



October 10, 2003

Mr. Lawrence Smith  
Director of Technical Application and Implementation Activities – FSP  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

RE: Comments on Proposed FASB Staff Position FIN 46-d, *Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, Consolidation of Variable Interest Entities.*

Dear Mr. Smith:

Wachovia Corporation is pleased to comment on the Proposed FASB Staff Position FIN 46-d, *Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, Consolidation of Variable Interest Entities* (the Proposed FSP).

While we support the Staff's efforts to provide clarifications, additional guidance and further examples on the application of FIN 46, we do not believe that the guidance in the Proposed FSP fully addresses the issues that are causing the confusion in the marketplace. In addition, we believe the Proposed FSP introduces concepts that are not supported by the provisions of FIN 46 and that will have a widespread impact, if the provisions of the Proposed FSP are not clarified or considered in the context of actual transactions.

The Proposed FSP places greater emphasis on decision makers in the determination of the primary beneficiary of a VIE. We do not understand the conceptual support for the emphasis placed on decision makers by the Proposed FSP and by FIN 46 itself. We understand that the Board's intent behind FIN 46 was a risk-based analysis of consolidation, with the risk from exposure to expected loss, as noted in the Proposed FSP, being a greater indicator of control, even if it is significantly less than the benefit from residual returns. We believe the Staff may be forcing the calculation of expected losses to address certain structures that the Board and Staff consider problematic under the consolidation model, regardless of the fact that the structures do economically disperse the risk of loss or place the risk of loss squarely on a single party.

### *Expected Loss Calculation*

From the time FIN 46 was issued, all constituents, including preparers and auditors of financial statements, have taken the view that the fees paid to decision makers and guarantors (paragraph 8 fees) impact only the calculation of expected residual returns. In fact, certain accounting firms have publicly stated this view. The Proposed FSP is the first guidance from the FASB to suggest that paragraph 8 fees have an impact on the calculation of expected losses. This guidance raises the following issues, which we believe need to be addressed by the Staff and the Board prior to issuing any final FSP and which should be considered in the context of whether the model in FIN 46 can be consistently applied.

- The Proposed FSP's guidance is inconsistent with FIN 46 itself, which states in paragraph 8 that the expected loss calculation is based on net income or loss of the entity and the changes in the fair value of the entity's assets, if those changes are not included in net income or loss.
- Given the inconsistency with FIN 46 and the significant impact of this guidance on the calculation of expected losses, we believe the guidance in the Proposed FSP represents an amendment of FIN 46. Providing this significant change to FIN 46 in a Staff Position has not subjected it to the public deliberations of the Board, does not provide constituents with a basis for understanding the Staff's views, and does not provide constituents the ability to fully analyze and appropriately comment on the provisions. Further, FSP FIN 46-5, which was finalized on July 24, 2003, and addressed a similar issue (namely, guarantor fees), did not provide any of the guidance that the Proposed FSP does.
- The guidance in the Proposed FSP implies that the net income or loss of an entity is to be analyzed for the expected loss calculation before consideration of paragraph 8 fees. Paragraph 8 of FIN 46 clearly states that net income or loss of the entity is the amount to be used.
- The guidance calls for adding back paragraph 8 fees, which represent a distribution to a variable interest holder. We do not understand why paragraph 8 fees are identified as the only distribution to variable interest holders to be added back in the calculation of expected losses.
- By including a variable paragraph 8 fee in the expected loss analysis, the Staff has introduced the concept of opportunity cost as an indicator of a variable interest. Decision-making does not give an enterprise an investment in a VIE; thus, negative variances in fees do not represent losses on investments, just a lower level of income received. This represents an opportunity loss, not an economic loss to the decision maker. We do not understand the Staff's views on this and believe that clarification is needed on what results in a variable interest.

The introduction of opportunity cost as part of the expected losses of a structure for certain decision-maker fees raises the question of whether opportunity cost should be viewed as expected losses for any residual interest held by any party to a VIE. For example, consider a subordinated debt holder who has an interest that allows it to

participate in excess cash flows, if any. This participation embodies opportunity cost, which arguably all parties considering the application of FIN 46 to such an instrument would have considered only part of the expected residual returns of the VIE. We believe that a consistent application of opportunity cost is warranted. However, we do not believe that opportunity cost should be considered part of expected losses. Requiring this calculation would introduce even more subjectivity into the model and potentially lead to conclusions that grossly misrepresent the economics of a VIE.

#### *Expected Residual Return Calculation*

In addition to the new approach noted above, the guidance and example in the Proposed FSP appear to lead to a double counting of paragraph 8 fees in the calculation of expected residual returns. The calculations of expected cash flows in Tables 1 and 2 of the Proposed FSP determine variability based on the net cash flows before the paragraph 8 fees. The amount is then increased by the fair value of the fees in the calculation of the decision maker's share of the entity's expected residual returns in Table 7. This fair value amount is determined in Table 4 based on the variability of the fees in each estimated cash flow analysis. Thus, the variability of the fees is included in the expected loss calculation twice.

#### *Fixed Fees*

The Proposed FSP states that a paragraph 8 fee which is a fixed amount is a variable interest "because it will receive a portion of the expected residual returns of the entity, if they occur." We do not understand how this is consistent with guidance in FIN 46 regarding fixed and unconditional obligations. Paragraph B8 of Appendix B notes that such an obligation is not a variable interest because "it is not variable." We believe the Staff should address this inconsistency.

In addition, we are concerned that there may not be a consistent view of what a fixed fee is. Specifically, is a fee that is a fixed percentage of an amount that varies (for example, a fixed percentage of the fair value of total assets) a fixed fee in the Staff's view?

#### *Confusion Between Use of Net Income and Cash Flows*

The Proposed FSP only further confuses the application of FIN 46's calculation of variability. There is significant confusion caused by the guidance in paragraphs 2 and 8 and Appendix A of FIN 46. As noted earlier, paragraph 8 clearly calls for use of net income or loss, along with the changes in fair value of assets. Appendix A, however, is a cash flow analysis based on Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. Neither of these are consistent with the definition of a variable interest in paragraph 2(c) of FIN 46, which states that a variable interest is an interest whose value changes with changes in an VIE's "net asset value." We encourage the Staff to work with the Board to provide a clear understanding of the analysis to use in determining the expected variability of an entity and, additionally, to what interests that variability should be allocated.

Additionally, the example used in the Proposed FSP continues use of a situation that is too simplified to apply in actual transactions. The example determines paragraph 8 fees based on the variances in cash flows; however, most of the structures we see have paragraph 8 fees that do not

October 10, 2003  
Mr. Lawrence Smith  
Page 4

vary based on cash flows, but on other factors such as total assets, debt, net income, etc. These different structures lead to a complicated process of trying to determine variability from different sources (changing asset balances and changing cash flows) and trying to apply them equally across a structure. Finally, the example itself is not realistic as none of the estimated cash flow scenarios result in the instrument returning its par value (the highest level of estimated cash flows on \$1 million investment is only \$900,000). We encourage the Staff to provide additional examples that reflect realistic transactions widely seen in the marketplace.

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We would be pleased to address any questions you may have regarding the comments in this letter or to discuss our position in more detail at your convenience. I can be reached at 704-383-6101 or by email at [david.julian@wachovia.com](mailto:david.julian@wachovia.com).

Sincerely,

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Corporate Controller