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Financial Accounting Standards Board
File Reference No. 1082-200
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Dear Members of the Board:

The U.S. Senate Permanent Subcommittee on Investigations, which I chair, is conducting an ongoing, in-depth inquiry into the collapse of Enron Corporation. Among other problems, the Subcommittee investigation has uncovered a number of significant accounting abuses involving Special Purpose Entities ("SPEs"). These abuses provide compelling evidence that current SPE accounting rules are inadequate to stop material accounting deceptions, and a major overhaul is needed to put an end to misleading financial statements that now result from SPE manipulations. That is why I am writing in support of the FASB Exposure Draft proposing a new interpretation of Accounting Research Bulletin 51 on consolidated financial statements to address "Consolidation of Certain Special-Purpose Entities." The Subcommittee investigation also indicates that the FASB proposal may benefit from some additional strengthening provisions.

The Subcommittee's investigation into Enron's collapse has uncovered at least five different types of SPE abuses involving billions of dollars and misleading accounting in the areas of inflated cash flow from operations, inflated earnings, and hidden debt. These SPE abuses can be categorized as follows: (1) bank-directed SPEs, such as Mahonia and Delta Energy, that were secretly established and used by major U.S. financial institutions to help Enron orchestrate phony energy derivative trades and declare billions of dollars in associated proceeds as cash flow from operations rather than cash flow from financing; (2) SPEs used by Enron and its underwriter to establish blind pool investment trusts that restricted investment disclosures to investors, analysts and others; (3) SPEs, such as the four Raptor SPEs, that were used by Enron to construct phony hedging arrangements to hide almost $1 billion in stock losses that otherwise would have reduced Enron's reported earnings; (4) employee-directed SPEs, such as Chewco and LJM, that were run by Enron employees and used to execute questionable asset sales and other transactions with Enron to manipulate Enron's financial statements; and (5) SPEs, such as Hawaii 125-0 Trust, that Enron used to conduct suspect financial asset sales under SFAS 125/140, keep debt off its balance sheet, and inflate its earnings.

The following comments summarize the SPE abuses examined by the Subcommittee's investigation to date and offer some thoughts on how FASB's new proposal might have applied to them and might be able to prevent similar abuses in the future. In some instances, suggestions are made for changes or additional provisions to help put an end to Enron-style SPE abuses. A few technical suggestions are also offered to improve the proposal.

(1) **Bank-Directed SPEs**

One of the more disturbing SPE abuses examined by the Subcommittee in its Enron investigation involves two offshore shell corporations that were secretly established and directed by JP Morgan Chase ("Chase") and Citigroup, two major U.S. financial institutions that transacted business with Enron. Evidence obtained by the Subcommittee, set forth in testimony and exhibits at a Subcommittee hearing on July 23, 2002, indicates that these SPEs were used by the banks to help Enron orchestrate over $8 billion in phony energy trades which Enron referred to as prepaid forward contracts or "prepays." Enron booked the $8 billion from these transactions as energy trading liabilities and cash flow from operations, when the funds were actually loan proceeds that should have been booked as cash flow from financing.

Documentation obtained by the Subcommittee shows that Chase established one of the SPEs that participated in the prepays, Mahonia, Inc., in the isle of Jersey with the assistance of a Jersey law firm. This law firm routinely provides to its clients a number of services associated with forming and operating offshore trusts and shell corporations, including filing initial paperwork and performing ongoing administrative services such as supplying trustees, directors and shareholders to form and operate the trusts and shell corporations, and completing required paperwork and payment of fees and taxes. One letter from the Jersey law firm to the Jersey regulator states quite plainly that the SPE is being established by Chase and is intended to assist Chase but, "for accounting and other requirements," will not be wholly owned by the bank. Citigroup formed a similar type of SPE, called Delta Energy, in the Cayman Islands using a Cayman law firm and an offshore bank to provide similar services.

In both cases, the SPE was set up so that the sponsoring bank had no technical legal ownership or voting control of the SPE, which was instead nominally owned by a charitable trust whose trustee, through various layers of intermediaries, was either an employee or agent of the law firm used by the bank to establish the SPE. While lacking legal ownership, each bank nevertheless paid for the SPE's formation, opened the bank accounts used by the SPE, used bank employees to negotiate deals on behalf of the SPE, supplied the SPE's financing, and either paid the SPE's legal and administrative costs or made sure specific transactions included payments to the SPE sufficient to pay its expenses. Neither SPE had any employees of its own, nor engaged in any business transaction that excluded its sponsoring bank.

In the case of Enron, the Subcommittee found that each bank used its offshore SPE to help Enron orchestrate three-way energy trades involving the bank, Enron, and the offshore SPE. These trades were set up to cancel each other out except for Enron's repayment of the disguised bank loan with interest and sometimes a small fee for the SPE. The SPEs had no business purpose for engaging in energy trading, there was no price risk involved in the linked trades, bank employees acted on behalf of the SPEs, and the banks supplied the money used in the linked trades. The SPEs were not more than nominally capitalized. At the Subcommittee hearing on July 23, both banks admitted that the energy trades were linked and did not involve price risk, but denied – and have continued to deny – controlling the offshore SPEs that were the third parties in the trades. While the evidence before the Subcommittee contradicts the position taken by the banks, their ongoing refusal to acknowledge their control of the offshore SPEs demonstrates the difficulties inherent in SPE accounting and the importance of clear and enforceable accounting principles.

Enron employees have stated that the company booked the prepays as trading liabilities and cash flow from operations, rather than as debt and cash flow from financing. The result was that Enron misrepresented both the size of its trading operations and the amount of its cash flow from operations. For example, in the year 2000, Enron reported in its financial statement about $20 billion in energy trading liabilities, of which about $4 billion, or 25 percent of the total, was attributable to the phony prepays with Chase and Citigroup. Enron also reported about $3.2 billion in cash flow from operations in 2000; about $1.5 billion of that total, or nearly 50 percent, came from the phony prepays. In addition to inflating its energy trading activity and cash flow from operations, Enron recorded only about $10 billion in debt on its 2000 balance sheet. If the Chase and Citigroup financings had been correctly recorded, Enron's debt would have increased 40 percent to $14 billion. As one internal Chase email noted, "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) bury it in their trading liabilities."

Existing SPE accounting rules do not address the bank-directed offshore SPEs, since the banks have no voting ownership interest in them. The new FASB proposal, on the other hand, would presumably deem each bank to be the "primary beneficiary" of its SPE and require consolidation, since the bank provided the SPE's financing, directed its activities to ensure the bank benefitted from the SPE's transactions, and did not use the SPEs to disperse the risks of the prepays.

One major concern, however, is that the proposal does not explicitly address the accounting consequences for Enron which also benefitted from the orchestrated transactions involving the bank-directed SPEs. Although these orchestrated transactions should not have been classified as independent trades by Enron for accounting purposes under current accounting standards, FASB should use the opportunity presented by its new proposal to make it explicitly clear that, in a series of transactions among parties, an SPE sponsored by or primarily benefitting one of the parties to the transactions cannot be deemed an independent third party for the purpose of disguising the linked transactions as independent, unrelated, or conducted at arms-length.

One way to prohibit this type of SPE abuse would be to amend the proposal to add broader guidance requiring a substantive analysis of SPE transactions focusing on whether an SPE is being used to advance legitimate economic objectives such as lowering financing costs or diversifying risk, or to achieve accounting objectives that advance the manipulation of a financial statement such as by hiding debt or inflating cash flow from operations. This analysis would provide a straightforward set of principles underlying the new SPE rule and could serve as a starting point for analyzing complex or currently unanticipated SPE transactions. If the analysis were to indicate that an SPE had been inserted in a deal primarily to achieve accounting objectives, then the guidance could direct that the SPE be consolidated with the primary beneficiary and the parties treat the transaction at issue as involving two parties rather than three. In the Enron matter, this analysis would presumably have required the offshore SPEs to be consolidated with their sponsoring banks, and the orchestrated energy trades would have collapsed and disclosed that the resulting transactions between the bank and Enron were nothing more than financings.

A second concern involves how the new proposal would apply to transactions such as the phony prepays in which the key SPE functions merely as a pass-through trading partner, without any need for equity, and where the trades themselves provide no basis for measuring "equity at risk." In analyzing such transactions, the guidance may want to offer an alternative test, such as whether the transaction, in fact, presents a meaningful price risk to the SPE, perhaps 10% of the value of the trade to be consistent with the rest of the proposal. The guidance could provide that, if the SPE does not have a minimum of 10% at risk in the trade, then it should be deemed an SPE without substance and consolidated with the primary beneficiary. The parties would then be compelled to treat the trading transactions as involving two parties rather than three. This type of approach would presumably help to prevent companies like Enron, Chase and Citigroup from executing pre-fabricated, circular trades in which 100% of the SPE's price risk is eliminated from inception.

A third concern involves how the new proposal would apply to situations where a company transacts business with an SPE sponsored by another entity, such as when Enron entered into trades with the Chase and Citigroup SPEs. Paragraph 14 of the proposal states that a company must consider "all evidence that the enterprise possesses or would reasonably be expected to possess" in making a consolidation decision. A company might claim, however, that it could not reasonably be expected to possess information about another entity's SPE. The proposal may want to consider requiring companies, prior to transacting business with an SPE, to obtain sufficient information about the SPE's sponsorship, financing, administration, and transaction history to determine whether the SPE would have to be consolidated with any other entity and, if so, how that would affect the accounting for the transaction.

(2) **Blind Pool Investment Trusts**

A subset of the phony prepays just described involve blind pool investment trusts that were set up by Citigroup, as Enron's underwriter, to obtain financing for Enron from the capital markets through 144A private offerings. A series of six bond offerings, known collectively as "Yosemite," involved the establishment of six blind pool SPEs. These six SPEs were established by Citigroup in either foreign or domestic jurisdictions, depending upon which of three currencies was to be raised: dollars, pounds sterling, or euros. Evidence obtained by the Subcommittee regarding these transactions is included in the testimony and exhibits at the Subcommittee's July 23 hearing.

In the Yosemite offerings, Enron and Citigroup created blind investment pools whose assets were held by an SPE trust which issued bonds to qualified investors. The investors in Yosemite I and II were told nothing about the investments in the trust except that they were AAA rated or Enron-related investments. The offering memorandum explicitly stated: "In the absence of an Indenture Event of Default, the Trust will not disclose to Noteholders information relating to Trust Investments held by it at any time." In theory, the assets placed in the trust were not fixed, but could vary over time. In fact, the money raised from the Yosemite bonds was used for only one purpose, to close out outstanding "prepays" that Enron had with Citigroup and other banks and to replace them with new prepays. In the subsequent Yosemite offerings, the investors were told nothing about the particular investments that would be made with their funds except that they would be AAA rated. In fact, the money raised from these later Yosemite bonds were used to purchase Citigroup certificates of deposit. Citigroup then used the money to fund Enron's new prepays, essentially enabling Enron to, again, borrow the funds through phony energy trades, while accounting for the borrowing as trading activity.

Because of the blind pool investment trusts, Enron and Citigroup kept the deceptive prepays out of view and away from the scrutiny of investors. Citigroup materials seeking to convince other companies to engage in similar transactions promoted the blind pool investment structure as providing a "black box" feature that eliminated a company's obligation to disclose particular investments to investors. When an investor later learned that Delta Energy might somehow be involved in the Yosemite investments and asked Enron for more information, an Enron employee abruptly told Citigroup to "shut this down" and prevent the investor from obtaining further information about either Delta or the assets in the trust.

In addition to restricting information about investments, the Yosemite transactions also obscured the beneficial ownership of the investment trusts themselves. In Yosemite I and II, the blind pool SPE was beneficially owned 5 percent by Enron; 45 percent by Whitewing, an Enron-related SPE; and 50 percent by Long Lane Master Trust IV, an SPE administered by FleetBoston. Long Lane also had, however, an undisclosed total return swap with Citigroup, which ensured that the rights and responsibilities of Long Lane's position actually vested in Citigroup. In subsequent Yosemite bond offerings, the blind pool SPE was beneficially owned 100 percent by a third party that, again, had a total return swap with Citigroup. The third party "balance sheet provider" in these bond offerings was either Royal Bank of Canada or ING Baring.

Still another undisclosed factor in the Yosemite transactions was the existence of guarantees by Enron. One, called a "magic note," effectively obligated Enron to ensure that all interest payments on the bonds and certificates were made in full. Another guarantee placed Enron obligations deriving from Yosemite-funded prepays on par with senior unsecured Enron debt.

The type of blind pool investment trusts involved in the Yosemite transactions raise troubling barriers to the transparency of particular investments, the ownership of the SPE holding the trust assets, the identity of the parties that retained the risks and rewards associated with the bonds, and the proper financial reporting of the phony prepays financed with the bond proceeds. The FASB proposal does not now explicitly address the existence of SPEs that function as blind pool investment trusts. The proposal might want to reference these SPE transactions and perhaps require any company seeking the secrecy of a blind pool investment trust to consolidate the trust involved, so that the trust's assets and liabilities are included in the company's financial statements.

(3) **SPE Hedging Abuses**

A third area of SPE abuse investigated by the Subcommittee involves Enron's Raptor transactions. The Raptors are a series of four complex transactions that began in mid-2000 and terminated a little over a year later in 2001. In each of the Raptor transactions, Enron orchestrated the establishment of an SPE and arranged for LJM2, a partnership managed and partly owned by Enron's chief financial officer, to provide the SPE with $30 million which supposedly served as the independent equity allowing the SPE to avoid consolidation with Enron. This $30 million was never truly at risk, however, since Enron had explicitly assured LJM2 that it would recoup its money plus approximately $10 million more within six months of each SPE's establishment. Enron, in fact, made the promised payments to LJM2 prior to any hedging activity being undertaken by the relevant Raptor SPEs. The only other assets contributed to the Raptor SPEs came from Enron itself, which pledged its own stock, contracts to buy Enron stock in the future, or warrants to buy stock in an Enron-related company called The New Power Company.

Despite their thin capitalization and limited credit capacity, Enron entered into derivative agreements with each of the Raptor SPEs to hedge the value of volatile stock investments which Enron held in other companies, including The New Power Company, and which Enron had used to claim earnings on its income statements. The derivatives did not apply to fixed investment assets, however, but permitted Enron to substitute assets over time. Enron then used the so-called Raptor hedges to offset mounting losses in its stock investments which otherwise would have reduced Enron's earnings. When the SPEs sustained substantial losses on the hedging activity, Enron alone was responsible for ensuring their creditworthiness and engaged in a variety of accounting gimmicks to support them, including using cross-guarantees among the four SPEs, instituting a questionable collar on the hedged assets, and restructuring the Raptors by pledging additional shares. In the space of one year, Enron used the alleged Raptor hedges to mask investment losses of almost $1 billion.

Enron, in effect, used the Raptor SPEs in a sham transaction to hedge its assets with itself. The result was a massive accounting deception that involved a substantial misstatement of earnings, later compounded by an accounting error that also reduced Enron's shareholder equity. Additional information about the Raptors is included in testimony and exhibits at the Subcommittee hearing on May 7, in a Subcommittee Report on the Role of the Board of Directors in Enron's Collapse issued July 8, and in the Powers Report issued by the Special

Investigative Committee of the Enron Board of Directors on February 1, 2002.

The new FASB proposal would clearly have required Enron to consolidate the Raptor SPEs on a number of grounds, including the company's status as the "primary beneficiary" of the SPEs, its role in providing the SPEs with financing, and the inability of the SPEs to conduct any activities without additional financial support from Enron. The abuses by Enron in the Raptors transactions were so great, however, that a better approach might be for the FASB proposal simply to prohibit any company from attempting to hedge investments with an SPE that the company itself has helped to sponsor, finance or guarantee, or for which the company is the primary beneficiary. SPEs by definition do not function as operating businesses, and a company that cannot find an independent third party, other than an SPE it has helped establish or finance, to hedge its price risk in investments should not be permitted to construct a sham hedging arrangement with that SPE to hide investment losses on its income statement.

(4) **Employee-Directed SPEs**

A fourth area of SPE abuse investigated by the Subcommittee involves SPEs run by the employees of the sponsoring company. Enron sponsored a number of entities run by Enron employees including JEDI, Chewco, Whitewing, Hawaii 125-0 Trust, LJM1 and LJM2. Some of these entities were SPEs; others were described by Enron as "unconsolidated affiliates." The employees, some of whom also had ownership interests in the entities, generally came from the office of Enron's chief financial officer. Each of these entities appears to have helped Enron manipulate its financial statements by engaging in questionable asset sales and other transactions, as set out in the May Subcommittee hearing, the July Subcommittee Report, and the Powers Report.

The Subcommittee has examined in particular LJM2, the investment partnership managed and partly owned by Enron's chief financial officer, Andrew Fastow. A key document by Arthur Andersen analyzes LJM2's formation in terms of whether it would have qualified as an SPE. The memorandum, by the head of Andersen's audit engagement team, noted that Mr. Fastow was to be the general partner of LJM2 in control of its day-to-day operations. It also noted that, while he theoretically could be removed at will by the limited partners, the partnership documents required supermajority votes by two different groups of limited partners, one of which was an advisory committee whose members were to be appointed by Mr. Fastow. Andersen concluded that, despite being at "the very upper limit of what may be acceptable," the proposed removal features were sufficient to ensure that the general partner, Mr. Fastow, did not control the partnership and LJM2 did not have to be consolidated by Enron.

The Andersen analysis of LJM2 raises serious questions about the need for better guidance from FASB on employee-directed SPEs. The new proposal requires a business enterprise to consolidate an SPE if it has a "controlling financial interest" in the SPE, which is further defined as existing when the business enterprise is the "primary beneficiary" of the SPE's assets, liabilities, and activities. The proposal states on page iii that the "relationship between an SPE and its primary beneficiary results in control by the primary beneficiary of further 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." In the case of employee-directed SPEs, the sponsor's employees may serve as the SPE's direct owner and manager, while also providing the mechanism by which the sponsor is assured of its status as the SPE's primary beneficiary.

The FASB proposal tangentially addresses this issue when it discusses related parties in Appendix B, but would be strengthened by including explicit guidance that an SPE which is owned or managed by a sponsor's employees or their relatives is a likely candidate for consolidation.

(5) **SFAS 125/140 SPE Abuses**

Another SPE abuse uncovered by the Subcommittee's Enron investigation involves actions taken by Enron to account for the sale of certain assets under SFAS 125, later superceded by SFAS 140, even though these assets did not qualify as the "financial assets" to which these accounting principles apply. The Subcommittee investigation has identified two distinct SPE abuses devised by Enron to take advantage of SFAS 125/140: selling SPEs assets that were never intended to qualify as "financial assets," and securitizing long-lived assets with short-term borrowing. In addition, Enron frequently retained the risks and rewards associated with the transferred assets by entering into a total return swap with the purchaser.

SFAS 125/140 was designed to govern the sale of "financial assets," such as mortgages and loans, to SPEs for subsequent securitization. Enron, in transactions such as the Hawaii 125-0 Trust series, instead used this accounting guidance to recognize gains on the transfer of what were in reality physical assets, such as power plants. To achieve the fiction that these physical assets were actually financial assets, Enron first transferred interests in the physical assets to a series of subsidiaries. Because the only asset held by the final subsidiary in the chain was a financial interest in another entity, Enron concluded that it could treat that asset as a "financial asset" under SFAS 125/140, transfer it as a "securitized" asset to an SPE it had sponsored, and then recognize income from the sale in earnings.

Enron also used SFAS 125/140 guidance to record income from sales of long-term contracts, such as contracts to deliver natural gas or crude oil at a set price in the future. While these long-term contracts, like mortgages or loans, entitled Enron to future cash flows, they were not receivables on GAAP financial statements. In one instance the power plant to which the long-term delivery contract applied was not even operational when the contract was securitized. Additionally, while this contract entitled Enron to cash flows for 20 years, the debt instrument purchased by the SPE was limited to six months. Six months after the sale, to meet its debt obligation, the SPE resold the asset to an Enron affiliate. Had Enron sold the asset to its affiliate directly, it would not have been able to recognize a gain on the sale – only cash flow from operations. But by selling it to the SPE first and then directing the SPE to resell the asset to the Enron affiliate, Enron recorded a gain on the sale as earnings on its income statement.

In both types of SFAS 125/140 transactions, Enron typically sold the asset to an SPE that was typically capitalized with 3 percent equity and 97 percent debt from a financial institution. Enron also typically guaranteed performance by the SPE to the debtholder through a total return swap, which meant that Enron never completely relinquished the risks and rewards associated with the "sold" asset. In one instance, the Subcommittee discovered a SFAS 125 transaction in which Enron had verbally guaranteed the performance for the 3% equity holder in addition to the total return swap on the 97%. A schematic chart depicting a typical SFAS 125/140 transaction at Enron, including the total return swap, is enclosed.

SPEs, such as the Hawaii 125-0 Trust, apparently borrowed more than $1 billion from one or more banks to obtain the funds used to "purchase" these assets from Enron. A chart provided by Enron management to the Enron Board of Directors during the summer of 2001, included in the Subcommittee's May hearing as Exhibit 42, indicates that at the beginning of 1999, Enron had over $500 million outstanding related to its SFAS 125/140 transactions. By June 30, 2001, this total exceeded $1.5 billion. Other documents indicate that the total income reported by Enron from SFAS 125/140 transactions may have exceeded $1 billion.

The FASB proposal addresses SPEs that hold financial assets in Paragraphs 22 and 23, demonstrating FASB's intent to coordinate SPE accounting with existing guidance on the sale of financial assets. However, the proposal needs to be strengthened in several respects to prevent the type of abuses engaged in by Enron. First, the proposal should provide that any of the conditions specified in Paragraph 23 would be enough to establish that an entity provides significant financial support to the SPE, rather than requiring that two of the three conditions be met. Secondly, Paragraph 23a should be amended to apply to any business enterprise that has the "*ability* to purchase and sell assets for the SPE." Too often in our investigation we discovered that Enron and its financial institutions, in reality, made decisions for SPEs even when they may not have had the technical authority to do so. Additionally, Paragraph 23 could state explicitly that an SPE's debt must match the value *and* life-span of the assets in the SPE (this provision could be applied to other sections of this interpretation as well) and that the original accounting for an SPE may be altered based upon subsequent transactions by the SPE. Finally, FASB should consider clarifying the type of assets that qualify as "financial assets" under SFAS 140.

Renting out the Balance Sheet

Another issue is raised by Paragraph 8c in the new proposal, which essentially provides that any operating business enterprise can choose to consolidate an SPE in its financial statement and, if it does so, no one else can be deemed the SPE's primary beneficiary. While this provision makes sense on its face, it also carries problems as illustrated by an instance in which Enron used the SPE of a financial institution, Merrill Lynch, to "park" an asset for a period of time. The goal of this transaction was to allow Enron to claim that the asset transfer was a "sale" and report the sales income as earnings on its income statement. To accomplish that objective, the SPE, which was established and consolidated by Merrill Lynch, purchased an interest in certain Nigerian power barges owned by Enron with $7 million dollars provided by Merrill Lynch and a $21 million seller-financed loan. It did so on the understanding that Enron would arrange for the resale of this interest within six months.

Setting aside revenue recognition issues related to the verbal agreement between Enron and Merrill Lynch to arrange the resale of the asset, Paragraph 8c would presumably operate to preclude Enron from consolidating an SPE already consolidated by Merrill Lynch. The amount of the investment ($7 million dollar equity investment and $21 million dollar note) is immaterial to Merrill Lynch's balance sheet, yet the transaction was important for Enron to meet its earnings target. This provision could be misused by financial institutions to assist companies in manipulating their financial statements by simply "renting" out the institution's balance sheet in exchange for fees or future business with the companies. For this reason, additional scrutiny should be applied to Paragraph 8c to determine whether its advantages outweigh its disadvantages in promoting accurate SPE financial reporting.

SPE Disclosure

An additional issue requiring clarification involves the extent and nature of the SPE disclosures that are intended to be required by the new proposal. Accounting manipulations involving SPEs are at the heart of ongoing concerns that publicly traded companies may have undisclosed assets, liabilities and transactions that may have a material impact on the financial condition of the company. Enron's limited disclosures regarding its use of SPEs, as well as the existence of previously undisclosed offshore SPEs associated with Chase and Citigroup, suggest that current SPE disclosure requirements need to be made more explicit and more detailed.

The first question is whether Paragraph 24 in the new proposal could be interpreted to allow a primary beneficiary of an SPE to report material SPE information in the footnotes to the company's financial statements, and not in the financial statements themselves. Since the purpose of the new proposal appears to be to require SPE obligations to be reported on the statement of financial position just as the obligations of a subsidiary would be, footnote disclosure alone would seem to be inadequate for SPEs for which the company is the primary beneficiary.

A second issue is the extent and nature of the SPE disclosures contemplated by Paragraph 25 which applies to SPEs for which a company is not the primary beneficiary. Users of financial statements clearly want more complete SPE disclosures to help them evaluate whether a company has material off-balance-sheet liabilities or assets, but as presently worded, it is unclear whether Paragraph 25 is intended to or would be sufficient to provide the information needed for such an evaluation. The proposal's disclosure section could be strengthened to require footnote disclosure or MDA discussion of a company's overall SPE activity, including information on the total number of existing SPEs the company has formed or in which it has an equity or financing interest, the countries where these SPEs are located, the types or purposes of these SPEs, the total amount and type of assets or debt held by these SPEs, the total number of other SPEs with which the company has transacted business and the nature of these transactions, the total amount and type of income recognized by the company as a result of SPE activity, and any other material impact on the company's financial condition resulting from its transactions with SPEs. Changes in the status of previously disclosed SPEs, such as a change in the SPE's primary beneficiary, could also be required to be reported. Disclosure could also be made mandatory for restatements resulting from improper accounting for SPEs and for any impact a restatement might have on other areas of the financial statements. If the proposal were to take a broader approach to SPE disclosure, it would also have to clarify whether the required disclosure of SPE activity applied to all SPEs with which a company has transacted business or to some, more limited subset.

10% Outside Equity Rule

One of the most difficult SPE accounting issues in the new proposal is establishing the minimum amount of outside equity in an SPE required for deconsolidation. Existing rules have been severely criticized for permitting an SPE with only 3 percent outside equity to be deconsolidated from its sponsor, even when the sponsor holds the remaining 97 percent. The new FASB proposal would increase the minimum from 3 to 10 percent, but to a layman, that is not much of a difference. While an argument could be made that a fully bankruptcy remote SPE with no outside equity can meet the requirements for deconsolidation, common sense argues that an SPE which is 90% owned by one entity is controlled by that entity and ought to be consolidated with it. If the goal is to permit deconsolidation of SPEs that are truly independent and not under the thumb of their primary beneficiary, the required minimum for outside equity should be set at a much higher threshhold, such as 25 percent, 30 percent or even 50 percent. In addition, while the FASB proposal characterizes the new 10% outside equity as a minimum investment, history suggests that accountants will soon view that 10% as the ceiling for outside investment in an SPE. For this reason, the new proposal may want to amend Paragraph 12 to require that all SPE equity investments be examined to determine whether the percentage of outside equity being invested in a particular SPE is "comparable to the equity of businesses that are not SPEs."

Additional Points

A few additional, technical suggestions are offered to further clarify and strengthen the proposal.

- Paragraph 6 states that "each party involved with the SPE must determine whether it provides significant financial support to the SPE." The proposal may want to clarify whether each of these parties or their auditors are required to communicate with each other about the SPE to obtain complete and accurate information.

- Paragraph 14 says that an "enterprise shall not restate previously issued financial statements if it becomes the primary beneficiary of an SPE subsequent to inception of the SPE or if it ceases to be the primary beneficiary of an SPE." This prohibition could be clarified to apply only to those situations where business relationships or circumstances have changed, and not to situations where an entity should reasonably have been aware of information requiring it to have recognized previously its status as a primary beneficiary of the SPE.

- The proposal would also benefit from a specific provision preventing companies from repurchasing an asset from an SPE without restating any income or cash flow generated from the initial sale to the SPE.

- Finally, the proposal is written in such technical terms that it might benefit from including more of the information contained in Appendix B, "Background Information and Basis for Conclusions." Paragraphs B2, B4, B5, B16, B19, and B26 are particularly helpful in understanding how the proposal is supposed to work.

Thank you for this opportunity to offer these comments. If your staff has any questions or concerns about this letter, please have your staff contact Elise Bean, the Acting Staff Director of the Subcommittee, at (202) 224-9505.

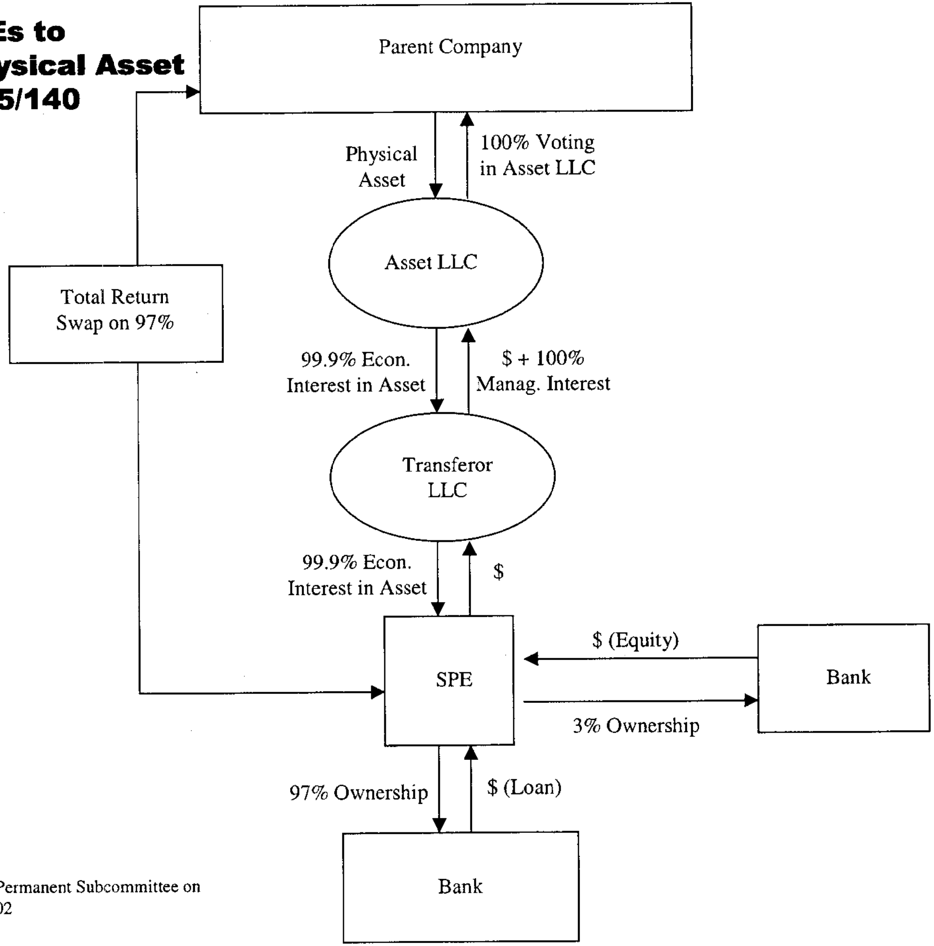
Sincerely,

Carl Levin

Carl Levin, Chairman
Permanent Subcommittee on Investigations

CL:ejb
Enclosure

Misuse of SPEs to Securitize Physical Asset under FAS 125/140



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