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EITF-100E
Comment Letter No. 4
233 N. Michigan Ave., Suite 2500
Chicago, IL, 60601

September 29, 2011

Via email to director@fasb.org

Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856

RE: Proposed Accounting Standards Update, "Derecognition of in Substance Real Estate—a Scope Clarification" (File Reference No. EITF-100E)

Dear Ms. Cospers:

We are pleased to provide comments on the proposal to clarify the scope of the real estate literature that applies to certain derecognition transactions ("the Proposal"). In that context, we agree the real estate literature in Subtopic 360-20 should apply.

However, the Proposal appears to assume a reporting entity's loss of control will always result "because of a default by the subsidiary on its nonrecourse debt." We believe the final ASU should clarify that not all events of default necessarily lead to the loss of a controlling financial interest. For example, it is not uncommon for a borrower to experience a "technical violation" of a covenant in a loan agreement, such as the failure to maintain a minimum level of working capital. In such cases, borrowers are commonly able to cure the violation in a short period of time. That is, neither the reporting entity nor the lender believes control of the real estate subsidiary has substantively changed hands.

As such, we believe an evaluation of the default is necessary to determine whether or not it results in the reporting entity losing control of its real estate subsidiary. Therefore, we recommend revising the Proposal to clarify that two separate, but sequential analyses are required:

- i) an analysis to determine whether the investor has lost control of the real estate entity under Topic 810, and then
- ii) a derecognition analysis of the underlying real estate asset under Subtopic 360-20, as well as an extinguishment analysis of the debt under Subtopic 405-20.

This two-step analysis appears consistent with the intent of the Proposal. The basis for conclusion acknowledges deconsolidation under Topic 810 is required when control is lost, and goes on to explain why a reporting entity "must also" satisfy the criteria in Subtopic 360-20 in order to derecognize the real estate asset.

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Our responses to the specific questions posed in the exposure draft are set out in the Appendix.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting at (312) 616-4667 or Adam Brown, Partner in the National Accounting Department at (214) 665-0673.

Very truly yours,

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Appendix - Questions for Respondents

Question 1: Do you agree that the scope of this proposed Update should be limited to a reporting entity's loss of control (as described in Subtopic 810-10) of a subsidiary that is in substance real estate when that loss of control is a result of the subsidiary defaulting on its nonrecourse debt? If not, what other situations have arisen in practice that the Task Force should consider?

We note the EITF and the working group for this issue explored a number of related questions during deliberations. We agree with the Task Force's decision to limit its consideration to the question initially posed, rather than delaying this project by expanding its scope. However, we believe the final amendments should clarify that not all events of default result in the loss of control over a real estate subsidiary, as discussed in our response to question 2.

Question 2: Do you agree that a reporting entity that ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate because of a default by the subsidiary on its nonrecourse debt should apply the guidance in Subtopic 360-20 to determine whether it should derecognize the assets (including real estate) and liabilities (including the related nonrecourse debt) of the subsidiary?

We agree Subtopic 360-20 should apply to the derecognition of real estate in the circumstance described. However, we believe there are several important clarifications to be made in the final ASU.

We understand the Task Force uses the term "in substance" to mean that practitioners shouldn't reach different accounting conclusions depending on whether real estate is held directly or through a legal entity. In this context, we agree that a focus on substance over form mitigates structuring opportunities. However, if something else is intended by the term "in substance," it should be more clearly defined.

Next, this issue assumes a reporting entity's loss of control occurred "because of a default by the subsidiary on its nonrecourse debt." We believe the final ASU should clarify that not all events of default necessarily result in the loss of a controlling financial interest. For example, it is not uncommon for a borrower to experience a "technical violation" of a covenant in a loan agreement, such as the failure to maintain a minimum level of working capital. In such cases, borrowers are commonly able to cure the violation in a short period of time. That is, neither the reporting entity nor the lender believes control of the real estate subsidiary has substantively changed hands.

As such, we believe an evaluation of the default is necessary to determine whether or not it results in the reporting entity losing control of its real estate subsidiary. In this context,



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the Proposal cites Subtopic 810-10, which includes ASC 810-10-35-4(e).¹ When the FASB added that factor to the list of reconsideration events in the variable interest consolidation literature, the FASB explained it was concerned about situations that should, but did not prompt a reconsideration of the entity's status as a VIE, for example, when an entity "experienced severe losses such that the holder(s) of the equity investment as a group lost power from the voting rights or similar rights of those interests and, thus, another party (for example, a guarantor or lender) obtained a controlling financial interest in the entity."² We believe this language and the nature of reconsideration events in general require the exercise of judgment. Without clarifying the Proposal, some may interpret the final ASU to indicate any event of default results in the loss of a controlling financial interest over a real estate subsidiary, something we do not believe the Task Force intended to convey.

In addition, the language in the Proposal appears internally inconsistent. In two places, it indicates the entity-based consolidation literature in ASC 810 applies to the default transactions within the scope of the Proposal:

- The addition of item (f.) in paragraph 360-20-15-3 implies Subtopic 810-10 should be applied to determine whether a controlling financial interest has been lost: "A transaction in which the parent of an in substance real estate subsidiary ceases to have a controlling financial interest (as described in Subtopic 810-10) in the subsidiary because of a default by the subsidiary on its nonrecourse debt. (emphasis added)"
- The addition of paragraph 360-20-55-71 states that an entity "applies the guidance in Topic 810 (emphasis added)" and concludes its controlling financial interest has been lost.

However, two other instances suggest otherwise:

- Paragraph 810-10-40-3Ac5 indicates the deconsolidation guidance in Subtopic 810-10 does not apply to sales of in substance real estate because those transactions are governed by Topic 360 or 976. We note this paragraph represents existing GAAP, rather than new proposed amendments.
- The addition of 810-10-40-3B states "The deconsolidation and derecognition guidance in this Section does not apply to a parent that ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt. For guidance in these circumstances, see Subtopic 360-20.... (emphasis added)"

We believe the Proposal should be revised to clarify that two separate, but sequential analyses are required: i) an analysis to determine whether the investor has lost control of the real estate entity under Topic 810, and then ii) a derecognition analysis of the underlying real estate asset under Subtopic 360-20, as well as an extinguishment analysis of the debt under Subtopic 405-20. This two-step analysis appears consistent with the intent of the Proposal. Paragraph BC 2 acknowledges deconsolidation under Topic 810 is

¹ Paragraph 4(e) of 810-15-35 indicates that an entity may become a VIE when "changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance."

² Paragraph A23, FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*



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required when control is lost, and the basis for conclusions goes on to explain why a reporting entity “must also” satisfy the criteria in Subtopic 360-20 in order to derecognize the real estate asset.

Question 3: Should additional guidance on applying the guidance in Subtopic 360-20 to transactions within the scope of this proposed Update be provided? If yes, under what circumstances?

The final amendments should provide guidance for situations in which an investor loses control of a real estate subsidiary with a noncontrolling interest, but the real estate asset and related debt continue to be carried in the parent’s financial statements. Specifically, what becomes of the noncontrolling interest?

In addition, we note the proposed amendments in Example 9 indicate that after the point of the borrower’s default, but:

[d]uring the time that the property continues to be held by the single-purpose entity, the lender makes substantially all of the operating decisions with respect to the property and receives all of the cash flows from the property’s operations. The reporting entity does not expect to have future participation in the management or economics of the single-purpose entity.... In addition, the reporting entity has waived its rights of ownership of the single-purpose entity, which provides the lender with the ability to foreclose and otherwise sell or transfer the underlying property without the reporting entity’s consent.

In this Example, derecognition of the real estate and related debt by the reporting entity in its consolidated statement of financial position is not appropriate...

We believe the final ASU should indicate (perhaps in the basis for conclusions) that the creditor will likely consolidate the real estate entity under the provisions of ASC 810-10. As a result, the same real estate asset will be presented on two different balance sheets. This outcome may be counter-intuitive to some practitioners. Further, some may believe that the investor should derecognize the real estate and debt at the point the lender first consolidates the real estate subsidiary. We believe the final ASU should acknowledge it is possible for the same asset to be reported on two sets of books to avoid confusion and potential future diversity on this point.

Question 4: Do you agree that the amendments in this proposed Update should be applied prospectively? If not, why not?

We disagree. Retrospective adoption would improve comparability for financial statement users. This would be particularly true in situations where a parent has lost control of two



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or more subsidiaries in consecutive reporting periods, where the accounting treatment would otherwise differ in the period when the final ASU is adopted.

Also, compared to most of the Board's recent standards and current projects that require retrospective treatment, we note a justification for prospective adoption isn't provided in the Proposal (paragraph BC 11 is silent on this point).

Question 5: Should an entity be permitted to early adopt the amendments in this proposed Update?

Yes. Some of the existing diversity in practice is consistent with the Proposal.

Question 6: How much time would be necessary for you to efficiently implement the provisions of this proposed Update?

The feedback from preparers should be most helpful in this regard. However, we do not envision excessive implementation costs.

Other Observations:

The proposed amendments state in 360-20-55-74 that "... in accordance with paragraph 405-20-40-1(b), the transfer of real estate accomplishes a legal release of the reporting entity, unless the reporting entity has provided a guarantee to the lender or the lender has recourse to the reporting entity or other assets of the reporting entity." We find this sentence somewhat confusing since:

- Whether or not a legal release from debt has been obtained is typically a fact-dependent question. We suggest revising the example to state that "based on the facts and circumstances, the reporting entity concludes that a legal release of the debt has been obtained."
- Introducing the possibility of additional loan guarantees or other forms of recourse provided by the reporting entity seems inconsistent with the context of a non-recourse loan secured by the only asset in a single-purpose entity.