

Some comments on the Board's recent decisions:

Letter of Comment No: 141  
File Reference: 1082-200  
Date Received: 11/08/02

**Not-For-Profits:**

In the past, PwC has applied EITF 90-15 and other SPE related guidance to not-for-profits and I believe other firms have as well. Therefore I am somewhat troubled by the thought that in the future, not-for-profits will have a free pass to place their debt off balance sheet. As an example, the financial difficulties of the health care industry may be hidden from concerned parties in the future. Rather than explicitly excluding them from the scope, I think it would be better to remain silent on the applicability to not-for-profits. Then at least practitioners can analogies in egregious situations.

I am extremely concerned about the decision to exempt for-profit companies from having to consolidate a not-for-profit SPE. Although I have not seen many off-balance sheet structures that involve not-for profits, I have seen some. In any case, I believe that if the FASB does not reverse this decision, the use of not-for-profit vehicles to structure off-balance debt will grow dramatically in the future. For example, consider synthetic leases. Most synthetic lease transactions are set up by lenders, whose only interest in the transaction is to make a loan. The equity in these structures is, in substance, just a subordinated loan with a slighted higher yield. There really is no "profit" in the arrangement. There is only a pass through of interest. Furthermore, the lessee receives all the tax benefits. Therefore, an ideal structure for a synthetic lease after the new interpretation would be to use a not-for-profit with zero equity. I do not know whether that structure would qualify for tax exempt status but it seems plausible. Even if it does not qualify under US tax law, will the interpretation make that a requirement to qualify for the scope exception?

**The paragraph 17 question**

I believe the original wording of paragraph 17 in the ED was the most practical approach to the conduit question. That approach was consistent with the economic reality of the conduit

arrangements, which is that the investors in the debt securities of those entities are somewhat indifferent to the credit support provided by the transferor of the underlying assets. They view the conduit as an adjunct to the sponsor's operations. The conduits are operated under the name of the sponsor and backed by the sponsor's credit support, and that is what is important to the investors. At the same time, the sponsor looks primarily to the transferors' credit to mitigate its risks. The substance of the arrangement is a loan by the bank to the transferor financed by a borrowing by the bank. The original wording was consistent with that view of the substance since it took commingled debt out of the equation from the standpoint of the transferor's assessment. From the transferor's perspective, they have retained most of the risks and therefore the benefits of their assets. Therefore, they should view their separable portion as a silo SPE. The sponsor should view the overall entity as one big SPE and should consolidate if they have the majority of the overall risk, viewing each transferors assets as either a loan receivable from the transferor or the underlying transferred assets, as appropriate in each case. The possible result that the transferor would have to consolidate the portion of the SPE representing its assets, while at the same time the sponsor would have to consolidate the entire conduit is not inappropriate, given the substance of the arrangement. Therefore, I believe Ron Lott's proposal is the best approach. That approach has the added benefit of avoiding the unexplainable result, which may occur based on the Board's current position, of a transferor having to consolidate assets that they have no relation to, other than the fact that their assets are in the same conduit.

### **The changes to paragraph 8c**

If I understand it correctly, the Board's decision would require that a group of assets and liabilities that are held within a separate corporation, partnership, trust, or other structure be classified into one of the two categories (1) entities for which the consolidation decision should be based on voting interests or (2) entities for which the consolidation decision should be based on variable interests. If the voting interest holders, as a group, have a controlling financial interest in a subsidiary, division, department, branch or other portion of an enterprise, then the voting interest holders should evaluate whether any one holder has a controlling financial interest as the term is used in ARB 51. If, however, the voting equity interests in the enterprise do not

give the holders a controlling financial interest, then the enterprise may be subject to consolidation by another variable interest holder in accordance with the ! interpretation. Groups of assets and liabilities that are part of a larger structure are not entities that are subject to this requirement. My interpretation of this is that all groups of assets and liabilities held in a separate structure must be evaluated for consolidation by either the voting interest approach or the variable interest approach depending on which approach is supportable in the circumstances. I think this is a tremendous improvement over the ED in that it avoids the necessity of defining SPE and SOE and it eliminates the possibility of rent-a-balance sheet arrangements.

The open and critical question in applying this concept is: what is meant by the phrase "or other structure"? Does a separate structure mean a separate legal entity or would it also include non-incorporated structures where the assets and liabilities might be deemed isolated by virtue of the fact that non-recourse debt is used? I think the broader interpretation (i.e., any structure that isolates the assets within a larger entity as occurs with non-recourse debt) should be applied. I think that would be consistent with prior practice and avoids a form distinction.

I have recently heard of a synthetic lease structure using an agency agreement whereby title to a leased property is held by an agent, "solely as agent" for two or three principals, the investors. The investors each own an undivided portion of the leased asset and may or may not finance their investment with non-recourse debt. Even if they fund their entire investment with equity, it would not meet the paragraph 9 criteria in the ED, since in a synthetic lease the residual value guarantee covers any possible risk. Is this a "structure" that should be examined to determine whether the interpretation applies? The answer is not clear to me since, if all outside parties are aware that the agent is strictly acting as an agent for the investors, I presume the legal effect is the same as if the asset were owned directly by the investors. In other words, in this case, if non-recourse debt is not used to finance the undivided interest, the asset has not really been isolated. On the other hand, the asset is separated through a "structure" of a sort. It would be helpful if the final interpretation would provide a specific enough definition of "structure" to enable practitioners to evaluate this and similar arrangements.