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TO: Director of Major Projects and Technical Activities
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SUBJECT: Your Proposed Interpretation
Consolidation of Certain Special Purpose Entities

This proposed interpretation by the Board is incredibly complex and arcane. I have great difficulty figuring out to which entities the interpretation is supposed to apply, and then how to apply the interpretation. I don't know whether the word "entities" is even the right word. Half a dozen examples, written in plain English, sure would help.

But, assuming that I correctly have figured out what the Board is saying, then I can't believe what the Board is proposing. In its determination and rush to get off-balance-sheet liabilities of SPEs onto someone's balance sheet after Enron's implosion last year and the subsequent publicity about Enron's off-balance-sheet activities and the publicity about the Board's inaction for a decade or more about accounting for SPEs, the Board now proposes to contaminate the liability side of corporate balance sheets by putting onto corporations' balance sheets "debt" that the reporting corporations do not owe. In the process, the Board now also proposes to contaminate the asset side of corporate balance sheets by putting onto corporations' balance sheets "assets" that the reporting corporations do not own, cannot sell, cannot pledge as collateral, cannot give to charity, and cannot distribute to shareholders—assets that belong to SPEs. Not only will that accounting not improve financial reporting, it will confuse and potentially mislead investors.

The Board says, in paragraph 14, that the assets (of the SPE) initially shall be reported [measured] by the "primary beneficiary" at fair value. The term "fair value" means the amount of cash that an asset would produce in a sales transaction. "Fair value" has no meaning with respect to an asset that the reporting enterprise does not own and therefore cannot sell; it is a non sequitur. Investors who read corporate balance sheets are entitled to assume that when an asset is reported at fair value (or at cost for that matter) that the reporting enterprise owns the asset and can sell it for cash. No amount of disclosure to the effect that the reporting enterprise really does not own the asset and therefore cannot sell it will cure the misleading impression given by reporting the asset in the balance sheet.

The Board says in the Summary of the proposed interpretation that, “The relationship between an SPE and its primary beneficiary results in control by the primary beneficiary of the future benefits from the assets of the SPE even though the primary beneficiary may not have the direct ability to make decisions about the uses of the assets.” What a strange meaning and use of the word “control” that statement by the Board is. How can one control something and yet “not have the direct ability to make decisions about the uses of [that something]”? That does not make sense.

The Board says, in paragraph 184 of its own Concepts Statement 6, that, “...an asset of an entity is the future economic benefits that the entity can control and thus can, within limits set by the nature of the benefit or the entity’s right to it, use as it pleases. The entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others’ use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners” [underlines added by me]. Reporting enterprises can do none of those things with assets of SPEs. So, how can the Board square the words in its own Concepts Statement 6 with the proposed interpretation? I can’t. Under the Board’s proposed interpretation, reporting enterprises that are “primary beneficiaries” will report phantom assets and liabilities, phantom revenues and expenses, and phantom cash flows. The Board is going to make yet a further hash of already horribly complex financial reports that are produced by application of the encyclopedia of Byzantine FASB rules already in place—financial reports that are not understandable by or comprehensible to investors. That is not just my opinion; read speeches by the chairman of the Securities and Exchange Commission wherein he makes the same point. See, for example, Chairman Pitt’s speeches of October 22, November 8, and November 29, 2001 on the SEC’s web site.

What is it that is the problem with accounting for SPEs? The problem is that guarantors are not reporting on their balance sheets as liabilities the fair value of guarantees (or undertakings) that they have issued. When an SPE is created, the creator thereof often guarantees the value of the assets, or a portion of the assets, held by the SPE. Or, guarantees that the assets in the SPE will produce a certain level or amount of cash flow. Or, undertakes to perform services related to the SPE at less than a fair rate for those services. Or, the creator of the SPE guarantees the payment of the interest and principal, or some of the interest and principal, of the debt of SPE. The solution to the problem is for the Board to require that the guarantor, on its balance sheet, report as a liability the fair value of its guarantee at the date of the issuance of that guarantee, with a corresponding charge to earnings. Then, at each balance sheet date thereafter, the fair value of that guarantee would be re-determined, with the change, plus or minus, entered into earnings. Along with disclosure of the pertinent facts about the guarantee or undertaking, this is a simple, straightforward solution to the problem—a solution that will be understandable by and comprehensible to investors. And, this solution to the problem will not have corporations reporting phantom assets and liabilities, phantom revenues and expenses, and phantom cash flows.

As to leases, lessees often guarantee the residual value of the leased asset, which guarantee becomes operative at the end of the lease. But, most leases that I have seen also impose on the lessee a termination penalty, which penalty generally becomes operative immediately on signing the lease. Payment of periodic amounts under the lease by the lessee (so-called lease payments) generally is optional in that the lessee need not make the periodic payment but may terminate the lease and pay the termination penalty. Thus, the termination penalty amount is the amount that the lessee unconditionally must pay, and that is the amount (undiscounted) that the lessee should report as its liability under the lease, with a corresponding charge to earnings, not the amount of the guaranteed residual value or the present value thereof.

If, as to lessees, the Board requires that some measure of the lessee's commitment to disburse cash, say the termination penalty amount, be reported as an asset, then the Board will be repeating the mistake that it made in FASB Statement 142 where it said that the cost of goodwill is an asset. Unless the amount recognized as an asset for a lease can be realized in cash through a sub-lease, that amount is just like goodwill in that it represents hoped-for future profits. Leased assets differ from owned assets in that owned assets can be converted into cash through a sale. If the lessee may not sub-lease the leased asset, the only way that any amount represented as an asset for a lease can be realized in cash is through future use of the leased asset. Thus, the realization of that amount depends on customers buying the lessee's services or product at a price that yields a profit. Lessees obviously do not control their customers' actions; thus to a lessee the asset is a contingent asset—just like goodwill. Contingent assets are not recognized until realized in cash.

The Board should not require, or even permit, primary beneficiaries of SPEs or lessees to report as assets on their balance sheets things that they do not own, cannot sell, cannot pledge as collateral, cannot give to charity, and cannot distribute to shareholders. Investors will be confused and potentially misled by that reporting.

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