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

Re: File Reference No. 1200-001

We are pleased to respond to the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* (the ED).

Although we support the FASB's objective of improving accounting standards for transfers of financial assets, we do not support the issuance of the ED in its current form because it:

- does not resolve the fundamental issue behind the FASB's decision to add a project on qualifying special purpose entities (QSPEs) to its agenda, which is whether a QSPE that holds long-term receivables but issues short-term beneficial interests should be constrained in its ability to issue new beneficial interests to repay holders of existing beneficial interests that are maturing,
- imposes a risks-and-rewards framework on transfers of financial assets involving QSPEs that is inconsistent with the control-based principle behind FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,
- effectively amends paragraph 9b of Statement 140 for two-step transfers to preclude a transferor from recognizing a transfer of financial assets as a sale if it retains a subordinated interest in the transferred assets, unless the transfer ultimately is to a QSPE, and
- will require calendar year companies with transactions that are in their revolving period or that transferred financial assets to QSPEs that refinance beneficial interests by issuing new beneficial interests to either restructure those arrangements in order to retain off-balance-sheet treatment or find new financing sources that will comply with the new QSPE rules, all during a period when they will already be stretched thin preparing year-end financial statements and, for public companies, attempting to comply with the requirements imposed by the Sarbanes-Oxley Act.

We are concerned that the FASB was more focused in this project on limiting the circumstances in which an entity would qualify as a QSPE and thus be excluded from the scope of FASB

Interpretation No. 46, *Consolidation of Variable Interest Entities*, than with providing limits on a QSPE's discretion to determine the terms of reissued beneficial interests. The result is a mixed model for accounting for transfers of financial assets under which transferors will not only be concerned with legal control over the transferred financial assets (the existing framework in Statement 140), but also effective control (the risks-and-rewards model of Interpretation 46).

During the deliberations on Interpretation 46, a number of Board members expressed concern that a transferor of financial assets could receive off-balance-sheet treatment by using a QSPE, even though it retained a majority of the expected losses from the transferred assets. We understand the concern, but believe the FASB is attempting to address issues with the control-based model in Statement 140 by requiring consolidation when the transferor is exposed to the risks and rewards of the transferred assets. We would prefer to see the Board reconsider whether the control-based model in Statement 140 is the most appropriate model to determine when sale treatment is appropriate, rather than create new rules designed to reduce the number of QSPEs (and thereby attempt to increase the number of entities subject to consolidation under Interpretation 46's risks-and-rewards model).

Finally, we believe the ED reflects a rules-based approach to standard setting that is inconsistent with the FASB's goal of applying a principles-based approach to standard setting. A number of the proposed modifications to paragraph 35 are "bright-line" rules, such as limits on the extent to which a party can provide support to a QSPE, or prohibiting certain types of assets that a QSPE may hold. We believe the FASB should clearly state the principle and provide implementation guidance to enable practitioners to apply the principle in as consistent a manner as possible.

The remainder of this letter expands on the topics listed above.

<u>Reissuance of beneficial interests</u>

We understood that the primary reason for adding a project on QSPEs to the FASB's agenda was the EITF's inability to reach a consensus on Issue No. 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140." The EITF discussed to what extent a QSPE is permitted to determine the terms of the beneficial interests issued after its inception, both before and after the transferor derecognizes the financial assets represented by the beneficial interests. The EITF also discussed whether the ability to determine the terms of the beneficial interests to be issued subsequent to the initial issuance was consistent with the requirement in Statement 140 that a QSPE's activities be "significantly limited" and "entirely specified," as discussed in paragraph 35(b).

Instead of addressing what was intended in Statement 140 by the phrases "significantly limited" and "entirely specified" and possibly placing some limits on the discretion of parties involved with a QSPE to determine the terms of reissued beneficial interests (or prohibiting the use of short-term beneficial interests to finance the acquisition of long-term financial assets), the ED creates new rules that do not clarify the application of paragraph 35(b). Further, we do not believe that the proposed changes to paragraph 35 will result either in a significant increase in the number of transactions that become subject to the consolidation guidance in Interpretation 46 or resolve the original issue over the amount of discretion involved in determining the terms of new beneficial interests to refinance interests that are maturing. Because the proposed changes create new bright lines, we believe transferors will be able to restructure transactions (at some expense) to meet the new "speed limits." While we acknowledge that establishing limits over the terms of reissued beneficial interests may also have involved setting bright lines, we believe that approach would at least have been consistent with the framework in paragraph 35(b) as it would have provided guidance interpreting the meaning of that paragraph.

If the Board decides to proceed with issuing a final statement based on what is included in the ED, the Basis for Conclusions should discuss the rationale behind the decision not to address the concern raised over the reissuance of beneficial interests. However, our preference is that the approach taken in the ED be reconsidered.

<u>Risks-and-rewards framework</u>

As noted earlier, the FASB elected in Statement 140 to take a control-based approach to determine when sale treatment was appropriate for transfers of financial assets. In so doing, the Board expressly rejected an approach that would have required transactions to be treated as financings if the transferor retained substantially all of the risks and rewards of the transferred assets, stating, in part:

> ... That [risks and rewards] approach could have resulted in an entity's continuing to recognize assets even though it had surrendered control over the assets to a successor entity. The approach in [IASC Exposure Draft] E40 was similar to that taken in Technical Bulletin 85-2. The Board concluded that the approaches proposed in E40 and provided in Technical Bulletin 85-2 were unsatisfactory because the result does not faithfully represent the effects of the transfer of assets and because of the potential for inconsistencies. (Paragraph 133)

The Board adopted a risks-and-rewards approach in Interpretation 46 to determine when a primary beneficiary had "effective control" and should consolidate a variable interest entity (VIE). However, it also retained the control-based model in Statement 140 to determine when to account for a transfer of financial assets as a sale. These conflicting models result in a transferor's accounting differing based on whether it transfers financial assets with recourse to a non-VIE (transferor able to recognize a sale while retaining the risks and rewards of the transferred financial assets), a VIE (transferor able to recognize a sale but is required to consolidate the VIE), or a QSPE (transferor able to recognize a sale while retaining the risks and rewards of the transferred assets). We are not convinced that accounting for the same transaction differently based solely on the identity of the transferee is a sound accounting model.

Paragraph 35 of Statement 140 specifies a number of conditions that must be met for an entity to be deemed to be a QSPE. None of the existing conditions in paragraph 35 limits the extent to which the transferor can be exposed to the risks and rewards of the financial assets held by the

QSPE. Rather, those conditions focus on the separateness of the QSPE from the transferor and limit the nature of the assets the QSPE can hold, consistent with the Board's intent that a QSPE be "limited to passively holding financial assets on behalf of BIHs [beneficial interest holders] in those assets" (paragraph 179 of Statement 140). The ED changes the focus of paragraph 35 and creates a mixed model for accounting for transfers of financial assets, partly based on control and partly based on risks-and-rewards. Further, the model as to when risks-and-rewards should be considered in a particular transaction depends on the form of certain arrangements with the QSPE.

Under the ED, an entity could not qualify as a QSPE:

- if the *transferor* agreed to transfer assets to satisfy defaulted receivables. However, if a *third party guarantor* agreed to transfer assets to satisfy those defaulted receivables, QSPE status would not be affected. The QSPE is in the same economic position in both circumstances; the only change is the identity of the party exposed to the risks-and-rewards.
- if the transferor agreed to transfer assets to satisfy defaulted receivables, as noted above. However, if the transferor retained a subordinated interest in the transferred receivables, QSPE status would not be affected, even though the transferor would not receive some or all of the expected cash flows on the subordinated interest if the obligors default on the underlying receivables.
- if it enters into an interest rate swap with the transferor to hedge the interest rate risk of financing fixed rate assets with floating rate beneficial interests (or vice versa), even if the timing of the principal cash flows from the assets are expected to be sufficient to repay maturing beneficial interests. However, it could enter into an interest rate swap with a third party and not affect its QSPE status.

We do not understand why, in the above examples, the identity of the party with the risks and rewards of the QSPE's assets affects the entity's qualifying status, nor do we understand why the form of a transferor's continuing involvement through the recourse provisions affects the entity's qualifying status. Further, with respect to the example in the third bullet, we do not understand why the FASB is choosing now to preclude transferor's from entering into interest rate swaps with a QSPE when those arrangements have been common since the issuance of Statement 125.

We do not believe the determination as to what assets may be held by a QSPE should be based on whether the transferor (or an agent of the transferor) is exposed to the risks and rewards of the transferred assets. Although the ED equates retention of risks and rewards with "effective control" over the transferred assets, as noted above, the Board rejected that argument when it adopted the financial components model, with its focus on legal control, in Statement 125. The transferor's retention of risks and rewards of the transferred assets, including risks and rewards arising indirectly from the QSPE's ability to reissue beneficial interests, does not give the transferor legal control over the financial assets. Accordingly, we encourage the Board to reconsider its approach in the ED to ensure the model for determining when an entity is a QSPE is consistent with Statement 140's control-based model (although, as stated earlier, we would actually prefer the Board reconsider the current model for accounting for transfers of financial assets).

Amendment of paragraph 9(b)

The ED amends paragraph 83 of Statement 140 to require the use of a QSPE as the second step in a "two-step" transfer if the transaction involves the issuance of beneficial interests in the financial assets transferred. The Board's rationale, as explained in paragraph A15 of the ED, was to preclude the transferor (or its affiliates or agents) from providing liquidity commitments, financial guarantees, or similar arrangements when the "ultimate transferees" receive beneficial interests in the transferred financial assets. If the entity used in the second step is not a QSPE, the ED indicates that the "pledge or exchange" condition in paragraph 9(b) would not be met. We are not sure how the Board came to that conclusion. We believe the Basis for Conclusions should explain the rationale used by the Board to come to that conclusion, including whether the Board sought advice in making the proposed change from attorneys with experience in transfers of financial assets.

Paragraph 9(b) requires one of two conditions to be met for sale treatment to be appropriate. If the transferee is a QSPE, the beneficial interest holders must have the ability to pledge or exchange the interests they hold; if it is not a QSPE, the transferee (the legal entity) must be able to pledge or exchange the transferred assets. In the latter instance, the focus is on the entity's ability to pledge or exchange its assets, not the ability of the "ultimate transferees" (the holders of beneficial interests) to pledge or exchange the transferee's assets. As such, we believe the ED's focus on the "ultimate transferee" is inconsistent with the guidance in paragraph 9(b) and the response to Question 22 of the FASB Staff Implementation Guide, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

By focusing on the "ultimate transferee's" ability to pledge or exchange the transferred assets and requiring the entity used in the second step of a two-step transaction to be a QSPE, we believe the FASB has effectively modified paragraph 9(b) to eliminate sale treatment for two-step transfers to an entity that is not a QSPE, even though that entity has the ability to pledge its assets to third parties other than the original holders of beneficial interests. That ability to pledge assets to parties other than the original beneficial interest holders satisfies the guidance in paragraph 9(b). However, by amending paragraph 83 to preclude the transferor from accounting for the transfer as a sale if the entity in the second step is not a QSPE, the entity's ability to pledge assets to parties other than the original beneficial interest holders appears to no longer be relevant to determining if the transferor has surrendered control over the transferred assets.

If the Board did not mean to amend paragraph 9(b), then we believe the proposed amendment of paragraph 83 should be deleted. If the Board meant to amend paragraph 9(b), it should clarify that and should change the words "Each transferee ... has the right to pledge or exchange ..." at the beginning of paragraph 9(b) to indicate "The holders of beneficial interests issued by a transferee that is neither a voting interest entity nor a QSPE ... have the right to pledge or exchange ..." when the transferor retains an undivided interest in the transferred assets. With the amendment of paragraph 83, the condition in paragraph 9(b) apparently could not be met for transfers to variable interest entities where the transferor retains a subordinated interest, even if the transferor would not have been required to consolidate the variable interest entity based on the guidance in paragraph 13 of Interpretation 46 and the variable interest entity had the unconstrained right to pledge the transferred assets. We do not understand why this amendment was necessary and request that the Basis for Conclusions discuss the rationale for the change.

Transition

We understand the FASB expects to issue a final standard in the fourth quarter of 2003. Given the transition provisions in the ED, calendar year public companies would be required to apply the guidance in the standard at a time most will be focused on preparing financial statements and meeting their Sarbanes-Oxley obligations. While that transition may not be problematic for companies with transactions that involve neither revolving period transfers nor QSPEs that issue new beneficial interests to repay maturing beneficial interests, it will be practically impossible for companies with those types of transactions to restructure their arrangements in a way that will preserve sale and nonconsolidation treatment and meet the deadline imposed by the ED.

Since the transition provisions may require a transferor to consolidate an existing QSPE based on the guidance in Interpretation 46, we believe a transition period for entities created prior to the issuance of the final standard, similar to that provided in Interpretation 46, would only be fair given the significant change in the Statement 140 model imposed by the ED. We believe public companies should not be required to apply the provisions in the final standard to existing QSPEs until the beginning of the third quarter of 2004 as that would provide them with an opportunity to restructure those transactions if they so desire.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to Joe Graziano at (732) 516-5560, or Jeff Ellis at (312) 602-8991.

Very truly yours,

Grant Thornton LLP