SPE or not?

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Physicians are admonished upon entering the practice of medicine to ?first, do no harm?. The Financial Accounting Standards Board (FASB) would do well to heed this advice as it formulates new interpretive guidance for US Generally Accepted Accounting Principles (GAAP) in this post-Enron debacle world.

The FASB is preparing an exposure draft on interpretation of its Statement No. 94 targeted at special purpose entities (SPEs). The avowed purpose is to consolidate the SPEs' assets and liabilities into the companies that set them up in order to implement all kinds of complex transactions. Likely to be subject to the new interpretation are securitizations, particularly collateralized debt obligations, operating leases that can be characterized as synthetic leases, and asset sales that qualify as financings under tax regulations and derivative contracts.

The FASB has come under intense criticism from Congress and the SEC for failure to promptly address perceived defects in financial reporting standards and conflict of interest rules. Harvey Pitt, chairman of the SEC recently told the Senate Banking, Housing and Urban Affairs Committee that the FASB has been ?broken for too long? to fix. Mr. Pitt wants to form a new regulatory body to completely remake GAAP. House and Senate bills introduced this month also seek to establish new regulatory agencies to oversee the accounting profession.

Against this backdrop the FASB is working feverishly to publish the exposure draft for public comment by the end of April with a view towards implementation before the end of the summer. While I applaud the FASB's efforts to improve the transparency and accuracy of financial statements, making rules in haste risks undoing common and proven financial practices and may benefit no one.

The key features of the proposed interpretation are to:

(1) provide guidance for determining when an entity, a ?Primary Beneficiary,? should consolidate an SPE;

(2) identify the Primary Beneficiary of an SPE as the entity having the principal economic benefits and risks that arise from the activities of the SPE, which benefits and risks relate to interests in the SPE exposed to significant variability of return;

(3) not provide a definition of an SPE, but look to the SPEs characteristics to determine if it supports the activities of the Primary Beneficiary;

(4) not consolidate an SPE that has sufficient independent economic substance to qualify as a separate economic entity for accounting purposes;

(5) define sufficient independent economic substance to include minimum 10% equity capitalization of the SPE by third party investors not related to the Primary Beneficiary, with such investors having the risks and rewards of ownership of the SPE; and

(6) require such an independent SPE to be able to finance its activities without assistance from or reliance on the Primary Beneficiary.

And there will be no grandfathering. The new interpretation will be applicable to all SPEs created after the date it is issued ? and to SPEs created before that date as of the beginning of the first fiscal year beginning after December 15, 2002.

So far, the new interpretation is not expected to apply to transferers of financial assets to qualifying SPEs under FASB Statement No. 140, certain reporting interests in employee benefit trusts and leveraged leases subject to FASB Statement No. 13, Accounting for Leases.

The bottom line is that each SPE that does not have sufficient independent economic substance, unless otherwise exempted, will be consolidated in the financial statements of its Primary Beneficiary, effectively raising the cost of the underlying transaction for that party.

SPEs have been used for years as a financial tool to insulate assets from the bankruptcy of transaction parties, aggregate and segregate various forms of collateral to support debt service and to establish efficient capital raising vehicles for the syndication of transactions in the bank and capital markets.

The problems that may arise from the interpretation are legion. By failing to establish a definition of the SPEs that will be subject to the new rules the FASB is taking an approach reminiscent of Justice Potter Stewart's views on pornography. He admitted he couldn't define it, but he contended: he knew it when he saw it. Auditors may now have to exercise a greater level of subjective judgment in deciding what to do with SPEs. If the solution to the subjectivity problem lies in the determination of Primary Beneficiary status, then you have compounded your troubles because you can find Primary Beneficiaries all over the transaction landscape.

Consider the following example: Company Alpha, an air carrier, wants to obtain the use of an aircraft. It approaches Bank Bravo to obtain financing for the aircraft. Bravo has a wholly-owned leasing subsidiary, Leaseco, which has substantial assets in its portfolio. Leaseco proposes to do a deal with Company Alpha that would qualify as an operating lease under FASB Statement No. 13.

Under the current rules the Alpha's CFO would look at the economics of the financing and see if the deal made sense. The aircraft would not be reflected on the balance sheet of the Company, and thus not be subject to a depreciation charge, and rent would be expensed at the rate set forth in the lease. The new interpretation, however, could yield several different accounting results for the same transaction depending on how auditors respond to various questions.

Is Leaseco an SPE? What if Leaseco funds itself primarily with full recourse commercial paper? Does it make a difference if Leaseco obtains its funds on a recourse basis from its parent? If Leaseco is an SPE, is its Primary Beneficiary Company Alpha or Bank Bravo? If Leaseco is not an SPE, can it use a trust to hold its interest in the aircraft without it being consolidated with Company Alpha? Does it matter who is the tax owner of the aircraft? If so, should accounting interpretation be subject to tax analysis? Does the new interpretation apply if Leaseco does not use leveraged lease accounting? If Leaseco retains all residual risk in the aircraft, does it affect Company Alpha's accounting if Leaseco hedges that risk? How could Leaseco establish that it did not use funds directly or indirectly supplied by Company Alpha to support such a hedge? Should Alpha's accounting treatment be dependent on how Leaseco or Bank Bravo account for the transaction?

The FASB discussions made available to the public to date do not help resolve these questions. Indeed, I fear that the new interpretation will yield more questions than answers and create more subjectivity than certainty. Uncertainty breeds inaction and inaction is not a good friend to capital formation.

I can appreciate that the FASB does not want to compromise its independence or fail to respond to perceived professional abuses of discretion. Nonetheless, it should avoid a knee-jerk reaction to political and media pressure and carefully analyze the broad implications of the proposals under consideration. The new interpretation should be afforded at least a 60 to 90 day public comment period and those comments should be given due consideration before final action is taken. While it may seem prudent for the FASB to act quickly, the interests of the public would be best served if the FASB acts deliberately.