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**Director of Major Projects and Technical Activities**

**Financial Accounting Standards Board**

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On June 28, 2002, the Financial Accounting Standards Board (FASB) issued an Exposure Draft of a Proposed Interpretation on consolidation of certain special-purpose entities (SPEs). The stated objective of this interpretation is not to restrict the use of SPEs but to improve financial reporting by enterprises involved with SPEs. The Board's intent is to achieve more consistent application of consolidation policies to SPEs and thus to improve the comparability between enterprises engaged in similar activities.

The purpose of this letter is to provide input and comments from three unrelated enterprises that provide capital on a programmatic basis to the nation's homebuilders. To facilitate the investment of our capital, we regularly use limited liability companies and limited partnerships legal structures to establish single and multi-purpose entities that acquire, own and develop real property. These legal structures are utilized to isolate and segregate the assets, liabilities and risks unique to owning and developing real property and are an inherent part of our normal business operations.

We support the Board's objective of achieving a more consistent application of consolidation policies to SPEs and improving financial reporting of enterprises involved with SPEs. However, while we certainly consider ourselves to be substantive operating entities, our concern is that the definition of a substantive operating entity, in its current

form, is subjective and could lead to the inconsistent application of consolidation policies within and across business sectors.

**Background**

This letter paper is being jointly written by Acacia Capital (Phoenix, AZ), Hearthstone Advisors (San Francisco, CA), and Saybrook Community Capital, LLC (Santa Monica, CA), collectively referred to herein as “the Authors”.

The Authors are engaged in the business of raising institutional capital for investment in residential property. This business grew out of a public policy initiative by the California Public Employees Retirement System (CalPers) in the early 1990’s designed to stimulate the investment of private and institutional capital in the homebuilding sector. Patterned after securitization, which created a more efficient market by facilitating institutional investment in mortgages, the initiative sought to create a more efficient capital market for the homebuilding sector by facilitating institutional investment in land development and residential construction. As the industry recovered from the recession of the late 1980’s and early 1990’s, the business of investing institutional and private funds in homebuilding has grown and has become an increasingly important source of capital for the homebuilding industry.

The Authors routinely form limited liability companies and limited partnerships to acquire, develop and sell residential land, via option agreements and joint venture agreements, to private and public homebuilders. These entities, referred to herein as “Operating Subsidiaries” are capitalized with substantive levels of equity and third party debt and are consolidated on the respective financial statements of each Author. By acquiring title to real property through these Operating Subsidiaries, we are able to isolate and segregate the unique liabilities and risks (such as third party claims related to environmental hazards) associated with owning and developing real property. These Operating Subsidiaries are the most efficient legal vehicle for segregating the risk of investing in land intended for residential development.

The Author's investment programs are a vital source of capital for many builders, especially those without access to the public markets. In our industry, the use of these Operating Subsidiaries in this manner promotes an efficient, risk-adjusted allocation of capital within the homebuilding sector. Without such protection, the flow of capital into the residential development sector would be sharply curtailed and its cost would increase significantly.

The Authors use of Operating Subsidiaries is driven by concerns for capital protection, not accounting treatment. Acacia and Hearthstone have been in this business for over ten years and Saybrook for more than 3 years. Collectively, the Authors have raised nearly to \$10 billion of capital from pension funds, endowments, private funds, institutions and high net worth individuals for investment in joint ventures and land options with public and private homebuilders. This sustained success in fundraising is due to the consistent track record of providing risk-adjusted returns to investors. These returns are enhanced by the liability protection afforded by the SPE.

### **Joint Ventures**

In a joint venture, two or more entities establish a new entity to pool knowledge and expertise and share risk in a transaction. One entity provides the majority of the capital and the other entities contribute their unique knowledge and expertise. In our business, the Authors would provide the capital and the other entities would be land developers or homebuilders. The parties agree to allocate the profits based on the capital invested and the value created by knowledge and expertise.

The accounting guidelines for such economic ventures are fairly straightforward. The entity that effectively controls the joint venture is deemed to be its primary beneficiary and must consolidate the venture's assets and liabilities. Effective control is usually defined as majority ownership or majority voting rights. In most cases, the party with the largest exposure to potential losses controls the venture. The accounting treatment for

joint ventures reflects the economic substance of the transaction. The party that either owns or controls a majority of the venture has the most capital at risk and must consolidate the venture.

### **Structured Options**

In an option transaction, the capital provider establishes and capitalizes a wholly owned Operating Subsidiary to hold fee title to one or more tangible assets. The Operating Subsidiary then enters into an option agreement with a builder that grants the builder the right to purchase a specific number of developed residential lots during the term of the option. The builder posts a non-refundable deposit and pays a fee to maintain the option. Should the builder wish to terminate the option, the deposit and any option fees paid prior to termination are forfeited as liquidating damages.

Public and private homebuilding companies regularly use options to hedge their exposure to a reduction in demand for their products. By optioning a portion of their inventory, a builder effectively gains a call on raw materials that mitigates potential exposure to excessive inventories. Should demand decline, these call options reduce the builder's exposure to potential economic losses.

The Interpretation references options only in its description of the possible origins of variable interests. However, by analogy, the Interpretation would prescribe different accounting treatment for an option transaction depending upon whether the entity that owns the optioned asset is deemed to be substantive operating enterprise or an SPE. If the entity is determined to be a substantive operating enterprise or a subsidiary of a substantive operating enterprise, its assets and liabilities would be rightfully consolidated by the enterprise that owns the entity. If, however, the entity is judged non-substantive, its owner could be precluded from being the primary beneficiary. The other party to the transaction, the optionee, would by default be designated the primary beneficiary.

If this occurs, the optionee would be forced to consolidate a SPE in which it has no ownership interest or control rights. If the entity contains multiple assets, a single optionee could be forced to consolidate assets and liabilities that are optioned to another party. Changes in the relative value of the assets within the entity could result in consolidation by different optionees from one period to the next. Unless the enterprise that owns the entity is forced to derecognize its subsidiary, the same assets and liabilities would be reported in consolidated financial statements of two different and otherwise unrelated enterprises – the entity’s owner and the optionee.

**Consolidated Entities of Substantive Operating Businesses**

The Board states that an SPE-like entity which is consolidated on the financial statements of a substantive operating enterprise is not a special purpose entity and is exempt from the Interpretation. The Board explicitly limits the scope of the Interpretation by stating, “No enterprise shall be deemed to be the primary beneficiary of a subsidiary, division, branch or other portion of a substantive operating enterprise, even if it is otherwise similar to an SPE that would be subject to the requirements of the Interpretation.”<sup>1</sup> The Board’s intent is clear. The decision to utilize a separate entity by an operating business because of the legal protections afforded by such an entity should not alter the accounting treatment of a wholly owned subsidiary.

Utilizing a substance test to properly distinguish between SPEs beholden to their primary beneficiary and SPEs utilized in the normal course of business by operating companies will work only if the test of substance is consistent within an industry and relatively uniform across industries. However, in its current form, the definition of a substantive operating enterprise in the Exposure Draft is sufficiently vague and ambiguous to allow for a wide degree of interpretation within and across industry groups.

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<sup>1</sup> As contained in Section 8c of the Proposed Interpretation

**Definition of Substantive Operating Enterprise**

As currently drafted, a Substantive Operating Enterprise must have the following four attributes. It must:

- Conduct business operations other than those performed for it by an SPE.
- Have employees.
- Have sufficient equity to finance its operations without support from another enterprise or entity except its owners.
- Issue it's own financial statements.

**Business Operations.** This attribute is not adequately defined. What constitutes business operations? How extensive must these business operations be? EITF 98-3 defines a business as “a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing returns to investors.” Self-sustaining business operations should be evidenced by an operating history, the existence of systems and standards that define the processes for normal, self-sustaining operations and resources sufficient to ensure a going concern. An accurate evaluation of an enterprise’s business operations must encompass the activities and assets conducted by the parent and all its operating subsidiaries

**Employees.** Having employees can mean many things. How are leased or part time employees to be treated? It is a common businesses practice to utilize an overhead entity to accumulate and allocate costs across multiple business units. Dedicated professionals employed by an affiliated overhead entity should certainly qualify as employees. A substantive operating enterprise would require the services of a sufficient number of owners, dedicated employees or contractors such that the enterprise remains a going concern.

**Sufficient Equity.** Sufficient equity is defined as an amount sufficient to allow the enterprise to finance its activities without relying on the variable interest holders. An equity investment of less than 10% of a SPE’s total assets is deemed insufficient. This

definition is clear, however, it should be clearly stated that the consolidated resources of the parent enterprise and all its operating subsidiaries must be included when determining self-sustainability. The financial substance of an enterprise is equal to the sum of its parts.

Financial Statements. A substantive operating enterprise certainly must issue its own financial statements. An additional provision requiring the financial statements to be CPA prepared or audited would help ensure that income and equity are determined in accordance with GAAP.

### Conclusion

The use of SPEs has proliferated and the Authors applaud the Board's actions to achieve a more consistent application of consolidation policies to SPE's. The Board's distinction between an SPE established by its primary beneficiary and an SPE established as a wholly owned and consolidated subsidiary of an operating business will improve financial reporting of SPEs while allowing operating business to continue to utilize the legal protections afforded by limited liability companies and limited partnerships.

However, consistent application of the Interpretation will only result if the determination of a substantive operating enterprise is consistent within an industry and relatively uniform across industries. As drafted, the definition of a substantive operating enterprise in the Exposure Draft is sufficiently vague and ambiguous and to allow for a wide degree of interpretation that will undermine the Board's objective.

We believe the Board should expand and clarify the definition of a substantive operating enterprise should be expanded and clarified to ensure that it implicitly recognizes (i) the business operations of an enterprise encompass the activities and assets conducted by the parent and all its operating subsidiaries and (ii) the financial self sufficiency of an enterprise is found in the sum of its parts; the parent enterprise and its consolidated subsidiaries.

If this new Interpretation it to achieve its goals, it must prescribe clear, unambiguous guidelines that will be consistently applied. Our concern is that without further clarification of the definition of a substantive operating enterprise, the Interpretation could lead to the inconsistent application of consolidation policies within and across business sectors.

Respectfully submitted,

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