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Through the SPE Looking Glass: Improving the Transparency of Special Purpose Entities

If there is one positive outcome from the recent Enron bankruptcy, it may be in the form of a stark reminder to regulators and enterprises that a lack of transparency in financial reporting imposes risk on investors and capital markets. Complex and voluminous accounting standards further complicate financial reporting. One specific area of complexity, risk and recent focus in the accounting arena is the use of special purpose entities (SPEs).

What is an SPE?

A special purpose entity, or SPE, is an entity created solely to carry out an activity or series of transactions directly related to a specific purpose. An SPE may take the legal form of a corporation, a partnership, a limited liability company, or even a trust. Typically, an SPE is created for one purpose, usually with little or no other activity and usually benefiting only one company. Often, an SPE is used to raise debt more efficiently or to manage a company's balance sheet. Examples of transactions that may involve SPEs include: financing arrangements; leasing arrangements; and sale/transfer of assets to an SPE that issues debt obligations or equity supported by the transferred assets. Specifically as it relates to financing arrangements, an SPE would serve as a vehicle whereby an entity, the sponsor, sells assets in exchange for cash or other assets. The funding for the SPE's purchase would come primarily from the SPE issuing debt or equity to third-party lenders or investors collateralized by the financial assets. Another common arrangement is one in which a company utilizes an SPE in relation to its headquarters or location leases. In these situations, a company would continue to use the asset while removing the debt and related real estate asset from the company's books via the SPE.

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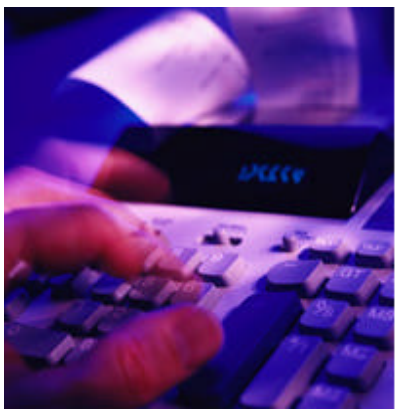

What are the Advantages of Using an SPE?

There are several advantages to using SPEs. One advantage is the ability to moderate risk by transferring the economic risks and rewards of assets to a non-consolidated third party, while retaining use of the assets. An additional advantage of an SPE is that often an SPE can create tax advantages for the transferor. As a pass-through entity, an SPE is typically not taxed at the entity level. Given the typical size of SPE transactions, the tax deductions are likely to outweigh any maintenance costs associated with the upkeep of the SPE. Lastly, when properly structured, an SPE often reduces credit risk or other risks for lenders or investors and may lower financing costs.

These advantages, and non-consolidation, come only upon meeting all of the following criteria:

1. A third-party owner independent of the sponsor has a sufficient equity investment in the SPE;
2. The independent third-party owner investment is substantive (that is, the third-party owns at least 3 percent of the SPE's total debt and equity or total assets);
3. The independent third-party owner has a controlling financial interest in the SPE (that is, the owner holds more than 50 percent of the voting interest of the SPE); and
4. The independent third-party owner possesses the substantive risks and rewards of its investment in the SPE (that is, the owner's investment and potential return are "at risk" and not guaranteed by the transferring organization).

While these criteria appear to be straightforward, the consideration given to each is often complicated as the initial agreements may be extensive. Additionally, in many situations side agreements may arise. The identification of the critical elements is essential. Further, the assessment of the elements in relation to the criteria is a matter of significant judgment. As noted in the press recently, applying judgment in these cases may often be difficult.

Non-consolidation is not appropriate by the sponsor when the independent owner makes only a nominal investment, the activities of the SPE are virtually all performed on the sponsor's behalf, or the risks and rewards of the assets of the SPE rest directly or indirectly with the sponsor. Although a sponsor of an SPE that meets all of the above conditions (items 1 - 4) generally is not required to consolidate the assets and liabilities of the SPE in its financial statements, the sponsor is required either to recognize in its financial statements, or to disclose in the footnotes to its financial statements, the obligations that may arise from its transactions and relationship with the SPE. Whether or not these obligations must be recognized in the financial statements or disclosed in the footnotes depends on the terms of the arrangement and the extent to which payment is probable.

Why the Increased Focus on SPEs?

The recent focus on SPEs has been driven by the alleged inappropriate use of SPEs by Enron and others to keep substantial debt off their balance sheets and avoid recognizing losses or expenses in their income statements. The rekindled debate around the use of SPEs is projected to have accounting implications to companies that utilize such vehicles for any purpose currently and in the future.

How Did We Get Where We Are?

The Securities and Exchange Commission (SEC) has been grappling with the authoritative accounting literature surrounding SPEs for several years. During the late 1980s and early 1990s, when the use of SPEs began to increase, the SEC Staff reiterated that for non-consolidation by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE (in practice, a substantial investment has been held to be at least 3 percent of the assets transferred to the special-purpose entity), has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE.

Further, the SEC indicated that the insertion of a nominally capitalized SPE should not change the accounting for a transaction. In response to these concerns raised by the SEC Staff and the issuance of multiple consensuses by the Emerging Issues Task Force, the Financial Accounting Standards Board (FASB) attempted to address the consolidation issues surrounding SPEs in its consolidation project. In 1995 and 1999, the FASB issued exposure drafts addressing consolidation policy. Both drafts were controversial in that they addressed many difficult considerations extending beyond SPEs. Also, there was much pressure on the FASB not to make any changes to the accounting for SPEs which resulted in no new guidance being issued for SPEs. After a number of attempts, the FASB was unable to issue any new standard on consolidation policy. The FASB formally suspended work on their consolidation policy project in January 2001.

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What Next? Full Disclosure and Reform

The final word on SPEs is still unclear as regulators, the accounting community and capital markets continue to absorb the fallout from increased scrutiny. What is clear is a movement toward increased emphasis on accountability and the quality of information provided by public companies to investors. Scantily described transactions, particularly those involving SPEs, will not be tolerated. Observations have been made that certain companies with SPEs have not historically provided sufficiently informative disclosures to support the accounting treatment taken. As SPEs typically involve very complicated transactions, it is imperative that they are described adequately so as not to be misleading to investors.

The SEC has already begun efforts to enhance the disclosures required in financial statements. In recent guidance, the SEC indicated that the extent of a registrant's reliance on off-balance sheet arrangements (which includes SPEs) should be described fully and clearly where those arrangements provide financing, liquidity or market or credit risk support for the registrant; engage in leasing, hedging or research and development services with the registrant; or expose the registrant to liability that is not reflected on the face of the financial statements. Further, registrants should consider the need to include information about the off-balance sheet arrangements such as their business purpose, their economic substance, the key terms and conditions of any commitments and the registrant's potential risk exposure resulting from such arrangements. Lastly, these disclosures should be clear and individually tailored and should not consist merely of recitation of the transaction's legal terms.

The SEC is also looking into various mechanisms for making company management more responsive to the public's expectations and interests. A two-fold approach is under consideration whereby company officers and directors would be provided with a clear understanding of their fiduciary obligations, and the consequences for not living up to them. In addition, there is an increased emphasis on the role of audit committees. Given the complexity of SPE transactions, combined with the current state of the authoritative literature in this area, it is imperative that management utilizing such vehicles, and audit committees overseeing such transactions, be thoroughly educated.

The SEC is also exploring ways to encourage the accounting profession to live up to its mandate in order to provide the investing public with confidence that a company's financial statements

are reliable and truthfully prepared. In today's environment, accounting standards are often cumbersome and new guidance is issued at a relatively fast pace. In addition, guidance is issued via various mediums and, as is the case with SPEs, there is often not one overriding standard. Company management and auditors must carefully take this into consideration and perform diligent and appropriate procedures and analyses related to SPE transactions. The decision to consolidate or not consolidate may result in vastly different accounting consequences. Additional reform in the standard-setting arena appears likely as the SEC is seeking to move to a principles-based set of accounting standards. The SEC also is looking to have greater influence over the FASB's agenda, including the timeframe for completing projects.

Specifically in relation to SPEs, significant changes are on the horizon. In response to pressure from legislators and regulators, the FASB has been working expeditiously on a new interpretation of the long existing consolidation standards. The FASB's efforts are expected to be focused on resolving the following issues related to consolidation of SPEs: (1) so-called straw man situations (for example, situations in which control of an entity is indirect and perhaps disguised through holdings of an entity's agents, management or other related parties), (2) entities that lack sufficient independent economic substance, (3) convertible instruments and other contractual arrangements that involve latent control, and (4) the distinction between participating rights and protective rights of various shareholders, partners and other investors in an entity. Based on recent FASB meetings to date, it appears that currently the FASB is contemplating an approach to SPEs that would increase the required 3 percent third-party owner investment to 10 percent. Further, in order to qualify for non-consolidation, the FASB is re-emphasizing that equity investors would have to be independent — that is, not a related party of the firm or company that is establishing the SPE.

Conclusion

Overall, regulatory authorities recognize the significant benefits of utilizing SPEs for legitimate activities like securitization, managing risk and tax management. However, they also recognize the need for more stringent authoritative accounting and disclosure guidance on SPE consolidation that increases the transparency of these often complex transactions. The enhanced disclosures and increased accountability currently under consideration may mitigate the concern of investors and regulators and lead to greater stability in the capital markets. The timeline for change is uncertain, however, it appears that it will be a fast-moving pace relative to other standard setting.