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Mr. Lawrence W. Smith
Director of Technical Application and Implementer Financial Accounting Standards Board
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Proposed FSP FIN46(R)-c, Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R)

Dear Mr. Smith:

We appreciate the opportunity to comment on proposed FASB Staff Position FIN46(R)-c, “Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R).” We agree with the proposed FSP that the design of an entity should be the basis for determining the entity’s variability for the purpose of applying Interpretation 46(R). We believe the proposed FSP provides guidance that will help preparers and auditors apply Interpretation 46(R), especially the following provisions:

- the guidance in paragraph 12 that emphasizes the comprehensive scope of the information and analysis required to determine the nature of the risks the entity was designed to create and pass through to its interest holders
- the examples illustrating the application of the proposed approach
- the charts accompanying the examples. Such charts are a useful tool in gaining an understanding of the roles of an entity’s interests and arrangements and illustrating those roles.

Many private companies are currently focusing on how Interpretation 46(R) will affect their year end financial statements. We believe this guidance could be particularly helpful to many of those companies that are analyzing potential variable interest entities for the first time without the benefit of having participated in or having monitored discussions on the evolution of the application of this complex standard. Accordingly, we encourage the Board to expedite finalizing this FSP.

Although we support the proposed approach in principle, we believe that some of the proposed guidance should be clarified and offer the following suggestions that we believe would improve the clarity and usefulness of the guidance in the FSP. Throughout the letter, we have provided drafting suggestions that address issues raised in our comments.

**Fair value versus cash flow**

The Background section (paragraphs 3 through 6) discusses the nature of the current diversity in practice that precipitated the issuance of the proposed FSP. That section briefly
describes the cash flow and the fair value methods of calculating expected variability, and how the calculation method selected has become, in practice, a basis for identifying an entity's variability.

We think that the Background discussion made it difficult for some readers to understand the guidance in paragraph 7 of the proposed FSP. We found that, because of the context provided by the Background section, readers thought that the “the variability to be considered” in paragraph 7 was a reference to cash flow or fair value variability. That perception led to an expectation that the guidance that followed was intended to provide a basis for deciding which of the two risks described in the background section (cash flow or fair value) should be used to determine variability. We think the FSP drafting should be clarified to emphasize that the design of an entity, rather than the selection of a calculation method, determines the variability to be considered in applying Interpretation 46(R).

Accordingly, we recommend eliminating paragraphs 3 (except for the first sentence), 4, 5, and the last sentence of 6 from the FSP. We do not believe that the background discussion is essential to the understanding of the proposed method of identifying an entity's variability. Furthermore, we believe the FSP should not discuss the “fair value” methodology that was developed by a few firms for the purpose of applying Interpretation 46(R) if the method is not fully explained and illustrated in accounting literature available to all of the FASB's constituents.

However, if the Board decides that a discussion of the nature of the existing diversity in practice, including a description of the “fair value” method, is essential to communicate to constituents how this FSP would change practice, we recommend that the discussion
• be presented in a basis section following the FSP guidance on determining variability
• clarify that the cash flow and fair value methods described are two of the ways used in practice to calculate the amount of expected variability and that the selection of a particular method is not the appropriate basis for determining the variability an entity was designed to create and pass through to its interest holders
• clarify the description of the “fair value” method calculation and provide an example to illustrate how it differs from the expected cash flow method that is illustrated in Appendix A of Interpretation 46(R). Both the valuation and the accounting professionals in our firm who read the proposed FSP were confused by the description of the “fair value” method, especially the reference in paragraph 4 to the use of “multiple risk-free interest rates for each time period.”
• emphasize that the selection and application of a methodology to calculate an estimate of the amount of expected variability for a particular entity is a matter of judgment and outside the scope of this FSP.
Paragraph 8
In the first sentence we suggest eliminating the phrases “are part of the assets and operations that” and “are part of the liabilities and equity that.” We think those phrases in that sentence incorrectly link GAAP descriptions with economic roles. For example, a guarantee does not become a liability of or equity in an entity as a result of absorbing losses of the entity.

Paragraph 10
We suggest adding prepayment risk to the list of risks that may be created and passed through to an entity’s interest holders. This is a common and distinct type of interest rate risk that we think can be identified apart from the type of interest rate risk discussed in the examples of the FSP. Prepayment risk can be significant, for example, to the holders of interest-only strips.

We believe that another factor to consider in developing an understanding of an entity’s design is “which parties were involved with the entity’s design or formation.”

Paragraph 11
Paragraph 11 requires consideration of whether an interest transfers substantially all of the entity’s risk or return of certain assets or operations, but does not explain how such an interest might affect the determination of the variability to be considered in the application of Interpretation 46(R). We believe replacing the second sentence in paragraph 11 with the following would help constituents understand the effect such an interest would have on the analysis of an entity’s design:

A total return swap or similar arrangement that transfers substantially all of the risk or return (or both) related to certain assets or operations of an entity is a strong indicator that the entity was designed to create the risk transferred.

Paragraph 13—Subordination
Footnote 7 of the proposed FSP states:

Paragraph B8 of Interpretation 46(R) discusses subordinated interests. Subordination is generally considered substantive if the subordinated interest will absorb expected losses prior to the senior interest. In these instances, the senior interest generally has a higher credit rating and lower interest rate compared to the subordinated interest. The amount of subordinated interest in relation to the overall expected losses and residual returns of the entity will also be a factor in determining whether such subordination is substantive. If the subordinated interest is legal form equity, the determination as to whether the subordination is substantive should be made irrespective as to whether that equity is considered sufficient pursuant to an analysis under paragraphs 5(a) and 9 of the Interpretation.
We suggest that the guidance in footnote 7 be clarified and included in the text of paragraph 13, rather than in a footnote.

Paragraph 13 states that if subordination is substantive, it is a strong indicator that the entity was designed to create the risks absorbed by the subordinated interest. According to the second sentence in footnote 7, subordination would be substantive regardless of the amount of the subordinated interest. However, the fourth sentence in the footnote indicates that the amount of the subordinated interest is part of the definition of "substantive." We believe paragraph 13 and footnote 7 do not clearly address whether a subordinated interest should be considered a strong indicator of the type of variability the entity was designed to create regardless of amount of that interest.

We also noted that the last sentence in footnote 7 of the proposed FSP refers to subordinated interest that is "legal form equity." We think the legal form is not relevant in that context because paragraph 5 of Interpretation 46(R) uses the GAAP, rather than the legal, definition of equity.

Assuming that the proposed guidance was intended to identify a subordinated interest as a strong indicator of the entity’s variability if the amount of that interest is significant, we believe following revision of paragraph 13 would clarify that guidance:

For entities that have issued both senior and subordinated interests, the determination of what variability should be considered should include an analysis of the nature and amount of the subordinated interests. Subordination refers to the role of an interest rather than to its label; that is, a subordinated interest would absorb an entity’s expected losses before a more senior interest would. If the amount of the subordinated interest is significant in relation to the amount of the entity’s total expected losses, then the risk absorbed by that subordinated interest is strongly indicated as variability that is created by the design of the entity. If the subordinated interest is equity-at-risk, as that term is used in paragraph 5 of Interpretation 46(R), the amount of that equity can be significant for the purpose of determining the variability to be considered, even if it is not sufficient under paragraphs 5(a) and 9 of Interpretation 46(R).

We acknowledge that the suggested clarification would not address the circular nature of the guidance on determining the significance of the amount of the subordinated interest. That is, the objective of the FSP guidance is to identify an entity’s variability, but for a subordinated interest to be a strong indicator of variability, the amount of that interest should be compared to the total amount of the entity’s negative variability.
Effective date and transition

According to the proposed FSP, an enterprise would apply the guidance in the final FSP prospectively

- to all entities (including newly created entities) with which the enterprise first becomes involved after the date the final FSP is posted to the FASB website
- to all entities previously analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph of Interpretation 46(R) after the date the final FSP is posted to the FASB website.

We believe that the proposed effective date and transition provisions do not address when and how the guidance in the final FSP should be applied to entities with which the reporting enterprise was involved before the date the FSP is finalized but for which the “analysis” under Interpretation 46(R) has not been completed as of the date the final FSP is posted.

Paragraph 15 of the proposed FSP includes effective date and transition guidance only for entities with which the enterprise is newly involved or for entities that were previously analyzed. The following examples illustrate situations in which a reporting enterprise was previously involved with an entity but the “analysis” under Interpretation 46(R) has not been completed on the date the final FSP is posted:

1. an entity that had not been “analyzed” because of the exception provided by paragraph 4g of Interpretation 46(R)
2. an entity that has not been “evaluated” because of the exception provided by paragraph 4h of Interpretation 46(R)
3. a small public company that first became involved with an entity in 2002 has a reconsideration event pursuant to paragraph 7 of Interpretation 46(R) on the day before the final FSP is posted to the website and the analysis under Interpretation 46(R) is not complete as of the date the final FSP is posted
4. a nonpublic company with a November 30 fiscal year-end has analyzed some, but not all, of the entities created before January 1, 2003. The company was involved with these entities as of December 1, 2005 (the date of the initial application of Interpretation 46(R) to these entities under paragraph 35 of the Interpretation).

We recommend that the Board address how and when the guidance in the final FSP would be applied in the situations described above.

In addition, we recommend that the Board clarify how the previously analyzed transition criterion should be applied. Our first concern with that criterion is that it may not always be clear when the analysis of an entity under Interpretation 46(R) is complete and related decisions final. Although large public companies in the business of creating financial entities may be performing a competent analysis of each arrangement under Interpretation 46(R) before they enter into that arrangement, we believe that many nonpublic and smaller public
companies will not have similar procedures and capabilities. For nonpublic and small public companies, the issuance of interim or annual financial statements may be the best indicator that an analysis under Interpretation 46(R) is complete.

We are also concerned that different interpretations of the previously analyzed transition criterion could lead to inconsistent application of the FSP. For example, one view is that paragraph 15 of the proposed FSP would only grandfather previous decisions made under Interpretation 46(R). (This view would be consistent with the September 7, 2005 Board minutes in which the staff describes the transition as one that would grandfather existing decisions made under Interpretation 46(R)). Under that view, the public company in situation (3) described above would apply this FSP in its analysis of the reconsideration event that occurred the day before the final FSP was posted, but would not be required to revisit its application of the Interpretation to its initial involvement with the entity, to its initial adoption of the Interpretation, or to any earlier reconsideration events. Another view of paragraph 15 of the FSP would be that the public company in situation (3) would not apply this FSP in its analysis of the reconsideration event that occurred the day before the final FSP was posted because the entity had been previously analyzed under Interpretation 46(R) as part of the public company’s initial adoption of the Interpretation.

One way to address our concerns about the ambiguity of the term previously analyzed, would be to eliminate the previously analyzed condition and require the FSP be applied prospectively to the initial involvement with an entity and to reconsideration events under paragraph 7 of Interpretation 46(R) that occur after the date the final FSP is posted to the website. The FSP guidance would also apply to an entity that ceases to qualify for a scope exception in paragraphs 4(g) or 4(h) of the Interpretation after the date the final FSP is posted.

Another approach that would address our concerns would be to adopt effective date and transition provisions for the FSP based on whether the analysis of an entity in accordance with Interpretation 46(R) is reflected in financial statements issued for interim or annual reporting periods ending on or before the date the final FSP is posted. The analysis of an entity in accordance with Interpretation 46(R) refers to the use of the guidance in the Interpretation to determine whether an entity is a variable interest entity and, if it is, whether the reporting enterprise is the primary beneficiary. Under this approach,

- an enterprise would apply the guidance in the FSP prospectively to all entities with which that enterprise first becomes involved after the last interim or annual reporting period ending on or before the date the final FSP is posted to the website
- an enterprise would apply the guidance in the FSP prospectively to all reconsideration events pursuant to paragraph 7 of the Interpretation that occur after the end of the last interim or annual reporting period ending on or before the final FSP is posted
• an enterprise would not be required to apply the guidance in the FSP to any previous
analysis of an entity in accordance with Interpretation 46(R), if, based on that analysis,
that entity is appropriately reflected in the enterprise’s financial statements for the last
interim or annual reporting period ending on or before the date the final FSP is posted
• if the last interim or annual reporting period ending on or before the date the final FSP
is posted does not appropriately reflect the analysis of an entity under Interpretation
46(R) because
  o the entity qualified for a scope exception under paragraphs 4(g) or 4(h) of the
   Interpretation, then the guidance in this FSP would apply to that entity if and
   when it ceases to qualify for the scope exception
  o in accordance with paragraph 35 of the Interpretation, a nonpublic reporting
   enterprise involved with that entity before January 1, 2004, initially applies the
   Interpretation to that entity in a reporting period ending after the final FSP is
   posted, then the guidance in this FSP would apply to the initial adoption of the
   Interpretation.
• early application in financial statements not yet issued and retrospective application
  would be permitted but not required.

Example 1a
We suggest that an explanation such as the following be added at the end of paragraph A4 to
explain why risk (b) in paragraph A3 is not a risk the entity was designed to create:

Because both the entity’s assets and debt bear fixed interest rates, changes in the
market interest rate over the life of the investment will not affect the entity’s ability
to pay the debt investors the full amount of periodic interest to which they are
contractually entitled. Therefore, risk (b) is not a risk the entity was designed to pass
onto its interest holders.

We suggest revising paragraph A4(a) as follows:

This entity was marketed to debt investors as an entity that will be exposed to
changes in the fair value of the investments due to credit risk and the cumulative
change in cash received at the end of the three year life due to the change in the fair
value of the investments over the three year life of the entity....

The suggested revisions would eliminate the reference to changes in fair value as a result of
credit risk. Because credit risk creates both fair value and cash flow risk, the reference to fair
value changes due to credit risk is unnecessary. The reference also appears to anticipate the
selection of the fair value method of calculating variability, without a full discussion or
endorsement of the method. Furthermore, if the entity in this example was not actively
managing and trading the assets, we do not think the entity would be exposed to cumulative changes in fair value. Regardless of how the interest rate fluctuates during the three years, it is only the interest rate on the date the assets are sold that affects the amounts received by the interest holders.

**Example 1b**

We suggest that the reasons that risks (c) and (d) in paragraph A6 are not considered to be risks the entity was designed to create be explained at the end of paragraph A7.

We suggest revising paragraph A7(a) as follows (see discussion of suggested revisions to paragraph A4(a)):

This entity was marketed to debt investors as an entity that will be exposed to changes in the fair value of the investments due to credit risk and the cumulative changes in fair value of a portfolio of intermediate term fixed-rate investments (including floating-rate investments effectively converted to fixed-rate investments by the swap) over the three-year life of the entity due to changes in intermediate term interest rates, with the equity tranche present to absorb the first dollar risk of loss.

**Example 1c**

Paragraph A8 contains the following statement: “At the end of five years, all the investments will be sold...” In this example, we understood that the investments were not sold but *matured.*

We recommend that the reason risk (c) in paragraph A9 is not considered to be a risk the entity was designed to create be explained at the end of paragraph A10.

We suggest that the phrase “changes in the fair value of investments due to” be eliminated before “credit risk” in paragraph A10(a), consistent with the suggested revisions to paragraphs A4(a) and A7(a).

**Example 2**

Paragraph A11 refers to the sale of three-year assets at the end of three years. We think that reference should be changed to “matured.”

We suggest adding the following risk (c) to paragraph A12, “Interest rate risk associated with changes in the fair value of the investment principal payment.” The analysis at the end of paragraph A13 should explain why this is not a risk the entity was designed to create and pass through, as follows:
The effect of changes in the interest rate on the fair value of the investment principal will not affect the entity's ability to pay the debt investors the full amount of debt principal to which they are contractually entitled. Therefore, risk (c) is not a risk the entity was designed to pass onto its interest holders.

In paragraph A13(c), we believe the last line should state, “...assets (fixed-rate) and liabilities (floating-rate).”

**Example 3**

We suggest the analysis at the end of paragraph A17 explain why risk (c) in paragraph A16 is not a risk the entity was designed to create.

**Example 4**

Because the marketing representations seem to be a significant factor in analyzing some of the entities, we think the description of the marketing to the debt investor in paragraph A20(c) could be more realistic. For example, because there are only two parties to the deal and the debt holder is the only one investing capital in the entity, we think it is likely that the debt holder was not just “marketed to” but had some ability to negotiate the terms of its investment.

**Example 5**

We recommend analyzing the lease in terms of the economic effects of the payments made by the lessee, as illustrated in the chart accompanying the example, rather than in terms of GAAP lease accounting, such as “direct financing lease receivable.” For example, analyze the periodic rent payments, the lessee’s commitment, if any, to pay operating and routine maintenance costs (which would absorb variability due to operating risk otherwise borne by debt and equity interests), the residual value guarantee, and the purchase option. We think that this approach would provide for more consistent analysis of leasing arrangements under Interpretation 46(R). This approach could be reflected in the risk factors in paragraph A22 as follows:

- in (b), replace “the direct financing lease receivable” with “rent payments”
- replace (c) with, “Interest rate risk with respect to any payments due under the terms of the lease or guarantees”
- add the following risk as (f), “Operating cost risk.”

We believe revisions such as the following would clarify the analysis in paragraph A23:

- we found the proposed discussion in factor (a) to be very confusing and difficult to follow. We note that the term “static” entity is not defined in Interpretation 46(R) or in this FSP, and we do not support creating new technical jargon for a concept that can be explained without it. We suggest the discussion in (a) be replaced with the following:
“Changes in interest rates that would change the fair value of amounts received under the leasing arrangement, guarantees, or purchase option would have no effect on the entity’s ability to pay the debt investors the full amount of periodic interest and principal to which they are contractually entitled. Therefore, risk (e) in paragraph A22 is not a risk the entity was designed to pass onto its interest holders.”

• replace the existing discussion in (e), which is the overall conclusion rather than a factor itself, with the following new factor: “The terms of the leasing arrangement, which require the lessee to pay directly the property’s utilities, taxes, insurance, and routine maintenance, transfer the property’s operating cost risk to the lessee.” We assumed the lessee is responsible for such costs because factor (b) states that the lessee has assumed essentially all of the obligations of ownership. We suggest the obligation to pay operating costs be added to the fact pattern in paragraph A21 and to the chart accompanying the example.

We suggest that the conclusion following the list of factors in paragraph A23 be revised to better illustrate the application of the guidance in the FSP, as follows:

Considered together, factors (b), (c), (d), and (e [if revised as we suggested]) clearly indicate that the leasing arrangement, including the guarantee and purchase option, effectively transfers all of the risks and rewards of the ownership of the property. As discussed in paragraph 11 [if revised as illustrated in this letter] such an arrangement is a strong indicator that the risks so transferred are the risks the entity was designed to create. Furthermore, the guarantees would absorb first-loss of the property value, thus are subordinate to the debt and equity interest, and such a loss could be significant to the entity. According to paragraph 13, the fact that the guarantees are subordinate interests that would absorb losses that are significant to the lessor entity is an additional indicator that the entity was designed to create the risks absorbed by the guarantees. Therefore, the analysis supports the conclusion that this entity was designed to create and pass along risk (a) in paragraph A22 to the third party guarantor and the lessee (through the residual guarantee and fixed price purchase option); and risk (f [per our suggested revision]) to the lessee. Accordingly, the third party guarantee and leasing arrangement are variable interests in the entity, notwithstanding the marketing material, described in factor (f), which characterized such interests as part of a portfolio of assets providing a fixed rate of return. The entity is also designed to create and pass through risk (b) in paragraph A22 to the debt and equity holders.

Example 6

In paragraph A26(a), (b), and (e), “contact” should be “contract.”
Paragraphs A25 and A27(b) both refer to the "enhanced yield" of the debt investments, but do not provide a reference point. In comparison to what is the yield enhanced?

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We would be pleased to discuss our comments and recommendations with Board members or staff. Please direct your questions or comments to Joseph Graziano at (732) 516-5560 or Ann McIntosh at (612) 677-5257.

Sincerely,

/s/ Grant Thornton LLP