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18 November 2008

Mr. Robert Herz  
Chair, Financial Accounting Standards Board  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06865-5116

**File Reference No.:1620-100**

**Re: Proposed FASB Statement, *Amendment to FASB Interpretation No. 46 (R)***

Dear Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the Exposure Draft (ED), *Amendments to FASB Interpretation No. 46 (R)*.

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

### **Executive Summary of Main Positions**

*General Comment:* **Accounting standards that permit companies to structure financial arrangements to avoid recognition or disclosure of material risk exposures need to be eliminated.** We strongly believe that financial reporting standards setters and regulators (of the banking system and the SEC) should no longer permit off-balance sheet assets, liabilities, and activities. The only way any entity can engage in or invest in off-balance sheet assets, liabilities, and activities is by using the credit, liquidity, and other financial resources provided by investors or creditors in the entity. Therefore, investors must be informed of how their investment is being used.

*International Convergence:* We agree that any changes to FIN 46 (R) should be ultimately aligned with current efforts of the International Accounting Standards Board (IASB) to amend international accounting consolidations, however, we nonetheless strongly urge the Board to reject pleas to shelve the ED until a converged standard is developed.

*Qualitative and Quantitative Analysis:* We agree that an entity with a variable interest in a variable interest entity (VIE) should qualitatively assess whether it has a controlling financial interest and, if it does, it should be considered the primary beneficiary (PB). This reduces complexity and is consistent with a principles-based approach to standards setting. The current set of examples presumes that a qualitative assessment will generally provide an unequivocal answer. We are not convinced that this will be the case and, therefore, suggest that the implementation guidance in Appendix A be expanded to provide examples of quantitative analysis in the event a qualitative assessment produces an ambivalent result.

It is our view that the use of a **derivative** (by any entity presented in a consolidated set of financial statements, including the agents thereof) transferring any risk or return (or both) from the VIE (e.g., total return swaps, credit default swaps referenced to assets or liabilities of the VIE) to the transferor must overcome the rebuttable presumption that there is continuing involvement and that the transferor is the PB.

With respect to situations in which an entity determines that power is shared among multiple parties, we believe that the party with a majority of the risks and rewards shall be deemed the PB. Moreover, if there appears to be a pro-rata sharing of the power and the risks and rewards, there shall be a rebuttable presumption that the transferor or party arranging the VIE is the PB unless it affirms it has no willingness or intention to provide support to the VIE. The sponsor or entity organizing the VIE should also disclose alternatives it has to share power, risks, and benefits currently housed in that class of VIEs as well as consequences if it can no longer do so. The determination of which entity is the PB should be centred on the total economic relationship with the VIE, not simply contractual provisions.

*Kick-out Rights:* We agree with the Board's view that substantive kick-out rights should be excluded from the qualitative assessment of control unless they are held by a single party. While kick-out provisions may provide structuring opportunities to achieve a conclusion that no single party has the power to direct activities, we feel the Board should conclude in favor of a principles-based approach.



### Continuation of Executive Summary of Main Positions

*Reconsideration Events:* We agree that FIN 46 (R) should be amended to require entities to consider whether there are any changes in facts or circumstances that would affect its status as a VIE or as a PB. This assessment should be an on-going assessment to more faithfully represent the true nature of the relationship between a VIE and the PB.

*Disclosures:* In our comment letter regarding FSP No. 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities* we stressed that recent market events signal the importance of full disclosure of an entity's obligations, none more important than disclosure of off-balance sheet obligations. Enhancements to the disclosures would enable investors to identify risks not previously known or understood.

*Effective Date:* We agree that the effective date should be as of the beginning of a reporting entity's first fiscal year that begins after November 15, 2009. This effective date will expedite the delivery of critical information needed by investors to fully assess the risks and rewards associated with these entities.

### General Comments

Events of the past several years have clearly exposed why off-balance sheet accounting for the risks and return consequences of certain assets, liabilities, and activities and their effects on the global capital markets is of extreme importance to investors, regulators, and the global economy. As we have stated numerous times, investors require clear and complete information about a company's contingencies, commitments and risk exposures in order to make reasoned and informed investment decisions. **Accounting standards that permit companies to structure financial arrangements to avoid recognition or disclosure of material risk exposures need to be eliminated.** We strongly believe that financial reporting standards setters and regulators (of the banking system and the SEC) should no longer permit off-balance sheet assets, liabilities, and activities. The only way any entity can engage in or invest in off-balance sheet assets, liabilities, and activities is by using the credit, liquidity, and other financial resources provided by investors or creditors in the entity. Therefore, investors must be informed of how their investment is being used.

Additionally, it should be noted that the Financial Stability Forum in its report on enhancing market and institutional resilience pointed clearly to the need for improvements in the accounting and disclosure standards for off-balance sheet vehicles. As noted in the report<sup>3</sup>:

*"The build-up and subsequent revelation of significant off-balance sheet exposures has highlighted the need for clarity about the treatment of off-balance sheet entities and about the risks they pose to financial institutions. The use of off-*

<sup>3</sup> Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 7, April 2008



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*balance sheet entities created a belief that risk did not lie with arrangers and led market participants to underestimate firms' risk exposures. Risk exposures and potential losses associated with off-balance sheet entities should be clearly presented in financial disclosures, and the accounting standards affecting these entities should be enhanced and their international convergence accelerated based on the lessons learned."*

We generally agree that the proposed amendments to FIN 46 (R) will improve the financial reporting by entities involved with variable interest entities and will provide more relevant and reliable information to users of financial statements.

### **Specific Comments**

#### International Convergence

We believe that any changes to FIN 46 (R) should be ultimately aligned with current efforts of the IASB and we strongly urge the Board to reject pleas from some who recommend that the ED to be shelved until such time that a converged standard is developed. While the ultimate goal is for both bodies to develop standards to provide timely transparent information about variable interest entities, it should be noted that the timeline for the IASB project is different. The FASB project is on a more expeditious timeline, which is in the best interests of investors. The FASB has expended considerable time and resources to develop a new standard and it is quite evident that immediate improvements are vital to supply investors and the capital markets with information about these significant exposures. Some have urged that until such time that a converged standard is developed, that expanded disclosure requirements be adopted. Our position has always been that disclosure is not a substitute for recognition and measurement, and recognition and measurement do not eliminate the need for disclosure. Accounts reported on the face of the financial statements are most critical and relevant to investors. The accounts represent the starting point to financial analysis, which must be complemented by high quality note disclosures.

#### Qualitative and Quantitative Analysis

We agree that an entity with a variable interest in a VIE should qualitatively assess whether it has a controlling financial interest and is therefore the primary beneficiary (PB). This reduces complexity and is consistent with a principles-based approach. We also agree with the Board's decision not to apply a more rules-based approach to determine a PB by intentionally not listing specific qualitative criteria for consideration. Doing so would negate judgments needed and could lead to a "check-the-box" mentality resulting in transactions structured solely to gain a preferred accounting treatment. We understand that the analysis may be applied inconsistently in certain situations, however, we believe, as the Board does, that if (a) the information used in the assessment is complete and accurate, and (b) the analyses of the pertinent factors and characteristics of both the variable interests and the variable interest entity are performed using sound judgement, the risk of inconsistency should be mitigated to an acceptable level. Disclosure of the pertinent factors underlying a reporting entity's conclusions would enhance a user's understanding of the consolidation policy. We note that the Board is concerned with the inconsistent and disparate results of quantitative assessments. However, we see no difference

between the inconsistency in quantitative and qualitative assessments. We believe that the type of activities conducted through a VIE and the structures used to enable these activities must necessarily involve quantitative assessments of risk-return tradeoffs. The current set of examples presumes that a qualitative assessment will generally provide an unequivocal answer. We are not convinced that this will be the case and, therefore, suggest that the implementation guidance in Appendix A be expanded to provide examples of quantitative analysis in the event a qualitative assessment produces an ambivalent result. For example, we are aware of situations wherein a sponsor creates a structure in which it could sell excess loss participations to avoid PB status while retaining all or substantially all of the economic risks and rewards of the VIE. We believe that in a case such as this, the quantitative analysis will provide further evidence of the true PB.

Furthermore, as noted in the ED, derivative instruments, including but not limited to total return swaps, credit default swaps, and similar arrangements, can be used to transfer the risk or return (or both) without actually transferring the assets. These cases should be evaluated carefully to determine if the arrangement effectively transfers significant risks to the counterparty, since the counterparty is likely to be the PB. It is our view that the use of a derivative transferring any risk or return (or both) from the VIE to the sponsor must overcome a rebuttable presumption that it has retained sufficient economic risks and/or benefits of the VIE, and, therefore, should be considered the PB.

With respect to situations in which an entity determines that power is shared among multiple parties, we believe that the party with a majority of the risks and rewards shall be deemed the PB. Moreover, if there appears to be a pro-rata sharing of the power and the risks and rewards, there shall be a rebuttable presumption that the transferor<sup>4</sup> is the PB unless it affirms it has no willingness or intention to provide support to the VIE. The determination of which entity is the PB should be centred on the total economic relationship with the VIE, not simply contractual provisions. Furthermore, consideration should be given to whether there exists an implicit financial responsibility for an enterprise to fund an entity's losses to protect its reputation.

We agree that a quantitative analysis should be used only when an entity cannot determine whether it meets the qualitative criteria. Those entities that default to a quantitative analysis should be required to fully disclose why they could not qualitatively determine the PB.

#### Application of Kick-out Rights

We agree with the Board's view that substantive kick-out rights should be excluded from the qualitative assessment of control unless they are held by a single party. While kick-out provisions may provide structuring opportunities to achieve a conclusion that no single party has the power to direct the activities, we feel that the Board should conclude in favour of a principles-based approach.

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<sup>4</sup> Note that the term "transferor" used in the context of shared power, could include a party who arranged the entity, or sponsor or administrators who have significant operational roles in the entity.



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We also emphasize that even in situations where kick-out rights are held unilaterally, the holder is not necessarily deemed to have control if the exercise of such rights would create an economic disadvantage. In accordance with the ED, substantive kick-out rights must have both of the following characteristics:

- a) the decision maker can be removed by the vote of a simple majority, and
- b) the parties holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights.

Barriers include financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive for removal. This underscores the need for careful scrutiny of the underlying kick-out rights provisions.

#### Reconsideration Events

We agree that FIN 46 (R) should be amended to require entities to consider whether there are any changes in facts or circumstances that would affect its status as a VIE or as a PB. This should be an on-going assessment of the entity's status as a variable interest entity and as a PB in order to capture in a timely manner all significant changes. As noted by the Board, under current guidance an entity identified as a PB at inception may remain as such throughout the life of the entity, even when it no longer has a majority of exposure to the VIE's estimated losses or rights to receive the entity's residual returns. It is our belief that this is not a faithful representation of the true facts. Continuous reconsideration is a more transparent means of identifying which entity possesses the risks and rewards.

#### Disclosures

In our comment letter regarding FSP No. 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities* we stressed that recent market events signal the importance of full disclosure of an entity's obligations, none more important than disclosure of off-balance sheet obligations. Enhancements to the disclosure will enable investors to identify risks not previously known or understood. We support the enhanced disclosure and further emphasize that the proposed disclosures should be presented in a manner that strengthens the clarity and understandability of the transactions. To that end, we suggest that the ED consider showing example disclosures linking the requirements with the expected outcome, namely-enhanced qualitative and quantitative information. In this regard, we found that many of the disclosures found in the report of the Senior Supervisors Group, "Leading Practice Disclosures for Selected Exposures," (April 2008) are useful for investors in assessing the nature, purpose, size, activities and risks.

The level of disclosure proposed by the ED may appear excessive, and will certainly draw cries of information overload as well as adverse cost-benefit arguments. However, structured financings and arrangements are themselves highly complex, and robust disclosure is essential to understanding the nature of the transactions and the associated risks because of the general lack





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of transparency in the disclosures existing today. Preparers may object to providing the expanded disclosure, but given the actual losses incurred from off-balance sheet transactions to date and the potential for more, we feel that the added transparency is essential to fully understanding the economic effects and risk exposure. Additionally, preparers of financial statements argue frequently that additional disclosures cannot be assimilated or are not used. We believe that more accurate and useful information does not result in overload. Moreover, key attributes of any disclosures should be parsimony and transparency. Entities with sound risk management and financial reporting practices should have much of the required information readily available as a part of their routine risk assessment for these investments. Not regularly analyzing risks could prove more costly in the long run as unforeseen developments adversely affect the financial fundamentals for these investments. We refer the Board to our comment letter dated October 20, 2008 addressing the FSP mentioned above for more information regarding enhanced disclosures.

#### Effective Date

We agree that the effective date should be as of the beginning of a reporting entity's first fiscal year that begins after November 15, 2009. The Board has rightly concluded that this date is appropriate given the current economic environment and the urgent need to improve transparency related to certain entities that are off-balance sheet. Specifically we agree with the Board's reasons as follows:

- There is an urgent need to improve transparency related to many variable interest entities that are not recognized in an entity's financial statements.
- There is significant diversity in practice in the application of key provisions of Interpretation 46 (R) and the financial results of that application.
- There are user concerns about the insufficiency of information provided by enterprises relating to their involvement in variable interest entities, as well as the extent and timeliness of information provided through disclosures.

#### **Closing Remarks**

In closing we would like to thank the Board for the opportunity to comment on the Exposure Draft and reiterate that we are generally supportive of the direction being taken in the amendments to FIN 46 (R). We once again urge the Board to expeditiously issue an improved standard so that these significant off-balance sheet transactions are finally made more transparent to investors and other users of financial statements.



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If you, other Board members or your staff have questions or seek further elaboration of our views, please contact either Matthew Waldron, CPA, by phone at +1.434-951-5321, or by e-mail at [matthew.waldron@cfainstitute.org](mailto:matthew.waldron@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

Kurt N. Schacht, CFA  
Managing Director

*/s/ Gerald I. White*

Gerald I. White, CFA  
Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council