Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

COMMENT

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In our view, the proposed capital standards do not appear to fully reflect the 2009 GAAP modifications and are inconsistent with the objectives of the present Risk-Based Capital Guidelines by not acknowledging the provisions of FAS 167 which provide for the separate classification of those consolidated assets and liabilities that do not increase risks to the consolidating banking institution. The full provisions of FAS 167 should be explicitly acknowledged and applied to the determination of capital ratios.

The importance of a risk-based approach to capital requirements has been most recently emphasized by the Department of the Treasury in its enunciation of "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" (September 3, 2009) particularly Core Principle #4: "Risk-based capital requirements should be a function of the relative risk of a banking firm's exposures, and risk-based capital ratios should better reflect a banking firm's current financial condition" emphasizing that "...it is crucial that relative risk weight be appropriately calibrated" (p.5). In the proposed standards the banking agencies state the belief "...that the broader accounting consolidation requirements implemented by the 2009 GAAP modifications will result in a regulatory capital treatment that more appropriately reflects the risks to which banking organizations are exposed" (p.13) and further state that "...the capital treatment of many exposures that would be consolidated under the new accounting standards aligns with risk-based capital principles and results in more appropriate risk-based capital charges" (p.14). Consistent with these statements, the banking agencies have requested specific

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comment with regard to the nature of the risks posed by the putatively consolidated entities in Questions 2 and 6, among others.

Notwithstanding the agencies' intent to align the new accounting standards with risk-based capital principles, the proposed standards omit reference to the provisions of FAS 167 (particularly paragraphs 22A and 23A, and A80, and A81) which provide for separate classification of assets and liabilities reflecting the inherent risklessness to the consolidating institution posed by those separately classified assets and liabilities. By not acknowledging that separately classified assets and liabilities should either be excluded from capital ratios or given a zero risk weight, the proposed standards do not provide for alignment taking into account the inherent risklessness to the consolidating institution of separately classified assets and liabilities.

Paragraph 22A of FAS 167 addressing separate classification under the title of "**Presentation**" states the following:

> A reporting enterprise shall present separately on the face of the statement of financial position (a) assets of a consolidated variable interest entity that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

FAS 167 further requires that the primary beneficiary make disclosures about such separately presented assets and liabilities that clarify the nature of the restrictions placed on the assets and the absence of recourse to the credit of the primary beneficiary. In particular, paragraph 23A of FAS 167 requires the primary beneficiary to disclose:

a. The carrying amounts and classification of the variable interest entity's assets and liabilities in the statement of financial position that are consolidated in accordance with this Interpretation, including qualitative information about the relationship(s) between those assets and liabilities. ***For example, if the variable interest entity's assets can be used only to settle obligations of the variable interest entity, the enterprise shall disclose qualitative information about the nature of the restrictions on those assets.***

b. ***Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary***. (Emphasis added).

The separate classification of (a) assets that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors do not have recourse to the credit of the primary beneficiary, necessarily recognizes that the primary beneficiary has neither the right to cash generated by these (separately classified) assets nor the responsibility to settle the (separately classified) liabilities. Since the rights and obligations underlying the separately classified assets and liabilities are not legally enforceable by or against the consolidating institution, they do not satisfy the definition of accounting assets and liabilities under the FASB Statement of Financial Accounting Concepts, Elements of Financial Statements (FASB, December, 1985) ("FASB Statement of Accounting Concepts"). See Comment on Exposure Draft, Amendments to FASB Interpretation No. 46(R) by Joshua Ronen and Kenneth Sagat, October 6, 2008, ("Ronen-Sagat FASB Comment") attached as Appendix.

The theory embraced by FAS 167 under which the assets and liabilities of the variable interest entity are consolidated into the financial statements of the primary beneficiary is premised on control over the variable interest entity being consolidated, rather than control over the individual assets or the obligation to settle individual liabilities. Indeed, the criterion for consolidation -- anchored in ARB 51 -- is whether the primary beneficiary has a "controlling financial interest" in the variable interest entity ("VIE"). Accordingly, under paragraph 14 A of FAS 167, the essential characteristics for consolidation involve "the power to direct the activities of a variable interest ***entity*** that most significantly impact the ***entity's*** economic performance," and "the obligation to absorb the losses of the ***entity*** . . . or the right to receive benefits from the entity that could potentially be significant to the variable interest ***entity.***" (emphasis added)

The unmistakable emphasis of the FASB on an entity-conceptual approach as a basis for consolidation inevitably results in the co-mingling of "non-assets" and "non-liabilities" with the

otherwise proper assets and liabilities of the primary beneficiary. See Ronen-Sagat FASB Comment. Hence, the separate classification provisions of paragraphs 22A and 23A of FAS 167 rectify the obfuscation of assets and liabilities caused by co-mingling so as to make the financial statements more transparent and permit the accurate measurement of the capital of financial institutions, particularly with respect to separately classified "off balance sheet" assets and liabilities which are not conceptually assets and liabilities of the consolidating financial institution under the FASB Statement of Accounting Concepts.

The assets that are classified as restricted to the settlement of obligations of the consolidated entity are not accounting assets of the consolidating institution under the definition of assets in the FASB Statement of Accounting Concepts, nor are the liabilities classified separately as associated with no recourse to the consolidating institution accounting liabilities of the consolidating institution under the definition of liabilities. See Ronen-Sagat FASB Comment. Inherently, these "non--assets" and "non-liabilities" are qualitatively different from assets and liabilities of the consolidating institution recognized and defined under the FASB Statement of Accounting Concepts.

A concern that reputational risk may result in some circumstances in assuming off balance sheet exposures does not detract from the inherent risklessness to the consolidating institution of separately classified assets and liabilities. An assumption of non-contractual (and legally unenforceable) exposure as a result of solely reputational risk is in many instances nothing more than a mere possibility.[1] A mere possibility of an assumption of exposure without evidence showing that it is probable does not change the inherent risklessness to the consolidating institution of separately classified assets and liabilities.[2]

[1] It is by no means clear that smaller banks would have the same reputational concerns as banks participating in SCAP.

[2] Presumably, the examinations conducted by the agencies would reveal any evidence of changed circumstances showing that an assumption of off balance sheet exposures is probable. In that event, the capital ratios may be adjusted accordingly.

There is precedent for excluding certain assets that are consolidated from a bank's risk-weighted assets. Section 1 (c) (1) of 12 C.F.R. Part 3 states: "[E]ven though the assets of the non-financial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) are excluded from the bank's risk-weighted assets." The FASB has required separate presentation of assets and liabilities falling under paragraphs 22A and 23A precisely because the former do not contribute to future cash inflows to the consolidating institution and the latter do not require future cash outflows from the consolidating institution even though those assets and liabilities are consolidated for financial statement presentation purposes. Likewise, it is more consonant with risk-based capital objectives for risk-based capital ratios to reflect the inherent risklessness to the consolidating institution associated with separately classified assets and liabilities.

Recognition that separately presented assets and liabilities under FAS 167 are inherently riskless to the consolidating institution will enable continued use of securitizations as an important part of the financial system.[3] While risk-based asset weights do not affect the calculation of leverage ratios, separately classified assets and liabilities should likewise be excluded from leverage ratios to rectify the consolidation of what essentially are "non-assets" and "non-liabilities" of the consolidating institution. This exclusion will give full recognition to the separate classification provisions of FAS 167.

[3] We cannot envision the impact of the proposed standards upon securitizations and related economic activity as less than significant, if not draconian.

APPENDIX

Comments on Exposure Draft, Amendments to FASB Interpretation No. 46(R)

October 6, 2008

Joshua Ronen* **and Kenneth A. Sagat****

Introduction

In this paper we address the first question in the Exposure Draft ("ED") for which you elicit comments, i.e., whether the proposed amendments are responsive to the objectives of the project. We understand the project's objective is the same as the objective of financial reporting quoted in ¶B49 of the ED which is "to provide information that is useful to present and potential investors, creditors, donors and other capital market participants in making rational investment, credit, and similar resource allocation decisions". We presume, consistent with Concept 1 of the FASB's Conceptual Framework ("CON 1"), that this objective would be satisfied by providing "information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the [related] enterprise (CON 1, ¶37).

Briefly stated, we do not believe the amendments proposed in the Exposure Draft ("ED") accomplish this objective; contrariwise, we believe they hinder the ability of investors to predict future cash flows or their associated timing and uncertainty. We elaborate below, and, in the Conclusion, we suggest alternatives which are consistent with GAAP but nevertheless take into account concerns with abuses historically associated with variable interest entities ("VIE's") in certain circumstances.

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How involvement in variable interest entities should be accounted for?

CON1 states that " Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources" (CON1 ¶ 40). The term "economic resources" is conceptually equivalent to "assets" (Concept 6 of the Conceptual Framework ("CON 6") footnote 5). Assets, in turn, are defined as "probable future economic benefits ***obtained*** or ***controlled*** by a particular entity as a result of past transactions or events" (CON 6, ¶ 25, emphasis ours). Claims to resources (obligations of the enterprise to transfer resources) are simply liabilities, and are defined in ¶ 35 of CON 6 as " probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." "Present obligations" include equitable and constructive obligations as well as legal obligations (¶37-40).[1]

To be responsive to the objectives of financial statements, the FASB should demonstrate that the criteria for determining when a primary beneficiary should consolidate an entity by including the entity's assets and liabilities in the primary beneficiary's financial statements

[1] ¶40 of CON 6 elaborates: " An equitable obligation stems from ethical or moral constraints rather than from rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right—to do what one ought to do rather than what one is legally required to do. For example, a business enterprise may have an equitable obligation to complete and deliver a product to a customer that has no other source of supply even though its failure to deliver would legally require only return of the customer's deposit. A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so. The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. Thus, the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities."

ensure that the assets or liabilities to be consolidated satisfy the respective definitions of assets and liabilities. In other words, does the application of paragraphs 14 – 14B of the ED consolidating the variable interest entity, result in the inclusion in an enterprise's assets of "economic benefits obtained or controlled" by the enterprise and the inclusion in an enterprise's liabilities of "legal, equitable, or constructive obligations."

To gain insight into the kind of obligations that are considered to be legal, equitable, or constructive, we analyze FASB standards that describe the nature of "implicit" obligations that should be treated as liabilities to be reflected in balance sheets. We resort to analysis of promulgated principles because the Concept Statements themselves are not part of Generally Accepted Accounting Principles ("GAAP"), rather they are meant to guide the standard-setters in promulgating the principles that constitute GAAP, and are not meant to be principles themselves.

GAAP recognizes as liabilities only legal, equitable, or constructive obligations. This principle would appear to exclude an implication of financial responsibility based on a notion of reputation risk (except when preexisting and compelling economic circumstances cause such risk to be construed as an "obligation"). Nevertheless, the proposed amendments to Interpretation 46R appear to embrace that notion. Thus, the ED would extend the definition of liabilities in GAAP beyond any recognized concept of "obligations". We discuss in the Appendix examples of FAS statements that make plain that GAAP allows the recognition of the liability only when there is a pre-existing promise or understanding (even if not strictly legally enforceable) from which an "obligation" may be inferred. There is no basis in GAAP for presently inferring an obligation from the possibility of a later voluntary assumption of financial responsibility based upon a calculation of costs and benefits existing at such later time.

The ED does not rely upon the GAAP definition of assets and liabilities and, rather, bases its consolidation criteria on the notion of control of the VIE (ED, ¶14A). Unfortunately, this can

lead to the inclusion in the enterprise's assets of VIE assets whose benefits are not obtained or controlled by the enterprise; and in the inclusion among the enterprise's liabilities of VIE's liabilities which the enterprise has no obligation to pay off. In fact, this inconsistency (between the proposed criteria and the assets and liabilities definition) may even lead to contradictions in the application of the proposed amendments of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a Replacement of FASB Statement 125* and the proposed amendments of Interpretation 46R. For example, suppose it was determined that an enterprise ceded control over a transferred financial asset. Under the proposed amendment to Interpretation 46R, it is conceivable that the transferring enterprise would be deemed to have the ability to impact the economic performance of the transferee because it manages the transferee's investment, funding and defeasance activities, and that, accordingly, it has an implicit financial responsibility which could potentially be significant as a result of the enterprise's concern regarding the risk to its reputation in the marketplace if the variable interest entity (the transferee) did not operate as designed (see Example 3, ¶A26-A38 of the ED). In this case the transferor would be considered a primary beneficiary who must consolidate the assets and liabilities of the VIE (transferee). As a result, the same asset over which the enterprise no longer has ***control*** under the proposed amendment to FAS 140 is deemed to be "economic benefits … ***controlled***" by the enterprise. Unless the word "control" in the proposed amendment to Interpretation 46R is meant to be interpreted differently from the word "control" in the proposed amendment to FAS 140, a contradiction is evident!

We appreciate the dilemma the Board faces: an inconsistency between the asset liability perspective that we have elaborated on and the entity approach to consolidation that derives from Accounting Research Bulletin ("ARB") 51, *Consolidated Financial Statements*. Under the latter, the criterion for including all the assets and liabilities of an entity in the assets and liabilities of an enterprise is the latter having a "controlling financial interest":

1. The purpose of consolidated statements is to present, primarily for the benefit of the

> shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

The bulletin goes on to state that the usual condition for a controlling financial interest is ownership of a majority voting interest. However, ARB 51 was issued in August 1959, many years before the conceptual framework was authored by the FASB. When a controlling financial interest exists, the ARB presumes that consolidated statements are more meaningful without anchoring the presumed resulting "meaningfulness" in the objectives of financial statements: helping to predict future cash flows and their timing and associated uncertainty. Indeed, we have shown above that consolidating all assets and liabilities, including assets that substantively are not controlled by the enterprise and liabilities that are not "obligations" of the enterprise, is not consistent with the objectives of financial statements.

The fact that ARB 51's criterion of "controlling financial interest" is not necessarily consistent with the objectives of financial statements may be attributed to a different conception of the purpose of financial statements than the one underlying the objectives of financial statements as stated in the FASB's Conceptual Framework. In 1959, when ARB 51 was issued, financial statements were primarily seen as fulfilling the stewardship role of accounting. At that time, accounting was not viewed as serving an informational function in the sense of providing users with information useful for prediction of future cash flows and their uncertainties such as to properly assess the risks and returns associated with their investments. The user-oriented approach to formulating accounting objectives made its appearance fully only a decade or so after the issuance of ARB 51.

From the perspective of stewardship, or agent principal relationships, where management is seen as agent of shareholders -- the principal, the criterion of "controlling financial

interest" appears sensible. If management effectively controls the operations of an entity, one should judge management's performance on the basis of results that include the outcomes of the operations of entities that management controls. This is a well known precept of the theory of agency. However, while consolidated results of operations, assets and liabilities may better inform evaluators of management's performance to enable them to make decisions related to retaining or promoting management, they are not necessarily informative to shareholders and creditors (actual and potential) about an enterprise's value. It is information about the value of the enterprise and changes therein over time that enables existing and potential investors and creditors to make informed investment and credit decisions. Elements of financial statements such as assets, liabilities, contingent gains, and contingent losses are more relevant to investment and credit decisions than information about how effectively management utilized assets it controlled; hence, an approach that is based on the definition of assets and liabilities is better suited to the informational role of accounting as articulated in the FASB's conceptual framework. It is obviously beyond the scope of this paper to address the issue of consolidations in general, although one might reason that two distinct sets of information should be provided: one for assessing management's performance, and another oriented to the prediction of future cash flows and their associated uncertainty and timing.

Under the reasonable assumption that such a drastic solution (two separate sets of statements) would not be entertained (at least in the short run), it behooves us to attempt to reconcile the "controlling financial interest" criterion of ARB 51 and Interpretation 46R and the ED with the objectives of financial statements articulated in the FASB's conceptual framework. It is relatively straightforward to conclude that a criterion of "controlling financial interest" for consolidation of all assets and liabilities of a subsidiary is consistent with the objectives of financial statements if and only if the "controlling financial interest" ARB 51 presumes a parent to have in its subsidiary ***implies*** full control over the benefits of ***all*** the subsidiary's assets and full financial responsibility and obligation to pay off ***all*** the subsidiary's liabilities. In other words, it is the control over the benefits of all the assets and

the responsibility for all the obligations of the consolidated entity that is the primary criterion for consolidation.

If we seek principled consistency between ARB 51's standard and the objectives of financial statements inclusive of its conception of assets and liabilities, then logically full consolidation should only occur when full financial rewards and responsibility may be implied. Accordingly, the proposed amendment to Interpretation 46R should state as the only criterion for consolidation that the enterprise controls the benefits of ***all*** the assets and assumes the responsibility for ***all*** the obligations of the consolidated entity.

The Board appears to have struggled with the inconsistency between the asset-liability view and the consolidated entity approach. For example, the proposed amendment of Interpretation 46R declares that financial responsibility ***implies*** controlling financial interest, but not the other way around: "An enterprise shall consider the rights and obligations conveyed by its variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both, ***and, thus*** provide the enterprise with a controlling financial interest" (Exposure Draft ("ED"), ¶14C, emphasis ours). We suggest that the former does not necessarily imply "a controlling financial interest." Indeed, if it did, there is no need to impose both criteria as conditions for consolidation (ED, ¶14B)

As discussed, faithfulness to the objectives of financial statements requires that consolidated assets should be those whose benefits are fully controlled by the enterprise, and consolidated liabilities should be those obligations for which the enterprise assumes full responsibility. These principles for consolidation differ substantively from the criteria of receiving the majority of expected residual returns and absorbing a majority of the expected losses. Consider first the receipt of expected residual returns. Is it possible to anticipate the receipt of a majority of residual returns without controlling the assets that yield the underlying returns? The answer must be yes. A majority of residual returns are

often the reward for entrepreneurial ingenuity and effort, not necessarily requiring the control of specific assets. Thus there can be situations where assets are not under the control of the enterprise -- and hence should not be consolidated -- while the enterprise is rewarded for innovating business structures. In these situations, the important measure of return on assets (ROA) would be distorted if the non-controlled assets of the entity are included among the assets of the enterprise. Thus, contrary to the implication stated in ¶14C of the ED, the control over all the assets and not the receipt of the majority of expected residual returns is the correct criterion; and the latter does not necessarily imply the former.

Likewise, the absorption of a majority of the expected losses is not a basis upon which to imply "a controlling financial interest." Absorbing the majority of expected losses need not result in financial responsibility to pay off all the obligations of the entity. For example, consider the facts and circumstances of Example 1 of the ED where an entity is financed with $94 of bonds (issued in 3 tranches) and $6 of equity. An expected loss of $6 would wipe out the equity but would not trigger an obligation to pay off the $94 liabilities. This continues to be the case if, say, there is an implicit additional financial responsibility to pay another $20 to bond holders intended to protect reputation. The total expected loss falls short of the total obligation of $94. Consolidation should result only when all assets of the entity are controlled by the enterprise and all liabilities of the entity are obligations of the enterprise. Short of that, expected residual returns to the enterprise and expected losses to be incurred by the enterprise should be estimated (and reasonably verified) and treated as contingent gains and contingent losses, respectively, under FAS 5. Moreover, full and truthful (as truthful as allowed by the verification technology) disclosures should be made to maximize transparency.

It should also be noted that whether an enterprise assumes financial responsibility to ensure that a variable interest entity operates as designed, depends on whether the enterprise, at some point in the future, decides, based on a calculus of costs and benefits

that assuming such a financial responsibility is a profitable investment. But such a decision is certainly not likely in good times -- when the returns on assets are adequate to meet all obligations of the entity. It is also unlikely that the enterprise would assume financial responsibility in bad times: the assets are impaired to such an extent that assuming financial responsibility would cost the enterprise more than the benefits of avoiding reputation loss. Thus, such a decision is likely only over a limited range of outcomes where the benefits of avoiding reputation loss exceed the cost of assuming financial responsibility. Evaluating a contingent loss from a future assumption of financial responsibility in a limited range of outcomes is precisely what FAS 5, *Accounting for Contingencies* prescribes in the case of loss contingencies. Evaluation of whether a probable contingent loss exists in accordance with FAS 5 is a necessary exercise: neither the mere involvement with a VIE and directing matters that affect its economic performance nor exposure to expected losses can or should automatically lead to the implication of a preexisting "obligation" justifying the recognition of a liability.

Indeed, The GAAP approach to the possibility of assuming future implicit responsibilities such as those resulting from relationships that imply that threat of reputational loss may give rise to a willingness to sacrifice resources in order to protect reputation is to evaluate such a possibility in accordance with FAS 5, which requires that accountants assess the probability of possible outcomes. Under FAS 5, a contingent loss should be treated as a liability only if the event giving rise to the loss is more likely than not to occur. In other words, if a low risk of payments is assessed, no liabilities are accrued. Similarly, in the case of an enterprise having a variable interest in a VIE, the probability of the enterprise having to sacrifice resources to meet an "implicit financial responsibility to ensure that a variable interest entity operates as designed" (ED, ¶B24) is a matter of judgment. Therefore, the probability of incurring a loss related to reputation risk should be evaluated and a contingent loss, if any, should be treated in accordance with FAS 5. Here are relevant provisions of FAS 5:

> 8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if *both* of the following conditions are met:
>
> a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.4 It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated

Interestingly, FAS 5 prohibits the accrual of a liability if the loss contingencies arise after the date of the financial statements:

> 11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

Treating implicit financial responsibility as a contingent loss under FAS 5 would accord with the objectives of financial statements in the sense of providing in the balance sheet, income

statement, and notes, information that helps predict future cash outflows associated with the contingent loss along with a quantification of the expected loss (preferably as the expected value rather than the most likely result) and an associated disclosure of dispersion, such as range, standard deviation, etc.. At the same time, treatment under FAS 5 would avoid unintended consequences of full consolidation, which will almost surely trigger requirements for injecting additional capital (whether or not necessary) causing and exacerbating the strain on financial markets in times of a credit crunch

Treatment under FAS 5 would give rise to full transparency in the sense of truthful reflection of the probable future cash outflow faced by an enterprise that has a variable interest in a VIE. By contrast, full consolidation of assets and liabilities of a variable interest entity, as would be required on the part of a "primary beneficiary" under the proposed criteria would obfuscate and distort the financial statements: the assets consolidated could lead to a prediction of future cash inflows over which the enterprise has little or no control, contrary to the definition of assets as "economic benefits obtained or controlled" by the enterprise; and the liabilities consolidated could lead to a prediction of future cash outflows, at least some of which will not occur because the enterprise is under no "legal, equitable, or constructive obligation" to pay. The outcome of such a consolidation, therefore, is to present misleading information which will make the financial statements ***nontransparent***.

To further emphasize this point, suppose that the enterprise can estimate a probability distribution of the future cash flows associated with its variable interest in a VIE. What would be a full and truthful disclosure of this relevant information, which is privately known by the enterprise? Unquestionably, disclosing the "true" estimated probability distribution would constitute full disclosure -- according full transparency. If it is argued that such a disclosure would increase the informational burden on users in the sense of being too complicated to process, descriptive measures of the distribution, such as mean, standard deviation, range, etc. could be provided as indicated above. Thus, the mean could be

presented as a liability on the balance sheet and the other moments of the distribution could be provided in footnotes. Under the proposed amendment however, the purported primary beneficiary, rather than truthfully reflecting the ***uncertainty*** associated with the possible cash outflows, would have to non-truthfully convey ***a full certainty*** that the maximal cash outflow of the distribution will be paid out; this would be just as misleading as pretending that the minimal cash outflow of the distribution will be paid out with certainty. Both extremes would be hazardous to the health of the financial markets. An uncertain and complex world cannot be made simple by merely describing it simplistically. Of course, we must be mindful of the hazard of misrepresentation: the enterprise may misrepresent the distribution of cash outflows. But to minimize misrepresentation, properly aligned incentives and a properly designed verification methodology are the right instruments; the extreme device of pretending that the maximal cash outflow will be incurred as would be the case under full consolidation is not.

Criteria for Consolidation: Conclusion

We conclude that a better criterion for consolidation is: The power to control and receive the benefits of all the assets of the entity ***and*** the present obligation to pay off all the liabilities of the entity. To the extent it is estimated that only some of the benefits of the assets would be received with some probability and only some of the liabilities of the entity would be assumed by the enterprise with some probability, the accounting treatment should follow the principles articulated in FAS 5. In any case full disclosures as specified in the ED should be made.

We are aware of the difficulties surrounding the activities of VIEs in light of their historical use and abuse as entities in which to "park" toxic assets, debt, and losses. We also appreciate the necessity for full transparency that led the Board to propose consolidation when the enterprise is determined to be "significantly" involved in the VIE's activities.

However, it is our opinion that the proposed criteria will lead to over inclusion of assets and liabilities in the enterprise's financial statements. This could be just as misleading as under inclusion. Higher perceived risk resulting from over inclusion of liabilities and assets can scare investors away from privately and socially beneficial projects. The ensuing social loss is just as harmful as the loss to investors from directing their savings to enterprises that understate their liabilities and assets -- falsely conveying less than the risk the enterprise is actually exposed to.

If, for whatever reason, the Board is reluctant at this juncture to consider a significant departure from the criteria set in ¶14A-a4C of the ED, we would suggest as a minimum substituting the following sentences for the existing last sentence of ¶14A:

> An enterprise shall be deemed to have a controlling financial interest in a variable interest entity if it has control over the benefits from the assets of the entity as a whole, and if it is has a present obligation for the entity's liabilities as a whole. In applying this principle, the enterprise may find it useful to consider the following characteristics.

We also suggest changing the first sentence of 14A.b. to the following:

> The right to receive benefits from all the variable interest entity's assets and the obligation for all the variable interest entity's liabilities.

We further suggest deleting the second sentence of ¶14A.b. and eliminating the quantitative analysis all together (¶14C).

Linked Presentation

Supposing that the facts and circumstances are such that the criteria for consolidation suggested above have been met, how then would the consolidated assets and liabilities of the entity be presented in the financial statements? We realize that the Board has considered, and rejected, a proposal for linked presentation, i.e., that the entity's assets and

liabilities be offset such that only a net asset or a net liability be presented. The Board stated the reason for the rejection to be the "short-term nature of this project" given the need to address significant issues related to linked presentation that require significant further analysis (ED, ¶B32). It is our opinion, however, that the potentially grave consequences of requiring the full consolidation of a vast number of VIEs in a radical departure from the past resulting in potential large capital needs for financial institutions call for a further review and consideration of linked presentation by the board, despite the "short term nature of this project".

Understandably, the Board may have qualms about allowing linked presentation when an enterprise's other (non-consolidated-entity-related) assets and liabilities may in-substance be similarly linked by virtue of the cash flows from these other assets being dedicated to meeting scheduled payments of these other liabilities. Understandably, the Board may have to reconcile such linked presentation with the provisions of Interpretation 39.[2] Nonetheless, we believe that allowing linked presentation as a temporary expedient until such time that the Board is able to consider its potential application to other assets and liabilities is advisable.

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[2] "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount

It is noteworthy that arguments against linked presentation such as those set forth in ¶311 of FAS 140, referred to in ¶ 137 of FAS 140 do not apply to the typical legal and business structure of VIE's.[3] Moreover, the FASB staff itself proposes linked presentation in the FASB Exposure Draft: *Invitation to Comment. Reducing Complexity in Reporting Financial Instruments (Including IASB Discussion Paper, Reducing Complexity in Reporting Financial Instruments*) (March 28, 2008)*:*

> C10 The staff further propose that for presentation purposes a recognized financial asset and a recognized financial liability should be presented together in the financial statements (referred to as '**linked presentation**' if either the entity is unconditionally obliged to pay benefits to settle the obligation when the asset generates benefits, or the entity is unconditionally entitled to the right to receive benefits from the asset when the financial liability is settled.

[3] In ¶ 137 of FAS 140 the Board observed that "the linked presentation would not have dealt with many of the problems created by the risks-and-rewards approach. Further, the Board concluded that it is not appropriate for an entity to offset restricted assets against a liability or to derecognize a liability merely because assets are dedicated to its repayment, as discussed in paragraphs 309-312". ¶311, lists, in support of rejecting linked presentation, the critical characteristics that disqualify in-substance defeasance transactions from de-recognition:

a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.

b. The lender is not limited to the cash flows from the assets in trust.

c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.

d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.

e. Neither the lender nor any of its representatives is a contractual party to establishing the defeasance trust, as holders of interests in a qualifying SPE or their representatives would be.

f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

In fact, an in-substance linked presentation is permitted under GAAP in other, similar, circumstances. Consider, for example, FAS 87, *Employers' Accounting for Pension* (Issued: December 1985), where the netting of the pension's assets and liabilities is an approved practice:

> 84. In applying accrual accounting to pensions, this Statement retains three fundamental aspects of past pension accounting: delaying recognition of certain events, reporting net cost, and ***offsetting liabilities and assets***. Those three features of practice have shaped financial reporting for pensions for many years even though they have been neither explicitly addressed nor widely understood and they conflict in some respects with accounting principles applied elsewhere. (Emphasis ours)
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> 87. The offsetting feature means that recognized values of assets contributed to a plan and liabilities for pensions recognized as net pension cost of past periods are shown net in the employer's statement of financial position, even though the liability has not been settled, the assets may be still largely controlled, and substantial risks and rewards associated with both of those amounts are clearly borne by the employer

Indeed, ¶ 87 above goes further and asserts that the netting of assets and liabilities occurs even as assets may be still largely controlled.

This offsetting of assets and liabilities of pensions is reinforced in FAS 158: *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (Issued: September 2006):

> Recognition of the Funded Status of a Single-Employer Defined Benefit Postretirement Plan
>
> 4. A business entity that sponsors one or more single-employer defined benefit plans shall:
>
> a. Recognize the funded status of a benefit plan—measured as the difference between the fair value of plan assets and the benefit obligation—in its statement of financial position. For a pension plan, the benefit obligation shall be the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation shall be the accumulated postretirement benefit obligation.

b. Aggregate the statuses of all overfunded plans and recognize that amount as an asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. A business entity that presents a classified statement of financial position shall classify the liability for an underfunded plan as a current liability, a noncurrent liability, or a combination of both. The current portion (determined on a plan-by-plan basis) is the amount by which the actuarial present value of benefits included in the benefit obligation payable in the next 12 months, or operating cycle if longer, exceeds the fair value of plan assets. The asset for an overfunded plan shall be classified as a noncurrent asset in a classified statement of financial position.

Thus, linked presentation is an established GAAP principle in circumstances that are not dissimilar from those surrounding the entities subject to the proposed provisions of the ED. We suggest that the Board consider applying this principle as an expedient temporary measure while it conducts a thorough review of the appropriateness of applying linked presentation to other assets and liabilities and considers interpretation No. 46(R) more broadly.

Appendix

FAS 143: Retirement of Long-Lived Assets

This standard, effective for financial statements issued for fiscal years beginning after June 15, 2002, applies to "legal obligations" associated with the retirement of long-lived assets. A promise may under certain circumstances be subject to the doctrine of promissory estoppels and, thus, result in a legal obligation:

> A2. This Statement applies to legal obligations associated with the retirement of a tangible long-lived asset. For purposes of this Statement, a legal obligation can result from (a) a government action, such as a law, statute, or ordinance, (b) an agreement between entities, such as a written or oral contract, or (c) a promise conveyed to a third party that imposes a reasonable expectation of performance upon the promisor under the doctrine of promissory estoppel. Black's Law Dictionary, seventh edition, defines promissory estoppel as, "the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment."
>
> A3. In most cases involving an asset retirement obligation, the determination of whether a legal obligation exists should be unambiguous. However, in situations in which no law, statute, ordinance, or contract exists but an entity makes a promise to a third party (which may include the public at large) about its intention to perform retirement activities, facts and circumstances need to be considered carefully in determining whether that promise has imposed a legal obligation upon the promisor under the doctrine of promissory estoppel. A legal obligation may exist even though no party has taken any formal action. In assessing whether a legal obligation exists, an entity is not permitted to forecast changes in the law or changes in the interpretation of existing laws and regulations. Preparers and their legal advisors are required to evaluate current circumstances to determine whether a legal obligation exists.
>
> A4. For example, assume a company operates a manufacturing facility and has plans to retire it within five years. Members of the local press have begun to publicize the fact that when the company ceases operations at the plant, it plans to abandon the site without demolishing the building and restoring the underlying land. Due to the significant negative publicity and demands by the public that the company commits to dismantling the plant upon retirement, the company's chief executive officer holds a press conference at city hall to announce that the company will demolish the building and restore the underlying land when the company ceases operations at the plant.

> Although no law, statute, ordinance, or written contract exists requiring the company to perform any demolition or restoration activities, the promise made by the company's chief executive officer may have created a legal obligation under the doctrine of promissory estoppel. In that circumstance, the company's management (and legal counsel, if necessary) would have to evaluate the particular facts and circumstances to determine whether a legal obligation exists.
>
> A5. Contracts between entities may contain an option or a provision that requires one party to the contract to perform retirement activities when an asset is retired. The other party may decide in the future not to exercise the option or to waive the provision to perform retirement activities, or that party may have a history of waiving similar provisions in other contracts. Even if there is an expectation of a waiver or nonenforcement, the contract still imposes a legal obligation. That obligation is included in the scope of this Statement. The likelihood of a waiver or nonenforcement will affect the measurement of the liability.

Accordingly, the underlying facts and circumstances must be examined to determine if there has been a promise and whether the promise is subject to promissory estoppels. By analogy, in the case of an enterprise that has a variable interest in a VIE, the factual question is whether the enterprise has made a promise and whether such a promise rises to the level of legal obligation. Unless this is the case, no liability has been created.

FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

In the entirely different context of FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* effective for fiscal years beginning of the December 15, 1992, representations can be construed as legal obligations but only in the circumstances described -- representations made to employees -- and only given a practice of paying postretirement benefits as a matter of routine. In this context, the concept of representation is a component of the definition of a "plan":

> An arrangement that is mutually understood by an employer and its employees, whereby an employer undertakes to provide its employees with benefits after they retire in exchange for their services over a specified period of time, upon attaining a

> specified age while in service, or a combination of both. A plan may be written or it may be implied by well-defined, although perhaps unwritten, practice of paying postretirement benefits or from oral representations made to current or former employees.

It is clear from both the definition of a plan and the following wording in paragraph 8 (below) that this treatment of oral representations is restricted to this Statement and to post-retirement benefits. Indeed, that FASB found it necessary explicitly to prescribe this treatment for oral representations under the specified conditions implies that it is not generally applicable – i.e., oral representations should not generally be recognized as accounting liabilities.

> 8. An employer's practice of providing postretirement benefits may take a variety of forms and the obligation may or may not be funded. This Statement applies to any arrangement that is in substance a postretirement benefit plan, regardless of its form or the means or timing of its funding. This Statement applies both to written plans and to unwritten plans whose existence is discernible either from a practice of paying postretirement benefits or from oral representations made to current or former employees. Absent evidence to the contrary, it shall be presumed that an employer that has provided postretirement benefits in the past or is currently promising those benefits to employees will continue to provide those future benefits.

In the case of an enterprise that has a variable interest in a VIE, there usually is not a representation, written or otherwise, that the enterprise is financially responsible for all the liabilities of the entity. To the extent that the enterprise has paid the entity's obligations in the past, thus incurring losses, conceivably a contingent loss giving rise to a liability may occur under the concept in ¶8 above if it were intended to apply to a VIE.

FAS 116, Accounting for Contributions Received and Contributions Made

FAS 116, effective for financial statements issued for fiscal years beginning after December 15, 1994, provides that promises to give a contribution, establish a liability or expense only if they are legally enforceable. First, consider the accounting treatment of a contribution:

5. A contribution is an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary **nonreciprocal transfer** by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services, and **unconditional promises** to give those items in the future. (Emphasis in original.)

6. A promise to give is a written or oral agreement to contribute cash or other assets to another entity; however, to be recognized in financial statements there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an **unconditional intention to give that is legally enforceable.** (Emphasis our).

18. Contributions made shall be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given. For example, gifts of items from inventory held for sale are recognized as decreases of inventory and contribution expenses, and unconditional promises to give cash are recognized as payables and contribution expenses. Contributions made shall be measured at the fair values of the assets given or, if made in the form of a settlement or cancellation of a donee's liabilities, at the fair value of the liabilities canceled. (Internal citations omitted.)

FAS 146, Accounting for Costs Associated with Exit or Disposal Activities

This Statement (Issued: June 2002) specifies that a liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability in CON 6 is met:

4. A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability is met. Paragraph 35 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines liabilities as follows:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. **Only present obligations to others are liabilities** under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. ***An exit or disposal plan, by***

> ***itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.*** (Emphasis ours).

Thus, the question is when is there a present obligation by the enterprise for costs expected to be incurred, and they lack the requisite past transaction for recognition of a liability. FAS 146 further provides:

> For one-time termination benefit plans, FAS 146 requires that a liability be recognized when all of the following conditions are met and the benefit arrangement has been communicated to employees (the "communication date").
>
> a. Management, having the authority to approve the action, commits to a plan of termination.
> b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
> c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
> d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.
>
> In addition to meeting conditions a. – d., the employer must also communicate that information to employees. The FASB specifically observed that the basis for recognizing a liability is because the communication of a promise to provide one–time termination benefits if employees are terminated ***creates a constructive obligation*** at the date of communication. (Emphasis ours).

It is difficult to identify circumstances attendant to the business arrangements that characterize the relationship between an enterprise and its sponsored VIE, which resemble

requirements that are similar in-substance to those specified above justifying the recognition of a constructive obligation.

FAS 68: Research and Development Arrangements

This statement, issued October 1982, dwells in detail on the nature of liabilities:

Obligation Is a Liability to Repay the Other Parties

5. If the enterprise is obligated to repay any of the funds provided by the other parties ***regardless of the outcome of the research and development***, the enterprise shall estimate and recognize that liability. This requirement applies whether the enterprise may settle the liability by paying cash, by issuing securities, or by some other means.

6. To conclude that a liability does not exist, the transfer of the financial risk involved with research and development from the enterprise to the other parties must be substantive and genuine. To the extent that the enterprise is committed to repay any of the funds provided by the other parties ***regardless of the outcome of the research and development***, all or part of the risk has not been transferred. The following are some examples in which the enterprise is committed to repay:

a. The enterprise ***guarantees, or has a contractual commitment*** that assures, repayment of the funds provided by the other parties ***regardless of the outcome of the research and development***.

b. The other parties ***can require*** the enterprise to purchase their interest in the research and development regardless of the outcome.

c. The other parties ***automatically will receive*** debt or equity securities of the enterprise upon termination or completion of the research and development ***regardless of the outcome***.

7. Even though the written agreements or contracts under the arrangement do not require the enterprise to repay any of the funds provided by the other parties, surrounding conditions might indicate that the enterprise is likely to bear the risk of failure of the research and development. If those conditions suggest that it is ***probable that the enterprise will repay any of the funds regardless of the outcome of the research and development***, there is a presumption that the

> enterprise has an obligation to repay the other parties. That presumption can be overcome only by substantial evidence to the contrary.
>
> 8. Examples of conditions leading to the presumption that the enterprise will repay the other parties include the following:
>
> a. The enterprise has ***indicated an intent*** to repay all or a portion of the funds provided ***regardless of the outcome of the research and development***.
>
> b. The enterprise would suffer a severe economic penalty if it failed to repay any of the funds provided to it ***regardless of the outcome of the research and development***. An economic penalty is considered "severe" if in the normal course of business an enterprise would probably choose to pay the other parties rather than incur the penalty. For example, an enterprise might purchase the partnership's interest in the research and development if the enterprise had provided the partnership with proprietary basic technology necessary for the enterprise's ongoing operations without retaining a way to recover that technology, or prevent it from being transferred to another party, except by purchasing the partnership's interest.
>
> c. A significant related party relationship between the enterprise and the parties funding the research and development exists at the time the enterprise enters into the arrangement.
>
> d. The enterprise has essentially completed the project before entering into the arrangement. (Emphasis ours)

The emphasized phrases above, if applied to the scenarios considered in the ED, would imply that viewing the entity's obligations as liabilities of the enterprise could be justified only in the extreme conditions where it is probable the enterprise is obligated to pay regardless of the performance of the entity's assets giving rise to a presumption of repayment. Neither the contractual arrangement nor the substantive economic reality that characterize the typical sponsor of a VIE comes close to meeting conditions such as the above for the recognition of a liability.

It is further instructive to consider the FASB's explanations of the above rules:

> 29. Some respondents believed that the Board should have based its conclusions on the definition of a loss contingency in Statement 5 rather than on the definition of a liability in Concepts Statement 3. The Board concluded that Statement 5 does not

address the primary issue involved in determining whether an enterprise involved in a research and development arrangement has a liability. Statement 5 deals with contingencies; that is, an existing condition, situation, or set of circumstances involving *uncertainty as to possible gain or loss* that will ultimately be resolved when one or more future events occur or fail to occur. This Statement deals with a transaction in which the issue is whether at the time an enterprise enters into a research and development arrangement (a) it is *committed* to repay any of the funds provided by the other parties regardless of the outcome of the research and development, (b) existing conditions indicate that it is likely that the enterprise will repay the other parties ***regardless of the outcome***, or (c) the enterprise is obligated only to perform research and development work for others.

30. Some people consider the likelihood of success of the research and development as the key issue in who bears the risk of failure of those activities. However, even though future benefits from a particular project may be foreseen, the amount generally cannot be measured with a reasonable degree of certainty. ***The key question in determining who bears the risk of failure is whether the enterprise is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development***. Concepts Statement 3 states that "an enterprise is not obligated to sacrifice assets in the future if it can avoid the future sacrifice at its discretion without significant penalty." A determination must be made of the penalty, if any, that the enterprise will incur if it does not repay any of the funds provided.

31. If an enterprise is contractually committed to repay any of the funds provided or has guaranteed or assured the other parties of repayment of the funds provided, ***regardless of the outcome of the research and development***, the enterprise clearly has a liability to repay the other parties. However, because of tax considerations, the agreements and contracts under the arrangement normally state that the enterprise is obligated only to perform services and generally do not require the enterprise to repay any of the funds provided if the research and development does not have future economic benefit. Nonetheless, the Board believes that substantive and genuine transfer of risk is essential for the enterprise's obligation to be limited to performing contractual services and that certain conditions create a presumption that the transfer of risk to the other parties may not be substantive or genuine. An enterprise involved in a research and development arrangement might incur equitable or constructive obligations through ***actions that bind*** the enterprise or by circumstances that change the nature of the enterprise's obligation from one to perform services for a fee to one to ***repay amounts provided by the other parties***. For example, an enterprise might provide the partnership with basic technology necessary for the enterprise's ongoing operations without retaining a way to recover that technology, or to prevent it from being transferred to another party, except by purchasing the partnership's interest in the research and development. Another example might be that there is a conflict of interest

and the limited partners could reasonably be expected to litigate successfully if the enterprise does not buy out the partnership. (Emphasis ours).