

COMMENTARY

The Evolving Accounting Standards for Special Purpose Entities and Consolidations

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INTRODUCTION

This paper reviews the major actions taken by the accounting standard setters—the Financial Accounting Standards Board (FASB) and its Emerging Issues Task Force (EITF)—in connection with special purpose entities (SPEs) and traces the evolution of related authoritative guidance. Accounting for SPEs entered public and professional prominence as a result of the Enron Corporation’s failure. The primary accounting issues regarding these entities are (1) whether they should be consolidated into the sponsor’s¹ (or primary beneficiary’s) financial statements or left “off-balance sheet,” and (2) whether the sponsor should be able to treat gains and losses resulting from transactions with SPEs as independent, arm’s-length transactions. Critics harshly criticized Enron’s auditor, Arthur Andersen, for allowing Enron to exclude from its financial statements the SPEs it sponsored, thereby keeping a substantial amount of debt off its balance sheet and recognizing substantially higher profits from transactions with SPEs. We believe it is useful, therefore, to review both the authoritative guidance for the general area of consolidation of financial statements as well as guidance specific to SPEs. This review also provides insight into how standard setting leading to changes in GAAP responds to changes in business practice, and how it might have been more effective in helping to prevent abuses in accounting for SPEs, such as those that ostensibly led to or exacerbated the downfall of Enron (Powers et al. 2002).

¹ The term “sponsor” is sometimes used to refer to the organization that legally creates the SPE, which may or may not be the primary beneficiary of the SPE. At other times, and in this paper, it is used to refer to the company for whose primary benefit the SPE has been created.

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WHAT ARE SPECIAL PURPOSE ENTITIES?

Until recently, many people in the accounting profession, including accounting educators, never heard of SPEs. Some who heard of these esoteric financing vehicles knew little about how they operated or the accounting standards that guide the accounting and financial reporting by companies who sponsor SPEs. Reports in the popular press that preceded Enron's Chapter 11 filing in December 2001 introduced many accountants for the first time to the topic of SPEs and sent many CPAs scrambling to understand the generally accepted accounting principles (GAAP) dealing with these entities. Even though SPE financing vehicles have been around for about two decades, they failed to capture the attention of many participants in the mainstream of accounting discourse. A search for references to SPEs in financial accounting textbooks yields virtually no results, and a search of the academic and professional accounting literature provides, at best, a limited explanation of this area of accounting.

Also called *special purpose vehicles*, SPEs typically are defined as entities created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company. They may take the legal form of a partnership, corporation, trust, or joint venture. SPEs began appearing in the portfolio of financing vehicles that investment banks and financial institutions offered their business customers in the late 1970s to early 1980s, primarily to help banks and other companies monetize, through off-balance-sheet securitizations, the substantial amounts of consumer receivables on their balance sheets. A newly created SPE would acquire capital by issuing equity and debt securities, and use the proceeds to purchase receivables from the sponsoring company, which often guaranteed the debt issued by the SPE. Because the receivables have limited and reliably measured risk of nonrepayment, a relatively small amount of equity usually was sufficient to absorb all expected losses, thus making it unlikely that the sponsoring company would have to fulfill its guarantee. In this way the sponsoring company could convert receivables into cash while paying a lower rate of interest than the alternative of debt or factoring, as the debt holder could be repaid from the collection of the receivables or the sponsor. SPEs also allow the sponsors to remove receivables from their balance sheets, and avoid recognizing debt incurred in the securitization.

Other Uses of SPEs

Another major application in the early years of SPEs related to transactions involving the acquisition of plant and equipment under long-term lease contracts. Companies could sponsor an SPE to acquire long-term assets with newly acquired debt and/or equity and enter into a contract to lease the assets from the SPE. This often enabled companies to treat the contract as an operating lease for accounting purposes, thereby placing the asset and related debt on the SPE's balance sheet instead of that of the sponsoring company.

Other SPEs, typically organized as limited partnerships, also have been employed for more than 20 years to fund research and development (R&D) activities. The sponsor often has only a contractual interest in the SPE, not an equity interest. The crucial accounting issue for these SPEs, addressed in FASB Statement No. 68 (FASB 1982), is whether the sponsor has directly or indirectly agreed to repay the funds provided by the outside parties. If such an obligation exists, then the sponsor recognizes it as a liability, and the sponsor records the R&D costs incurred by the SPE as an expense. To avoid recognizing the liability and expense, the sponsor must demonstrate that the financial risks involved with the R&D activities are transferred from the sponsor to the outside parties.

SPEs and Off-Balance-Sheet Financing

Before discussing the evolution of authoritative guidance for SPEs, we examine the broader issue of off-balance-sheet financing, the context within which that guidance has been developed. SPEs are just one of the vehicles that companies use to structure financing that avoids recognizing assets and liabilities on their financial statements. Other vehicles include operating leases, take-or-pay contracts, and throughput arrangements² that enable a company to use something in its future operations in exchange for agreed upon payments. In these situations the accounting problem is to determine whether an asset or liability exists, and when to report such items on the balance sheet. GAAP already requires arrangements such as capital leases and certain SPEs to be included on the balance sheet of the primary beneficiary of the contracts. For some specified arrangements where assets and liabilities are not reported on the balance sheet, particularly operating leases, information about future obligations under the contracts must be disclosed in the notes to the financial statements.

Consider unconsolidated equity investments in which an investor owns less than 50 percent, SPEs created for the primary benefit of a company, or other off-balance-sheet entities. Here the challenge to the accounting profession is to focus on whether consolidation of such entities actually improves users' understanding of a company's financial position and results of operations. For most equity method investments, consolidation does not change net income or net assets, causing only offsetting changes in the components of those measures. Consolidating equity method investments currently not consolidated could reduce disclosures about those investments in the notes to the financial statements. As a broad objective, the FASB and the SEC should guide the profession in requiring on-balance-sheet treatment where it enhances the financial statements, but allowing off-balance-sheet treatment where it provides better information to investors.

Sources of Authoritative Guidance for Accounting for SPEs

When the idea of SPEs was first conceived in the minds of some bright financial engineers, no definitive accounting guidance existed. Although specific accounting guidance for innovative business methods of necessity must lag actual practice, the conceptual framework and other general guidelines should help accountants treat innovative practices. When SPEs began to appear, corporate accountants, auditors, and the SEC could look only to general principles in the authoritative accounting literature regarding the recognition and de-recognition of assets and liabilities, criteria for recognizing asset sales, consolidation of related entities, and more generally to the "entity concept" literature.

From the early 1980s until the mid-1990s, SPEs proliferated in business practice without any specific official guidance from the Financial Accounting Standards Board (FASB). Until 1996, all specific guidance regarding SPEs came from the FASB's surrogate body, the Emerging Issues Task Force (EITF), formed by the FASB in 1984 to provide timely financial-reporting guidance on matters that the Board may not have addressed or issued authoritative guidance. As stated on the FASB's web site (FASB

² Typical *take-or-pay contracts* obligate the purchaser to take and pay for any product that is offered to it or pay a specified amount if it refuses to take the product. A *throughput arrangement* involves an agreement to put a specified amount of product per period through a particular facility; for example, an agreement to ship a specified amount of crude oil per period through a particular pipeline (*New York Times* 2002).

2002a), the composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, when the EITF reaches a consensus on an issue, signified by the support of 11 of the 13 voting members, the FASB usually takes that as an indication that no Board action is needed. Consensus positions of the EITF are considered part of GAAP. However, lack of consensus is often viewed as an indication that action by the FASB is necessary.

Nine of the 13 voting members of the EITF are affiliated with public accounting firms, with one member from each of the Big 5 firms, and four members from large companies.³ The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the right to participate in discussions and present the SEC's views on topics of discussion. Although the FASB's Director of Research and Technical Activities is the non-voting Chairman of the EITF, there is no overlap between the members of the FASB and the EITF. Note that the influence of the public accounting sector of the accounting profession is much greater on the EITF (nine of 13 members are currently public accounting practitioners) than it is on the FASB (three of seven full-time members were public accounting practitioners prior to joining the Board). One might conclude that authoritative guidance provided by the EITF is likely to have more of a public accounting tilt than if it is provided by the FASB.

The first FASB statement that included any direct reference to SPEs was Statement No. 125 (FASB 1996), later replaced by Statement No. 140 (FASB 2000b). Both of these Statements focus narrowly on issues involving the transfer (sale) of financial assets, primarily securitization and servicing of receivables. Authoritative guidance for other SPEs has been developed in a rather piecemeal fashion by the EITF. Exhibit 1 lists in chronological order the major FASB and EITF pronouncements addressing consolidations and SPEs. The next section of the paper discusses this authoritative guidance.

AUTHORITATIVE GUIDANCE ON CONSOLIDATIONS

Accounting Research Bulletin No. 51

Over the past 40 to 50 years, the accounting profession gradually developed general policies governing the consolidation of financial statements of companies and their controlled subsidiaries and affiliates. Accounting Research Bulletin (ARB) No. 51 (AICPA 1959) established broad requirements for companies to fully consolidate majority-owned subsidiaries into their financial statements and show the equity of minority-interest shareholders in the consolidated financial statements. ARB No. 51 also requires the elimination of intercompany balances and transactions between the two entities so that the consolidated statements represent the financial position and results of operations of a single reporting entity. An important exception in ARB No. 51 that allowed companies to avoid consolidation for "nonhomogenous" majority-owned subsidiaries was removed in 1987.

³ The roster of the current membership of the EITF and their affiliations was provided to the authors by the FASB.

EXHIBIT 1
Chronology of Major Accounting Pronouncements
Related to Consolidations and SPEs

- 1959 – Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*
- 1971 – Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
- 1983 – FASB Statement No. 76, *Extinguishment of Debt*
- 1983 – FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
- 1984 – Emerging Issues Task Force (EITF) Issue No. 84-30, *Sales of Loans to Special-Purpose Entities*
- 1987 – FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries—An Amendment of ARB No. 51, with Related Amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12*
- 1989 – EITF Topic No. D-14, *Transactions Involving Special-Purpose Entities*
- 1990 – EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*
- 1996 – FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- 1996 – EITF Issue No. 96-20, *Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities*
- 1996 – EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*
- 2000 – Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—A Replacement of FASB Statement No. 125*
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Consolidation vs. the Equity Method

In 1971, the Accounting Principles Board (APB), forerunner to the FASB, issued APB Opinion No. 18 (AICPA 1971a), requiring companies to use the “equity method” for equity investments over which they have significant influence, generally defined as ownership of 20 through 50 percent of voting stock. An early interpretation of APB Opinion No. 18 stated that it is also appropriate to apply the provisions of this opinion to investments in noncorporate investments, such as partnerships and unincorporated joint ventures (AICPA 1971b). Under the equity method, an investor company recognizes its proportionate share of the investee’s GAAP income along with an offsetting increase in the investment asset, and recognizes dividends received from such investments as a decrease in the investment asset. APB Opinion No. 18 also requires the elimination of intercompany profits and losses from equity method income, consistent with the consolidation provisions of ARB No. 51 (AICPA 1959).

The major difference between consolidating equity investments and reporting them under the equity method is in the details. Under full consolidation, the investee’s assets, liabilities, revenues, and expenses are combined with those of the parent company, and the minority interest’s equity in net assets and net income are disclosed in the consolidated financial statements. The equity method suppresses the components and reports only the investor’s proportionate share of an investee’s net assets and net

income on the investor's balance sheet and income statement, respectively. Typically there is no difference in total stockholders' equity or net income between the consolidation and equity methods.⁴ All other things being equal, a company consolidating an equity investment will normally appear larger, with more assets, liabilities, revenues, and expenses, than a company using the equity method for the investment. The company that can use the equity method, and avoid consolidation, is often able to improve its debt-to-equity ratios, as well as ratios for returns on assets and sales.

Pro Forma Effects

The 20–50 percent guideline for applying the equity method made it easy for companies to actively manage their balance sheets by controlling their percentage ownership in subsidiaries. For example, the “49 percent solution” (Goizueta 1988) was attributed to The Coca-Cola Company in the early 80s, when Coke structured many of its investments in companies just below a 50 percent ownership level, thereby avoiding full consolidation. Even today, if Coca-Cola consolidates its equity method investments in which it owns more than 40 percent of the outstanding voting stock, Coke's total liabilities increase by almost 300 percent, substantially raising its debt-to-equity ratio from 1.24 to 4.79.⁵ Media reports (Peterson 1998) indicate that the debt-rating agencies actually calculate Coke's ratios on a *pro forma* basis that assumes consolidation of its major equity method investments. These *pro forma* calculations are possible because the required GAAP disclosures for equity method investments include summary income statements and balance sheets for significant individual or groups of investments. These supplementary equity method disclosure requirements cause companies such as Coca-Cola to present information under the equity method that loses its identity in consolidation.

FASB Statement No. 94

In 1987, FASB Statement No. 94 expanded the consolidation principle to require companies to consolidate “all” majority-owned subsidiaries, even if they are nonhomogenous. Previously, under ARB No. 51, many companies reported investments in nonhomogenous subsidiaries by the equity method, without consolidation, even though the investments were wholly owned. The classic nonhomogeneous examples were the financing subsidiaries that General Motors and Ford—GMAC and Ford Motor Credit—created to finance the sales of their products. The parents of these financing subsidiaries claimed that they were primarily manufacturing companies and that consolidating their financing subsidiaries would result in undesirable distortions.

The FASB stated in the “Background Information” appendix to Statement No. 94 (FASB 1987) that its goal was to develop a reporting entity concept for business enterprises, and that it had “tentatively concluded that the concept should be based primarily on control rather than on ownership of a majority voting interest, which is the most common but not the only means of controlling a subsidiary” (FASB 1987, para. 20). Even though the issue of control was not a factor in the decision to require consolidation

⁴ Differences between the equity and consolidated methods may result if the investor's share of losses exceeds the carrying amount of the investment under the equity method or if the investor had a gain or loss on issuances of stock by an equity investee.

⁵ Data are from *The Coca-Cola Company 2000 Annual Report*, calculated as total liabilities divided by total shareholders' equity (before adjusting for any intercompany loans, that would be eliminated upon consolidation).

of majority-owned subsidiaries, the FASB used Statement No. 94 as an opportunity to emphasize its intentions regarding the direction of future standards on consolidations. Two exposure drafts on an expanded control concept eventually emerged in the second half of the 1990s.

AUTHORITATIVE GUIDANCE ON SPECIAL PURPOSE ENTITIES

FASB Statement Nos. 76 and 77

In November 1983, the FASB issued Statement Nos. 76 and 77 (FASB 1983a, 1983b) covering accounting for extinguishments of debt and the transfer (or sale) of receivables where the buyer has recourse against the seller. These statements were precursors to subsequent pronouncements directly related to SPEs. Statement No. 76 provided for *in-substance defeasance*—that debt may be accounted for as having been extinguished even though the creditor did not relieve the debtor of the obligation—so long as there are assets placed in trust outside of the debtor’s control sufficient to satisfy the obligation. Statement No. 77 permitted the transfer of receivables with recourse to be treated as a sale under the following conditions: the seller surrenders control of the receivables, the amount of recourse obligations can be estimated, and the buyer cannot return the receivables to the seller beyond the recourse provisions. Later, in 1996, the FASB rescinded the provisions of Statement No. 76 and superseded the conditions of Statement 77.

EITF Issue No. 84-30

The first specific reference to SPEs in the authoritative accounting literature appeared in 1984 in Emerging Issues Task Force Issue No. 84-30, which involved the sale to SPEs of banks’ loans receivable. The EITF observed that banks were creating SPEs, wholly owned by parties not related to the bank, to purchase loan receivables from the bank using funds provided to the SPE by debt and equity investors. Such SPEs enabled banks to take advantage of the provisions of FASB Statement Nos. 76 and 77, allowing them to remove receivables from their books without recognizing a liability for funds received in exchange for the receivables. After the EITF failed to reach a consensus in Issue No. 84-30, its Chairman stated that Statement Nos. 76 and 77 were intended to deal with the traditional practice of selling receivables to other financial entities, not to SPEs created by a bank for the sole purpose of buying the bank’s receivables. The FASB staff stated, however, that the assets and liabilities of such SPEs should be consolidated in the financial statements of the transferor of the receivables.

EITF Topic D-14 and Nonconsolidation of SPEs

SPEs were addressed again in 1989 in Topic D-14.⁶ This topic was the first authoritative endorsement for not consolidating certain SPEs; the SEC Observer to the EITF stated that nonconsolidation and sales recognition by the sponsor or transferor may be appropriate if the majority owner(s) of the SPE:

- is an independent third party who made a substantive capital investment in the SPE;
- has control of the SPE; and
- has substantive risks and rewards of ownership in the SPE.

⁶ Often the EITF issues “Topics,” staff announcements made at EITF meetings on technical matters discussed by the EITF that have long-term relevance but do not relate specifically to a numbered EITF Issue. Sometimes an EITF topic is issued to publicize a position taken by the SEC in an EITF meeting.

This SEC interpretation laid a broad foundation for future practice favoring nonconsolidation of certain SPEs. However, the SEC Observer also noted that the SEC supported consolidation in various leasing situations “where an SPE holds title to the asset, but performs little, if any, substantive functions, and it is clear that the lessee assumes substantially all of the risks and rewards of ownership” (EITF 2002, Issue No. 84-30, para. 4).

EITF Issue No. 90-15

In 1990, building on the foundation of Topic D-14, the EITF released Issue No. 90-15, which eventually became general guidance on nonconsolidation of certain SPEs. Although this issue dealt specifically with leasing transactions, the SEC staff addressed several questions related to implementing the EITF consensus, including the applicability of Topic D-14 and EITF Issue No. 90-15 to SPEs created for non-leasing transactions.

EITF Issue No. 90-15’s Consolidation Conditions

Issue No. 90-15 requires consolidation if the SPE lessor meets three conditions:

- it is involved in leasing transactions with a single lessee;
- the lessee retains substantially all the risks and rewards of ownership of the leased asset; and
- the owner of the SPE has not made a substantial residual equity investment in the SPE.

Importantly, the SEC Observer stated that, although the EITF consensus on this Issue did not include non-leasing transactions in its scope, the SEC staff considers Topic D-14 to apply to more SPE transactions than those addressed by Issue No. 90-15, and that the views on SPEs expressed in that Issue are broadly consistent with those of the SEC staff. The SEC Observer stated: “accordingly, the conditions set forth in Issue No. 90-15 may be useful in evaluating other transactions involving SPEs” (EITF 2002, Issue No. 90-15, Q. 2). This clearly set the stage for new applications of unconsolidated SPEs that remove assets and liabilities from the balance sheet for a wide variety of business purposes, beyond leasing or receivables securitization transactions. Without this interpretation, many of Enron’s SPEs would likely never have been created.

The SEC Staff’s “3% Rule”

The SEC staff’s response to Issue No. 90-15 also provided the first quantitative guidance on what constitutes “substantive residual equity investment” by the outside owner(s) of an SPE. It indicated that the minimum investment is *3 percent* of the SPEs total assets, but that in some circumstances a higher percentage equity investment is needed. Despite this caveat that 3 percent may be an insufficient level of outside equity investment in some SPEs to avoid consolidation, the 3 percent guideline appears to have become regarded in practice as an absolute standard, by both corporate managers and their auditors. Issue No. 90-15 also stated that to avoid consolidation, the outside equity investment may not be in the form of a note payable and that there cannot be any guarantees limiting the risk of the independent equity investor throughout the life of the SPE. In 1996, EITF Issue No. 96-21 provided additional implementation guidance on the third condition of Issue No. 90-15 that requires consolidation of SPEs when outside investors do not make a substantial residual equity investment.

Note that neither Issue No. 90-15, nor other pronouncements involving SPEs, restrict the sponsor of the SPE from guaranteeing loans made to the SPE. Consequently,

although the sponsor cannot directly protect equity investors in unconsolidated SPEs from risk, the sponsor can indirectly reduce that risk by guaranteeing the SPEs' debt. Furthermore, the sponsors were not explicitly prohibited from engaging in Enron's practice of bailing out the equity investors by almost immediately transferring funds to SPEs in the form of fees that, in turn, were paid to the investors.⁷

The underlying presumption of Topic D-14 and EITF Issue No. 90-15 is that sponsors of SPEs want to avoid consolidation; therefore, the guidance is couched in terms of the above three conditions that require consolidation. By implication, to avoid consolidation, a transferor of assets to an SPE must not meet any one of these conditions. If for some reason a sponsor wished to consolidate its SPE, but failed to meet the three conditions stated in Issue No. 90-15, then it must establish that it controlled the SPE as defined in ARB No. 51 by showing that it held more than half of the equity interest in the SPE. Otherwise, consolidation is inappropriate.

FASB Statement No. 125

The FASB first addressed the SPE issue with an official Board pronouncement in Statement No. 125 (FASB 1996), but only within the limited context of the transfer of financial assets and the extinguishments of debt. Statement No. 125 was intended to resolve many of the outstanding questions regarding accounting for transactions involving the securitization of receivables. It focused on issues of "isolation" and "control" of the financial assets, but it did not address consolidation, because that was the subject of a separate FASB project. Therefore, it did not adopt the criteria of EITF Issue No. 90-15 in determining whether an SPE created for securitizing financial assets should be consolidated. In addition, it did not replace or modify Issue No. 90-15 with respect to leasing or other types of SPE transactions. Consequently, it was possible for an SPE to qualify for *nonconsolidation* under Statement No. 125, even though the SPE satisfied the *consolidation* provisions of Issue No. 90-15.

"Qualifying" Special Purpose Entities

FASB Statement No. 125 permitted treating a financial asset transfer to another entity as a sale if the assets were isolated from the transferor, the transferee had unrestricted freedom to pledge the assets, and the transferor did not maintain effective control over the assets through promises to redeem or repurchase the assets. In establishing guidelines for treating the transfer of assets as a "sale," Statement No. 125 introduced the term "qualifying SPE" (QSPE), to refer to a type of SPE that, without any further tests, meets a minimum standard for treating the asset transfer as a sale. A QSPE is a very limited scope SPE that meets two conditions:

- it is a trust, corporation, or other legal entity whose activities are limited to (1) holding title to transferred financial assets, (2) issuing beneficial interests, (3) collecting cash proceeds from assets held, (4) reinvesting proceeds in financial instruments pending distribution to beneficial holders, and (5) distributing proceeds to the holders of its beneficial interests; and
- it has a standing under the law distinct from the transferor.

⁷ Such payments to equity investors are treated by EITF Issue No. 96-21, for the purpose of determining whether an SPE sponsor has met the 3 percent requirement of EITF Issue No. 90-15, as a return of investment if the payments exceed the accumulated earnings of the SPE.

In describing the characteristics of a QSPE, the FASB did not mention the 3 percent outside equity requirement or any other requirements regarding outside residual equity investment, only that it have legal standing separate from the transferor. Statement No. 125 also did not specifically address the consolidation issue.

Soon after the release of Statement No. 125, EITF Issue No. 96-20 addressed questions about whether an SPE could remain *unconsolidated* if it met the “qualifications” of a QSPE in Statement No. 125, even though it satisfied the conditions for *consolidation* set out in EITF Issue No. 90-15. The EITF addressed this apparent conflict between FASB Statement No. 125 and EITF Issue No. 90-15 by stating that, for QSPEs, the control-of-assets criterion, and not the conditions of EITF No. 90-15, determines whether consolidation is necessary (EITF 2002, Issue No. 96-20). The EITF ruled that Statement No. 125 was limited to the very narrow set of transactions involving the transfer of financial assets to a QSPE, and that for all other transactions involving SPEs, the EITF Issue No. 90-15 conditions govern the consolidation issue.

FASB Statement No. 140

In September 2000, the FASB issued Statement No. 140, replacing Statement No. 125 and nullifying EITF Issue No. 96-20. Statement No. 140 affirmed the criteria in Statement No. 125 for identifying a sale of financial assets; however, it expanded the definition of a QSPE by providing a detailed description of the restricted types of financial assets the QSPE may hold and the limited conditions under which it may sell non-cash financial assets. The FASB was apparently attempting to narrowly limit QSPEs to the types of transactions typically found in a securitization situation. It stipulated that outside parties, which may not include the transferor, its affiliates, or agents, must have at least “10 percent” of the “fair value of their [the QSPE’s] beneficial interests” (debt or equity), unless the transfer is a guaranteed mortgage securitization (FASB 2000b, para. 36). The FASB also stated affirmatively (FASB 2000b, para. 46) that QSPEs are not consolidated with the transferor’s financial statements.

To summarize the above discussion of SPEs, from the time of EITF Topic D-14 in 1989 until FASB Statement No. 140 in 2000, the EITF and FASB attempted to establish criteria for the nonconsolidation of SPEs. The EITF criteria for nonconsolidation center on requiring control of the SPE by one or more independent third parties who have substantial at-risk equity investments in the SPE, interpreted to mean a minimum of 3 percent of the total assets of the SPE. The latest FASB criteria apply only to “qualifying” SPEs, whose activities must fall within certain narrow limits. The stream of guidance in EITF Topic D-14 and Issue No. 90-15 became the general guidance for SPEs, with more narrowly defined rules in FASB Statement No. 140 governing QSPEs created for certain financial asset transfers and securitizations.

THE FASB CONSOLIDATION PROJECT

Throughout the record of the EITF’s deliberations, there are numerous references to the “consolidation project” of the FASB and the expectation that this project ultimately will resolve the financial statement consolidation issue, including consolidation of SPEs. Added to the FASB’s agenda in 1982, the consolidation project focused primarily on reconsidering consolidation issues addressed in ARB No. 51 and ABP Opinion No. 18.

Despite the passage of 20 years and a significant amount of work by the FASB and its staff, the portion of the project dealing with consolidation or nonconsolidation of subsidiaries, affiliates, and related entities (including SPEs) produced only Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*. However, the Board issued

several papers and exposure drafts, including a 1994 comprehensive discussion paper, *Preliminary Views on Major Issues Related to Consolidations* (FASB 1994), a 1995 exposure draft of a proposed statement, *Consolidated Financial Statements: Policy and Procedures* (FASB 1995), and a 1999 revised exposure draft, *Consolidated Financial Statements: Purpose and Policy* (FASB 1999). In September 2000, the Board announced yet another modification to its proposed consolidation policy, discussed below.

“Legal” vs. “Effective Control”

In the absence of a definitive and comprehensive pronouncement, the accounting profession and applicable standards follow the general policy of requiring consolidation of related entities when one of the companies has, directly or indirectly, a controlling “financial interest” in another company, as evidenced by a majority ownership of outstanding voting common stock. As noted, some companies avoided consolidating equity investments by reducing their percentage of ownership to 50 percent or less. For this reason, a primary objective of the FASB in the consolidation project is to expand the control notion from an approach based solely on “legal” control, as evidenced by voting stock ownership, to one based on “effective” control. The effective control concept allows for circumstances in which a company controls another company, through board representation or because of widely distributed “minority” stock ownership, even though the company owns less than a majority of the other company’s voting stock.

Impact on SPEs

Throughout the consolidation project, the FASB dealt with the *general* case of what constitutes control of one company by another. It has not dealt with the issue of consolidation of SPEs as a *special* case. Indeed, the 1994 *Preliminary Views* document did not address arrangements where an SPE exists for the primary benefit of its sponsor with virtually all of the risks borne by the sponsor, even though the SPE is technically controlled by an independent outside owner. In the 1999 revised exposure draft, *Consolidated Financial Statements: Purpose and Policy*, the FASB addressed SPEs in the “Implementation Guidance” appendix by applying the Board’s definition of control to five SPE scenarios. These scenarios include a fund-raising foundation that benefits a not-for-profit university, a charitable trust that benefits a charitable organization, and a not-for-profit credit union that benefits a company’s employees. Only two of the scenarios involve SPEs created by for-profit corporations and related to the sponsor’s primary business activities; and both describe SPEs created to invest in or acquire long-term real estate properties.

In another appendix to the 1999 exposure draft dealing with “Background Information” and “Basis for Conclusions,” the FASB reacted to respondents’ requests to exclude certain SPEs from the requirements of the proposed standard by stating, “there is no basis for presuming that substantially all entities with limited purposes or lives could not be controlled entities” (FASB 1999, para. 232). It stated further, “it would not be evenhanded to provide an exemption to certain types of entities merely because difficulties may be encountered in assessing whether they are controlled.” Clearly, the exposure draft gave the impression that the FASB intended the same “effective control” criterion to apply to SPEs as to other types of equity investments.

Even though the 1999 exposure draft provided for no specific exceptions for SPEs, the proposed standard did not cite any expected effects on existing GAAP governing SPEs; that is, the 1999 exposure draft did not call for amending or nullifying existing guidance, such as EITF Topic D-14 and EITF Issue No. 90-15. In our view, the net effect

was for the proposed new consolidation standard to apply in all potential consolidation situations, including SPEs, yet the existing EITF authoritative guidance for SPEs was to remain in effect. This approach to consolidation policy was altered somewhat in September 2000 when the FASB distributed a working draft of a "modified approach" dealing with entities with limited powers (FASB 2000a). Here the Board offered an analytical methodology for determining the various circumstances under which a related entity with limited powers must be consolidated, again without any reference to existing EITF guidance for SPEs.

Recent Developments

In January 2001, the FASB announced its failure to achieve sufficient Board support for the revised and modified proposed standard to proceed to a final statement on consolidation policy. It stated that, "its effort to deal with the consolidation policy issues should continue" and that "those efforts should include the need to develop effective guidance for SPEs" (FASB 2002b). In November 2001, though, following the Enron implosion, the Board discussed the consolidation project and how to proceed with it. Rather than focus on some of the broader issues of control that derailed the previous exposure drafts, it decided to concentrate on developing interpretive guidance for dealing with several situations under the current consolidation accounting standards for entities that lack sufficient independent economic substance. The FASB expects effective guidance for those situations to resolve many problems encountered in present practice, including some of the ones related to SPEs.

The Board is currently developing guidance for interpreting existing standards as they relate to the consolidation of certain SPEs, and it plans to issue an exposure draft and a final interpretive pronouncement by year-end 2002. A preliminary FASB discussion document, prepared in March 2002 for the Financial Accounting Standards Advisory Council (FASAC), indicates that the new guidance will apply to SPEs that function to support the activities of the "primary beneficiary," the entity that retains or obtains the principal economic benefits and risks that arise from the SPE's activities (FASAC 2002). The new guidance will provide specific tests for identifying a primary beneficiary that will be required to consolidate the SPE. Consolidation can be avoided if the SPE has sufficient independent economic substance to qualify as a separate economic entity, as evidenced by its ability to finance its operations without assistance from or reliance on the primary beneficiary. The preliminary discussion document indicates that the Board will provide more specific guidance regarding the outside owners' required at-risk equity investment, the nature of the risks and rewards of outside ownership, and the ability of third-party owners to make decisions about and manage the SPE's activities. The discussion memo indicates that the Board is also considering requiring unconsolidated SPEs to have at least 10 percent of their assets provided by independent third-party owners. Undoubtedly, the interpretative guidance under consideration by the FASB will eliminate the current off-balance-sheet treatment of many SPEs.

SUMMARY AND CONCLUSIONS

After more than 20 years since SPEs appeared on the business scene, there remains a confusing, if not convoluted, set of guidelines regarding the consolidation of SPEs. Two streams of reasonably understandable guidance exist for leasing transactions (EITF Issue No. 90-15) and for transfers of financial assets through securitizations (FASB Statement No. 140). Until now, the only authoritative guidance for other types of SPEs, including many of those used by Enron, is the indication by the EITF and SEC that the

guidance outlined in EITF Issue No. 90-15 and Topic D-14, which deals specifically with leasing transactions, is “appropriate” for other non-lease-related SPEs.

The bankruptcy of the Enron Corporation associated with its use of sponsored unconsolidated SPEs has brought these financial innovations to the attention of the public and accounting profession. From our review of the slowly evolving authoritative guidance on the proper GAAP accounting for SPEs, we draw the following conclusions. Initially, although thinly capitalized, SPEs designed to monetize assets such as accounts receivable were properly accounted for by applying the traditional definitions of assets, liabilities, and unrelated entities. These SPEs engage in FASB Statement No. 140-type transactions. Cash is usually received for the receivables sold to the SPEs, so there is no problem with establishing the value and, hence, the gain or loss on the assets sold. Although the sponsoring corporation often guarantees the SPEs’ debt, the probability of this becoming a liability is small, because the equity capital provided by unrelated investors is sufficient to absorb the losses, which could be measured objectively. Nonconsolidation is generally appropriate.

Then, SPEs were used for the acquisition or sale and leaseback of plant and equipment. However, the arrangements companies must make with their lessor SPEs to avoid consolidation under EITF Issue No. 90-15 are not substantially different from arrangements typically made when leasing properties from established financial institutions in terms of the risks assumed by the lessee. The problem at Enron, as it expanded the role of SPEs, was that even though its SPEs were thinly capitalized and held assets that posed considerable risks, Enron took the limited authoritative pronouncements literally, allowing them to not consolidate the SPEs, even in situations where Enron assumed virtually all of the risks. See Benston and Hartgraves (2002) for a description and analysis of what Enron did and did not do.

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