



August 29, 2002

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
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Subject: Comments Regarding the Exposure Draft of the Proposed Interpretation for Consolidation of Certain Special Purpose Entities, an interpretation of ARB No. 51; File Reference No. 1082-200

Dear Ms. Bielstein:

I am writing on behalf of the Equipment Leasing Association (“ELA”) to provide comments to the Financial Accounting Standards Board (“Board”) regarding the Exposure Draft (“ED”) of the Proposed Interpretation of Consolidation of Certain Special Purpose Entities, an interpretation of ARB 51. We welcome the opportunity to provide both information and commentary in response to the Board’s request on its ED on accounting for special purpose entities (“SPEs”). A central part of the mission of the ELA and its Financial Accounting Committee is to provide educational information to the public as well as standards setters like the Board relative to data and analyses on leasing industry products, practices, and trends.

Organized in 1961, the ELA is a non-profit association that represents companies involved in the dynamic equipment leasing and finance industry to the business community, government, and media. ELA’s diverse membership consists of independent leasing companies, banks, captives, financial services corporations, broker/packageers and investment banks; as well as service providers like accountants, consultants, equipment managers, executive recruiters, insurance companies, lawyers, publishers, and software providers. ELA promotes the leasing industry as a major source of funds for capital investment in the U.S. and other countries. Headquartered in Arlington, Virginia, ELA is a national organization with more than 850 member companies and a staff of 27 professionals. In 2002, equipment leasing is estimated to be a \$244 billion industry.

Overview

We understand that the Board intends to achieve more consistent application of consolidation policies to certain SPEs and thereby improve the comparability between

enterprises in similar activities, that is, between enterprises who conduct activities through SPEs and those that do not. We also understand that the Board has a stated objective not to restrict the use of SPEs but to improve financial reporting by enterprises involved with SPEs. The Board has also stated that it recognizes that most SPEs serve valid business purposes, for example, by isolating assets or activities to protect the interests of creditors or other investors or to allocate risks among participants.

However, the ELA believes that the ED advances an approach that does not appear to conform to the Board's stated objectives in this project or the existing general rule of consolidation policy. From our perspective, the ED implies that existing consolidation guidance is insufficient and that it does not form an adequate foundation to draw upon in addressing situations where one of the parties involved with an SPE may have latent control. It also appears that the Board's variable interest model does not represent an extension of existing guidance. The ED requires a party who is identified as the primary beneficiary through the application of a series of economic tests to consolidate the SPE even in situations where this party has neither a controlling financial interest nor a majority of the economic benefits. We do not believe an interpretation should be used to increase the basis for consolidation.

We believe that the Board needs to understand and recognize that the isolated instances that prompted this ED should not form the basis for the imposition of a new consolidation regime to be broadly applied to all SPE-sponsored transactions. The abuses related to the failure to properly apply existing guidance and fraudulent actions. We understand that the abuses arose from side guarantees that served to protect the equity investors from accepting true risk of loss. Hence, we believe that audit standards should address non-compliance or circumvention risk while accounting standards should address capital adequacy.

We support the Board's overall objective of establishing capital adequacy based upon the inherent risk and expected losses related to that risk. However, given the special purpose nature of an SPE and high quality assets that SPEs often hold (e.g., investment grade assets), we believe that the Board should eliminate the 10 percent presumption and the similar business benchmark. Instead, the Board should expand its discussion on how capital adequacy should be determined both in situations involving rated and unrated equity tranches.

Since we do not believe that recent incidents evidence a broken regime, this proposed interpretation should build on existing rules instead of drawing on new ones. For example, we believe that EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, and related literature ("EITF 90-15"), should provide a workable framework from the perspective of both preparers and users. EITF 90-15 requires that, for an SPE lessor to be considered substantive, the owner(s) of record invest at least 3 percent residual equity capital that is subordinated to other interests in all events and circumstances and that cannot be returned during the lease term. The so-called 3 percent rule could be replaced with a principles-

based approach where the equity requirement would vary based on the based on the facts and circumstances as the Securities and Exchange Commission originally intended.

We also believe that the Board should limit the scope of SPEs subject to special evaluation in a manner similar to EITF 90-15. This pronouncement applies to leases where the expected substantive residual risks and substantially all of the residual rewards of the leased asset(s) and obligations imposed by the underlying debt of the SPE reside directly or indirectly with the lessee. However, in this context, it should not apply to leases where the lessor retains a meaningful interest in the residual value by either retaining upside potential or downside risk. By limiting the scope in this way, EITF 90-15 essentially discriminated in a substantive manner under the same principles that apply in determining the nature of a lease (a true risk shifting lease or a loan-like lease) for commercial law or income tax law.

The ELA does not believe that the ED would improve transparency regarding a reporting company's relationship with SPEs. For example, it would potentially distort the financial position of a reporting enterprise by including assets over which it has no financial claim and liabilities that it has no requirements to satisfy from the assets it controls or otherwise.

We believe that the changes to the financial statements arising from the variable interest model may prove to be confusing to the readers. A primary beneficiary would include assets, liabilities, minority interests, revenues, expenses, cash flows, and footnotes that are not additive to its other elements in terms of control or majority ownership. This primary beneficiary could later on subtract these elements and then add them back, depending on the nature of its particular interests. This appearance and disappearance would be even harder to interpret as it could arise either from the reporting enterprise's own actions or the independent actions of others over which the reporting enterprise has no control and may not be known at the time it occurs.

Fundamentally, we are concerned that the ED may impede the legitimate flow of capital. It would likely usher in uncertainty of outcome, processing inefficiencies, and significant implementation costs. Accordingly, we believe that the provisions of any new interpretation should be deliberate in its assessment of these unintended consequences.

In the sections below, we comment or address particular concerns that we have about the proposed definitions and scope, consolidation based on voting interests, consolidation based on variable interests, disclosure and implementation.

Definitions and Scope

We support the Board's proposed scope exclusions and related definitions as they evidence the Board's intent to interpret, not supercede, existing literature. However, we encourage the Board to redefine what is an SPE (instead of what it is not) and to exclude SPEs where the existing literature provides adequate guidance, e.g., joint ventures and similar arrangements. We believe that the Board should also exclude participated

transactions involving multiple investors who individually qualify as a substantive operating enterprise (“SOE”), where the use of an SPE has been used to effect co-ownership, and where the SPE has not changed the accounting outcome when compared to a direct (non-SPE-based) contractual relationship among the parties.

Substantive operating enterprise. We believe that the Board should draw on existing literature, notably EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, in defining an SOE. We believe that the proposed definition contains vague criteria, which could lead to diversity in practice.

Joint Ventures and similar arrangements. The ED does not state whether or not a venturer should stop its consolidation analysis after applying the guidance of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to investments in corporate joint ventures and AIN-APB 18, Interpretation No. 2, *The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18*. Apparently, some believe that the analysis should continue by applying the proposed new interpretative guidance before a reporting enterprise can conclude how it should report its investment. If it should continue, then it appears that the ED may cause an otherwise joint venturer, who would qualify for the equity method of accounting under APB 18 and related literature, nonetheless to consolidate the joint venture and bring on balance sheet assets and liabilities over which it has shared control.

Today, in determining the reporting of an investment in a joint venture, the venturers apply the guidance of APB 18 for corporate joint ventures and AIN-APB 18, #2 for investments in partnerships and unincorporated joint ventures. If a corporate joint venture has five distinct characteristics as described in APB Opinion No. 18 (notably, a venture subject to joint control), then each venturer accounts for its investments under the equity method of accounting irrespective of its ownership percentage. Similarly, if a non-corporate joint venture has the same five characteristics, then it would also account for its investment under the equity method of accounting, again irrespective of its ownership percentage.

The ED appears to introduce new criteria in the reporting of joint venture interests. For example, it appears that those joint ventures that do not qualify as SOEs, perhaps because they do not have employees or do not issue separate financial statements, would need to continue the analysis and apply the ED. Then, if the joint venture was deemed to be an SPE (at least for conservative analysis purposes), then it may not qualify for consolidation based on voting interest if its return is structurally limited by such means as fixed priced contracts, if it has any guarantees from others regardless of the amount of guarantee coverage, or the likelihood of a claim under the guarantee. Further, assuming that the venturers cannot base consolidation on voting interests, then one of the venturers apparently may have to consolidate because relative ownership matters under the ED and disproportionate sharing arrangements may temporarily identify one of the venturers as having the largest variable interest.

The same applicability issue may also apply to similar arrangements, such as investments in real estate ventures or other ventures. Statement of Position 78-9, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*, provides that, if voting interests are not clearly indicated, majority ownership may not constitute control if major decisions such as the acquisition, sale or refinancing of ventures assets must be approved by one or more of the venturers. It also provides that, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. Accordingly, the substance of the arrangement determines whether or not any venturer, general partner, or limited partner is in control of the major operating and financing policies of the venture or partnership.

Multiple participated transactions. The ED appears to bring transactions within its scope based on the ownership arrangement. We do not believe that the legal mechanism to achieve co-ownership (SPE or non-SPE/contractual-based) should affect the accounting outcome. Nor do we believe that the presence or absence of a controlling investor who qualifies as an SOE should affect the accounting outcome. By limiting the scope exclusion to SPEs that are consolidated by SOEs, it appears that the form would affect the accounting outcome when the substance of the underlying transaction has not changed. We believe that the accounting outcome should not change if the SPE does not alter the rights and obligations of the parties. For example, if the SPE merely serves to effect co-ownership in essentially the same way as co-owned property, the accounting outcome should be the same.

More importantly, the ED's proposed distinction based on the nature of the direct counterparty could inappropriately impede the flow of capital for larger sized transactions or, worse, preclude participation by capital providers who cannot directly own the leased property (e.g., foreign capital providers). Hence, we believe that participated transactions that legitimately use SPEs for capital raising purposes should be excluded from the scope when they do not change the accounting outcome.

Voting Interest Model

We generally agree with the proposed conditions for consolidation based on voting interests. However, we believe that the condition described at paragraph 9(c) should be clarified and partially modified to make it consistent with existing generally accepted accounting principles ("GAAP"). It appears that paragraph 9(c) contains the following two distinct conditions: (1) the equity investment is subordinate to all other investments and other interests for the life of the lease; and (2) it is the first interest subject to should be clarified or modified to make it consistent with existing GAAP. As to the first sub-condition, we recommend that the Board set it apart and incorporate the relevant parts in EITF 90-15 and 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*, in clarifying the meaning of subordination. As to the

second sub-condition, we recommend that Board change the word “or” to “and” to make it consistent with the condition 2 in EITF 90-15.

We note that EITF 90-15 potentially requires the lessee to consolidate its SPE lessor only with respect to a leasing transaction where the lessor’s upside potential is insubstantial and the lessor’s downside risk is insubstantial. We believe that the Board should not cause an SPE to apply the variable interest model in the situation where the equity owners have retained the first risk of loss but have theoretically limited their upside potential (by means of a fixed priced purchase option set at or above fair value granted to the lessee). APB Opinion No. 18 or related literature does not appear to explicitly or implicitly impose this economic requirement in qualifying for the equity method of accounting. Accordingly, we believe that the proposed condition should be revised to conform to EITF 90-15 and should not introduce a new condition that is not found in APB Opinion No. 18 or related literature.

Variable Interests Model

We support application of the variable interest model in situations where the accounting may have changed due to the presence of the SPE. For example, such situations would include sales recognition or off-balance-sheet reporting where the SPE provides a different accounting result relative to the accounting for the rights and obligations between substantive parties. However, as mentioned above, we do not support use of an interpretation to require consolidation based on a variable interest unless such interest conveys a controlling financial interest or a majority of the economic benefits.

We also believe that the variable interest model should narrow the parties to a leasing transaction that may be identified as the primary beneficiary to those who have a significant interest in the benefits and risks of ownership. These parties generally would only include the lessee and the lessor. However, if another party’s interest were subject to a significant and genuine first risk of loss relating to the leased asset or related liabilities, that party should also be considered in the primary beneficiary analysis. For example, a non-recourse lender may be the primary beneficiary if the lessor does not have a meaningful interest in the residual value of the leased property and/or has not invested equity commensurate with expected future losses.

As discussed below, we believe that the ED’s proposed approach to (re)identifying the primary beneficiary would be unworkable in practice and may unintentionally disrupt the efficient flow of capital supporting legitimate transactions. For example, upon the issuance of the ED, market participants have begun to request limitations on transfers to resolve uncertainty of accounting outcome. Such restrictions on secondary market activities would increase economic capital requirements leading to higher prices. Also, since the ED approach appears to require analysis under the variable interest model for many participated transactions, it would also have the unintentional effect of sub optimizing the participation, as a majority owned entity would have significantly greater predictability and stability of outcome.

Determination of the Primary Beneficiary

Many of the secondary parties to an SPE financing may be unintended primary beneficiaries. Under the ED, one or more of the secondary parties may ultimately have to consolidate the SPE at some point in time. Examples include letters of credit providers, derivative counterparties, residual value insurers, and lenders. Given the potential flux and impact on capital adequacy, these parties may be reluctant to participate in SPE financings to avoid primary beneficiary risk and volatility. This reluctance may lead to the use of less efficient capital raising structures.

Recently, potential primary beneficiaries have requested that the operative documents explicit restrict transfers of interests to entities other than to SOEs. As mentioned above, the vagueness of the SOE definition may adversely affect prospects or timing of any transfers. Further, such restrictions conflict with the principle of safety and soundness that underlie bank regulations and may invite regulatory criticism for imprudently reducing a regulated enterprise's ability to timely sell down or sell out of a risk exposure.

Primary Beneficiary Reassessment at Each Reporting Date

The ED expects participants to identify the primary beneficiary at each accounting period. This would implicitly require each participant to use commercially reasonable means (if not, best efforts) in monitoring the actions of others, particularly those who have had been previously identified as having a dominate variable interest.

We believe that the reassessment should not be required unless and until the reporting enterprise (or a related party) takes actions to increase or decrease its variable interest or modify the terms and conditions of its interest. Such an approach would be consistent with the general recognition approach

We note that a leveraged tax lease is classified only once, at the inception of the transaction, based upon the total rental payments, and risks and rewards over the entire term of the transaction in accordance with the provisions of Statement of Financial Accounting Standards No. 13, *Accounting for Leases*. Although the relative components of a lease investment, e.g., gross rentals, debt service, unguaranteed residual value, tax benefits, and other factors change over time, we do not believe that such changes (which are largely predictable) should serve to potentially cause a change in "control" or ownership. Instead, we believe that any reassessment should be limited to situations where the enterprise has modified the terms and conditions of the lease.

Disclosure

We support the Board's proposed disclosures with respect to the primary beneficiary disclosures to ensure that users have sufficient information to understand what amounts have included in the reporting enterprise's financial statements, particularly when the primary beneficiary does not have a controlling interest or majority of the benefits.

However, we also support expanded disclosure requirements for parties with a significant interest in the SPE. We believe that these disclosures should be similar to those required by APB 18 for investments that convey significant influence over the operating and financing policies of the SPE.

We are concerned that the proposed disclosure requirements for parties who provide significant administrative services may be too broad as these parties have only fiduciary and ministerial duties and generally have no residual interest in the SPE. Further, these parties generally do not have access to information about the GAAP assets and liabilities of the SPE.

Effective Date and Transition

We are concerned that the Board has not provided significant lead-time to implement the proposed interpretation. Given the extensive use of SPEs in leasing and the number of parties involved, we believe that the Board should extend the proposed effective date to January 1, 2004.

Summary

To assist the Board in gaining a better understanding of the potential unintended consequences arising from the ED, we have attached as an exhibit to this letter representative examples of leasing transactions.

We appreciate the opportunity to comment about this important Board project. We remain available as a resource to the Board and its staff to provide additional or clarifying information. Please feel free to contact me at any time to arrange for follow-on information.

Sincerely,

Michael Fleming

Michael Fleming
President, Equipment Leasing Association

EXHIBIT TO LETTER TO THE FASB

Examples for Comments Regarding the Exposure Draft of the Proposed Interpretation for Consolidation of Certain Special Purpose Entities, an Interpretation of ARB No. 51; File Reference 1082-200

Example 1 – Joint Venture – Vendor Financing Vehicle

Two companies will form a Joint Venture (“JV”), organized as a limited liability company under the laws of the state of Delaware, to engage in providing lease financing for the acquisition of products manufactured by one of the members (“Member X”). The other member (“Member Y”) is a substantial financial institution engaged in the leasing industry. The intent of Member X is to (i) provide financing to customers for the acquisition of its products, (ii) maintain an on-going relationship with its customers, and (iii) participate in the financial rewards of providing lease financing. Member X has decided to use joint venturing instead of forming a captive finance company. In so doing, it has avoided the cost of building the back-office infrastructure to properly manage a leasing operation and would be looking to Member Y for the back-office management of the JV. Member Y is interested in the JV because it will be a way to earn a favorable rate of return given the risk of the investment. Member Y has the in-house capacity and will provide the back-office administration to the JV.

The JV will be capitalized with debt provided by a third-party lender, debt capital will represent approximately 90% of the funding needed by the JV. Equity capital will be provided on a 50%/50% basis.

In connection with the formation of the JV, Member X will pay Member Y a 1% structuring fee and will be responsible for all reasonable costs and expenses related to the formation of the JV.

The members have agreed to the following allocations:

1. Tax benefits will be allocated to the members based on each member’s share of the equity investment in the JV (or 50/50).
2. All cash amounts, except as described at item 3 below, will also be based on funded equity (or 50/50).
3. Upon receipt of sufficient rentals and/or residual proceeds to achieve a defined “Target Amount,” the sharing arrangement will flip from 50/50 to 60/40 in favor of Member X.

All of the leases provided by the JV will be full payout tax leases that are accounted for as single-investor finance leases. Most of the leases extend an early buyout right or end of term fixed priced purchase option to the lessee. In qualifying as a true lease for income

tax and commercial law purposes, the JV lessor will retain a meaningful unguaranteed residual risk in the leased property.

Neither of the members will be personally liable for any obligation of the JV and neither member is guaranteeing any results of the JV.

The JV will be structured such that all important JV matters are decided jointly by the members. Should the members fail to reach agreement on any matter, the matter will be decided through an arbitration procedure with an independent arbitrator. Member Y, however, will be designated as the managing member responsible for the day-to-day administration of the JV's portfolio of leases. Member X will be responsible for generating new business opportunities for the JV and will be primarily responsible for any credit default workouts and end-of-term re-leasing or asset sales given its familiarity with this equipment segment.

Examples of the things that are joint decisions of the members include:

- Extension of lease financing to new customers,
- Sale of lease assets for amounts that are less than the book basis of the asset,
- The incurrence of indebtedness (outside the normal course)
- Any amendment to the JV agreement or any of the underlying standard lease documents (other than minor administrative changes),
- Appointment or removal of any auditor or advisor to the JV,
- Insurance decisions,
- Decisions related to litigation (above minor amounts),
- Use of JV funds other than as prescribed under the JV agreement,
- Any bankruptcy declaration,
- Any merger, consolidation or termination of the JV,
- The creation of any encumbrances.

Under current literature, Member X and Y would account for its investment under the equity method of accounting. However, as we interpret the Exposure Draft ("ED"), the following unintended consequences were noted:

1. The nature of the JV would need to be analyzed to determine whether or not it constitutes an SPE.
2. The members would need to determine if either one has established a parent-subsidiary relationship.
3. If the JV is determined to be an SPE (or deemed to be an SPE for conservative analysis purposes) and neither member has established a parent subsidiary relationship, then each member would need to determine if it should apply the voting interests model or the variable interest model in determining whether it should apply the equity method or full consolidation in accounting for its investment.

If the response to all of the following key questions is "yes," then each member would determine the appropriate accounting for its investment based on the voting interest model. If the response to any of the following key questions is "no," then each member

would determine the appropriate accounting for its investment based on variable interest model:

1. Do both members of the JV have voting rights that convey the current ability to make decisions and manage the special-purpose entity's ("SPE") activities to the extent they are not predetermined by the establishing documents of the SPE or by contracts or other arrangements? Probably yes.
2. Is the amount of equity investment in the JV is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders? Probably yes.
3. Is the equity investment in the JV subordinate to all other equity investments and other interests for the entire life of the SPE? Is the equity investment the first interest subject to loss if the SPE's assets are not sufficient to meet its obligations and is its return not limited or guaranteed directly or indirectly by the SPE or other parties involved in the SPE? Probably no (due to the lessee's purchase rights which serve to structurally limit the venture's return).
4. Are the assets exchanged for the equity interest not subordinated to the beneficial interests in another SPE (either substantive voting equity interest or variable interests)? Yes.
5. Has the equity investment in the JV come from outside sources, that is, has it been provided from sources other than from the SPE (directly or indirectly) or from other parties with variable interests in the SPE (for example, by fees, charitable contributions, or other payments)? Yes.

Since condition 9(c) apparently has not been met, then the members would need to apply the variable interests model. The initial structuring fee may cause Member X to be designated as the initial primary beneficiary particularly if Member X conducts significant business with the third party providers relative to Member Y. However, Member Y may become the primary beneficiary later on due to the disproportionate sharing arrangement.

Example 2 – Consolidation of Indenture Trusts

Indenture trusts are a standard part of leveraged leases including leases that are accounted for as capital leases by the lessee. Indenture trustees act in a fiduciary capacity for non-recourse lenders providing funding secured by the lease and the underlying asset. The lease appears on the balance sheet of the equity investor. In the vast majority of cases, the leases are consolidated with the third party lessor using leveraged lease accounting, but they may be consolidated pro rata if the equity investor has an undivided interest in the asset, or with the lessee if the lease is a capital lease. Lenders are providing financing that is non-recourse to the lessor and earn a stated return based on the underlying credit quality of the lessee. The lender has no variable interest other than payment of earned interest and return of loan principal.

Indenture trusts serve to facilitate efficient access to capital markets and to create liquidity in secondary markets. Indenture trusts are not used to circumvent consolidation

of an SPE. The lenders record the amount of their loan participation on their balance sheet as an asset in the form of a receivable. The indenture trustee is typically a bank or a trust company acceptable to the lender and lessee with the financial wherewithal and capital to support its obligations under the transaction documents. An indenture trustee is used in these transactions to accomplish the following objectives:

- Hold the first perfected lien on the leased asset and related collateral such as the lease.
- Unify the loan interest when there are multiple debt investors and represent each of the lenders. Lenders commonly seek risk diversification by managing the amount of their exposure in any individual transaction.
- Act in an agency capacity for investors such as insurance companies and mutual funds that are prohibited under their bylaws and industry regulations from serving in such agency roles.
- Allow for the transfer of secured loan certificates without risk of loss of benefit of the first lien.

The trustee's actions are directed under the terms of the trust indenture which is a document executed between the borrower and the trustee. The lenders are not a party to the document even though the trustee under the terms of the indenture must seek direction from the lenders before taking any action or approving any request under the transaction documents. The trustee is held to a negligence standard for liability for its actions.

Example 3 – Inconsistent Application of Accounting Standards

The ED may lead to different accounting results for lessees for substantially the same lease transactions.

For deal size and portfolio concentration considerations, Lessor X decides to sponsor a legal syndication of a newly awarded leasing transaction. In taking the transaction to market, Lessor X identifies two bidding lessors, Lessor Y and Lessor Z, with competitive pricing and terms and conditions. Lessor X draws on the bidding information to offer the lessee with a lease syndication proposal in which each of the three lessors would participate as equal co-owners at the market-clearing price. A business trust will be used as the vehicle to establish co-ownership and to convey the right to use the property to the lessee. The business trust also serves to insulate the participants from liability and to facilitate subsequent transfers of interest.

In this example, each lessor qualifies as an SOE. The lease qualifies as a finance lease from the standpoint of the lessor and as an operating lease from the standpoint of the lessee. Lease classification is unaffected by the presence or absence of the business trust.

Since the lease transaction will be consummated through a separate legal entity, it would potentially come within the scope of the ED regardless of its business purpose or its otherwise neutral effect on the accounting for the lease. Further, since no one lessor has a

controlling interest, the SPE-sponsored transaction would not qualify for the substantive operating enterprise scope exclusion even though each lessor participant qualifies as an SOE.

However, if one participant were the majority owner, with, say, 51 percent participation, then it would appear that the transaction would fall outside the scope of the ED. This lessor would report the entire investment on its balance sheet when it only has a 51 percent pro rata economic interest in the risks and rewards of the leased asset.

Further, in the context of the discussion under EITF 01-8, *Determining Whether an Arrangement is a Lease*, it would appear that a different scope conclusion would be reached regardless of the different ownership interests held if the leased property were collectively owned by the syndicate members as undivided interest holders with each holder entering into a separate lease agreement with the same lessee. In that case, since a contractual arrangement is used instead of a trust to create co-ownership and to convey the right to use the property, the ED would not appear to apply.

Hence, it appears that the scope of the ED varies based on the legal arrangement per se instead of its business purpose or its effect on the accounting for the underlying arrangement. By adopting this approach, the Board would move in the opposite direction of state and federal laws that have encouraged the use of SPE for legitimate business reasons in the interest of facilitating commerce.

Based on the above analysis, we believe that the Board should not include within its scope an SPE-sponsored transaction that has a substantive, independent business purpose and that does not serve to change the accounting treatment of the sponsored transaction relative to a direct transaction. Alternatively, the Board could expand the definition of an SOE to include entities owned by SOEs and that such owning entities should continue to apply existing literature in determining how to account for their investment. Or, the Board could re-interpret EITF 00-1, *Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures*, to expand the applicability of pro rata consolidation to include any transaction sponsored through an SPE.

Example 4 – Multiple Investor Leveraged Leases

An example may be a leveraged tax lease of one leased asset with a 7-year lease term, a 20 percent residual, no lessee guarantees, with 10 mortgagors, 10 equity investors, and a third party residual guarantor (like an insurance company). All of the parties to the transaction are substantive operating entities (“SOEs”). Typically the mortgagors advance 80 percent of the asset cost, so each lender will have, at inception, 8 percent at risk and the debt fully amortizes. Typically the equity investors (owners of the leveraged lease SPE or lessors) invest 20 percent, so each investor, at inception, will be at risk for 2 percent of the asset cost, accreting over the life of the lease. In the case of both the mortgagors and the lessors, there is a lead that acts as agent for administration (billing and collecting) and will earn a fee. In order to achieve leveraged lease accounting, the

lessors often purchase residual value insurance so that the present value of the rents and residual value insurance equals or exceeds 90 percent of the fair value of the leased property.

SFAS 13, *Accounting for Leases*, and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, would support that each lessor would account for their investment as a leveraged lease. Each lessor has its own unique tax rate, tax assumptions, and a different residual assumption based on their assessment of possible future values of the leased equipment, so their multiple investment sinking fund yield and asset and deferred tax balances will be different. The mortgagors record their loans on their balance sheet. The residual value insurer collects its premium and accounts for the policy using insurance accounting.

Under the ED, the primary beneficiary, at inception is likely to be any of the parties to the transaction. Furthermore, the primary beneficiary can change merely by the passage of time as the payment of rent will amortize the debt balances.

If existing literature (i.e. SFAS 13 or SFAS 140) supports the transaction, the language in the ED should perhaps scope out lease SPEs. This will allow lenders, swap counterparties, letter of credit providers, and residual insurers to participate in lease transactions without the risk that they might have to consolidate the lease SPE.

Example 5 – Differing Primary Beneficiaries

For example, a lessee in a 12-year tax lease may have an opportunity to participate in the residual gains, by virtue of an early fixed buy-out option. Once this early buy-out option expires, the lessee has no other opportunity to share the rewards or incur the risks inherent in the estimated residual value. In this example, the lessee may be deemed to be the primary beneficiary during the first 6 years of the lease term and/or at other points in time where it is likely that the fair market value of the residual will provide the lessee with an opportunity to gain from increases in the market value of the residual value. Once the lessee purchase option expires, it may be the lessor, or the mortgagor, who is deemed to be the primary beneficiary of the asset.

A similar issue may arise in a leveraged lease where the debt amortizes during the early portion of the lease term, with the equity amortizing during the later portion. One may conclude that the mortgagor is the primary beneficiary early in the lease, transferring to the lessor during the later portion of the term – due solely to the passage of time. As a result, consolidation may change at multiple points in time over the course of a transaction. Further, since the selection of the primary beneficiary is a principles based, significant inconsistencies in practice could occur.

SFAS 13 would support that lease classification should continue to be determined at the inception of the lease. Should the asset become impaired and result in a change to the obligations of the participants, we have considerable guidance available to insure that the parties recognize and report the impairment in their respective financial statements.

each lessor would account for their investment as a leveraged lease.

Example 6 – SPE Application for Debt in a Leveraged Lease

This example is representative of the typical leveraged lease. A lessee enters into a leveraged lease of \$100 million of production equipment with a third party owner whose net investment is consolidated onto its balance sheet using leveraged lease accounting. The owner or lessor issues non-recourse notes in the amount of \$80 million directly to six investor companies. The respective investments from the six lenders are \$30 million, \$20 million, \$10 million, \$10 million, \$5 million, and \$5 million, on a pari passu basis. No one investor controls decision-making and decisions commonly require a 51% approval of loan participants.

Under the guidance of the ED, the \$30 million lender would be deemed the primary beneficiary. The ED requires that a primary beneficiary consolidate all SPEs that lack sufficient independent economic substance. The primary beneficiary is an enterprise that “provides significant financial support to an SPE and benefits from its activities by holding a majority of the variable interests in the SPE or a significant portion of the total variable interests that is significantly more than the variable interest held by any other entity.” Following the guidance in the ED, an indenture trust may require consolidation on the financial statements of the largest note issuer, as there are no equity-like risks associated with the trust. All the interests in the indenture trust are debt-like. All of the equity-like risk, however, is with the lessor. With respect to the combined structure taken in its entirety and considering all parties, it is the lessor that bears the first risk of loss. Thus, we do not believe that looking to an investor’s interests in debt-like investments as a means of identifying the party with implied control and therefore requiring an investor to consolidate an indenture trust based on such holdings fairly represents an lender’s financial position.

The same lease arrangement occurs, however, there are two loan participants with equal investments of \$40 million. Neither lender holds significantly more variable interest leading preparers to observe other variable interests, including the lessor and lessee.

The lessor consolidates the indenture trust because it has the next most significant variable interest to the extent that the lessee defaults on its obligations and the lessor can be deprived of its equity interest in the leased asset by the lenders’ first lien.

Issues that surface in connection with conclusion include:

- The lessor’s consolidation of the indenture trust subverts leveraged leasing accounting that would normally result in recognition of a net equity investment.
- The benefits of the loan supporting the lease, the use of the indenture trustee and the lessee’s obligations are unchanged from the first example but result in different consolidation conclusions

Example 7 – SPE Application in the ETC Market

A railroad or airline issues equipment trust certificates (“ETCs”) to support the acquisition of rail or aircraft assets that are afforded special protection under the U.S. bankruptcy code. By isolating ownership of these assets in a trust, the certificates obtain credit ratings that are higher than their senior unsecured debt and are able to borrow at more favorable pricing. ETCs open up an efficient and liquid part of the capital markets to these companies that are notoriously large consumers of capital. Typically, ETCs are in an amount equal to 75 to 80 percent of the fair value of the asset. ETCs are always issued in conjunction with a lease form of obligation with the asset user or lessee, but the form of the lease may be a leveraged lease in which a third party is the owner for tax purposes and the lease is normally an operating lease for the lessee, or the lease is in effect a direct borrowing of the company and is accounted for as a capital lease by the lessee. Distribution of the ETCs is normally highly dispersed since it is a security that is publicly registered or distributed under the SEC’s 144A exemption.

In the case of a capital lease, the lessee would consolidate the equipment trust since there is no single lender whose interest represents significantly more of the variable interest amongst the lenders. The lessee, however, already applies the principles of SFAS 13, suggesting a divergence in accounting application.

Example 8 – Early Buy-Out Ramifications

The ED may lead to different accounting results for lessees for substantially the same lease transactions. The following two transactions may result in different accounting treatment for the lessee, even though the terms for the lessee are identical.

Lease Transaction A

Lessor X purchases an asset and enters into a lease with Lessor Y. Lessor X is a special purpose entity, owned 100% by a substantive operating company.

The lease contains a typical early buyout option (“EBO”) where the lessee may purchase the asset prior to the end of the lease term for a fixed price, determined at lease inception to be 105% of the estimated FMV at the EBO date. The Internal Revenue Service guidelines require that there is no compulsion for the lessee to purchase the asset at the EBO date. This is ensured by comparing the EBO price to the remainder of the lease payments from the EBO date to lease end, discounted back to the EBO date using the lessee’s weighted average cost of capital. This also demonstrates that the EBO price does not represent a bargain purchase.

Accounting Analysis

Under SFAS 13, the lease is accounted for by the lessee as an operating lease. In addition, the existence of the SPE does not impact the SFAS 13 treatment, because the lessee is scoped out from being deemed the primary beneficiary of the SPE lessor, under paragraph 8c of the Proposed Interpretation.

Lease Transaction B

Lease Transaction B is identical to Lease Transaction A, except that Lessor X is owned by four different equity participants 25% each (each of which is a substantive operating entity). All decision making by Lessor X requires unanimous consent by all four equity participants. The critical actions, rights, and obligations of Lessor X are governed under the operative documents (participation agreement and lease agreement).

Accounting Analysis

Leasing transactions often involve substantial assets, which due to their high dollar value, are financed through SPEs that are set up to facilitate multiple equity participants (which are substantive operating entities) sharing in the risks for the subject lease transaction. The current accepted accounting practice is for each equity participant to consolidate its undivided interest on a prorata basis.

Under SFAS 13, the lease would still be accounted for by the lessee as an operating lease. However, the ED does not clearly scope out the lessee from being deemed the primary beneficiary of the SPE lessor, under paragraph 8c, because the SPE is owned by multiple substantive operating entities, even though they each consolidate their share of the lease.

Under the ED, the lessee could be viewed as the primary beneficiary because the existence of the EBO is viewed as a variable interest. This may be caused by future FMV variances from the original appraisal, which result in potential residual upside for the lessee. This seems to result in an amendment to SFAS 13 for lessee accounting.