



LETTER OF COMMENT NO. 68

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5166

Dear Sir:

The Financial Reporting Committee ("FRC") of the Institute of Management Accountants ("IMA") is writing to provide its views on the Proposed Statement of Financial Accounting Standards, Amendments to FASB Interpretation No. 46(R) (the "Exposure Draft"). The FRC is the financial reporting technical committee of the IMA. FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

Overall Observations

We have found FIN 46(R), as issued and amended, to be among the most difficult standards in US GAAP to apply. The interpretive challenges are pervasive and include: (1) determining whether an entity is in the scope of FIN 46(R), (2) assessing whether an in-scope entity is a variable interest entity ("VIE"), (3) determining whether the reporting enterprises involvement with the entity is a variable interest, and (4) concluding, based on the results of an analysis of expected returns, whether the reporting enterprise is the primary beneficiary. The Exposure Draft will significantly change the scope of consolidated statements, not just for QSPEs and other SPEs, but also for voting interest entities that incur substantial operating losses, debtors involved in troubled debt restructurings, joint ventures and other entities accounted for under the equity method. We urge the Board to consider whether such a significant change should be implemented unilaterally by the FASB.

While the Exposure Draft does result in certain improvements from the current accounting literature, as discussed further below, our recommendation is that the Board and the IASB jointly develop a converged global standard. The FRC believes that the enhanced disclosures to be promulgated very soon by the Board are responsive to the immediate concerns on lack of transparency regarding securitization and structured finance activities.



Convergence

Since the issuance of the Exposure Draft, the IASB has accelerated its redeliberation of IAS27, Consolidated and Separate Financial Statements, and SIC-12, Consolidation of Special Purpose Entities, and has now prepared a draft discussion document that may be issued in the near future for comment. We believe that the FASB and the IASB should use this as a platform for a converged standard. The principles in the Exposure Draft and the IASB's draft document are broadly similar. However, if the Board continues with a separate project, any differences in the ultimate standards could result in preparers consolidating entities only to deconsolidate an entity a few years later (if they adopt IFRS and the IFRS has a different accounting model) or vice versa.

For example, as we will discuss further below, FIN 46R resulted in certain operating joint ventures (i.e. two entities that collaborate together on an operating initiative) to be consolidated by one of the venture investors (as that investor absorbed the majority of the expected losses). Now the FASB is proposing a very different model for consolidation under FIN 46(R) in which the primary beneficiary is the entity that has the "power to direct". Under this new criterion of "power to direct", these joint venture entities may need to be deconsolidated. To the extent the IASB issues a pronouncement different from that of the FASB, companies may have to consolidate these entities again upon adoption of IFRS. We believe it is not in the best interest of financial reporting for the FASB to keep changing the principles of consolidation every few years. Instability in the principles underlying accounting standards undermines the accounting profession and the confidence the equity markets have in the development of high quality accounting standards. Put simply, it does not make sense to subject constituents to separate FASB and IASB statements within just a few years, when there is an opportunity to issue a convergent standard that will only require adoption once.

Accounting Principle for Consolidation

Currently, ARB 51 and FIN 46(R) contain different accounting models for determining whether an entity must be consolidated. ARB 51 prescribes a control model which is usually demonstrated through a majority voting interest. FIN 46(R) is an economic model that requires consolidation by an enterprise when it absorbs a majority of the expected returns / risks. Under the proposed statement, the accounting model under FIN 46(R) will shift from an economic model to a model that is unclear if it is a control model or an economic model. Specifically, it is unclear how one

should interpret the "power to direct matters that most significantly impact the activities of a variable interest entity" under the proposed statement. Does "power to direct" mean that one party has control or does it mean something less than control? If the FASB believes that "power to direct" will be defined as control of the operations of the business, how is this model different from our current model under ARB 51?

Determining the Primary Beneficiary

The intent of paragraph 5(c) of Interpretation 46(R) is to prevent an enterprise from avoiding consolidation by structuring an entity with nonsubstantive voting rights. Specifically, paragraph 5(c) of Interpretation 46(R) requires that an enterprise consider if its economic interests are disproportionate to its voting interests and if substantially all of the benefit of the entity's activities are for the benefit of the party with the disproportionately few voting rights. If both conditions are met, the entity is considered a VIE. Furthermore, under the current FIN 46(R) model, the entity that absorbs the majority of the expected losses from the VIE would consolidate the VIE. However, under the proposed Exposure Draft, joint venture arrangements for which one party absorbs the majority of the expected losses, will need to be deconsolidated as the entity that absorbs the majority of the expected losses will not necessarily have the "power to direct" (e.g. shared power exists).

One of the many conclusions of FIN 46(R) that was troubling at the time FIN 46(R) was issued was this exact matter. Specifically, companies were troubled with the conclusion that operating entities for which one has the majority of the expected returns but does not have the "power to direct" or control would have to be consolidated. However, we were told that the current accounting pronouncements needed to address an economic model when the majority of the *expected returns were being absorbed by one of the parties*. Now under the Exposure Draft, we are presented with a new set of principles that will require such joint venture entities to be deconsolidated. Companies ended up consolidating entities which will have to be deconsolidated only a few years later. Although the Exposure Draft will result in more securitization entities being consolidated, it will likely have the opposite effect for operating joint ventures. Instability in the principles underlying accounting standards is not helpful to the process.

Continuous Reassessment

We do not agree with the Board's decision to require continuous reassessments to determine whether an entity is a variable interest entity. We would expect that requiring a reporting entity to reassess its involvement with all entities that have a potential to be VIEs (which could number in

the hundreds or thousands) continuously will be extremely onerous and difficult to sustain. Accordingly, we find this requirement not to be operational. In this regard, we prefer FIN 46(R) as issued.

Kick-Out Rights

Currently under the FASB consolidation standards, if limited partners (as a group) have the ability to kick-out the general partner, the general partner would be prohibited from consolidating the entity. However, under the Exposure Draft, it appears that if the limited partners (as a group) have the ability to kick-out the general partner, such rights would not preclude the general partner from consolidating the VIE. In fact the general partner would be required to consolidate the VIE unless one of the limited partners has the sole ability to kick-out the general partner. Under a model based on control or power, it is unclear to us why the general partner would be required to consolidate a VIE for which the group of limited partners has kick-out rights but not consolidate the VIE for which one of the limited partners have kick-out rights.

Troubled Debt Restructuring

Under the Exposure Draft, a troubled debt restructuring could cause an entity to become a VIE. The existing standard explicitly states that a troubled debt restructuring is not an event that requires reconsideration of whether the debtor is a VIE. Depending on the meaning of the term "power", a lender could be required to consolidate a borrower. If the lender is not required to consolidate the debtor, it is quite likely that the lender would have a "significant" variable interest in the borrower/VIE. We are concerned that it will be difficult, if not impossible in some situations, for a lender to meet all of the disclosure requirements under the Exposure Draft for holders of resulting variable interests. In this regard, we prefer FIN 46(R) as issued.

Other comments

We believe that the Board should take the opportunity to incorporate the guidance contained in FSP's FIN 46R-1 through 7 into the final standard.

We believe that additional examples illustrating how "power to direct" should be applied would be helpful.

We look forward to participating in the Board's future deliberations on this topic in any manner



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that would be helpful to a successful resolution of these issues We welcome the opportunity to discuss these views further at your convenience; I can be reached at (513) 983-6666.

Sincerely,

A handwritten signature in black ink, appearing to read "Mick Homan", is written in a cursive style.

Mick Homan
Chair, Financial Reporting Committee
Institute of Management Accountants

