

Letter of Comment No: 52 File Reference: 1082-200

Date Received:

August 30, 2002

Suzanne O. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. 1082-200, Exposure Draft of a Proposed Interpretation, Consolidation of Special-Purpose Entities, an Interpretation of ARB 51

Dear Ms. Bielstein:

The Association for Financial Professionals (AFP) welcomes the opportunity to comment on the Exposure Draft of a Proposed Interpretation, Consolidation of Special-Purpose Entities, an Interpretation of ARB 51. The proposed standard addresses balance sheet treatment of special-purpose entities (SPEs) where control of an SPE cannot be determined through ownership of voting interests.

AFP agrees that any entity that provides primary financial support for an SPE should be required to consolidate the SPE in its financial statements. However, AFP is concerned about the effect that the implementation of the new standard will have on companies that use SPEs, especially synthetic leases. Rapid consolidation of SPEs may result in violations of covenants contained in credit and debt agreements of many companies, with serious negative consequences for their operations. We believe that the Financial Accounting Standards Board (FASB) should consider extending the effective date for companies that will violate a debt covenant due to the new accounting standard. Rapid consolidation will harm the great majority of companies that have entered into responsible SPE arrangements for sound business reasons.

The membership of AFP includes approximately 14,000 financial executives employed by over 5,000 corporations and other organizations. Our members represent a broad spectrum of financial disciplines; their organizations are drawn generally from the Fortune 1000 and middle-market companies in a wide variety of industries, including manufacturing, retail, energy, financial services, and technology. AFP supports members throughout their careers with research, continuing education, career development, professional certifications, publications, representation to key legislators and regulators, and the development of industry standards.

Summary of Proposed Interpretation

The current standard, Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, provides for consolidation when one party exercises control through owning a majority of the voting interests. Many SPEs, however, are structured so that the parties do not have voting interests. The proposed interpretation addresses determination of control over SPEs in the absence of voting interests.

The proposed standard will require each enterprise involved with an SPE to determine whether it provides financial support through a variable interest. Variable interests generally subject the enterprise to a risk of losing an investment in the SPE or incurring a loss as a result of a contingent obligation. Variable interests can include guarantees or credit enhancements, leases, loans, contractual rights and obligations, derivatives, residual interests in assets transferred to the SPE, and other similar arrangements.

Under the proposed interpretation, the primary beneficiary of the SPE's operations is the enterprise that has either (1) a majority of the variable interests or (2) a variable interest that is a significant portion of the total and significantly more than variable interests held by any other party. The primary beneficiary is required to consolidate the assets, liabilities and operations of the SPE. SPEs that hold financial assets, such as mortgages, can be excluded from consolidation if the SPE meets conditions specified in the proposed interpretation.

AFP's Position on Proposed Interpretation

AFP supports an accounting standard for consolidation of SPEs. However, AFP is concerned about the possible detrimental impact that the effective date will have on many companies that will be required to consolidate synthetic leases and other SPEs. The proposed changes may cause these companies to be in violation of contractual restrictions, known as covenants, in their lines of credit, debt and other credit facilities. Typically a violation will accelerate the loan maturity unless the borrower can "cure" the violation or negotiate different terms. AFP believes that many companies will experience significant negative consequences if they are required to renegotiate credit agreements prior to the expiration of an agreement. These companies have not become more risky or less creditworthy; instead, a change in generally accepted accounting principles (GAAP) has triggered a violation.

Pervasiveness of Covenants. A recent study by the Risk Management Association (RMA) demonstrated the pervasiveness of covenants in large bank loans¹. RMA reviewed a sample of 238 loans made from 1992 to 1994 and classified the type and frequencies of covenants in the loan sample. They found the following regarding the more common covenants:

¹ The RMA Journal, March 2002

- Financing. Limitations on debt, debt-like contracts such as leases, or on changes in capital structure. Occurred in 91 percent of loans.
- Financial. Restrictions based on specific balance sheet, income statement, or cash flow items. Occurred in **96 percent** of loans.
- Debt and leverage. Specify either a minimum standard for debt relative to equity or a maximum standard for debt relative to some form of cash flow. Occurred in 74 percent of loans.
- Coverage and cash flow. Specify some minimum standard for an amount of cash flow or a minimum standard for cash flow relative to debt service. Occurred in 78 percent of loans.

Companies sometimes have agreements that allow for exceptions or automatic adjustments to covenants for changes in GAAP. However, in a survey of a leadership group of AFP practitioner members who are representative of the AFP membership at large, most reported that they had no such provisions in their lines of credit.

Effects of Violating Debt Covenants. The proposed interpretation would be effective as of the beginning of the first fiscal period after March 15, 2003 for SPEs created before the issuance date and existing as of March 15, 2003. Because of the long term nature of lines of credit and similar credit facilities, most companies will be required to renegotiate before their credit agreements expire. The average maturity of loans in the RMA sample was 47 months and 91 percent of the loans were revolving credit. Additionally, in our survey of AFP members, 91 percent reported an average maturity of over one year remaining and the typical respondent indicated two to three years remaining on their lines of credit.

Companies may experience significant detrimental outcomes when they ask lenders for modifications or exceptions to covenants during the terms of their existing lines of credit. In the AFP sample, over two-thirds reported that lenders would likely require concessions in return for modifying the covenants. Almost half said that their lenders would honor the request in return for the companies accepting a higher price for the credit or payment of up-front fees. Several stated that credit would likely be withdrawn by lenders unless they could bring their financial statements into compliance with covenants.

In the current environment where credit is scarce and expensive, even companies with sound business plans and stable financial positions might not be able to renegotiate their lines of credit. A lack of financing could have a significant negative effect on companies that rely on credit to offset seasonal and cyclical business fluctuations. Further, companies experiencing an increased need for credit due to economic or industry conditions are most likely to have credit withdrawn. The current scarcity of capital may

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be exacerbated by a possible reduction in commercial paper conduits available to companies, as a result of this proposed interpretation.

In our survey, 80 percent of the respondents reported likely unfavorable consequences to their operations, including severe financial distress, if their lenders withdrew the lines of credit due to covenant violations, as shown below:

- 52 percent would experience a reduction in financial flexibility
- 24 percent would have difficulty paying short term liabilities
- 16 percent would reduce capital spending
- 20 percent would experience severe financial distress

Conclusion and Recommendation

AFP agrees that there is a need for SPE consolidation guidance and supports the FASB's proposed accounting practices. The consolidation of SPEs however could have serious negative effects on companies that violate covenants in their credit and debt agreements because of the accounting change. As shown by our survey, many companies would have to renegotiate existing lines of credit and would receive terms that are less favorable, including increased price and significant up-front fees. In some cases, lenders might refuse requests for a modification of covenants and require the companies to cure the covenant violations. In addition, there could be significant unfavorable consequences for companies if lenders withdrew the lines of credit. Our survey indicated that companies would experience a reduction in financial flexibility, difficulty in paying short-term liabilities and a reduction in capital spending. Some reported that they would experience severe financial distress.

Recommendation. AFP recommends that the FASB consider extending the effective date of March 15, 2003 for consolidating SPEs that were in existence upon issuance of the final interpretation. This will protect companies that have entered into legitimate SPE arrangements for valid business purposes.

Specifically, AFP proposes a transition for companies that have covenants that would be violated as a result an SPE consolidation. The effective date for consolidating existing SPEs should be the shorter of two years from the issuance date of the new standard or the expiration of credit lines that contain covenants that would be violated. This will help mitigate the potentially serious consequences of a covenant violation by providing companies with additional time for existing agreements to expire and for companies to renegotiate lines of credit. This transition rule will also require companies with potential covenant violations to comply within a reasonable period of time and for companies without violations to comply by the March 15 deadline.

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Companies should also be required to make appropriate disclosures in their financial statements when SPEs are not consolidated, as allowed under our recommendation above. For example, companies should disclose what the effect would have been on the balance sheet and income statement if they had consolidated an SPE.

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On behalf of our 14,000 members, AFP appreciates the opportunity to comment on the FASB proposed interpretation. If you have any questions, please contact Gregory Fletcher, AFP's Director of Financial Accounting and Reporting, at (301) 961-8869.

Sincerely,

Alvin C. Rodack, CCM Associate Treasurer The Ohio State University Chairman

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Financial Accounting and Investor Relations (FAIR) Task Force