Deloitte & Touche

HEADS UP™

ACCOUNTING, TAX AND REGULATORY DEVELOPMENTS AFFECTING CAPITAL MARKETS INSTRUMENTS AND STRATEGIES

In This Issue

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- FASB's Consolidation Proposal
- Questions & Answers

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SPE – ED Reading?

FASB's Consolidation Proposal

Characterizing current guidance as "fragmented and incomplete," FASB has issued its anxiously awaited exposure draft, *Consolidation of Certain Special Purpose Entities*.[1] If adopted, the proposal will overhaul today's rules and expand SPE consolidation by companies involved in certain securitization and lease deals. But the exposure draft's reach is much broader – participants in SPEs devoted to research and development, inventory financing, mineral exploitation, reinsurance and a range of other activities face the possibility of consolidating certain vehicles.

The question on the table is when a company's involvement with an SPE requires it to include the vehicle's assets and liabilities in its consolidated US GAAP financial statements. Potential parents include entities that sell assets to the vehicle, lessees, lenders, investors, transaction sponsors, bankers, credit enhancers, etc.

Here's the plan. The new rules will apply immediately to SPEs created after the date that FASB issues a final Interpretation (slated for near year-end). **SPEs created before that date will become subject to the Interpretation as of the beginning of the first interim or annual period after March 15, 2003. In other words, apply the new rules typically as of April 1, 2003 with NO grandfathering.**

Highlights of the proposal are listed below (as is our custom, we've relegated the details to an Attachment).

- While only one substantive operating enterprise can consolidate an SPE, there is **no requirement that every SPE have an accounting parent**. Some SPEs will not be consolidated by any entity.
- **The ED affirms FAS 140's approach to QSPE non-consolidation** - A financial asset transferor cannot consolidate a QSPE. Remember, this rule applies only to a transferor. Any other consolidation prohibitions? Yes, employers don't consolidate employee benefit plans covered by FAS 87, 106 or 112.

[1] *The document takes the form of an interpretation (versus a Statement of Financial Accounting Standards) of Accounting Research Bulletin No. 51, Consolidated Financial Statements*

- A seller of financial assets to a **multi-seller conduit** (e.g. asset backed commercial paper conduits) needs to evaluate all of its transactions. How? If its rights and obligations are restricted to an **identifiable silo of assets** within a single legal SPE (e.g. the conduit), the seller should evaluate the silo as a separate SPE for accounting purposes.
- An SPE administrator (e.g. a bank that manages a conduit) will have to disclose the purpose of the SPE and its assets and liabilities (unless the administrator must consolidate the SPE).
- **Some well-capitalized SPEs are not subject to the consolidation provisions of the proposed interpretation**. Instead, conventional consolidation rules apply (the parent is the entity that holds a controlling financial interest, typically demonstrated by having a voting majority of the equity class). To avoid the fallout from the provisions of the ED, the SPE equity class must meet five specific criteria. **To justify equity levels that are less than 10% of total assets**, participants must identify comparable equity levels at operating companies that are similar to the SPE. Equity levels that equal or exceed 10% must also be justified, but an expected loss scenario, rather than comparables, provides acceptable evidence.
- When the SPE is not well capitalized (see previous point), the "**primary beneficiary**" of an SPE consolidates it. The primary beneficiary generally is the single substantive operating enterprise (including affiliates and "de facto" affiliates) whose holding of variable interests constitutes:
  - A majority of the total variable interests in the SPE, or
  - The largest minority of the variable interests that is both (1) a significant portion of the total **and** (2) significantly larger than the second largest holder.
- The ED introduces a new category of SPEs (we're calling them Financial SPEs or FSPEs) and special rules apply. FSPEs differ from QSPEs under FAS 140 because (1) FSPEs can buy, originate and sell financial assets (QSPEs have more limited powers) but (2) they cannot buy equity securities. For financial SPEs, a primary beneficiary exists when a single entity meets two out of the following three tests (see Attachment, Question III-5 for the precise wording of the tests):
  1. It has significant discretion over the purchase and sale of assets,
  2. It provides liquidity, credit or other asset support **(including owning a subordinated class)**.
  3. It earns fees that are not "market-based"

FASB is characterizing the ED as fast track. Comments are due by August 30, 2002. Download the ED from FASB's website at www.fasb.org.

[Editor's Note: Deloitte & Touche Partner Jim Mountain greatly contributed to this edition of Heads Up]

ATTACHMENT

Attachment 1: Questions & Answers – Consolidation of Certain Special Purpose Entities

Table of Contents

I. Overview

II. SPE Consolidation - General (Consolidation Based on Variable Interests)
1. Why are special consolidation rules for SPEs needed?
2. What is an SPE?
3. What are *variable interests?*
4. What are *market-based fees*?
5. When are fees for services considered a variable interest?
6. Who is the primary beneficiary?
7. How do I determine the size of a variable interest if the SPE has issued various classes of interests with different risk exposures?
8. What happens if unrelated holders of the two largest variable interests have similarly sized expected losses?
9. How are "related parties" handled for purposes of determining a primary beneficiary?
10. Assume that I conclude that I am not the primary beneficiary based on an analysis of the data on the date I buy my variable interest. Need I repeat the analysis later?

III. Certain SPEs that Hold Financial Assets
1. Why does the ED propose special rules for these SPEs?
2. Can I presume that an SPE that holds only financial assets is an FSPE?
3. What does it take for an SPE to be an FSPE?
4. This is getting pretty confusing. How do I sort it out?
5. Who is the primary beneficiary of an FSPE?

IV. Multi-Seller Conduits
1. How about some background?
2. How does the ED affect current accounting?
3. When would a bank sponsor/administrator consolidate a multi-seller conduit?

V. SPEs with Adequate Voting Equity
1. What are the implications if an SPE has adequate voting equity?
2. What characteristics indicate that the equity is adequate?
3. Question I-2 indicates that a substantive operating entity must have *sufficient equity to finance its operations without support from any other enterprise or entity except its owners*. Does that mean that a substantive operating entity can become an SPE *subject to the interpretation* if losses reduce the equity below a "sufficient level"?
4. For purposes of criterion 2 (see Question V-2), is 10% a safe harbor? In other words, can I presume that equity levels at or above this amount are adequate?
5. Must the "Equity" be equity in legal form?
6. During a quarter, the expected loss profile of the SPE dramatically increases. Expected losses now exceed levels required by criterion 2 (Question V-2). What's the consequence of the change?

VI. SPE-like Entities that Are Consolidated by a Substantive Entity
1. I participate in an SPE that is consolidated by another substantive operating entity. How do I apply the proposed interpretation?
2. The answer to Question VI-1 is counter-intuitive. What explains this outcome?

VII. Transition and Disclosure
1. What is the proposed effective date?
2. What disclosures should be made?

ATTACHMENT

I. Overview

The table below highlights the key consolidation outcomes for various situations involving SPEs. The left-most column cross-references to subsequent sections of the Attachment that provide the details.

Situation	Description	Which Participant is Exempt from Consolidation?	Which Participant Should Consolidate?
II **SPEs** not otherwise identified in this table		Generally none. All participants are candidates for consolidation.	The participant, known as the **primary beneficiary**, because of its relative holdings of **variable interests**.
III **QSPEs**	Holds only financial assets transferred to it, is subject to limitations on its activities and is restricted from selling assets under most circumstances.	A transferor to a QSPE does not consolidate per FAS 140.	Non-transferor participants evaluate for consolidation under FSPE guidance (usually) or SPE guidance.
III **FSPEs**	Similar to QSPEs except that (1) an FSPE cannot buy equity securities and (2) an FSPE has more latitude in buying, originating and selling financial assets.	Any participant who fails to meet at least two of three specified conditions.	A single entity that meets two of three specified conditions.
IV **Silos** in multi-seller SPEs	A silo is a virtual SPE consisting of certain specifically identified assets and allocated SPE liabilities.	No unique provisions, depends on whether the silo is a QSPE, FSPE or a "regular SPE".	Same.
V SPEs with **adequate voting equity**	An SPE with a voting equity class (presumed to be at least 10%) that also meets other conditions.	Any participant who does not hold an interest in the voting equity class.	Any holder with a controlling voting interest in the equity class.
VI SPEs that are consolidated by a substantive entity		Any participant in the SPE other than the substantive parent.	The substantive parent.

II. SPE Consolidation - General (Consolidation Based on Variable Interests)

1. Why are special consolidation rules for SPEs needed?

Traditionally, GAAP characterizes the accounting parent as the entity that has a controlling financial interest (usually discerned by voting rights) in a subsidiary. But SPEs complicate the analysis; often the SPE might not issue voting interests and, even when it does, there might be nothing of significance on which to vote. Why? All major decisions are usually preprogrammed in the documents that created the SPE.

2. What is an SPE?

FASB divides the universe of entities into two groups – SPEs and *substantive operating entities.* A substantive operating entity conducts business operations apart from those performed for it by an SPE, has employees, and **has sufficient equity to finance its operations without support from any other enterprise or entity except its owners**.[2] Usually, it issues its own financial statements. SPEs are simply everything else.

3. What are *variable interests?*

The magnitude of a holder's variable interests in an SPE determines whether it is the vehicle's primary beneficiary. For most SPEs covered by the proposed interpretation, the primary beneficiary is the accounting parent. Simply put, variable interests are the means by which an entity participates financially in the activities of an SPE. They may be represented by loans, guarantees, residual interests, management or service contracts (see Question II-4), leases, derivatives, asset purchase options or obligations, referral arrangements or other contractual arrangements or by ownership interests such as preferred stock or limited partnership interests.

As a general rule, the greater the loss potential of a particular variable interest, the more it contributes to a conclusion that its holder is a primary beneficiary. See Question II-7.

4. What are *market-based fees?*

Some participants in an SPE provide services to the SPE in exchange for a fee.[3] They may or may not hold other types of interests (e.g. a collateral manager in a CDO transaction that receives a fee for managing the collateral and also invests in the CDO's preference shares). A fee is market-based if it is negotiated at arm's length under competitive conditions. The corollary? Presume a fee is not market-based unless it can be demonstrated to be comparable to fees in similar observable arm's length transactions or arrangements.[4]

[2] *Self-sufficiency is the foundation on which the proposed interpretation rests. If an SPE has inadequate equity to support itself, it is presumed that another participant(s) provides that support by virtue of holding variable interests. FASB assumes that this party (parties) has established a controlling financial interest by having taken steps to prevent the SPE from acting in a manner detrimental to those interests.*

[3] *Fees need not be payable in cash. They also include SPE interests that the service provider acquires at no cost or at a favorable price.*

[4] *During its deliberations, FASB indicated that a fee might be market-based if other participants could terminate the service provider at will and without cause. The ED does not include this provision.*

ATTACHMENT

5. When are fees for services considered a variable interest?

Sometimes the service provider must include the expected fees as a variable interest (along with any other variable interests it holds) in order to determine whether it is the primary beneficiary. **A fee that is not market-based is a variable interest**.

Even market-based fees can be variable interests. A market-based fee is a variable interest if the service provider (1) has an SPE investment at risk, (2) can be compelled to transfer assets or to issue securities to the SPE or to a party with an interest in an SPE or (3) has made a significant incremental investment in its own business to earn the fee (for interests that are variable).

Example 1. Mortgage Mania purchases the rights to service mortgages underlying a private label residential mortgage backed security issued by an SPE. Even though the mortgage servicing fee and services required are consistent with the fees for other private-label MBS (thus they are market-based), the fees constitute a variable interest. Why? Because Mortgage Mania has an investment at risk – the price it paid for the servicing rights.

6. Who is the primary beneficiary?

It's an important question. The primary beneficiary of an SPE is the enterprise that is the accounting parent and thus consolidates the vehicle (but see sections III and V for other circumstances).

FASB views the primary beneficiary as akin to the party that has a traditional controlling financial interest in the SPE. Only one enterprise can be a primary beneficiary of a particular SPE and, in some cases, an SPE may have no primary beneficiary. Generally, the primary beneficiary is the entity that either:

- Has a majority of the total variable interests, or
- Has the largest minority variable interest that is both significant to the overall total and is significantly larger than the holder of the second largest variable interest.

For financial SPEs (see Question III-5), special rules apply.

Example 2. An SPE issues two classes of interests: a senior bond class and a subordinated bond class. The subordinated bond class will absorb all of the credit and other market losses the vehicle expects to incur over its life. Assume the SPE is neither a QSPE nor an FSPE.

Trust Co. owns 1/3 of the subordinated bond class. Two substantive investors unrelated to Trust Co. own the remaining subordinated bonds. Trust Co. does not consolidate the SPE. While Trust Co. owns a variable interest that is significant to the total interests, it is not significantly larger than the holding of any other single investor.

Example 2a. Start with the same facts as in the previous example. During the first quarter, the other two subordinated investors each sell 50% of their bonds to different investors. At the end of the quarter, Trust Co.'s. 33% variable interest is significant to the total and is now larger than the second largest holding (16.67% = 33.3%/2). Trust Co. must now (as it must at the end of every accounting period) reevaluate whether it is the SPE's primary beneficiary.

7. How do I determine the size of a variable interest if the SPE has issued various classes of interests with different risk exposures?

A participant should evaluate the size of each holder's variable interest based on its relative **probability weighted expected loss**, excluding gains. We think this means that a variable interest holder needs to identify future scenarios under which any of the variable interests would have a negative internal rate of return over its life.

To evaluate each variable interest, a participant assigns to each scenario an estimated probability of occurrence and the absolute dollar amount of loss. Some scenarios might result in a gain for some variable interests and a loss for others – only those scenarios with a loss are considered for a particular variable interest.

Example 3. Interested Investor and Prince Pal are the two participants in an SPE that buys a $100, 9-year bullet bond bearing an 8% coupon (all amounts in the example are for illustrative purposes only). The issuer of the SPE's bond has the right to prepay it, at par, any time during the bond's term. Assume that the SPE is neither a QSPE nor an FSPE (see Section III).

Each participant paid $50 for its interest in the SPE. The interests entitle each investor, respectively, to the interest-only and principal-only cash flows from the bond. The following table shows the probability weighted expected loss of both investors' interests according to four scenarios:

	Interested Investor		Prince Pal	
Scenario – *Probability*	*Cash Realized*	*Weighted Loss*	*Cash Realized*	*Weighted Loss*
Full Contract Term – 40%	$72	-	$100	-
Prepay after 5 Yrs. – 30%	$40	$3.00	$100	-
Default after 7 Yrs. – 20%	$56	-	$ 30	$4.00
Default after 3 Yrs. – 10%	$24	$2.60	$ 60	-
Total Expected Loss		**$5.60**		**$4.00**

Here's one way we calculated the weighted loss. It's the negative difference between the $50 cost of the investment and the cash realized times the probability of the scenario. For example, in the prepayment scenario, Interested Investor only recovered $40 of its $50 investment, for a net loss of $10 over the 5 years. Weighting that by the 30% probability of the scenario, Interested Investor has a $3 expected loss in that scenario.*

In the default scenario, we made assumptions about principal recoveries on the SPE's bond. Notice that only the default scenarios lead to a cumulative lifetime loss for the SPE itself. If only those scenarios were analyzed, Prince Pal would have the largest variable interest. But when scenarios include the possibility of prepayment, the waterfall gives Interested Investor more loss exposure and the "honor" of being the primary beneficiary.

*Note that the calculation ignores the time value of money, an important factor needed to calculate fair value and the expected economic loss. Maybe the final interpretation will address this point.

ATTACHMENT

8. What happens if unrelated holders of the two largest variable interests have similarly sized expected losses?

If the interests have similar underlying characteristics, neither holder is the primary beneficiary. But if one interest is more subordinate than the other, its holder is the Primary Beneficiary. If they are both equally subordinate, weigh more heavily the variable interest subject to the dominant risk in the SPE.

9. How are "related parties" handled for purposes of determining a primary beneficiary?

An SPE participant includes the variable holdings of related parties (as defined by FAS 57) as its own for purposes of making the primary beneficiary analysis. But a participant should treat the holdings of certain other entities, not officially related parties, the same way. Who are these entities? They can be de facto agents of the primary beneficiary, donees, "controlled" SPEs, and other similar wards that hold variable interests. Note to lawyers and bankers. A de facto agency relationship exists when a party provides significant amounts of professional services to the participant or has similar business arrangements.

If the group, taken together, qualifies as the primary beneficiary, then one substantive operating entity within the group is that primary beneficiary. The first candidate to be the primary beneficiary within the group is the entity that serves as the principal (versus an agent). No agency relationship? The primary beneficiary is the party most closely associated with the SPE activities. Still no primary beneficiary? Look to the party that has the largest variable interest in the group.

10. Assume that I conclude that I am not the primary beneficiary based on an analysis of the data on the date I buy my variable interest. Need I repeat the analysis later?

Yes. See example 2. According to the proposed interpretation, all factors influencing consolidation decisions must be reconsidered at each reporting date. To make the analysis, use all "all evidence that the enterprise possesses or would reasonably be expected to possess." The ED doesn't require SPE participants to make an *exhaustive* search for information about the actions of unrelated parties.

III. Certain SPEs that Hold Financial Assets

1. Why does the ED propose special rules for these SPEs?

FASB recognizes that SPEs that hold only financial assets might serve to effectively disperse risks among a variety of participants. Thus, the primary beneficiary determined as described in Section II might not be the right candidate to be the accounting parent. So FASB devised a special SPE category – ***SPEs that Hold Certain Financial Assets***. For convenience, we are (as are others) calling them Financial SPEs or FSPEs. A participant applies a different test to determine if it is the primary beneficiary (and the accounting parent) of an FSPE (Question III-5).

2. Can I presume that an SPE that holds only financial assets is an FSPE?

A logical question but the answer is no. Many SPEs that hold financial assets will not qualify as FSPEs. In these circumstances, the accounting parent is the primary beneficiary as described in Section II.

3. What does it take for an SPE to be an FSPE?

The holdings and activities of the SPE must meet certain conditions. FASB modeled these on FAS 140's Qualifying Special Purpose Entity (QSPE) requirements.[5] Per FAS 140, a transferor of financial assets to a QSPE does not consolidate the vehicle – but the ED will likely apply to non-transferor participants in a QSPE. The table below compares the requirements for QSPEs and FSPEs:

Characteristic (Summary)	QSPEs	FSPEs
Nature of Entity	Must be a trust or legal vehicle that is *demonstrably distinct* from the transferor.	Same, except there may not be any transferor.
SPE Assets	Principally financial assets or nonfinancial assets (temporarily) obtained in the process of collecting financial assets. A QSPE cannot have the discretion to vote.	Same except that an FSPE cannot hold equity securities unless held temporarily and obtained in the process of collecting other financial assets.
Permitted Activities – General	Significantly limited.	Same.
Permitted Activities – Acquiring Assets	Can only passively accept financial assets transferred to it.	Can buy or originate (i.e. lend) financial assets.
Permitted Activities – Selling Assets	Cannot sell financial assets except under specified circumstances.	Can sell financial assets.
Derivative Holdings	Derivatives: ▪ Cannot require a decision (a la an option). ▪ Must effectively partly or fully (but not excessively) counteract some risk associated with beneficial interests or related transferred assets. ▪ Notional amount cannot exceed total beneficial interests issued to non-transferor investors.	Same, except there may not be any transferor.

[5] See Deloitte & Touche's *Securitization Accounting Under FASB 140* for a comprehensive analysis of QSPEs. Go to www.deloitte.com/us and click *on e-library*. Put a check in the *contents-articles* box and search using the term *securitization*.

A T T A C H M E N T

4. This is getting pretty confusing. How do I sort it out?

Consult the table below to see how this all fits together. Assume that the SPE does not have an equity class that meets the requirements outlined in Question V-2.

Vehicle Qualifies As:	Transferor	Other Participants
Both a QSPE and an FSPE	Does not consolidate.	Participants should apply special rules applicable to FSPEs (See Question III-V).
An FSPE but not a QSPE	No special provisions. Apply same guidance in the same fashion as other participants.	Participants should apply special rules applicable to FSPEs.
A QSPE but not an FSPE (e.g. the QSPE buys equity securities)	Does not consolidate.	Atypical situation: participants should apply the ED's general SPE consolidation rules (See Section II).
Neither a QSPE nor an FSPE	No special provisions. Apply same guidance in the same fashion as other participants.	Participants should apply the ED's general SPE consolidation rules.

5. Who is the primary beneficiary of an FSPE?

Use special rules to determine whether an enterprise is the primary beneficiary of a financial SPE. A primary beneficiary of a financial SPE meets two out of the following three criteria, as cited in paragraph 23:

1. It has authority to purchase and sell assets for the SPE and has sufficient discretion in exercising that authority to significantly affect the revenues, expenses, gains, and losses of the SPE.
2. It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit or **asset support that is subordinate to the interest of other parties** (emphasis added).
3. It receives a fee that is not market based (See Question II-4).

If two or more participants in a financial SPE meet two out of the three criteria, then the one with the largest variable interest (See Question II-6) is the primary beneficiary. If no party meets two of the three criteria, the financial SPE has no primary beneficiary.

IV. Multi-Seller Conduits

1. How about some background?

Securitizations often feature many unrelated companies each transferring financial assets (usually receivables of some form) to a single SPE (e.g. a conduit). Typically, a financial institution administers the SPE and the vehicle finances itself by issuing debt (commercial paper or medium term notes). Each transferor enhances the credit worthiness of the assets it sold, perhaps by retaining a subordinated interest.

Assuming a particular company's transfer satisfies the criteria of FAS 140, the transaction is off-balance sheet under today's accounting. No single transferor consolidates the conduit on the theory that the SPE has many other participants. If each single transferor consolidates its piece of the deal, the accounting by each appears to constitute the prohibited practice of pro rata consolidation.

2. How does the ED affect current accounting?

Under the proposed ED, each transferor normally would evaluate consolidation on a **silo** basis rather than on a legal entity basis.

What's a silo? It's a specifically identified group of assets to which a particular participant's rights and obligations are restricted. If the SPE's creditors have an equal claim to all of the assets of the SPE, a reasonable allocation of a portion of the liabilities should be ascribed to the silo. That particular participant should evaluate the silo as a separate SPE.

Example 4. Diversified Tools sells its trade receivables to a commercial paper conduit sponsored by Big City Bank. To provide credit support, Diversified retains, in the form of over collateralization, a 10% subordinated beneficial interest in its transferred receivables. The commercial paper is a general obligation of the conduit; it is supported by all of the Conduit's assets, not by any particular group of the Conduit's assets.

Big City administers the conduit and provides the conduit's back-up liquidity facility in the event that the conduit cannot rollover the CP. Diversified's rights and obligations are limited to receivables it transferred to the conduit.

Diversified should evaluate its sold receivables and an appropriate allocated portion of the conduit's commercial paper as a silo, i.e. as a separate SPE. Other transferors would make similar evaluations with respect to the receivables they transferred.

3. When would a bank sponsor/administrator consolidate a multi-seller conduit?

The ED is conspicuously silent on this question. Unless the provisions of a final interpretation provide otherwise, we think that the bank should determine whether it is the primary beneficiary of the entire conduit using FSPE or conventional SPE rules, as appropriate.

But here's an anomaly. Assume several of the asset transferors conclude that they should each consolidate the assets and liabilities of their silos. If the bank is the primary beneficiary of the conduit in its entirety (and thus its accounting parent), the assets and allocated liabilities of the silo will be double counted – i.e. consolidated by each of the transferors and the bank.

Another point needs clarification. If the bank concludes that it is the primary beneficiary of the entire conduit, will each of the transferors be exempt from consolidation because each of the virtual SPEs is included in the consolidated financial statements of the bank, a substantive operating entity? See section VI.

ATTACHMENT

V. SPEs with Adequate Voting Equity

1. What are the implications if an SPE has adequate voting equity?

Conventional consolidation rules, not those of the proposed interpretation, apply to SPEs that possess substantial equity. If the five criteria cited in Question V-2 are met (replacing the old 3% equity at risk test), the accounting parent is any entity that has a controlling financial interest in the equity class (usually revealed by a having a majority vote).

Other participants (i.e. all holders of debt and equity classes senior to the residual equity class, asset transferors, sponsors, etc.) in the SPE should not consolidate.

2. What characteristics indicate that the equity is adequate?

Five criteria all must be met[6]:

1. The equity owners have voting or similar rights that allow them to make decisions and manage the SPE's affairs to the extent they are not predetermined otherwise (e.g. in the documents that create the SPE).
2. The equity investment is sufficient to conduct and finance the activities of the SPE without support from variable interest holders. What's sufficient? The amount will vary based on the nature and risk profile of the SPE's assets and liabilities. Generally, the equity needs to be sufficient at all times to cover expected losses (see Question II-7). **An equity interest less than 10% of total assets is presumed to be insufficient. An investment of less than 10% is sufficient only when there is persuasive evidence that similar, non-SPE businesses operate at comparable equity levels.** It appears that no other form of evidence can be used to overcome this presumption (also see Question V-4 if the investment is greater than or equal to 10%).
3. **The equity investment is first loss and subordinated to all other interests throughout the life of the SPE**. It is not guaranteed directly or indirectly. The equity is not adequately at risk if:
   - A variable interest holder will reimburse losses or has arranged for another party to do so,
   - Cash flow allocations effectively remove the risk,
   - Variable interest holders provide, or arrange for, credit enhancements of the SPE's assets or guarantees of the SPE's debt,
   - Variable interest holders (or others as arranged for by variable interest holders) guarantee residual values or have protective purchase agreements,
   - A variable interest holder has a total return swap with the SPE,
   - **A variable interest holder shares in exposure to the SPE's first dollar risk of loss** (e.g. THE VARIABLE INTEREST HOLDER IS ALSO AN EQUITY OWNER).[7]
   - The residual interest in the SPE is either nominal or lacks significant variability,
   - A variable interest holder can receive most of the benefits of the SPE for less than fair value, such as a right to buy new products, processes or operations, or
   - Equity owners are entitled to payments on debt-like terms or otherwise expect debt-like rates of return.

[6] *Here's a key to reading the criteria – you have to segregate the equity class being evaluated for adequacy from other variable interests. Assuming that all of the criteria are met, the equity interest is not considered a variable interest. Thus, if a criterion mentions a variable interest, it is referring to positions held by parties who hold variable interests apart from the most residual equity class. If the criterion refers to equity owners, it is referring to the residual equity class that is the basis for non-consolidation by the variable interest holders. We admit that this footnote, designed to clarify, is also a little confusing.*

[7] *We're basing this point (and example 5) on a literal reading of paragraph A2(f). Some question why a participant's simultaneous investment (1) in the SPE's equity (so long as the equity class meets the 5 criteria) and (2) in a variable interest (that is entirely senior to the equity) "taints" the entire equity class.*

4. The equity was not purchased in exchange for subordinated interests in another SPE.
5. The equity investment was not paid for through fees, a donation, or financed by another variable interest holder.

Example 5. An SPE capitalizes itself with an equity class (assume it is appropriately sized for the risk), a subordinated debt class and a senior debt class. One of the investors in the subordinated debt also holds a minority position in the equity class.

The SPE is subject to the provisions of the proposed interpretation. The equity class is not adequately at risk. Why? A variable interest holder (the owner of a subordinated bond) also has a stake in the equity class (thus, busting criterion 3). (See Footnote 7.)

3. Question I-2 indicates that a substantive operating entity must have *sufficient equity to finance its operations without support from any other enterprise or entity except its owners*. Does that mean that a substantive operating entity can become an SPE *subject to the interpretation* if losses reduce the equity below a "sufficient level"?

Probably not. Criterion 2 does not apply to an enterprise that had been a substantive operating entity that subsequently incurred losses. Technically, the enterprise is an SPE. Assuming that it continues to meet the other criteria listed in Question V-2, it is an SPE excluded from the scope of the ED. Consolidation continues to be based on voting interests.

4. For purposes of criterion 2 (see Question V-2), is 10% a safe harbor? In other words, can I presume that equity levels at or above this amount are adequate?

No safe harbor exists. In all cases, the adequacy of the level of equity needs to be justified. However, the adequacy of 10% or greater equity can be justified by comparables (see Question V-2) or, in the absence of comparables, based on an expected loss scenario analysis (see Question II-7).

5. Must the "Equity" be equity in legal form?

Under today's SPE rules, at risk equity requires the instrument to be equity in both legal form and in substance. While the ED doesn't focus on legal form, it's probably implicit in the guidance. For example, an instrument that an SPE would classify as a non-equity instrument in its own GAAP financial statements would (in our view) likely constitute a variable interest rather than an equity instrument. See Question V-2 for the distinction.

6. During a quarter, the expected loss profile of the SPE dramatically increases. Expected losses now exceed levels required by criterion 2 (Question V-2). What's the consequence of the change?

Adequacy of the equity must be reassessed at each reporting date. Thus, based on expected future losses, an SPE might no longer qualify as an SPE with adequate voting equity. A participant should evaluate whether it is the primary beneficiary (and hence the accounting parent) using FSPE or SPE guidance as appropriate.

ATTACHMENT

VI. SPE-like Entities that Are Consolidated by a Substantive Entity

1. I participate in an SPE that is consolidated by another substantive operating entity. How do I apply the proposed interpretation?

Don't bother. The proposed interpretation does not apply to a subsidiary, division, department, branch, or other portion of a substantive operating entity even if is otherwise similar to an SPE that would be subject to the proposal.

Example 6. No-Debt Inc. leases equipment from a thinly capitalized vehicle, Specialized Leases, LLC. Specialized owns the property, financed with non-recourse debt. No-Debt Co. guarantees a substantial portion of the equipment's residual value. The lease is an operating lease. Humongous Finance Co., a substantive operating entity, consolidates the assets and liabilities of Specialized.

No-Debt Inc. does not consolidate Specialized, even if the residual value guarantee would otherwise make it the primary beneficiary. Specialized is accounted for as a subsidiary of Humongous.

2. The answer to Question VI-1 is counter-intuitive. What explains this outcome?

If No-Debt Inc. and Humongous each concluded it was the parent, the assets and liabilities of Specialized would show up in two sets of consolidated financial statements. If Humongous concluded it was not the parent, it would have to derecognize assets and liabilities already included in its consolidated financial statements. FASB argues that derecognition issues are beyond the scope of the Interpretation.

That said, we still don't understand entirely the rationale for (or, even worse, how to apply) the guidance. We don't think FASB intended to provide for purely **voluntary consolidation** of an SPE by a substantive operating entity (i.e. it determines it is the parent regardless of whether consolidation is called for by other provisions of the ED).

VII. Transition and Disclosure

1. What is the proposed effective date?

A final interpretation will be effective immediately on the date it is issued by the FASB. However, for SPEs created before that date, the provisions apply as of the beginning of the first fiscal period beginning after March 15, 2003 (typically April 1, 2003). FASB encourages early adoption of the final interpretation.

If the new rules require you to consolidate a previously unconsolidated SPE, record it at the fair value of its assets and liabilities at the date of initial application. Report the cumulative effect on equity as an income adjustment, akin to a change in accounting principle.

2. What disclosures should be made?

A primary beneficiary must disclose the carrying amount and classification of the assets of a consolidated SPE that collaterize the SPEs' obligations. If creditors have no recourse to the general credit of the primary beneficiary, that fact must be disclosed.

A non-primary beneficiary that provides significant administrative services to an SPE (e.g. collecting/distributing cash or placing interests) must disclose the assets and liabilities of the SPE and the SPE's purpose.

FASB encourages, but does not require, pro forma disclosure of the effect of the interpretation (total assets, total liabilities, income etc.) in periods reported before the Interpretation is first applied.

Disclosure requirements of other standards continue to apply.