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January 6, 2009

Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

RE: Proposed Accounting Standards Update, "Amendments to Statement 167 for Certain Investment Funds" (File Reference No. 1750-100)

## Dear Technical Director:

We appreciate the opportunity to comment on the proposed Accounting Standards Update, "Amendments to Statement 167 for Certain Investment Funds" (the "proposed ASU" or "the proposal"). We agree with the Board's decision to defer the effective date of Statement 167 for reporting enterprises' interests in certain investment entities and we believe it is important that consistent guidance on principal and agent relationships exist in U.S. and international accounting standards. While we support the issuance and overall objectives of the proposed ASU, we believe the Board should clarify certain aspects of the guidance prior to final issuance. In addition, we have included observations for the Board's consideration regarding how to evaluate whether a service provider or decision maker is a principal or an agent. Our general observations and specific comments on the proposed ASU are set forth below.

### Unlimited Liability of General Partners

The Board should consider the potential impact of the proposed condition in ASC subparagraph 810-10-65-2(aa)(1)(ii) on a general partner's ability to apply the deferral to its interest in investment entities that are limited partnerships. That subparagraph precludes application of the deferral to an entity for which the reporting enterprise has "an obligation to fund losses of the entity that could potentially be significant to the entity." Generally, as a matter of law, the general partner has unlimited liability in a limited partnership structure. Therefore, as written, this condition may effectively preclude asset managers of investment entities that are limited partnerships from applying the deferral if the asset manager is the general partner.

Since we do not believe it is the Board's intention to preclude reporting enterprises that act as the general partner of an investment entity that is a limited partnership from applying the deferral, we believe that alternative language should be included so that

<sup>&</sup>lt;sup>1</sup> FASB Statement No. 167, Amendments to FASB Interpretation 46(R).



reporting enterprises would not consider a general partner's unlimited legal liability when evaluating the proposed condition in ASC subparagraph 810-10-65-2(aa)(1)(ii). We suggest modifying the second sentence of that condition as follows (added text is <u>underlined</u>): "This condition should be evaluated considering any implicit or explicit guarantees provided by the reporting entity and its related parties, if any, <u>but excluding consideration of the general partner's unlimited liability in entities that are limited partnerships.</u>"

If the Board intends that the general partner could meet the proposed deferral condition in ASC subparagraph 810-10-65-2(aa)(1)(ii) only in certain circumstances, such as when the assets of the entity in which the general partner holds an interest comprise predominantly financial assets (e.g., the entity is not a real estate investment partnership that is subject to legal claims, such as slip and fall claims, for which the general partner has unlimited liability), or when the general partner is financially unable to satisfy any significant legal claims that may arise as a result of being the general partner (e.g., if the general partner is an entity that has an insignificant amount of equity at risk), the Board should clarify its intent. In addition, the Board should address whether it would be appropriate to extend the rationale in either case by analogy for purposes other than evaluating whether an entity in which a general partner holds an interest qualifies for the deferral in the proposed ASU.

# Scope

The amendments to ASC paragraph 810-10-65-2 should more clearly identify the population of entities that would qualify for the deferral. The proposed ASU indicates that reporting enterprises with interests in an entity that has all of the attributes specified in paragraph 946-10-15-2(a) through (d) or for which it is industry practice to apply measurement principles for financial reporting that are consistent with those in ASC Topic 946 are eligible for the deferral. ASC Topic 946 states that investment companies within the scope of that guidance are required to report their investment assets at fair value. Although not explicitly stated, we understand that the reference to fair value means changes in fair value would be recognized currently in the statement of operations. However, the proposed ASU does not address that aspect of the measurement principle in ASC Topic 946. We do not believe that the Board intended for reporting enterprises with interests in entities that classify their investment assets as available-for-sale to be eligible to apply the deferral to those entities because they do not account for changes in the fair value of their investment assets currently in the statement of operations. We suggest modifying ASC subparagraph 810-10-65-2(aa)(1)(i)(01) to clarify this matter as follows (added text is underlined): "Has all of the attributes specified in paragraph 946-10-15-

<sup>&</sup>lt;sup>2</sup> ASC Topic 946, Financial Services—Investment Companies.



2(a) through (d) <u>and measures its investment assets in accordance with the measurement principles in Topic 946 (i.e., at fair value with changes in fair value recognized currently in the statement of operations) for financial reporting purposes."</u>

We believe that for an entity that does not have all of the attributes specified in ASC subparagraphs 946-10-15-2(a) through (d) to qualify for the deferral, the entity should either actually apply measurement principles that are consistent with those in ASC Topic 946 for financial reporting purposes based on industry practice under U.S. GAAP, or a determination should be required that the entity would apply those measurement principles for financial reporting purposes based on industry practice if it were applying U.S. GAAP. For example, if an entity applies a comprehensive basis of accounting for financial reporting purposes other than U.S. GAAP, such as International Financial Reporting Standards or a tax- or cash-basis method, a determination should be required that the entity would apply measurement principles consistent with those in ASC Topic 946 for financial reporting purposes based on industry practice if it were applying U.S. GAAP. We suggest modifying ASC subparagraph 810-10-65-2(aa)(1)(i)(02) to address this matter as follows (added text is underlined, deleted text is struck out): "Does not have all of the attributes specified in paragraph 946-10-15-2(a) through (d) but is an entity that applies for which it is industry practice to apply guidance consistent with the measurement principles consistent with those in Topic 946 for financial reporting purposes based on industry practice under U.S. GAAP, or that would apply those measurement principles based on industry practice if it were applying U.S. GAAP."

In addition to the foregoing, the Board should give further consideration to whether mortgage REITs would qualify for the deferral as currently drafted. The proposed changes to ASC paragraph 810-10-65-2 indicate that "[e]xamples of entities that may meet the preceding conditions include a mutual fund, a hedge fund, a mortgage real estate investment fund, a private equity fund, and a venture capital fund." We understand that some mortgage REITs adopted the guidance in ASC Subtopics 946-10, 946-323, and 946-810 before December 15, 2007 and continued to apply that guidance after the issuance of FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1.*Because they have all of the attributes specified in ASC subparagraphs 946-10-15-2(a) through (d) and measure their investment assets at fair value with changes in fair value

<sup>&</sup>lt;sup>3</sup> ASC Subtopic 946-10, Financial Services—Investment Companies – Overall, ASC Subtopic 946-323, Financial Services—Investment Companies – Investments – Equity Method and Joint Ventures, and ASC Subtopic 946-810, Financial Services—Investment Companies – Consolidation (collectively AICPA Statement of Position 07-1, Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies).



recognized currently in the statement of operations, those mortgage REITs would qualify for the deferral if the reporting enterprise does not have an obligation to fund losses that could potentially be significant to the mortgage REIT, and the mortgage REIT is not a securitization entity or asset-backed financing entity (as noted below, it is unclear how this criterion would be met for a mortgage REIT) and was not formerly considered a qualifying special-purpose entity.

However, our research indicates that most mortgage REITs did not adopt the guidance in ASC Subtopics 946-10, 946-323, and 946-810 and most of these entities classify their investment assets as available-for-sale, with changes in fair value recorded in other comprehensive income (OCI), not the statement of operations. In a sample of 24 public mortgage REITs that we selected, 75% (18 of 24) classified their investment assets as available-for-sale and 25% (6 of 24) classified their investment assets as either trading or available-for-sale. In addition, it is not clear why a mortgage REIT would not be considered an asset-backed financing entity. If the Board intends for mortgage REITs to be eligible for the deferral, the Board should consider whether the conditions in ASC subparagraphs 810-10-65-2(aa)(1)(i)(02) and 810-10-65-2(aa)(1)(iii)(02) should be revised or if an explicit scope exception for these entities should be included in the proposed ASU.

#### Disclosure Requirement

The proposal indicates that the amendments would not defer the disclosure requirements in Statement 167 and all entities will be required to provide the disclosures in Statement 167 for all variable interest entities (VIEs) in which they hold a variable interest, including those VIEs that qualify for the deferral. For purposes of these disclosure requirements, it is not clear if the proposed ASU would require a determination of whether an entity is a VIE, and whether the reporting enterprise has a variable interest in that entity, on the basis of the provisions of FIN 46R as amended by Statement 167. We understand that the Board intended for reporting enterprises with interests in entities that qualify for the deferral to be required to determine whether to apply the Statement 167 disclosure provisions based on the application of unamended FIN 46R to those entities. The Board should clarify its intent in the final ASU.

### Proposed Changes to Paragraph B22

At its November 11 meeting, the Board agreed to conform the concept of significance in paragraph B22(c) of FIN 46R to that of paragraph 14A(b) of FIN 46R. (The concept of significance in paragraph B22(c) is a probability-weighted notion whereas significance for purposes of paragraph 14A(b) is evaluated without regard to probability.) We

<sup>&</sup>lt;sup>4</sup> FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (ASC Subtopic 810-10, *Consolidation – Overall*).



understand, based on informal discussions with the FASB staff, that the Board decided after its November 11 meeting not to propose an amendment to conform the concepts of significance at this time in part because of the proximity of the proposed ASU's issuance to the effective date of Statement 167. We support the Board's decision not to propose fundamental changes to paragraph B22 in the proposed ASU. However, as discussed further below, the differences in the significance concepts of paragraph B22 and paragraph 14A(b) may lessen the effectiveness of the revisions that Statement 167 made to the FIN 46R primary beneficiary model should that model remain an integral part of the consolidation guidance developed as part of the Board's joint consolidation project with the IASB.

A service provider or decision maker that obtains its power through a service contract does not apply the primary beneficiary test in paragraph 14A if the service provider's or decision maker's fee is not a variable interest under the provisions of paragraph B22. This minimizes the applicability of the new qualitative primary beneficiary test in paragraph 14A for VIEs with such service providers or decision makers because the significance conditions in paragraph B22 that must be met for their fees not to be variable interests generally will be met when substantially all of the VIEs' expected variability (determined using probability-weighted expected cash flows as discussed in paragraphs 2(b) and 8 of FIN 46R, which were not amended by Statement 167) is absorbed by variable interests held by parties that are not related parties of the decision maker. Thus, paragraph B22 currently results in continued "primacy" of the quantitative-based methods of determining whether a VIE is consolidated in many cases, and may perpetuate the use of arrangements such as expected loss notes that are designed to avoid consolidation. We understand that this is one of the concerns that prompted the Board's decision at its November 11 meeting. We encourage the Board to consider the interaction between the significance concepts used in determining the effect of an enterprise's economic interests on the evaluation of whether the enterprise is the primary beneficiary of a VIE and on whether the enterprise is a principal or an agent in its deliberations with the IASB in the Boards' joint consolidation project.

The Boards may want to consider conforming the significance concepts for the primary beneficiary and principal/agent evaluations with respect to the risk of loss, but not the right to receive benefits for two reasons. First, the terms "expected losses" and "expected residual returns" are terms in FIN 46R that are definitionally tied to expected cash flow calculations performed in accordance with Concepts Statement 7.5 Simply stating that the quantitative approach prescribed in FIN 46R is not required for purposes of determining whether an enterprise has these obligations or rights (as subparagraph 810-10-55-37(c) in

<sup>&</sup>lt;sup>5</sup> Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements.



the proposed ASU would do) does not change that. Second, as defined in FIN 46R, expected losses and expected residual returns do not represent actual losses or actual returns, which is what the significance test used in determining the effect of an enterprise's economic interests on the evaluation of whether the enterprise is the primary beneficiary of a VIE (in paragraph 14A(b) of FIN 46R) refers to.

It also appears that it may not be appropriate to make the significance concepts for the primary beneficiary (paragraph 14A(b)) and principal/agent (paragraph B22) evaluations completely identical. For example, a managing member of an LLC or a general partner of a limited partnership that has a 1% equity interest and currently consolidates the LLC or limited partnership in accordance with the requirements of ASC Subtopic 810-20 because the other members or partners do not have substantive kick-out rights or substantive participating rights should not be able to avoid consolidation by making the LLC or partnership a VIE and concluding that it would not meet the significance criterion in paragraph 14A(b). Even a 1% managing member interest (that does not involve unlimited liability, which gives rise to an obligation to absorb losses that could potentially be significant to the entity) should be deemed to meet the paragraph 14A(b) significance criterion because such an interest has the right to receive benefits that could be significant to the LLC. However, if the significance concepts for the primary beneficiary and principal/agent evaluations were completely identical, application of that same reasoning to other arrangements (e.g., residential mortgage-backed securitization arrangements) would probably mean that a service provider would be deemed to be acting as a principal (i.e., not as a fiduciary) if it held even a very small portion of the residual interests in an entity (e.g., 1%). This would make it very unlikely that most service providers would qualify as fiduciaries if they have non-fee variable interests (which include residual interests in many cases). That outcome would appear to be inconsistent with the financial reporting needs of some financial statement users, particularly investors in investment managers. Accordingly, the Boards may want to consider retaining different significance concepts for economic benefits received by an enterprise for purposes of the primary beneficiary and principal/agent evaluations.

In addition to the foregoing, the Boards may wish to consider increasing the threshold used to establish that an enterprise is a principal rather than an agent of an entity solely due to fees received by the enterprise from the entity from more than insignificant to a majority of the entity's total anticipated economic performance and variability in anticipated economic performance. A majority threshold may be a more appropriate test for evaluating whether the enterprise is a principal or an agent when the fees are

<sup>&</sup>lt;sup>6</sup> ASC Subtopic 810-20, *Consolidation – Control of Partnerships and Similar Entities* (previously EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights").



compensation for the services provided, commensurate with the level of effort required to provide those services, and the service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

These changes to paragraph B22 likely would address the primary concerns expressed by the Board's constituents related to the evaluation of investment management arrangements and performance fees and would make the standard more operational by reducing opportunities for accounting arbitrage based on different concepts of significance within the standard. Finally, we encourage the Boards to reconsider, in their joint consolidation project, the Statement 167 conclusions about the impact of kick-out rights and participating rights on the evaluation of whether an enterprise has power or is acting as a principal or an agent.

## Clarification of Employee Benefit Plans

We agree with the Board's proposed change to include language clarifying that related-party arrangements should be considered for all of the conditions in paragraph B22. However, it would be helpful for the Board to address in the proposed ASU whether employee benefit plans should be considered related parties for purposes of applying paragraph B22(c). Proposed ASU paragraph 810-10-55-37A indicates that for purposes of evaluating paragraph B22, a related party "[e]xcludes an employee of the decision maker or service provider, except if the employee is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic." We do not believe that employee benefit plans subject to the provisions of ASC Subtopics 715-30 and 715-60, or ASC Topics 712, 960, and 962 should be considered related parties for purposes of evaluating paragraph B22(c) unless the employee benefit plan is used in an effort to circumvent the provisions of FIN 46R. We suggest that the Board clarify this point in the proposed ASU.

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<sup>7</sup> ASC Subtopic 715-30, Compensation—Retirement Benefits – Defined Benefit Plans—Pension (previously FASB Statement No. 87, Employers' Accounting for Pensions), ASC Subtopic 715-60, Compensation—Retirement Benefits – Defined Benefit Plans—Other Postretirement (previously FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions), ASC Topic 712, Compensation—Nonretirement Postemployment Benefits (previously FASB Statement No. 112, Employers' Accounting for Postretirement Benefits) or ASC Topics 960, Plan Accounting—Defined Benefit Pension Plans, and 962, Plan Accounting—Defined Contribution Pension Plans, (AICPA Audit and Accounting Guide, Audits of Employee Benefit Plans).



We would be happy to further discuss these issues at the request of the Board or the staff. If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419 or Kimber Bascom at (212) 909-5564.

Sincerely,

