

SUMMARY OF TENTATIVE DECISIONS
ENTITIES THAT LACK SUFFICIENT INDEPENDENT
ECONOMIC SUBSTANCE

Background

The Board is developing an exposure draft of an Interpretation of FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. The Interpretation will provide guidance for determining when an entity, the *Primary Beneficiary*, should consolidate another entity, an SPE, that functions to support the activities of the Primary Beneficiary. The objective of the proposed Interpretation is to improve the transparency of financial statements by providing a more complete picture of an entity's activities

The proposed Interpretation does not limit the use of SPEs. SPEs are often used to allocate risks among the various participants in the SPE and to provide a source of lower cost funding because of the segregation of collateral. Those economic benefits of using SPEs will continue. However, the accounting optic of off-balance sheet treatment of nonsubstantive SPEs will be eliminated in many situations.

Reason for Issuing the Proposed Interpretation

Transactions involving SPEs have become increasingly prevalent. Also, SPEs usually are arranged in a manner that makes it difficult to determine if another entity has a controlling financial interest in the SPE that would result in that other entity consolidating the SPE. Preparers of financial statements, their auditors, and analysts and other users of financial statements have indicated that guidance is needed for determining when SPEs should be consolidated by another entity.

Differences Between the Proposed Interpretation and Current Practice

The proposed Interpretation is similar to current practice because it requires that an SPE be consolidated by another entity if the SPE is nonsubstantive and supports the activities of that other entity. The guidance in the proposed Interpretation:

- Expands the situations in which an entity is considered to be an SPE.
- Provides that interests in an SPE that are exposed to significant variability in returns for reasonably possible outcomes are used to determine which entity is the SPE's Primary Beneficiary.
- Identifies parties that shall be considered one and the same as the Primary Beneficiary for applying the requirements of the Interpretation. These parties include the Primary Beneficiary's related parties as defined in Statement No. 57 and other parties having certain attributes.
- Requires an SPE's Primary Beneficiary to consolidate an SPE covered by the Interpretation unless the investment by independent, third party equity owner(s) provide the SPE with the ability to fund or finance its operations without assistance from or reliance on the Primary Beneficiary. The Interpretation presumes that that condition would not exist if the level of that investment is less than 10 percent of the total capital of the SPE, including both the SPE's equity and debt, unless there is clear and compelling evidence to the contrary. Prior to the proposed Interpretation, practice interpreted three percent to be sufficient equity.
- Requires an SPE's Primary Beneficiary to consolidate an SPE unless the SPE's equity owner(s) bears all of the exposure to the first dollars of loss and its potential rewards are unlimited. Prior to the Interpretation, an SPE often was not consolidated even in circumstances where the owners of the SPE have limited potential returns and were not exposed to losses until after other parties had suffered losses.

How the Changes in the Proposed Interpretation will Change and Improve Financial Reporting

Many nonsubstantive SPEs currently not consolidated by the entity it supports will be consolidated by the SPE's Primary Beneficiary, resulting in a more representationally faithful depiction of that entity's assets and liabilities.

How the Conclusions in this Interpretation Relate to the Conceptual Framework

Including SPEs that do not have sufficient independent economic substance in the consolidated financial statements of the SPE's Primary Beneficiary will provide information that helps in assessing the amounts, timing, and uncertainty of prospective net cash flows to the consolidated entity. FASB Concepts Statement No. 1, *Objective of Financial Reporting by Business Enterprises*, states that financial reporting should provide such information. Also, completeness is identified in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as an important element of representational faithfulness and relevance.

Scope

The proposed Interpretation applies to all entities except:

- The transferor (or its affiliates) of assets to a qualifying SPE under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- Reporting interests in employee benefits trusts subject to the provisions of FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 112, *Employers' Accounting for Postemployment Benefits*

Objective

Consolidated financial statements present the results of operations and the financial position of a parent company and its subsidiaries as if the group were a single company with several branches or divisions. An affiliate is a subsidiary and should be included in the consolidated financial statements if the parent has a controlling financial interest and, therefore, has control over the

activities of the subsidiary and the benefits flowing from those activities. A common way of achieving a controlling financial interest is to hold a majority of the voting interest in the subsidiary, in which case the parent can control the subsidiary through its governing board.

SPEs are often arranged without a governing board or with a governing board that has limited ability to make decisions that control the entity's activities. The activities of the SPE are often limited by the documents that establish it and in those instances most, if not all decisions, are predetermined. In other circumstances, the arrangements that control the SPE may be structured in such a way that it is difficult to determine which party to the arrangements has the decision-making power that is normally held by shareholders, partners, investors, or the governing board. In those circumstances it is difficult to determine which party to the arrangement, if any, should consolidate the SPE.

SPEs that are covered by the Interpretation function to support the activities of another entity, the Primary Beneficiary. The Interpretation provides guidance based on the notion that the Primary Beneficiary is economically compelled to control the activities of an SPE that supports it and to which the Primary Beneficiary is exposed to the SPE's variable interests. That control is established either through the documents that establish the SPE or some other mechanism.

An SPE (with an identified Primary Beneficiary) that has sufficient independent economic substance to qualify as a separate economic entity for accounting purposes is not consolidated by the Primary Beneficiary (although the SPE might be controlled by and consolidated by one of the SPE's owners). An SPE that does not have sufficient independent economic substance is considered to be nonsubstantive and controlled by the Primary Beneficiary and is consolidated by the Primary Beneficiary. The Interpretation provides guidance for determining which entities are SPEs, identifying the Primary Beneficiary, and whether an SPE has sufficient independent economic substance to be considered substantive.

Description of an SPE

An SPE's activities support the activities of a Primary Beneficiary. An SPE often has one or more of the following characteristics:

1. Its activities and purpose effectively are limited. SPEs frequently are designed to accomplish one purpose or engage in a single type of activity, but the entity is not necessarily legally or contractually limited to that purpose or activity.
2. Most of its activities and operating decisions are effectively specified in or governed by the SPE's formation or governance documents or by financing, operating, and investor agreements such that some or all decisions are predetermined. As a consequence, the substantive decision-making power of shareholders, partners, investors, owners, the governing boards, and so forth that is normally used to determine whether one entity has a controlling financial interest in another entity may be limited or nonexistent. Substantive decision-making power pertains to matters that have a significant impact on the nature and level of risks and potential reward to which the entity is exposed.
3. No independent party has a substantive equity investment that is at risk, and its capital structure has significant leverage.
4. It is not a business as described in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business."

The existence or absence of any or all of the above listed characteristics is not a bright line for determining whether or not an entity is an SPE that is covered by the Interpretation. The critical factor is whether an entity supports the activities of a Primary Beneficiary. All aspects of an entity must be evaluated and professional judgment must be exercised to determine if an entity is an SPE covered by this Interpretation.

A subsidiary that is consolidated by a substantive operating entity (or a group of related assets and liabilities within a substantive operating entity) is not an SPE as that term is used in the Interpretation. Thus, the activities of a substantive operating entity that have been segregated by corporate shells or other structures are not considered to be an SPE covered by the Interpretation. For example, a subsidiary of a substantive operating entity that functions as a lessor for property leased to a single lessee is not covered by the Interpretation. Substantive operating entities meet the definition of a business in EITF Issue 98-3, have sufficient equity to conduct commercial operations, and have owners with decision-making powers.

Identifying the Primary Beneficiary

A Primary Beneficiary is an entity for which some aspect(s) of its activities involve an SPE. Only one party can be the Primary Beneficiary of an SPE. A Primary Beneficiary is the entity that retains or obtains the principal economic benefits and risks that arise from the activities of the SPE. Those economic benefits and risks relate to interests in the SPE that are exposed to significant variability in returns for reasonably possible outcomes (variable interests).

Variable interests in an SPE are retained or obtained by the Primary Beneficiary through various agreements and arrangements, such as leases, management contracts, referral agreements, options to acquire, purchase contracts, credit enhancements, providing guarantees (debt or asset values), and providing financing. Some SPEs are created by the Primary Beneficiary, and some SPEs are formed by other parties such as lenders, attorneys, or investment bankers.

Determinations of variability should be based on outcomes that are reasonably possible and without regard to outcomes that are less than reasonably possible (for example, all asset values drop to zero).

Contracts to provide services to an SPE for market-based fees, including incentive fees, are not variable interests. Alternatively, arrangements that provide for an incentive fee that is equivalent to “net income” are not market-based, and those fees are considered to be variable interests. The ability to replace a service provider without cause is an indication that its fees are market-based.

When different types of variable interest exist, the interest that has exposure to losses before other variable interests is considered to be the interest with the greatest level of variability. Thus, those interests are given more weight than the other variable interests in deciding who is the Primary Beneficiary.

Examples of interests in an SPE that are exposed to significant variability in returns or outcomes are:

- The transferor of financial assets in a securitization would have significant variability of returns for reasonably possible outcomes when the transferor provides credit enhancement, such as over collateralization, to the SPE through which the assets are securitized.
- The lessee from a nonsubstantive SPE in a long-term lease that includes a residual value guarantee and fixed-price purchase option of long-lived assets such as real estate, aircraft, trucks, and other equipment would have significant variability of returns for reasonably possible outcomes involving an increase or decrease in the value of the leased asset.
- Alternatively, the lender to a nonsubstantive SPE would have significant variability of returns for reasonably possible outcomes if the SPE is the lessor of long-lived assets, such as real estate, aircraft, trucks, and other equipment using a relatively short lease term or for long-term leases where there is no residual value guarantees.
- An entity providing management services to a nonsubstantial SPE would have an interest with significant variability if its fee structure captured the net results of the SPE's operations after deducting a capped return for the holders of the nominal equity interests in the SPE.

The Primary Beneficiary is the entity that holds a significant amount of the variable interests in an SPE, and that amount of variable interests is significantly more than the variable interests held by the other individual entities that hold variable interests. If no entity holds a significant amount of the variable interests, or a significant amount of the variable interests that is significantly more than the variable interests held by each of the other individual entities that hold variable interests, the SPE does not have a Primary Beneficiary.

The exercise of professional judgment is required to identify the Primary Beneficiary because many parties may hold variable interests in an SPE and those interests may have different degrees of variability. The objective in determining the Primary Beneficiary is to identify the entity that is economically compelled to control the activities of the SPE because of the entity's holdings of variable interests. Those holdings identify the entity whose activities the SPE supports.

Also, the Primary Beneficiary usually reports less information or less timely information in its financial statements than it would have reported if it entered into economically similar transactions or arrangements without using an SPE.

Related Parties

A Primary Beneficiary will need to identify all of its related parties. Those related parties are considered to be one and the same as the Primary Beneficiary for purposes of applying the requirements of this Interpretation. Thus, the Primary Beneficiary's related parties cannot be independent, third-party investors in an SPE.

Parties that are considered one and the same as the Primary Beneficiary include the related parties identified in FASB Statement No. 57, *Related Party Disclosures*. Other parties that should be considered to be one and the same as the Primary Beneficiary include:

- A party that cannot sell, transfer, or encumber its interest in the SPE without the prior approval of the Primary Beneficiary.
- A party that does not have the ability to fund or finance its operations without assistance from or reliance on the Primary Beneficiary.
- A party that received its interest in the SPE as a contribution from the Primary Beneficiary. This includes but is not limited to not-for-profit organizations.
- A party that has a defacto agency relationship with the Primary Beneficiary as a result of providing significant amounts of professional or other services or because of other business arrangements.

Examples

The following list provides examples of typical SPE activities and the entity that normally would be considered to be the Primary Beneficiary. This list of examples is not intended to be all inclusive. Other situations and transactions also may involve SPEs.

<u>Activity</u>	<u>Normally the Primary Beneficiary</u>
• To securitize financial assets with a single-entity SPE	The transferor of the financial assets
• To build and lease real estate, power plants, and other facilities without residual value guarantees and lessee purchase options	The lender to the SPE
• To buy and lease aircraft, trucks, and other equipment without residual value guarantees and lessee purchase options	The lender to the SPE
• Lease arrangements where the lessee provides significant residual value guarantees and has fixed price purchase option	The lessee
• To buy and hold inventory	The entity that is seeking to finance inventory pending its future use or resale
• To fund research and development or development activities such as medical technology, drugs, electronic devices, software, movies	The entity that has the right to acquire the SPE or the results of the SPE's efforts at less than fair value
• To fund exploration for and/or development of natural resources	The transferor of the resource rights and holder of purchase rights
• To fund start-up operations such as retail stores, restaurants, nursing and retirement facilities	The entity that has the right to acquire the SPE or the results of the SPE's efforts at less than fair value
• To fund lending, the buying and selling of financial instruments, reinsurance operations, and CDO, CBO, and CLO trusts	The entity receiving the spread between incoming and outgoing funds net of expenses
• To monetize future cash flows	The entity that transfers the right to the future cash flows
• To act as a counterparty to a swap or other form of a derivative contract	The entity that is seeking to transfer risk to a counterparty

Multi-Seller/Lease Conduits

Multi-Seller/Lease conduits are separated into individual SPEs for each transferor or lessee if the transferor or lessee is in the same position as if they were involved in a single-entity SPE. A transferor or lessee is in the same position as if they were involved in a single-entity SPE if their rights and obligations relate only to the assets they have transferred to the conduit or are leasing from the conduit.

In separating the conduit into separate SPEs for each transferor or lessee, the debt issued by the conduit and any equity in the conduit is allocated to the separate SPEs in a rational and consistent manner based on the portion of the assets in the conduit that relate to the individual transferor or lessee.

If a transferor or lessee is exposed to rights and obligations for assets that have not been transferred by that transferor or leased by the lessee, the conduit is not separated into individual SPEs.

Sufficient Independent Economic Substance

The principal factor determining whether an SPE is consolidated by its Primary Beneficiary is whether it has sufficient independent economic substance. An SPE has sufficient independent economic substance if, at all times during its life, it has the ability to stand on its own independent of other entities; that is, it has the ability to fund or finance its operation without assistance from or reliance on the Primary Beneficiary. An SPE has that ability if, and only if, its owner(s) is an independent, third party that:

- Has a substantive equity investment at risk in the SPE
- Has substantive exposure to risk of variable returns that are generally characteristics of equity ownership
- Has the ability to make decisions about and manage the SPE's activities to the extent those decisions have not been predetermined for the SPE.

Substantive Equity Investment at Risk

An equity investment by the independent, third party owner(s) is a substantive equity investment at risk if it meets all of the following conditions:

- Represents an equity interest in legal form or an equivalent form for a non-corporate entity
- Is subordinate to all debt and preferred equity interests (even in the event of bankruptcy)
- Represents the residual equity interest during the entire life of the SPE.

An equity investment is not at risk if it meets any of the following criteria:

- It has been directly or indirectly financed by the Primary Beneficiary
- It has been directly or indirectly provided to the owner(s) by fees contributions, or other payments from the SPE or the Primary Beneficiary
- It is the result of a charitable contribution
- It is in the form of an investment in another SPE (an investment in one SPE cannot be used to capitalize another SPE).

The equity investment by the independent, third party owner(s) must provide the SPE with the ability to fund or finance its operations without assistance from or reliance on the Primary Beneficiary at all times over the life of the SPE. In order to stand on its own without assistance from the Primary Beneficiary, an SPE would require equity sufficient to absorb its reasonably possible losses and expenses.

The equity investment should be comparable in amount to that which would be expected for substantive businesses (not SPEs) of similar size and engaged in similar transactions that have similar risks and rewards. For example, the amount of equity needed for an SPE that holds exclusively high quality assets funded by debt would be less than the amount of equity needed for an SPE engaged in activities such as:

- Buying and selling high risk financial or nonfinancial assets
- Ongoing research and development activities
- Buying or selling derivatives.

In some situations, subordinated debt (or a similar instrument) may be part of an entity's capital structure that is exposed to the entity's reasonably possible losses and expenses. This arrangement prevents the SPE from having sufficient equity investment at risk. The subordinated debt is a variable interest and the holder of the subordinated debt may be the SPE's Primary Beneficiary.

The amount of a substantive equity investment at risk that is sufficient to fund or finance an SPE's activities without assistance from or reliance on the Primary Beneficiary is presumed to be at least 10 percent of the SPE's total capital. Total capital in this context is the sum of the equity investment by the independent, third party owner(s) and all of the SPE's debt and preferred equity interests. The amount of investment in the SPE by the independent, third party owner(s) is determined by measurements based on generally accepted accounting principles.

The presumption that a substantive equity investment at risk must be at least 10 percent of the SPE's total capital is overcome only if there is clear and compelling evidence, for each of the following situations, that a smaller amount is sufficient to:

- Fund or finance the activities of substantive businesses (not SPEs) of similar size and engaged in similar transactions that have similar risks and rewards
- Fund or finance the SPE's operations without assistance from or reliance on the Primary Beneficiary at all times over the life of the SPE
- Absorb all of the SPE's reasonably possible losses and expenses.

When the underlying nature or risk of an SPE's activities changes, the Primary Beneficiary should reassess the amount of independent equity investment in the SPE that is sufficient to fund or finance the SPE's activities and whether the SPE overcomes the presumption that the amount is at least 10 percent of the SPE's total capital.

Substantive Exposure To Risk of Variable Returns

The second element of sufficient independent economic substance is that the substantive equity investment at risk by the independent, third-party owner(s) has substantive exposure to risk of variable returns from the activities of the SPE. Accordingly, an entity does not have sufficient

independent economic substance if the risk of loss on any portion of the substantive equity investment at risk is shielded by guarantees or other arrangements provided by the Primary Beneficiary (either directly or indirectly by making arrangements for another party to do so) that result in other entities absorbing losses from the activities of the SPE before the independent, third-party equity owner(s) suffers loss of its entire equity investment at risk. Examples of how that would occur include:

- The Primary Beneficiary will reimburse the SPE or the third-party equity owner(s) for losses suffered by the SPE or has made arrangements for another party to do so.
- The SPE's allocation of cash flows effectively removes the risk of loss of the substantive equity investment at risk.
- The Primary Beneficiary issues a standby letter of credit or provides other credit enhancements related to financing the SPE's assets and activities or has made arrangements for another party to do so.
- The Primary Beneficiary directly or indirectly guarantees the SPE's debt or has made arrangements for another party to do so.
- The Primary Beneficiary guarantees residual values of the SPE's assets or agrees to future purchases of the SPE's assets at predetermined prices or has made arrangements for another party to do so.
- The SPE has entered into a "total return swap" with the Primary Beneficiary.
- The Primary Beneficiary also is an equity owner for which a proportional amount of the first dollars of loss is allocated to it.
- The independent, third-party equity owner(s) shares exposure to the first dollars of loss.

In summary, a substantive equity investment at risk of variable returns bears all of the exposure to the first dollars of loss.

A substantive equity investment at risk also has the potential for substantive returns attributable to equity ownership. An SPE does not have sufficient economic substance if the potential returns from equity ownership are directly or indirectly limited (capped) or are not approximately commensurate with the level of risk of loss of the investment. Examples of that type of situation include, but are not limited to, the following:

- Predetermined distribution arrangements limit the residual interest of the SPE to either a nominal portion of the SPE's net cash flows or to an amount that lacks significant variability.
- The Primary Beneficiary has the right to receive most of any benefits other than cash, such as rights to inventions, new products, or new processes resulting from the SPE's activities at a price that is less than the fair value of those benefits.
- The owners' equity investment interests have repayment provisions that are similar to those for some of the SPE's debt obligations or that otherwise reflect a debt rate of return.

Ability to Make Decisions

The third element of sufficient independent economic substance requires the independent, third-party equity owner(s) to have the ability to make decisions about and manage the SPE's activities to the extent those decisions have not been predetermined for the SPE. The Primary Beneficiary should not have veto rights with respect to those decisions.

Predetermined decisions include unilateral contractual rights held by others, such as purchase and renewal options in leases, if they are included in contracts that are entered into when the SPE is established or concurrent with or shortly after the SPE begins its operations. Those contractual rights generally relate to events that occur only occasionally and may be rights that are typically provided in similar transactions that are entered into by entities that are not SPEs.

The requirement that the independent, third party equity owner(s) has the ability to make decisions is not met if the rights to make ongoing operating decisions (such as remedies to be taken in the event of a default by a lessee or borrower) have been transferred by contract (for example, pursuant to a management contract with the Primary Beneficiary or contractual rights given to a lender) unless the owner(s) has the ability to terminate that contract at will.

Disclosure

The assets held by an SPE usually serve as collateral for the debt of the SPE. When a Primary Beneficiary consolidates an SPE, the consolidated financial statements should disclose the carrying amount and classification of assets that are collateral for obligations as of the date of the latest statement of financial position presented or show such assets as a separate line on the face

of the statement of financial position. Additionally, if the debt of the SPE is nonrecourse debt to the general credit of the Primary Beneficiary, that situation needs to be disclosed on the face of the statement of financial position or disclosed in the notes to the financial statements.

Transition and Effective Date

The provisions of the proposed Interpretation will be applied to all SPEs created after the date it is issued. For SPEs created before that date, the provisions of the Interpretation will be initially applied to those SPEs still existing as of the beginning of the first fiscal year beginning after December 15, 2002. The effect of initially applying the Interpretation will be reported in a manner similar to the cumulative effect of a change in accounting principles.