

defining issues

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New Accounting for SPEs

Accounting for special-purpose entities, or SPEs, is about to be transformed to increase the number of SPEs that are consolidated by those companies whose activities are supported by the SPE. Many companies that have used SPEs are likely to bring assets and liabilities on the balance sheet with negative effects on their debt-to-equity ratios, return on assets, operating and profitability metrics, and cost of financing. This could lead to downgraded credit ratings and regulatory standing as well as debt-covenant violations. After the transformation of the accounting, SPEs likely will continue to exist and be used to the extent they represent cost-efficient financing vehicles. This edition of *Defining Issues* explains the direction of the FASB project on SPE accounting, so companies can begin to assess how it might affect them and be better prepared to adapt to the new requirements when they are issued.

An exposure draft of an Interpretation of Statement No. 94¹ is scheduled for April, with a relatively short period for public comment (30 or 40 days). The final Interpretation will be issued in August, according to current estimates. The Interpretation does not apply to those who transfer assets to SPEs that meet the criteria for Qualifying Special Purpose Entities (or QSPEs) defined in Statement 140.² QSPEs are used in financial asset securitizations such as credit-card, mortgage-loan, and auto-loan securitizations. The Interpretation's scope also excludes certain pension plans and post-employment plans.

WHAT IS AN SPE?

There is no official definition of an SPE, even though SPEs have been discussed by standard setters, the SEC, and the accounting profession since the 1980s. But some characteristics are common. For example, they typically have no independent management or employees. Administrative

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(1) SFAS No. 94, Consolidation of All Majority Owned Subsidiaries, October 1987.

(2) SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, September 2000, pars. 35-41.

“The FASB is committed to proceeding expeditiously, consistent with its mission and due process, to address any financial accounting and reporting issues that may arise as a result of Enron’s bankruptcy.”

-- Edmund L. Jenkins, FASB Chairman Testimony before the House Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, February 14, 2002.

functions are often performed by a trustee who receives and distributes cash in accordance with the terms of contracts and who serves as an intermediary between the SPE and the parties that created it. If the SPE holds financial assets, one of these parties usually services them under a servicing agreement.

A business trust is the most common legal form used to establish an SPE. However, limited partnerships, limited liability companies, and corporations are not uncommon. The choice may be determined by income-tax objectives.

Regardless of legal form, virtually all of the capital required to fund the activities of an SPE comes from borrowings – owners of the equity seldom provide more than three percent of an SPE’s capitalization. The activities of most SPEs are limited to those specifically addressed in its trust agreement, charter, or articles of formation, although there is no requirement that they be so limited. SPEs have no other purpose than the transaction for which they were created.

The FASB’s Interpretation will not define an SPE, but will instead present indicators that identify an SPE for accounting purposes. The following indicators are under consideration:

- There is an identifiable “primary beneficiary,” and the activities of the SPE support the activities of the primary beneficiary.
- The entity’s activities and business purpose are limited by a charter or other documentation of similar standing.
- Its decision-making powers are either limited or non-existent.
- The SPE generally would not meet the definition of a business, which would be self-sustaining and include revenue sources.³

COMMON USES OF SPEs

Often these structures are used to finance specific assets or a revolving asset base transferred to the SPE. The transfer of trade receivables, loans, or investment securities to the SPE would generally be followed by the SPE’s issuance of debt to investors secured by the transferred assets. The borrower/transferor gains access to a source of funds less expensive than would otherwise be available. This advantage derives from isolating the assets in an entity prohibited from undertaking any other business activity or taking on any additional debt, thereby creating a better security interest in the assets for the lender/investor. SPE financing structures issue many forms of asset-backed securities, including collateralized bond, debt, and loan obligations; and trade receivable commercial paper conduits.

An SPE might be the lessor of a property built for the specific needs of an identified lessee, such as a power plant or a production facility. These transactions are often referred to as synthetic leases and provide tax-advantaged financing lower than traditional mortgage loans. Another form of tax-advantaged SPE transaction is the sale to an SPE of an asset that qualifies as a financing under tax regulations, with any gain on sale deferred for tax purposes. These are known as debt-for-tax transactions.

We believe SPEs will continue to be used as described above after the Interpretation is in place whenever companies find it cost-effective to do so.

A NEW CONCEPT: SUFFICIENT INDEPENDENT ECONOMIC SUBSTANCE

The FASB met on February 27 and explained its new approach to accounting for SPEs. The approach is designed to require consolidation of non-substantive entities by the primary beneficiary of the SPE’s activities. Substantive entities — those with sufficient independent economic substance — would not be

(3) EITF Issue 98-3, Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business, January 20, 2000.

consolidated with the primary beneficiary whose activities are supported by the SPE.

The new approach will be an extension of the existing control model for consolidation, but the FASB recognizes that control in the traditional sense is not relevant to SPEs because of the characteristics of an SPE, such as the limited nature of the activities, nominal equity, and general absence of business operations. The FASB's concept of control for SPEs stems from this economic assumption: The entity that bears most of the risks and enjoys most of the rewards of the SPE has the economic compulsion to control the SPE and, therefore, should consolidate the SPE.

The FASB's approach would require the primary beneficiary of an SPE to consolidate it unless the SPE has independent economic substance sufficient not to be consolidated. Sufficient independent economic substance would be demonstrated if the SPE meets these criteria:

- Can the SPE, based solely on its own financial standing, fund or finance its operations, without the support of the primary beneficiary?
- Are the owners of the SPE independent of the primary beneficiary?

CURRENT CONSOLIDATION REQUIREMENTS

The focus of current SPE consolidation guidance has been on whether the SPE is a substantive third-party entity with owners other than the parties to the transaction for which the SPE serves as an intermediary. Under this approach, the substance of an SPE is demonstrated if the owners:

- Make a substantive investment in the residual equity capital of the SPE,
- Control the SPE, and
- Bear the risks and rewards of ownership relating to the assets of the SPE.

Most SPEs that are not OSPEs have achieved "substantive entity" status by issuing to their "owners of record" securities that are considered to be equity in legal form and that represent at least three percent of the SPE's capital. In practice, certificates of beneficial interest issued by a trust have been considered equity for the residual equity capital test, even though such certificates usually have economic characteristics more akin to subordinated debt. Although the owners control the activities of the SPE in a strict legal sense, that control typically is delegated to a manager or trustee whose duties consist of making sure the parties transacting with the SPE abide by the terms of their contracts. Although the owners of the equity investment are at risk relative to the SPE's assets, in substance that risk is confined to credit risk relating to commitments or guarantees of the entity. In practice, this has not resulted in the owners absorbing the first dollar of losses.

- Do the owners bear the risks and rewards of ownership of the SPE?
- Do the owners have substantive residual equity at risk?
- Are any management decisions, other than what is predetermined under the formation documents, made by the owners?

We believe that the underlying principle in the sufficient-independent-economic-substance test is the first criterion above—that is, whether the entity can obtain independent financing with its equity structure and formation documents.

THE PRIMARY BENEFICIARY

The FASB is introducing the concept of a "primary beneficiary" into the SPE consolidation decision. No set of specific characteristics is available at this time to differentiate the "primary beneficiary" from other parties to SPE transactions other than what is implied by the term. The primary beneficiary is the party that has the principal portion of

the risks and rewards from an SPE's activities, the party whose investment is thereby exposed to significant variability of return from those activities. The FASB stated that an SPE can have only one primary beneficiary.

The primary beneficiary might be the party that transferred assets (such as trade receivables) to the SPE or the party that created the SPE (the sponsor, often a financial institution), or the party that directs investment decisions according to the legal documents. However, the lender to the SPE is unlikely to meet the definition of the primary beneficiary.

The FASB has indicated that the variability of return, meaning amounts at risk, not necessarily return on investment, will be the determining factor. Questions remain about what impact, if any, hedging activities and derivatives held by the SPE should have on the identification of the primary beneficiary. One theory is that the party that bears substantially all the risks presumably is in line to obtain proportionate rewards.

The primary beneficiary may prove the most difficult concept to understand and put into practice. The difficulty is clear in the case of SPEs established for more than one party, for example, multiple-seller trade receivable conduits. The FASB intends to discuss multiple seller and multiple lease arrangements before the Interpretation is exposed for comment.

SUBSTANTIVE EQUITY INVESTMENT AT RISK

The characteristics of substantive equity at risk under the FASB's current approach are not very different from existing requirements.⁴ The majority owner's investment must be legal form equity, that is, it must not be a debt instrument, such as loan or a note. In addition, the rights of the equity holder must be subordinate to all debt issued by the SPE and must represent the residual cash flows from the arrangement. The equity cannot be financed with non-recourse debt, nor can it be financed with recourse debt if no other assets or operations give substance to the recourse provisions. In addition, the equity cannot be funded from an investment in another SPE or from contributions from a charitable trust.

The FASB does, however, plan to change the threshold for what constitutes a third party's substantive residual equity investment in an SPE. If the residual equity investment is less than three percent of the SPE's total capital, the SPE must be consolidated under current practice, but the FASB has said that in no case would equity less than ten percent be considered substantive. The ten percent equity criterion is a floor, not a ceiling. In fact, the amount of equity at risk would increase beyond the floor amount if the entity is unable to meet the overriding principle

of sufficient independent economic substance — the ability to obtain independent financing. This change alone would increase the number of SPEs that would be consolidated. Structures unconsolidated under the new rules would likely incur significantly higher financing costs for asset transfers or lease arrangements, because the returns paid to the equity investor are higher than the returns paid to debt investors. Some structures will cease to be cost-effective methods to create off-balance sheet financing.

The FASB has said that the ten-percent criterion, like the current three-percent requirement, will apply to the capital levels throughout the life of the SPE. In addition, the minimum equity amount in many cases will need to be higher than the floor amount to compensate for any fees or dividends anticipated to be paid to the equity holders. Such payments by the SPE are considered a return of equity to the investor and can reduce the equity below the ten-percent level. Similarly, if an equity investor holds debt issued by the SPE, loan-commitment fees and other fees paid to an equity participant that is also a debt participant are considered a return of equity, which can cause the equity to drop below the ten-percent level.

RISK AND REWARDS OF OWNERSHIP

Under the planned Interpretation, if the equity owner is not at risk for the first dollar of loss (i.e., not obligated to pay for the loss), the entity does not have sufficient independent economic substance, and the primary beneficiary would be required to consolidate the SPE. An SPE's third-party owner's residual equity investment at risk could not be reduced by the primary beneficiary or its affiliates and still be considered substantive. Hedging transactions, credit enhancements, guarantees that exist to absorb losses before the owners are at risk, total return swaps, and other agreements that mitigate the residual risks to the equity investor that are provided by the primary beneficiary would free the owner from paying for the first dollar of losses. The concept of first dollar loss would be a very significant change from current practice. Many existing SPEs would probably be consolidated under the requirement.

(4) EITF Issue 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, July 11, 1991; EITF Issue 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities*, September 19, 1996.

Conditions that directly or indirectly cap the rewards to the equity owners could also qualify an SPE for consolidation. For example, returns to the equity investor could not be based on predetermined cash flows, also known as preferred returns. The equity owners could not give up to the primary beneficiary the rights to receive most, if any, benefits under the transaction, such as future appreciation in property owned by the SPE subject to an operating lease. However, the effect of a primary beneficiary's entry into servicing arrangements with the SPE in connection with trade receivables or loans transferred to an SPE is currently unclear.

The concept of exposure to first dollar loss would have a significant effect on SPE leasing transactions. In these transactions, the equity owner/lessor is typically exposed to the last 10% of loss due to a decline in property value, because the lessee has provided a first loss residual value guarantee. If the risk-sharing arrangement is changed to make financial institutions bear the first dollar of loss, they would be less willing to participate in the transactions. Financial institutions underwrite such deals today primarily based on the credit quality of the lessee, not the property-value risk. Their pricing would be greatly affected by removing the lessee-provided residual-value guarantees. Changes in risk-sharing arrangements could lead synthetic lease-

ACCOUNTING AND DISCLOSURES BY GUARANTORS

The Interpretation discussed in this *Defining Issues* is not the only FASB project that will affect SPE accounting. The new project on guarantees will affect all transactions with guarantees, including SPE transactions. The new project's scope is recognition, measurement, and disclosure by issuers of guarantees, specifically including guarantees of others' debt. The FASB believes guarantees impose these obligations on the guarantor:

- An obligation to *stand ready to perform* during the term of the guarantee in the event a specified triggering event occurs, and
- A contingent obligation to make a future payment if the triggering event occurs.

The FASB is not entertaining any changes in accounting for the contingency. However, the Board has agreed that the obligation to *stand ready to perform* is in itself a liability, separate from the contingency and that should be recognized at fair value when initially granted ("day one" accounting). No guidance is expected on the subsequent accounting for that obligation, so some diversity in practice can be anticipated. If this liability is significant, the company would have to disclose the accounting policy.

The FASB is considering disclosure requirements that would be applicable even if is not probable that the guarantor would need to make any payments. The disclosure requirements would include:

- The nature of the guarantee, that is, how the guarantee arose and what events trigger the guarantor's performance;
- The maximum potential loss, meaning the excess of any future cash payments over the current amount of the liability for the obligation; and
- Any provisions that provide recourse allowing the guarantor to recover either from third parties or from collateral amounts paid under the guarantee.

ing structures to migrate from SPE/lessors to leasing-company subsidiaries of financial institutions. These subsidiaries often have higher regulatory capital requirements that could drive up the cost of the financing.

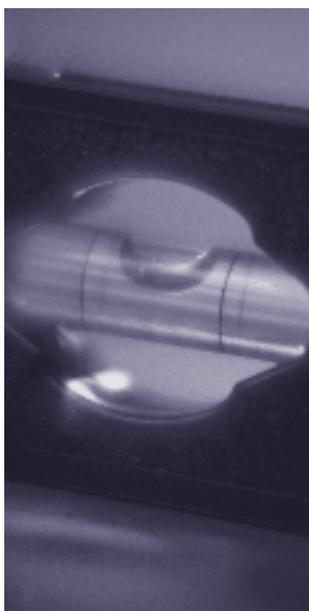
RELATED PARTIES

The Interpretation would require companies to identify related parties, and an identified related party would be considered one and the same as the primary beneficiary. This concept would be another significant change to current practice. In addition to related parties identified using the criteria in Statement No. 57,⁵ parties would be considered related for purposes of the Interpretation if they:

- Cannot sell or transfer the beneficial interest issued by the SPE without the approval of the primary beneficiary,
- Require the financial support of the primary beneficiary,
- Are a not-for-profit party that received its interest in the SPE as a contribution from the primary beneficiary, or
- Have a close relationship with the primary beneficiary from providing professional services to the primary beneficiary.

The potential impact of the last bullet related to professional services is not clear, but it is expected to significantly expand the definition of parties related to the primary beneficiary.

(5) SFAS No. 57, Related Party Disclosures, March 1982.



DISPLAY

The FASB has not reached firm decisions on the display of SPE equity in the consolidated financial statements of the primary beneficiary. As currently envisioned, the primary beneficiary who consolidates an SPE would display any nonsubstantive equity of the SPE as a liability. Equity that is genuinely at risk, but beneath the ten percent floor, would be displayed as minority interest.

TRANSITION

According to the FASB's current position, companies will have to apply the new rules to existing SPEs, as well as to SPEs formed after the Interpretation is released, but the FASB is expected to allow companies a period of time, until December 31, 2002, to bring existing SPEs in compliance with the new requirements. The FASB has said they will not require prior year balance sheets and income statements to be restated. Consolidation of SPEs will be effective for fiscal years beginning after December 15, 2002. Therefore, a calendar year company would consolidate the SPEs that do not meet the sufficient independent economic substance requirements as of January 1, 2003.

Many companies' financial reports are likely to be affected by the new rules. Upon consolidation, financial assets and liabilities would be brought on the books of the primary beneficiary at the then fair value, with any difference between the assets and liabilities recorded as a cumulative adjustment to the income statement (i.e., below continuing operations). Earnings from the assets and cost of funds on the debt would be reflected in the income statement going forward. Nonfinancial assets such as real estate would be recorded at historical cost upon consolidation. For example, if a corporate headquarters building financed under a synthetic lease is required to be put on the balance sheet, the company will have to gross up the balance sheet for the asset, net of accumulated depreciation, and the debt at its amortized amount, and recognize any net difference in the cumulative effect adjustment. The income statement going forward would not reflect the rent expense. Instead the company will record depreciation expense for the building and interest expense on the debt



The transformation of SPE accounting is not just a change in accounting policy. We expect it will be very difficult for existing SPEs to be restructured in order to meet the sufficient independent economic substance criteria. To the extent it prompts companies to revise structures used for many years as efficient sources of financing and removes alternative funding vehicles, capital costs will increase. Investors will be looking for indications of these increased costs in the months to come. *Defining Issues* will continue to follow the SPE project and report significant changes.

The observations in this text are based on attendance at FASB meetings by KPMG representatives. Persons planning to adapt their accounting or SPE structures should consult with their accounting and legal advisors.
Additional information on SPE accounting is available from your local KPMG representative or office.

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