparers and auditors have struggled with how to determine an entity’s expected losses for purposes of applying the requirements of Interpretation 46. The problem is particularly acute when the entity is an operating business. While the expected loss concept may be capable of being applied to an entity that holds only financial assets, we believe that it breaks down when the entity is an operating company. The concepts of entity design and expected losses are foreign to the day-to-day operating environment of manufacturing companies, where expected returns are not determined by the performance of financial assets and liabilities. Rather, they are the result of management’s creativity, ability to execute a business strategy, ability to produce high quality products and services, and acumen in identifying or anticipating shifts in customer demands and needs. Seismic variations in future returns would occur if plants were to break down, workers went on strike, or products failed at a much higher rate than normal. Such variables do not lend themselves to the computational rigor required by Interpretation 46. And even if such computations were feasible, the perpetual nature of operating companies means that there will be residual values at the end of the forecast period – no matter how long that period lasts. Almost by definition, the variation in the residual will be the single most important factor in determining the fair value of the entity and the distribution of expected returns.

We believe that the Board and its constituents would be better served if the scope of Interpretation 46 were narrowed to exclude entities that meet the definition of a business in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.” If the Board were to act upon our recommendation, application of the Interpretation would be greatly simplified and many of the practice issues discussed in the appendices to this letter would be resolved or significantly mitigated, while not compromising the principle objective that Interpretation 46 was designed to address: the accounting for abusive transactions structured using SPEs.

In addition to fixing the scope, we believe the effective dates of Interpretation 46 and the ED should be deferred broadly for all companies. We do not believe an effective date of interim or annual reporting periods ending after December 15, 2003 (December 31, 2003 for public companies with a calendar year end) is achievable because of the timing of when the ED will be issued and the fact that it will not deal with all of the implementation issues that have arisen in a comprehensive manner, resulting in continued piecemeal adoption of the Interpretation. It is simply not realistic to assume that companies will be able to understand and apply all of the new guidance in time to implement it robustly in their year-end financial statements.

Since Interpretation 46 was issued in mid-January, the FASB staff has provided implementation guidance through FASB Staff Positions (FSPs) in the following areas: scope (FIN 46-1); identifying
separate VIEs within a larger VIE (FIN 46-2); when variable interests in specified assets are considered to be variable interests in the entity (FIN 46-3); transition (FIN 46-4); and treatment of fees paid to a decision maker (FIN 46-7). Each of these FSPs provided important, fundamental clarifications of the guidance in Interpretation 46. In addition, the FASB staff recently proposed guidance in FSP FIN 46-f to assist in determining whether rights given to holders of variable interests that are not classified within an entity's equity are so significant that they preclude equity holders from directing the entity's activities and is preparing to issue draft guidance that will replace the guidance in Appendix B of Interpretation 46. In addition, we understand that the FASB staff is working to provide guidance on the appropriate methodology (or methodologies) for allocating an entity's expected losses among variable interest holders for purposes of identifying its primary beneficiary. All of the foregoing guidance is critical to a company's adoption of Interpretation 46 as it affects whether an entity is deemed to be a VIE and the way in which it determines if it is the primary beneficiary. However, a substantial portion of that guidance will be issued in the final two weeks of the year and some of it may not be available until early 2004.

Each of the FSPs that have been issued or proposed, or that we expect will be proposed, has had (will have) a significant impact on how companies have applied the guidance in Interpretation 46. The guidance in the ED, if issued as a final Interpretation, will also have a significant impact on how companies have understood and applied Interpretation 46. For example, as discussed further in Appendix B to this letter, we believe the proposed change to paragraph 5 of Interpretation 46 will require companies to consider (or reconsider) the status of entities such as joint ventures that were previously not thought to be VIEs. Many of these ventures contain arrangements that result in a venturer's voting rights not being proportional to their rights to receive the expected residual returns of the entity. Because everything that has been issued and that will be issued was needed to properly implement Interpretation 46, we believe additional time is necessary to allow preparers and auditors to absorb the changes so that Interpretation 46 can be implemented in a way that will lead to high quality results.

We note that many companies have spent a considerable amount of time and money implementing Interpretation 46 as originally issued. Each clarification of Interpretation 46 not only has the potential of increasing the pool of transactions or entities that need to be assessed, but also requiring companies to incur additional costs to reassess entities that were previously considered. By the time the FASB staff issues guidance on how to allocate expected losses to holders of variable interests in 2004, companies will most likely have had to assess and reassess the same entities (for large companies this figure is in the thousands) because of all of the subsequent changes. We do not think it is fair to place such a burden on constituents. We also do not believe it is in anyone's best interest to require adoption of a standard when it is known that additional guidance will be provided shortly afterward that may fundamentally change a company's conclusions as to whether an entity was a VIE and whether it was, or was not, the primary beneficiary. We are concerned about the potential adverse effect on investor confidence in financial reporting if a company determines as of December 31, 2003 that it is not a VIEs primary beneficiary based on what the company understands is an acceptable expected loss allocation model, but then is required to disclose in the first or second quarter of 2004 that it is the primary beneficiary based on the new guidance.
We do not believe that preparers will have sufficient time to absorb all of the changes to Interpretation 46 and reconsider the status of all of the entities with which they are involved because of the expected mid-December release of the final Interpretation is only compounded by the extensive demands going beyond what is normal that will be placed on preparers this year. In addition to accelerated reporting requirements for public companies that will place greater pressure on preparers and auditors, preparers will be struggling to obtain the information necessary to provide the tabular disclosure of contractual purchase obligations required by FR 67, Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations; to provide new pension disclosures pursuant to a standard that will not be finalized until the beginning of December at the earliest; to begin planning to comply with the requirements of Section 404 of the Sarbanes-Oxley Act; and to determine whether Management’s Discussion and Analysis needs to be revised based on new guidance expected to be issued by the SEC.

We also do not believe that the Board will have sufficient time to give proper consideration to the comments it will receive, particularly since it is not scheduled to redeliberate the conclusions in the ED until December 10, 2003 at the earliest (based on the agenda for the December 3, 2003 Board meeting included in Action Alert No. 03-47). Based on this schedule, it seems unlikely to us that a final Interpretation can be ready by mid-December without rushing the process. Because of the many concerns that have been raised over the guidance in Interpretation 46, we believe that the Board should take whatever time is necessary to adequately consider constituent comments, even if it means the objective of a mid-December issuance cannot be achieved.

The above concerns mirror the views expressed by the three Board members that dissented to the ED, with which we strongly agree. We therefore encourage the Board to defer the effective date until it can provide guidance on the fundamental issues still to be addressed. If the scope is not modified as we have suggested above, we believe preparers will need at least six months after the ED and the FSPs referred to above are issued to be able to properly apply the guidance. If, however, the Board elects to narrow the Interpretations’ scope, we believe a deferral of less than six months would be feasible. In either event, we recognize that some companies may be in a position to adopt the guidance earlier than others and believe those who are prepared should be permitted to early-adopt the Interpretation.

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We appreciate your consideration of our comments. Please feel free to contact me at (203) 373-3563 if you have any questions regarding this letter or the issues listed in the attachment.

Sincerely,

Mitch A. Danaher
Chair, Financial Reporting Committee
Institute of Management Accountants
Appendix A
Summary

The addition of trusts and mutual funds organized as trusts to the list of entities exempted from Interpretation 46's scope generally highlights two provisions in the Interpretation that we believe should be reconsidered:

- The manner in which variable interest entities are identified based on the conditions in paragraph 5, and
- The way in which fees paid to a decision maker or manager are included in determining the entity's expected residual returns.

Additionally, we believe the requirement that expected losses and expected residual returns be excluded from determining the entity's expected losses and expected residual returns when the variable interests in specified assets are widely dispersed should be reconsidered, as well.

We do not understand the reason for deleting the phrase "from other parties" in paragraph 5(a) and are concerned that it will open the potential for companies to either consolidate or avoid consolidating an entity under the voting interest model by reducing the amount of equity contributed at inception, causing the entity to meet the condition in paragraph 5(a) as modified.

Although we agree with the principle in the modified paragraph 15 that an enterprise should reconsider whether it is the primary beneficiary of a VIE if the design of the entity is changed, we believe the requirement in modified paragraph 15(b) will significantly increase the cost of complying with the Interpretation and assumes, incorrectly, that enterprises will always have access to information about the primary beneficiary's actions. We believe the focus of this paragraph should be on determining when an enterprise's obligation to absorb expected losses has been increased (other than when that obligation to absorb expected losses increases solely as a result of negative variability in returns that is greater than initial expectations).

We agree with the additional wording included in paragraphs 7 and 15 that a modification of an entity's borrowing arrangements in response to operating losses does not require reconsideration of the entity's status as a VIE or its primary beneficiary. However, the way the modified guidance is explained in paragraph A25 of the basis for conclusions raises concerns that it will only apply in a limited number of fact patterns.

We believe the conclusion in modified paragraph 17 that a de facto principal is the primary beneficiary if the activities of the VIE are not more closely associated with the activities of any other party may result in circumstances where the accounting does not reflect the economic substance of an arrangement.

While we agree with the change to paragraph 21 to require recognition of goodwill by the primary beneficiary, we believe the Board should consider providing guidance on two application issues that may be relevant to VIEs created prior to February 1, 2003:

- How to account for a possible goodwill impairment on initial adoption of Interpretation 46 when one or more of the indicators of impairment in paragraph 28 of FASB Statement No. 142, Goodwill and Other Intangible Assets, arose in a prior annual reporting period, but a
valuation supporting the amount of goodwill was not performed.

- If the VIE meets the definition of a business in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," how the guidance in paragraphs 18 and 28 of Interpretation 46 should be applied since that guidance is not consistent with the guidance in FASB Statement No. 141, Business Combinations.

- Whether the “substantially all of the entity’s activities” condition in modified paragraph 5(ii) should be assessed using qualitative factors, quantitative factors, or a combination of qualitative and quantitative factors.

- Other comments, including the need for:
  - greater clarity in the basis for conclusions,
  - guidance on practice issues in addition to those previously raised with the Board, and
  - codifying the guidance in Interpretation 46, the ED, and the various issued and to-be issued FSPs.
APPENDIX B

Determining Whether an Entity is a VIE

The amendment of paragraph 4 to exclude trusts managed by a bank’s trust department and mutual funds organized as trusts from Interpretation 46’s scope broadly raises two concerns. The first concern relates to the fact that these entities were considered to be VIEs in the first place. Trusts generally have sufficient equity at risk to absorb the expected losses (as the trusts tend to have no borrowings), and the beneficiaries are exposed to expected losses and are entitled to returns generated by the trust. However, as with franchise arrangements, because the decision-making abilities have been delegated or shared with a party that is not a holder of the equity investment at risk, the condition in paragraph 5(b)(1) has been met. Based on the discussion in paragraph C20 of Interpretation 46, we understand that the Board’s intent in creating the conditions in paragraph 5 of Interpretation 46 was to identify situations where the equity was not sufficient to absorb expected losses and, therefore, the holders of the subordinated financial support restricted the holders of the equity interests from exercising control over the entity.

When an entity is entirely or primarily capitalized in the form of equity interests, the fact the equity investors have delegated asset investment decisions to a third party investment manager should not result in a conclusion that the entity is a VIE. Similarly, if the holders of the equity interests have non-shared decision-making authority over the substantive activities of the entity, are exposed to the first risk of loss, and have the right to the residual returns, we do not understand reaching a conclusion that the entity is a VIE based on a calculation that appears to work well only in the simplest circumstances involving either financial assets or a limited number of similar, nonfinancial assets. We believe the Board should reconsider the criteria used in paragraph 5 to identify VIEs. As mentioned previously, one change that would help to reduce the complexity of implementing the Interpretation significantly would be to exclude entities that meet the definition of a business in Issue 98-3 from the scope.

Whether or not the Board reconsiders the criteria in paragraph 5, we believe it is imperative that additional discussion be added to the basis for conclusions to explain why certain entities (such as trusts managed by a bank’s trust department and mutual funds organized as trusts) are not within the scope of the Interpretation. Paragraph A13 of the basis for conclusions explains that the “activities of mutual funds ... and personal trusts ... are by design, customary practice, and law, not for the benefit of the trustee or related parties of the trustee.” We believe that same conclusion could be applied to sponsors of conduits. The fees they receive for the services provided to the conduit (e.g., deciding whether a potential transferor will be allowed to transfer financial assets to a conduit, providing liquidity support, and providing other administrative services) are such a small portion of the benefits retained by transferors through their retained interests that it is difficult to see why one activity (the conduit) is for the benefit of the manager while the other activity (the trust) is not when the economics are so similar. By expanding the discussion in the basis for conclusions to indicate why certain entities are excluded but others with similar economics are not, constituents should have an easier time determining when entities for which the Board has not specifically provided a scope exclusion should be subject to consolidation under Interpretation 46.

Our second concern relates to the fact that, once a trust is identified as a VIE, the trust department or
manager could be identified as its primary beneficiary. We agree with the observation in paragraph A13 of the ED that “the Board did not expect trustees to be deemed to be the primary beneficiaries of those trusts.” However, based on the way that fees paid to a manager are included in determining the entity’s expected residual returns under paragraph (c) of Interpretation 46, once a trust is determined to be a VIE, it is almost inevitable that the manager will be required to consolidate unless a single beneficiary has a majority of the trusts’ expected losses. For example, the variability in returns of a trust that invests in obligations of the US Government is expected to be low. If one party was not obligated to absorb a majority of the negative variability in expected returns, the asset manager would be required to compare its gross expected fee from managing the trust to the positive variability in expected returns to which other variable interest holders are entitled. Because the asset manager is comparing a gross amount (its expected fees) to a net amount (the probability-weighted residual returns in excess of expected returns), it is highly likely that the gross amount will be greater particularly when the return on the assets held by the trust is not volatile. We have never understood why the Board decided to compare apples to oranges in this particular circumstance and the basis for conclusions to Interpretation 46 does not discuss its reasoning. We believe paragraph 8(c) should be modified so that only the expected positive variability in the fee is included in determining the entity’s expected residual returns. If the fee is in fact a variable interest, we see no reason why it should be treated differently than any other variable interest for purposes of determining the entity’s expected residual returns.

Finally, to the extent the variable interests in a trust relate to specified assets, paragraph 12 of Interpretation 46 requires the exclusion of expected losses to be borne and expected returns to be received by the beneficiaries (except when one beneficiary is entitled to more than 50 percent of the trust), compounding the impact of how fees are treated in determining the entity’s expected residual returns. We did not understand the Board’s rationale for excluding the losses to be absorbed by variable interest holders from the determination of the entity’s expected losses when the variable interests related to assets that were not more than one-half of the entity’s assets and the variable interest holder had no other variable interests that related to the overall entity. As explained in paragraph C28, the purpose of the majority requirement was to “not prevent a decision maker with a sufficiently large variable interest in a so-called multi-seller variable interest entity from consolidating that entity because transferors of assets to a variable interest entity retain subordinated residual interests in certain of the transferred assets.” That decision has resulted in parties consolidating multi-seller entities when they have exposure only to catastrophic risk, a result that is not intuitive, and is why concerns about bank trust departments consolidating the trusts they manage was raised as an issue. We believe, rather than providing an exception from the scope of Interpretation 46 for certain trusts, the Board should reconsider its conclusion in paragraph 12. A party should only consolidate an entity if it is exposed to a majority of the entity’s total expected losses. Where those losses are widely dispersed, we believe it is appropriate that no one consolidate the entity. We recognize that this would likely lead to sponsors of conduits not being required to consolidate, but believe that result is appropriate given the economics of those arrangements.

**Modifications of Paragraph 5(a)**

We do not understand the reason for modifying paragraph 5(a) of Interpretation 46 to delete the phrase “from other parties.” Was there a specific abuse the Board was attempting to address through this modification? We believe this modification will identify entities as VIEs even though
the equity investors will absorb all of the expected losses of the entity and are able to control the entity’s activities. Please consider the following example:

Company A and Company B agree to form a joint venture to manufacture a product using technology developed by Company A. Company B provides manufacturing services for third parties. The joint venture will borrow to fund construction of a facility that will be dedicated to the manufacture of the specified product. Because Company A and Company B are financially strong, the lender allows them to not fund their entire proposed capital contribution, but obtains a guarantee obligating the venturers to fund the entity’s operating losses as they occur. Under the terms of the arrangement, if either Company A or Company B violates certain financial ratios, they would be required to fund their entire capital contribution unless waived by the lender.

Based on our understanding of the modification of paragraph 5(a), the joint venture would be deemed to be a VIE because the venturers did not contribute an amount at inception equal to the entity’s expected losses. However, the lender felt sufficiently comfortable with the financial strength of the venturers that it was still willing to lend on the basis of the venturers’ guarantees to fund operating losses. Concluding that the joint venture is a VIE seems counterintuitive if the venturers in fact jointly control the activities of the joint venture and are exposed to the expected losses and entitled to the expected residual returns.

Although we cannot identify an abuse that the modification is attempting to address, we can identify an abuse that will be permitted by the change. That abuse relates to the flexibility a party has in structuring an entity so it either does, or does not, meet the conditions to be a VIE, without changing the substance of the arrangement to any of the parties involved. Please consider the following example:

Company X and Company Y form a joint venture to manufacture and sell a product. Because the product is patent-protected, the joint venture will not have any competition during the term of the patent. Accordingly, the joint venture expects to sell the product at a significant profit over its manufacturing costs. Company X’s analysts are concerned primarily with its gross margin and Company X would like to be able to consolidate the joint venture so it can report a higher gross margin. Company Y is unwilling to give up its joint control over the venture, so Company X proposes that, rather than capitalize the joint venture with equity sufficient to absorb expected losses, the venturers contribute a portion of the investment in the form of subordinated debt. The joint venture’s lender is willing to permit other debt as long as that other debt is subordinate. The joint venture’s profit and loss allocations are modified so that Company X will be allocated $1 more, of both losses and residual returns, than Company Y.

Based on the proposed modification, the joint venture would be deemed to be a VIE and Company X its primary beneficiary because of its obligation to absorb a majority of the ventures expected losses. We do not believe that is a desirable result. We believe subordinated financial support from a party other than the equity investors is substantively different than subordinated financial support provided by the equity investors. When it is exposed to expected losses, it is logical that subordinated financial support provided by a third party will have a higher cost to the equity investors than if they provided their own subordinated financial support. In that circumstance, the
equity investors need to determine if they are better off incurring the greater cost of obtaining
subordinated financial support from third parties or increasing the amount of their own contribution.
Accordingly, we believe the Board should not proceed with this proposed change to paragraph 5(a).

Reconsideration Events

While we agree with the principle of reconsidering both the entity’s status and the identification of
the primary beneficiary when the design of the entity changes, we do not agree that changes in the
ownership interests should cause a reassessment, except for the party that is selling or buying an
interest in the entity. With respect to design changes, presumably all parties involved with an entity
would be aware of significant changes, particularly when those changes increase the risks to which a
party is exposed. Requiring a variable interest holder who is not involved in the transaction that
changes the ownership of the entity to reconsider whether it is the primary beneficiary is extremely
onerous, particularly when the holder’s exposure to losses and right to residual returns has not been
affected by the change in ownership.

We suggest deleting the phrase “or ownership of interests in the entity” from the proposed
modifications of paragraphs 7 and 15. We also suggest deleting the example in proposed paragraph
15(b) and replacing it with one that clarifies that a holder is only required to reassess whether it is
the primary beneficiary if its exposure to loss increases as a result of a transaction among other
parties involved with the entity. We observe that the example in paragraph 15(b) contains two
assumptions, neither of which we believe is completely valid. First, it assumes that all parties
involved with a VIE know who the primary beneficiary is. However, companies are only concerned
with determining whether they are the primary beneficiary, not whether another party might be the
primary beneficiary. Second, it assumes that all parties are entitled to information whenever one
party to the transaction sells an interest. While that may be the case in certain structures, we do not
believe that right to information will exist universally, such as when the primary beneficiary sells its
variable interests in a private placement.

Debt Restructurings and Modifications

As explained in paragraph A25 of the basis for conclusions, the Board does not believe that
restructuring an entity’s debts or other contracts would be a reconsideration event unless the
characteristics of the equity investment at risk or the level of subordinated financial support are
modified. Paragraph A25 indicates that a debt restructuring in which the lender (or, presumably,
another party involved with the entity) creates a new level of subordinated financial support for the
entity results in a reconsideration event. A reconsideration event will also be deemed to have
occurred if the lender is provided with new voting rights as a result of the restructuring. The
discussion in paragraph A25 raises questions about debt restructurings that are a combination of
types as described in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled
Debt Restructurings. For example, if the lender restructures the loan and accepts common stock in
the borrower, would that trigger a reconsideration event? How about warrants to purchase common
stock? We assume the former would, based on the discussion in paragraph A25 that a restructuring
in which the lender acquires new voting rights would be a reconsideration event, but are not sure
about the latter. However, that conclusion conflicts with the discussion in paragraph A25 that, if the
lender only reduces the outstanding principal balance without changing any other terms of the loan,
the lender would merely be acknowledging expected losses of the entity that have already occurred.

If a lender who accepts equity in the borrower is doing so only with respect to the portion of the loan for which it has concluded a loss is probable under FASB Statement No. 5, *Accounting for Contingencies*, that does not seem to us to be a circumstance where the entity’s status or the identification of the primary beneficiary should be reconsidered. We also do not believe the lender has provided additional subordinated financial support to the entity based on its conclusion that the portion of the loan exchanged for an equity interest was uncollectible. To require reconsideration of the entity’s status in that circumstance provides a disincentive to the lender to attempt to recoup its losses (even though accepting the equity interest does not increase its exposure to losses) because if it does accept equity, it may be required to consolidate the entity if it is deemed to be a VIE. That would effectively reverse the Board’s decision in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, to amend Statement 15 to preclude in-substance foreclosure accounting.

We believe a restructuring or modification of an agreement should not result in a reconsideration event unless it is accompanied by a change in the entity’s design. We do not agree that merely accepting an equity interest in, or providing additional funds to, the entity causes the design of the entity to change. In some situations, a lender could receive a sufficient number of shares so that it has significant influence over the entity’s activities. However, if the lender had significant influence over the borrower before the restructuring, we believe the receipt of shares would not be considered a change in the entity’s design and would therefore not cause a reconsideration event. We note that the EITF is currently addressing Issue No. 02-14, “Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means,” which supports our belief that the receipt of an equity investment in the borrower does not necessarily result in a change in the amount of influence the lender has over the borrower’s activities.

We encourage the Board to revisit the proposed addition to paragraphs 7 and 15 to ensure that transactions that do not affect the design of the borrower are not being excluded from that guidance based solely on a change in the form of a lender’s investment.

**De Facto Agency Relationship**

We do not agree with the proposed addition of the parenthetical comments “(or de facto agency)” and “(or de facto principal)” in paragraph 17 of Interpretation 46 because it could result in accounting that does not reflect economic substance. We believe determining whether a party is an agent of another requires those parties to consider all relevant facts and circumstances. We believe the parties to an arrangement involving a “de facto” agent should look to the guidance in EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments,” and EITF Issue No. 99-19, “Reporting Revenue Gross as a Principal versus Net as an Agent,” to determine if a principal-agent relationship exists. If it was the FASB’s intent that a de facto agency relationship establish a non-rebuttable presumption that the de facto agent is in actuality an agent, we do not believe that intent was clear in the way paragraph 16 is explained in the Basis for Conclusions (paragraphs C38 to C41) or in the way paragraph 17 of Interpretation 46 is written. Please consider the following example:
Company A acquires a variable interest in VIE. Company A's variable interest is a significant interest in VIE, but by itself is not sufficient to make Company A VIE's primary beneficiary. Investment Bank, a party unrelated to Company A, provides a significant amount of financial advisory services to Company A (debt and equity placement, acquisition advisory services, etc.) so as to meet the definition of a de facto agent in paragraph 16(d) of Interpretation 46. None of the services provided relate to Company A's decision to acquire an interest in VIE. Merchant Bank, Investment Bank's sister company, also acquires a significant variable interest in VIE.

There are no agreements between Company A, Investment Bank, or Merchant Bank that constrain Merchant Bank's ability to sell, transfer or encumber its variable interest in VIE, and Company A has not provided any guarantees, directly or indirectly, of Merchant Bank's investment in VIE. Merchant Bank has other similar investments in its portfolio and is actively engaged in buying and selling such investments. As such, Merchant Bank is acting as a principal. Merchant Bank's investment in VIE does not cause it to be VIE's primary beneficiary. If Merchant Bank's variable interest were combined with Company A's variable interest in VIE, the holder would be the primary beneficiary (assume that is because the holder would be exposed to a majority of expected losses, although it would be equally valid that they could become the primary beneficiary because they were now entitled to a majority of the expected residual returns). VIE's activities are not more closely associated with either Company A's activities or Merchant Bank's activities.

Given the above facts and the proposed addition of the parenthetical comments to paragraph 17 of Interpretation 46, Company A would have to consolidate VIE because the proposed wording requires one to conclude, in the absence of VIE's activities being more closely associated with one of the other variable interest holders, that Merchant Bank is acting as Company A's agent. Presumably Company A would then deconsolidate if Merchant Bank sold its investment, but would then reconsolidate if Merchant Bank acquired a new interest in VIE, a result that could occur since Merchant Bank is acting as a principal and thus can do what it wishes with its investment. We do not think it is a desirable result to have decisions made by a principal impact the decision to consolidate or deconsolidate. Accordingly, we suggest that the guidance in the aforementioned EITF consensuses be applied in determining if an agency relationship exists.

Further, we believe the principal/agent analysis should be performed before aggregating interests held by a "de facto agent" with interests held by a "de facto principal" to determine whether those interests, if held by a single party, would identify that party as the entity's primary beneficiary. If the relationship among the parties is only analyzed after considering whether the activities of the entity are more closely associated with one of the parties in the related party group, it may not matter that all of the parties in the related group are acting as principals. We do not believe consolidation of a VIE is any more appropriate just because the activities of the entity are more closely associated with a party if that consolidation decision is based on a false characterization of the nature of the relationship between the parties. While we recognize the Board's appropriate concern with transactions where one party is clearly acting as an agent of another to allow that party to avoid consolidation, we believe applying the EITF consensuses will adequately identify those abusive situations.
If the Board decides not to permit an analysis of the conditions in Issue 99-19 and Issue 96-19 in determining which variable interests should be aggregated, we believe it should provide additional guidance on what it meant by the phrase “more closely associated with” in paragraph 17. For example, assume that two computer chip manufacturers establish a joint venture to produce chips. The parties take all of the venture’s production. However, one manufacturer acquires 60 percent of the joint venture’s production, while the other acquires the remainder. Are the operations of the manufacturer that acquires 60 percent of the production more closely associated with the joint venture? If so, why is that the conclusion? How did the Board intend for that provision to be applied? We believe the operations of the manufacturer that acquires 60 percent of the venture’s production would not be more closely associated with the joint venture. For that condition to be met, we believe a higher threshold, similar to the one in proposed paragraph 5(c)(ii), should be used. Expanding the discussion in the basis for conclusions to address this issue would be helpful.

**Goodwill Recognition/Allocation of Purchase Price**

We agree with the Board’s decision to require the recognition of goodwill when the VIE meets the definition of a business in EITF Issue No. 98-3. However, it is not clear from the discussion in paragraph A37 of the basis for conclusions just what types of arrangements were of concern to the Board. As noted previously, there are many opportunities to structure an entity so it is either subject to, or excluded from, the VIE model. If the Board is concerned about abuses in structuring business combinations so that the entity acquired is a VIE, we believe it should also reconsider the proposed modification of paragraph 5(a), which will permit flexibility in designing an entity so it is (or is not, depending on the needs of the parties involved) a VIE, without affecting the economics in any significant way.

While we agree with the Board’s direction on this issue, it raises at least two implementation issues that were avoided under the guidance in Interpretation 46:

- How to account for a possible goodwill impairment on initial adoption of Interpretation 46 when one or more of the indicators of impairment in paragraph 28 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, arose in a prior annual reporting period, but a valuation supporting the amount of goodwill was not performed.
- If the VIE meets the definition of a business in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” how the guidance in paragraphs 18 and 28 of Interpretation 46 should be applied since that guidance is not consistent with the guidance in FASB Statement No. 141, *Business Combinations*.

The first issue is limited to transition for VIEs created before February 1, 2003 where the primary beneficiary became the primary beneficiary in a prior annual reporting period. As provided in paragraph 28 of Interpretation 46, the primary beneficiary should initially measure the assets, liabilities, and noncontrolling interests of the VIE at their carrying amounts. “Carrying amounts” is defined as the fair value of the assets, liabilities, and noncontrolling interests on the date the primary beneficiary first met the conditions to be the primary beneficiary. Please consider the following example:

Company became involved with VIE on January 1, 2001 by acquiring an investment in VIE’s
debt and equity securities. Company became VIEs primary beneficiary on that date. There have been no reconsideration events since January 1, 2001. Company adopts Interpretation 46 on December 31, 2003 and records VIE's assets, liabilities, and noncontrolling interests at their fair values on January 1, 2001, adjusted for subsequent activity that would have been recorded had Company consolidated VIE on January 1, 2001. The amounts recorded include a significant amount of goodwill. In the fourth quarter of 2001, VIE suffered the loss of several of its key personnel. However, all of the key personnel were replaced by the end of the fourth quarter of 2002, and VIE's operations, after having incurred significant losses during 2002, recovered to their prior levels during 2003.

Paragraph 28(d) of Statement 142 identifies a loss of key personnel as a factor that could require the testing of goodwill for impairment. Since Company did not consolidate VIE, it did not have goodwill that is required to be tested for impairment under Statement 142 and therefore did not obtain a valuation supporting the amount of goodwill that will be recorded in consolidation at December 31, 2003. As no indicator of potential impairment exists as of the date Company adopts Interpretation 46, it would presumably not be required to obtain a valuation. We believe the final Interpretation should provide guidance on this issue as it may not be an infrequent occurrence given the state of the economy over the last two years.

The second issue is one that is not limited to transition for pre-existing VIEs. Given the Board's decision to capitalize goodwill when the VIE meets the definition of a business, we are not sure if the guidance in Statement 141 should be applied in determining the amounts at which assets, liabilities, and noncontrolling interests should be recorded. The approach in Statement 141 will not always result in recording the assets acquired and liabilities assumed at their fair values on the acquisition date (see, for example, the guidance on recording inventories, plant and equipment to be sold, and pension and other postemployment or postretirement benefits in paragraph 37 of Statement 141). Paragraph 18 of Interpretation 46 simply requires the primary beneficiary to record the assets, liabilities, and noncontrolling interests at their fair values at the date the enterprise became the primary beneficiary. Paragraph 18 does not indicate that a different method of determining fair value is appropriate when the VIE is a business. However, the guidance in that paragraph was drafted before the Board's decision to capitalize goodwill. We believe that, when the VIE is a business, the guidance in Statement 141 should be applied to determine the amounts at which assets acquired and liabilities assumed are to be recorded.

"Anti-Abuse" Provision (Paragraph 5(c))

We are concerned that the proposed changes to the last sentence in paragraph 5 (new paragraph 5(c)) will significantly increase the number of entities that companies must evaluate under the variable interest entity model. It is common in most joint ventures where the venturers' economic and voting rights are equal for one venturer to receive a fee for a shared service arrangement (for example, providing bookkeeping services to the joint venture), lease payments for providing office space or equipment to the joint venture, or payments for licensing technology to the joint venture. As currently drafted, the condition in paragraph 5(c)(i) would be met since the venturer providing the service or leasing the office space or equipment or licensing technology to the joint venture will have voting rights that are not proportional to its right to receive the entity's residual returns. We do not agree with the requirement to consider all other arrangements that a company has with an entity
for purposes of determining if voting rights are disproportionate to economic rights, except when those arrangements have terms that are off-market. The requirement to consider all other interests in the entity will place a significant amount of pressure on determining whether the activities of the entity are substantially all on behalf of the venturer with the disproportionate voting and economic rights. The parenthetical examples in paragraph 5(c)(ii) will not prove helpful in most situations. For example:

Manufacturer A would like to open a factory in China to produce electronics equipment. As a condition of granting Manufacturer A permission, the government requires Manufacturer A to structure the arrangement as a joint venture with Manufacturer B, a local company that has experience in manufacturing equipment similar to the equipment that Manufacturer A would like to produce. The arrangement will be structured so that each venturer will make the same contribution. That contribution will entitle each venturer to receive 50 percent of the profits and losses of the venture, and will provide them with equal voting rights. In addition, Manufacturer A will receive a fee for licensing its technology to the joint venture. Output from the joint venture will be sold to local resellers.

The arrangement described above will meet the condition in paragraph 5(c)(i) because Manufacturer A is entitled to a residual return that exceeds its 50 percent voting interest in the joint venture. However, it is not clear whether the entity’s activities are substantially all on either party’s behalf. If analyzed from a quantitative perspective, each party receives one-half of the economic benefits from the joint venture and neither acquires the joint venture’s output. Accordingly, neither party would be required to consolidate, based on a quantitative analysis. We are unsure how a qualitative assessment should be made in this circumstance. An argument could be made that the activities of the joint venture are substantially all on behalf of Manufacturer A, Manufacturer B, or the government since each party receives something it would not have received without the joint venture. Manufacturer A gains access to a new market; Manufacturer B gains access to a new customer; and the government may be able to reduce its costs associated with unemployment or underemployment. In a speech at the National Conference on Current SEC Developments in December 2000, a member of the SEC staff identified qualitative factors that the staff believed should be used to identify the sponsor of an SPE. Should those qualitative factors be used to identify whether an entity’s activities are substantially all on behalf of the party with disproportionately few voting rights?

Given our expectation that many more entities will meet the condition in modified paragraph 5(c)(i), we believe the Board should provide further guidance on how it intended the condition in paragraph 5(c)(ii) to be applied.

Other Comments and Questions

While we would prefer the Board revisit the way in which VIEs are identified, we agree with the scope exception provided for trusts managed by bank trust departments and mutual funds organized as trusts. However, the exclusion of mutual funds organized in corporate form from the scope exception raises a question as to whether the Board believes those mutual funds could be VIEs. If it was not the Board’s intent that mutual funds organized in corporate form be treated as VIEs, we would suggest expanding proposed paragraph 4(h) to include those entities to make that intent clear.
We believe the basis for conclusions should be expanded to make clear to readers the Board’s intent in reaching some of its conclusions. For example, paragraphs A15, A16, and A18 indicate that a change was required to make the guidance “more effective.” It would be helpful to explain why the original guidance would not have been effective by use of an example, and to then explain how the modified guidance will change the analysis. We have a similar concern about the discussion in paragraph A20, which indicates that “the determination [of whether an entity has sufficient equity] frequently begins and ends with the quantitative assessment in paragraph 9(c).” The basis for conclusions does not explain why paragraph 5 was modified to de-emphasize the quantitative analysis, nor does it adequately explain how an enterprise should qualitatively determine whether an entity has adequate equity.

Perhaps one reason why the analysis of the sufficiency of equity begins and ends with the quantitative analysis is because the qualitative considerations in paragraphs 9(a) and 9(b) are difficult, if not impossible, to identify. For example, an entity with a significant amount of equity borrows from a bank on terms that are equivalent to what a company with an investment grade credit rating would receive. However, the bank, being cautious, requires the owner of the entity to provide a guarantee of the entity’s borrowings. That guarantee precludes making the qualitative assessment under paragraph 9(a). The company may then determine it is easier to calculate the expected losses than it is to attempt to identify a public company with similar assets, determine if those assets are of similar credit quality, and then determine if the comparable company operates without subordinated financial support. We believe most preparers and auditors have concluded the level of effort required to perform that perhaps inconclusive analysis is likely to exceed the effort needed to calculate the expected losses.

In addition to the matters that have already been brought to the FASB staff’s attention, we believe guidance should be provided on the following topics, as discussed further below:

1. Whether trusts used to issue preferred stock to investors are subject to the guidance in Interpretation 46 and, if so, what factors should be considered in determining the primary beneficiary.
2. What the impact is on the lessor’s accounting for a leveraged lease when the trust that holds the leased asset is a VIE and the lessee is the trust’s primary beneficiary.
3. How a primary beneficiary should account for losses of a VIE that exceed the amount recorded for the noncontrolling interest when the primary beneficiary’s obligation to absorb those losses is limited.
4. Whether the guidance in Interpretation 46 applies when a voting interest entity is placed in bankruptcy by its shareholder or shareholders.
5. What is meant by “long-term return to variable interests” in the modified version of paragraph 8.
6. What guidance not-for-profit entities excluded from the scope of Interpretation 46 should look to in determining whether they should consolidate a VIE.

Issue 1: Although most preparers and auditors agree that the trusts are subject to the guidance in Interpretation 46, there are differing views as to how the analysis should be performed to determine
the primary beneficiary. We believe the appropriate analysis is one that views the equity contributed by the parent at inception (and then loaned back to the parent) as a guarantee by the parent company to the trust for the benefit of the holders of the trust preferred securities. If the guarantee were sufficient to absorb a majority of the expected losses, the parent company would continue to consolidate the trust. However, if that guarantee were not sufficient, the parent would analyze whether it has a majority of the expected residual returns through a call option. This analysis is consistent with the analysis that would be performed in a sale leaseback of equipment involving a trust where the seller lessee provides a guarantee of the residual value of the equipment and holds a fixed price purchase option on the equipment.

Since the two transactions are identical from an economic perspective, we believe the analysis as to who the primary beneficiary is should also be the same. In the trust-preferred arrangement, the parent company receives the proceeds from the trusts' issuance of common and preferred securities in exchange for a note payable held by the trust. By retaining the subordinated equity interest in the trust, the parent company's shareholders in effect provide a guarantee to the extent of the equity interest. In the sale-leaseback arrangement, the seller-lessee receives proceeds on the sale of the equipment; the buyer-lessor owns the equipment, but also has a contingent note receivable from the seller-lessee to the extent the fair value of the equipment declines. Since the seller-lessee would be required to consolidate the trust, we believe the parent should be required to consolidate the issuer of the trust preferred securities as long as the equity interest is sufficient to absorb a majority of the expected losses.

Issue 2: We understand the Board has provided informal guidance on this topic, which appears to be addressing the same issue as the first topic, and we request that the guidance, as well as the basis used to reach the conclusion, be communicated in a more formal manner so that all constituents are aware of the conclusion.

Issue 3: The current consolidation model would clearly require a parent company to continue to recognize losses incurred by its subsidiary. However, differences clearly exist between a parent with a subsidiary that is controlled through voting rights and a parent with a subsidiary that is not controlled through voting rights. In the former, the parent could decide at any time to liquidate the subsidiary and thus discontinue recognizing losses. In the latter, however, the parent often does not have the current ability to liquidate the subsidiary and may not receive that ability in the future (as may be the case if the primary beneficiary consolidates because it has provided a guarantee of substantially all of a VIE's assets; the primary beneficiary would not receive the right to control the VIE if the guarantee is ultimately not needed). We believe a modified consolidation procedure is necessary in circumstances such as this to distinguish between entities consolidated under the voting control model and those consolidated under the VIE model.

Issue 4: Preparers and auditors have differing opinions as to whether Interpretation 46 applies when an entity that was previously subject to consolidation under the voting interest model is placed under bankruptcy protection by its shareholder or shareholders. We believe the Board should provide guidance on whether and, if so, how Interpretation 46 applies. We believe Interpretation 46 does not apply when an entity is in bankruptcy. Paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, as amended, states that "a subsidiary should not be consolidated where control ... does not rest with the majority owners (as, for instance, where the subsidiary is ... in bankruptcy)." Since
ARB 51 no longer applies when an entity is in bankruptcy (because the majority owner no longer has a controlling financial interest), and since Interpretation 46 was issued to provide interpretive guidance on ARB 51's requirement that an investor with a controlling financial interest in an entity consolidate that entity, Interpretation 46 would not apply, either. However, if the Board concludes that Interpretation 46 does apply, we believe it may be necessary for the Board to expand the exception provided in proposed paragraph 4(g) as it may be difficult, if not impossible, for a primary beneficiary to obtain financial information about the entity in bankruptcy that is needed to perform consolidation procedures.

Issue 5. We believe the final Interpretation should explain what is meant by “long-term return to variable interests” in modified paragraph 8. Does it exclude short-term returns or losses that would accrue to holders of commercial paper issued by the entity? Does it mean the short-term volatility in the return on an entity’s assets is not important? We are also unclear as to how the change relates to the discussion in paragraph A19 of the basis for conclusions. If the intent of the modification is to change the focus from “variability in the entity’s net income or loss” and “variability in the fair value of the entity’s assets” to “variability in the entity's cash flows,” we believe the modified paragraph 8 should be rewritten to make that change more explicit. If our understanding of the Board’s intent is correct, then we suggest changing paragraph 8 to state “A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the cash flows to be ultimately distributed to the holders...”

Issue 6: The Board has expanded the scope exception originally given in Interpretation 46 to not-for-profit organizations that followed the consolidation requirements of AICPA SOP 94-3, Reporting of Related Entities by Not-for-Profit Organizations, to all not-for-profit organizations as defined in FASB Statement No. 117, Financial Statements of Not-For-Profit Organizations. While the Board has now been clear in what guidance does not apply to not-for-profit organizations, we believe it should clarify what guidance does apply. The Board included the following observation in paragraph C8 of Interpretation 46:

The Board is aware that some of the requirements in ARB 51 are applied in modified forms to certain not-for-profit organizations and does not intend this Interpretation to cause a change in those practices.

We understand the Board was referring to the fact that many not-for-profit organizations (in particular, the health care organizations that were the subject of FSP FIN 46-1) applied the guidance in the various EITF Issues addressing consolidation of special purpose entities to determine if the not-for-profit organization should consolidate a special-purpose entity (other than not for profit entities) used in transactions, such as leases of medical office buildings, designed to obtain off-balance-sheet treatment. If our understanding is correct, clarifying that point will allow practice to apply the guidance as the Board intended.

Finally, given all of the changes and interpretations affecting Interpretation 46, we believe the Board should issue a codification so that all of the literature covering VIEs is contained in a single place.