

Private Company Financial Reporting Committee

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JUDITH H. O'DELL
Chair

October 30, 2008

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: FASB Exposure Draft, Proposed Statement of Financial Accounting Standards - Amendments to FASB Interpretation No. 46(R), (“Exposure Draft”)

Dear Mr. Herz:

In previous letters, dated May 23, 2008 and July 18, 2008, the Private Company Financial Reporting Committee (“PCFRC”) brought to the attention of the FASB concerns and issues private company financial reporting constituents have with FASB Interpretation No. 46 (R), *Consolidation of Variable Interest Entities*, (“FIN 46R”). In addition, the PCFRC made a recommendation related to FIN 46R and asked the FASB to include in the Exposure Draft questions focused on private company reporting. The PCFRC appreciates FASB’s inclusion of question number seven in the Exposure Draft, which addresses exceptions for private companies. Below, the PCFRC provides some key points about the application of FIN 46R in the private company sector and makes an additional recommendation related to FIN 46R. The PCFRC also provides answers to the questions posed by the FASB in the Exposure Draft.

Key Points and Additional Recommendation on FIN 46R and the Exposure Draft

The PCFRC reiterates the following key points about the application of FIN 46R in the private company sector.

- Lenders have expressed that the consolidation of entities required by FIN 46R can mask the assets that serve as collateral for debt. This problem

often occurs in common scenarios in which private companies encounter FIN 46R: 1) Consolidating related-party leasing companies, where a single member LLC owns both the lessor and the lessee reporting operating company; and 2) The consolidation of non-homogeneous variable interest entities (“VIE”). Consequently, these private company financial reporting users often request alternative financial statements and information that does not consolidate such entities.

- Inconsistent interpretation and implementation of FIN 46R is common among private companies, causing diversity in practice. The subjectivity of certain requirements of the existing FIN 46R and the complexity of the Interpretation may be driving its inconsistent interpretation and implementation in the private company arena. As such, the PCFRC appreciates the FASB reconsidering the requirements of FIN 46R in the Exposure Draft.
- Driven by certain user needs, as described above, and by the complexity and cost of complying with FIN 46R, GAAP-exception reports have significantly increased due to noncompliance with the Interpretation. Ideally, the use of GAAP exceptions should be kept at a minimum. The increasing frequency of GAAP exceptions, attributable to FIN 46R, diminishes the value and meaningfulness of GAAP compliance.

Recommendation – Provide a scope exemption to FIN 46R for private company related party leasing companies who account for the related party leases under paragraph 29 of FASB Statement No. 13, *Accounting for Leases* (“FASB 13”)

In light of the above points, the PCFRC’s ongoing work in considering financial statement user needs and the costs and benefits related to FIN 46R, and recent input from key PCFRC Resource Group members, the PCFRC recommends that a private company that meets the definition of related parties in paragraph 16 of FIN 46R and is engaged in a leasing transaction that otherwise would be accounted for in accordance with FASB 13 should not be subject to FIN 46R but should instead follow the guidance in FASB 13, paragraph 29, with respect to accounting for leases with related parties. The PCFRC believes that FASB Statement No. 13 would be the more appropriate standard to apply in these situations. The completion of the FASB’s convergence project on lease accounting will eventually provide the accounting for these transactions.

The current disclosure requirements in FASB Statement No. 57, *Related Party Transactions*, No. 5, *Accounting for Contingencies*, FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, provide financial

statement users with enough information to evaluate the reporting entity and its activities with these kinds of entities in the private sector.

Providing this scope exemption for these private companies will greatly alleviate the issues stated above, including reducing the inconsistent interpretation and implementation of FIN 46R, and reducing GAAP exceptions related to FIN 46R.

Alternative View: Two members of the PCFRC expressed concern about structuring in the application of FASB 13, paragraph 29, and desire the scope exemption to specifically require lease capitalization and transferring of substantially all variability with the lease. A FASB 13 note may not fully express the total liabilities due on the leased property/equipment. This has the potential of masking off-balance sheet debt. If, in the interim period preceding the completion of the FASB's convergence project on lease accounting, the FASB shares those concerns about structuring in the application of FASB 13, paragraph 29, the FASB could craft the scope exemption to only permit the scope exemption if the lease was treated as a capital lease that transfers substantially all variability to the operating company/primary beneficiary from the leasing company.

Additional examples and guidance pertaining to private companies

The PCFRC believes additional examples and guidance are needed in the Exposure Draft to address common situations in the private company sector. Currently, the Exposure Draft examples do not pertain to the most common private company situations. The PCFRC has included some examples in an appendix to this letter, which are common situations faced by smaller private companies. If the FASB were to explain how FIN 46R applies in those examples and include them in the Exposure Draft, private company constituents would benefit. Moreover, consistency in the application of FIN 46R may be increased and GAAP exceptions may be reduced in the private company sphere if examples relevant to smaller private companies are included in the Exposure Draft.

Specific Responses to Questions Asked in the Exposure Draft

Q1. Will the proposed Statement meet the project's objectives to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements?

PCFRC Response to Question 1:

The PCFRC believes that the Exposure Draft's proposed qualitative approach to determining if an enterprise's variable interests give it a controlling financial interest is an improvement. In addition, the proposal to require ongoing

assessments to determine whether an entity is a VIE and whether an enterprise is the primary beneficiary of a VIE is an improvement as well. This ongoing assessment will help in the determination of when an enterprise can deconsolidate an entity that no longer meets the definition of a VIE.

As stated at the beginning of this letter, private company constituents have overall concerns and issues with FIN 46R. Lenders find that the consolidation of entities required by FIN 46R can mask the assets that serve as collateral for their debt and as such consolidated financial statements fail to provide useful and relevant information for credit decisions. Sureties do not share that point of view and find that consolidated statements are useful and relevant for their purposes.

Based on feedback the PCFRC received from certain constituents of the investment management industry, FIN 46R may have an unintended negative impact on the financial statements of sponsors of certain investment partnerships. The PCFRC did not have time to research this issue further and has suggested to those individuals that they express their concerns directly to the FASB.

Q2. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits to users of financial statements?

PCFRC Response to Question 2:

As stated in our July 18, 2008 letter to the FASB, FIN 46R compliance costs are burdensome for private company financial statement preparers and practitioners. Moreover, the benefits related to the expenditure of these costs are questionable. Significant compliance costs are often attributable to identifying variable interests (especially implicit variable interests), assessing and quantifying those variable interests, the complexity related to understanding the Interpretation, performing the consolidation work, and additional audit, review, and compilation fees. Further, users of private company financial statements have indicated that Statements such as FIN 46R have contributed to delays in the issuance of financial reports without corresponding benefit to the users. Users have indicated that these delays cause declining relevance in the usefulness of the financial statements.

The proposed qualitative approach in the Exposure Draft may reduce compliance costs, provided that examples and guidance specific to common situations encountered in the private company sector are included in the Exposure Draft.

Q3 The Board decided to adopt a more principles-based approach to determine the primary beneficiary of a variable interest entity. Do you believe the principles

in paragraphs 14–14B of Interpretation 46(R), as amended by this proposed Statement, are sufficiently clear and operational?

PCFRC Response to Question 3

The principles in paragraphs 14-14B appear to be sufficiently clear and operational. However, the implementation guidance and examples in the Exposure Draft do not address common private company situations. The PCFRC is ready to work with the FASB on the development of additional examples relevant to the private company sector.

Q4. The Board concluded that it would be helpful to provide examples of the application of the principles in this proposed Statement. Do you believe that the examples in Appendix A clearly indicate how the principles in paragraphs 14–14B of Interpretation 46(R), as amended by this proposed Statement, would be applied? If not, please articulate what additional information or guidance is necessary, considering the basis for the Board’s conclusions.

PCFRC Response to Question 4:

The PCFRC believes that additional examples and guidance pertaining to the common situations found in the private company sector would be helpful. An appendix to this letter contains common situations encountered by smaller private companies. If the FASB could develop those examples, explain how FIN 46R applies in those situations and include them in the Exposure Draft, private company constituents would benefit. Moreover, consistency in the application of FIN 46R may be increased and GAAP exceptions may be reduced in the private company sphere if examples relevant to private companies are included in the Exposure Draft. The PCFRC offers its help to the FASB staff in further developing examples for the Exposure Draft.

Q5. This proposed Statement retains the quantitative analysis for situations in which an enterprise cannot determine whether it is the primary beneficiary through the qualitative analysis in paragraph 14A of Interpretation 46(R), as amended by this proposed Statement. In Appendix A, each example either identifies a primary beneficiary or concludes that no primary beneficiary exists through a qualitative analysis. The Board may consider removing the quantitative analysis for determining whether an enterprise is the primary beneficiary of a variable interest entity. Do you believe that the quantitative analysis is necessary based on the proposed amended guidance for determining the primary beneficiary? Do you believe that the quantitative analysis would be performed in many situations? Why or why not?

PCFRC Response to Question 5:

The PCFRC believes that the determination of the primary beneficiary will almost always be resolved through the qualitative analysis in the private company sector. In those rare cases in which it is not, the quantitative analysis should be retained to resolve the determination.

Q6. For the reasons stated in paragraphs B6–B15 of this proposed Statement, the Board decided to require ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity. Do you agree with the Board's decision to require ongoing assessments? If not, please provide reasons (conceptual or otherwise) as to why you disagree with these requirements considering all of the proposed amendments in this proposed Statement.

PCFRC Response to Question 6:

The PCFRC agrees with the FASB's decision to require ongoing assessments to determine whether an entity is a VIE and whether an enterprise is the primary beneficiary of a VIE. The status of VIEs can change quickly in the private company world. The Exposure Draft appears to indicate that if a VIE no longer requires consolidation, it simply would not be consolidated in the current reporting period. If this is the case, the PCFRC believes that it needs to be more clearly stated. If this is not the case, the PCFRC suggests that further clarification and guidance is needed on the topic of deconsolidation.

Q7. Do you believe that any exceptions to this proposed Statement should be made for private or not-for-profit entities? If so, please articulate the conceptual basis and reasons for the exceptions.

PCFRC Response to Question 7:

The PCFRC appreciates the FASB including this question in the Exposure Draft.

As stated at the beginning of this letter, the PCFRC recommends that a private company that meets the definition of related parties in paragraph 16 of FIN 46R and is engaged in a leasing transaction that otherwise would be accounted for in accordance with FASB 13 should not be subject to FIN 46R but should instead follow the guidance in FASB 13, paragraph 29, with respect to accounting for leases with related parties. The PCFRC believes that FASB Statement No. 13 would be the more appropriate standard to apply in these situations. The completion of the FASB's convergence project on lease accounting will eventually provide the accounting for these transactions. The disclosure

requirements in FASB Statement No. 57, *Related Party Transactions*, No. 5, *Accounting for Contingencies*, FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, provide financial statement users with sufficient information to evaluate the reporting entity and its activities with these kinds of entities in the private sector.

Many private company financial statement users, particularly lenders, make credit decisions based on a separate analysis of the financial capacity of the primary operating entity, as well as each legal entity that comprises the borrowing group. Therefore, these users often request the separate financial statements of each component. Sureties agree but also require the consolidated set of financial statements.

The PCFRC asks that the FASB include in the Basis for Conclusions of the Exposure Draft a discussion of the FASB's consideration of private company concerns and issues and the conclusions reached regarding those matters.

Alternative View: Two members of the PCFRC expressed concern about structuring in the application of FASB 13, paragraph 29 and desire the scope exemption to specifically require lease capitalization and transferring of substantially all variability with the lease. A FASB 13 note may not fully express the total liabilities due on the leased property/equipment. This has the potential of masking off-balance sheet debt. If, in the interim period preceding the completion of the FASB's convergence project on lease accounting, the FASB shares those concerns about structuring in the application of FASB 13, paragraph 29, the FASB could craft the scope exemption to only permit the scope exemption if the lease was treated as a capital lease that transfers substantially all variability to the operating company/primary beneficiary from the leasing company.

Q8. Financial statement users indicated that the information disclosed in accordance with Interpretation 46(R) about an enterprise's involvement or involvements with variable interest entities and the associated risks are often insufficient and untimely. Do you believe the disclosure requirements in this proposed Statement address those concerns?

PCFRC Response to Question 8:

The disclosure requirements in the proposed Exposure Draft appear to be burdensome for private companies. The breadth of the disclosures could cause delays in the issuance of private company financial statements. In the private company sector, most financial statement users are concerned with the identification and evaluation of VIEs on a stand-alone basis. In addition, most

smaller private companies may only have one or two VIEs. Due to the short comment period of the Exposure Draft, the PCFRC did not have sufficient time to obtain detailed feedback from private company financial reporting users on the specific disclosure requirements proposed in the Exposure Draft. The PCFRC will provide the FASB with information about the disclosure requirements as such information is received by the PCFRC and evaluated.

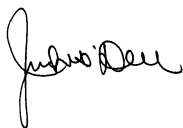
Q9. Should the elements of a consolidated variable interest entity be required or permitted to be classified separately from other elements in an enterprise's financial statements?

PCFRC Response to Question 9:

The PCFRC believes that the elements of a consolidated variable interest entity should be permitted to be classified separately from other elements in an enterprise's financial statements. Such a presentation would be beneficial to many users of private company financial statements, who make lending and other decisions on an entity-by-entity basis.

The PCFRC appreciates the FASB's consideration of these comments and recommendations on the Exposure Draft and the application of FIN 46R in the private company sector. Please feel free to contact me if you have any questions or comments. In light of the short comment period of the Exposure Draft, the PCFRC may bring additional issues to the FASB's attention as the project progresses.

Sincerely,



Judith H. O'Dell
Chair
Private Company Financial Reporting Committee

Typical Private Company Arrangements

A. Joe is the sole shareholder of ABC manufacturing company. The company grows out of its existing plant. Joe forms Joe LLC which buys land and a building. He contributes enough cash to fund a 20% downpayment and obtains a mortgage for the remaining 80% of the purchase price. Joe LLC leases the land and building to ABC manufacturing company for a fair market rent. The rent is sufficient to make mortgage payments.

B. Same as above except Joe does not form an LLC. He buys the property as an individual.

C. Same as A above. The manufacturing company is very successful. Joe personally buys a ranch in Colorado. Joe puts 20% down and obtains a mortgage for the balance of the purchase. To obtain a more favorable interest rate, ABC Manufacturing Company is also a guarantor on the mortgage. The ranch operates at a slight loss each year

D. Joe and his son Bob are each 50% shareholders of XYZ Construction Company. Joe is the 100% member of Joe's Heavy Equipment Company LLC. The LLC owns bulldozers and other heavy construction equipment. The LLC leases these machines to XYZ Construction Company on a daily or as needed basis. The rental fees are at a fair market price. The LLC is capitalized with 40% equity and 60% equipment loans. The rental income is sufficient to pay the loans and maintain the equipment. The LLC occasionally rents the equipment to other contractors.