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COMMENTARY

# Comments on the FASB's Proposals on Consolidating Special-Purpose Entities and Related Standard-Setting Issues

## AAA Financial Accounting Standards Committee

## INTRODUCTION

The June 28, 2002 Financial Accounting Standards Board Exposure Draft (ED), *Proposed Interpretation: Consolidation of Certain Special-Purpose Entities—an interpretation of ARB No. 51,* addresses the consolidation of special-purpose entities (SPEs). Accounting Research Bulletin (ARB) No. 51 (AICPA 1959), *Consolidated Financial Statements*, does not apply to SPEs because they have no voting interests nor are they subject to control by means other than voting shares. This paper presents the views of the American Accounting Association's Financial Accounting Standards Committee (hereafter, the Committee) with respect to the ED.[1]

For an insightful description of the history of and accounting for SPEs, see Hartgraves and Benston (2002). In brief, SPEs tend to be entities created by a sponsor—usually a single company—for a limited purpose. SPEs' legal forms vary and include corporations, partnerships, trusts, and joint ventures. They have been used for decades in asset securitization transactions, leasing, and R&D activities. Often the legal structure allows the SPE to be considered "bankruptcy remote"—that is, the assets of the SPE are not subject to bankruptcy claims against the sponsoring company. Additionally, the legal structure often allows the SPE to borrow at favorable rates, for example, through the isolation and credit enhancement of its assets. The structure also can enable the SPE to effectively disperse risks via, for example, the pooling of contracts that are then securitized.

The major accounting issue affecting SPEs is whether they should be consolidated and by whom. The ED calls for consolidation of SPEs by the entity that has a controlling financial interest therein—the primary beneficiary—whether this interest is due to voting shares or other forms of control. As such, the ED provides guidance on identifying and measuring *variable interests*—the basis for determining control when SPEs are not subject to control through voting interests. *Variable interests* are defined as "the means through which financial support is provided to an SPE and through which the providers gain or lose from activities and events that change the values of the SPE's assets and liabilities" (ED, para. 7). Variable interests can arise from contractual rights and

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[1] This article is based on the AAA Financial Accounting Standards Committee's comment letter to FASB. The original comment letter is available at http://www.aaa-edu.org. The article reflects views of the Committee and not those of the AAA.

obligations, such as those in loan agreements, from residual interests in transferred assets, and from nonvoting interests such as limited partnership interests. The entity with the majority of variable interests in the SPE or with a variable interest that is significantly more than the any other party's variable interest is said to be the SPE's primary beneficiary, and should consolidate the SPE. The sponsoring entity that created the SPE may or may not be the primary beneficiary.

Because the ED specifically excludes "qualifying SPEs" as defined in SFAS No. 140 (FASB 2000), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the ED does not require SPEs that effectively disperse risk to be consolidated. However, many common forms of synthetic leases and a variety of other activities that use SPEs but do not effectively disperse risks will be consolidated under the ED.[2]

## A PERSPECTIVE ON A PRINCIPLES-BASED CONSOLIDATION STANDARD

### Basis for Consolidation

The Committee recognizes that there remains considerable disagreement over the principles that should govern the development of an appropriate consolidation policy standard. (See, for example, the issues raised in FASB [1991a, 1995, 1999].) This disagreement is reflected in the various unsuccessful attempts by the FASB to revise consolidation standards (FASB 1995, 1999). In past comment letters, the Committee has sided with the economic unit concept of consolidated financial statements and the broader definition of effective economic control as the basis for consolidation (AAA FASC 1994, 1995, 1996). Effective economic control is a function of the facts and circumstances of the situation. The Committee consistently has rejected legal control as the sole basis for consolidation. A primary drawback of the legal approach is that companies can avoid consolidation of SPEs by legal arrangements that obscure the economics of SPE-related transactions. We continue to maintain our support for effective economic control, which often coincides with legal control, and expand upon our positions in this section.

In the Committee's view, a consolidation standard should be principles-based and follow from the definitions of assets and liabilities.[3] Statement of Concepts No. 6 (FASB 1985) defines assets and liabilities as follows:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (para. 25)
>
> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (para. 35)

The Committee's perspective on a principles-based standard requires the financial statement preparer to exercise judgment in determining whether the risks and benefits of ownership are retained through an ability to exercise effective economic control regardless of the form of the specific transaction. The Committee believes the effective control approach to consolidation of SPEs generally is consistent with the definition of an asset. That definition implies that an entity's assets should be consolidated with the "parent's" only if the "parent" retains the risks and benefits of ownership through the exercise of effective economic control. Because the entity's liabilities require a probable

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[2] In a synthetic lease arrangement, a subsidiary of a commercial bank with a nominal (typically 3 percent) equity investment holds title to the property. The bank provides a loan for the remaining (97 percent) value of the property. The property is then leased to a corporation that is the tenant of the property with net rent payments equal to the debt service payments on the loan and a return on the subsidiary's nominal equity investment. Other contractual provisions of the lease, such as residual values of the leased asset, result in the corporate tenant bearing the risks of ownership (Pollert and Glickman 2002).

[3] A particularly cogent discussion of the merits of an asset/liability approach to accounting standard setting is found in Storey and Storey (1998). See especially page 87 where the authors discuss how this approach is more logically consistent and complete than one starting with the measurement of earnings.

future sacrifice of the entity's assets, the entity's obligations are appropriately consolidated with the "parent" if its assets are appropriately consolidated with the "parent."

Effective economic control need not be defined solely as a function of voting rights. It is conceivable, even common, that the risks and benefits of ownership are retained without voting control or even voting shares. For example, if total equity is so small that it is insufficient for an entity to operate on its own, then effective economic control may be held by an enterprise with no equity but that has guaranteed significant portions of the entity's debt or the residual value of its assets. In return for bearing those risks, the nonequity-holding party may be in a position to manage the assets of the entity and earn a return commensurate with the risks being taken. In other words, that enterprise may have retained the risks and benefits of ownership through its effective economic control of the entity. To capture such transactions and situations, a principles-based consolidation standard must move beyond the notion of voting control to a broader notion of effective economic control.[4]

Evidence of effective economic control of the risks and benefits of ownership may be direct or indirect. *Direct evidence of control* exists when an entity has an ongoing direct ability to make decisions regarding asset use. Such ability can arise, for example, from a 51 percent majority ownership with a majority-rule requirement for decisions or from explicit contractual clauses granting ongoing decision rights to the entity. *Indirect evidence of control* refers to situations where the assets of an SPE appear to be used primarily for the benefit of the entity even though the entity has no explicit ongoing decision rights. For example, at the inception of an SPE, the sponsoring entity may put into place contracts and/or binding agreements that dictate the future operating activities of the SPE in a manner intended to safeguard the risks and benefits of ownership retained by the sponsoring entity.

Professional judgment by preparers and auditors is critical in determining whether effective control exists based on an assessment of direct and indirect evidence. Simply because the sponsor of an SPE places restrictions on the SPE's future operating activities does not necessarily constitute indirect evidence of effective economic control. The SPE may be truly independent of the sponsor such that it is inappropriate to consolidate it. This could be the case where the facts and circumstances indicate that an entity has, in a meaningful economic sense, truly sold assets to an SPE. On the other hand, the presence of recourse provisions in otherwise similar circumstances might lead to the conclusion that a true sale has not taken place. In that case, consolidation of the SPE seems appropriate, even though the sponsoring entity does not retain decision-making authority over the SPE's ongoing activities by virtue of contracts or agreements restricting the SPE's operations.

Given the importance of professional judgment under a principles-based standard, implementation guidance and sufficient disclosure are critical. The standard must provide general examples so that preparers can apply it in good faith as consistently as possible across time and entities. Guidance is essential to help companies evaluate direct and indirect evidence for the purpose of identifying whether effective economic control is present, identifying the risks and rewards of ownership, measuring noncontrolling interests in consolidation, and so on. Additionally, because principles-based standards are likely to be interpreted differently even by well-intentioned managers, a principles-based consolidation standard must require sufficient disclosure to allow users to understand and evaluate management's consolidation choices.

Finally, in considering a broad standard for consolidation, harmonization with international standard-setting bodies is an important issue. IASB standards currently recommend proportionate consolidation in some instances, such as joint ventures. It is reasonable to envision future IASB standards that recommend proportionate consolidation for special-purpose entities. Some members of the Committee believe that using proportionate consolidation for SPEs and other entities is

[4] This, of course, is consistent with the path taken by the FASB in its recent consolidation initiatives such as FASB (1999).

advantageous in that the balance sheets of several entities collectively will reflect the assets and liabilities of the SPE. This approach precludes companies from structuring transactions to avoid recognition and eliminates "orphan" SPEs that show up on no entities' financial statements. However, because proportionate consolidation is not consistent with the Committee's views of effective economic control as a basis for consolidation, the majority of the Committee does not support proportionate consolidation.

### Application of a Principles-Based Consolidation Standard to SPEs

To illustrate the application of a principles-based consolidation standard to a situation contemplated by the ED, consider the case of a synthetic lease. A company sets up an SPE to purchase and finance assets on its behalf, and the assets are then leased to the company via an operating lease. The company-lessee typically does not have an equity position in the SPE, but effectively bears the risk and benefits of ownership of the leased assets through residual value guarantees. Moreover, the company's use of the assets and the residual value guarantees provide direct evidence of the company's effective economic control over the SPE. Accordingly, the company should consolidate the SPE under the Committee's approach to consolidation.

Another example involves a bank that creates an SPE to purchase receivables or debt instruments such as car loans or lease payments in the marketplace. The assets are not top grade and require active management. The SPE funds its purchases by issuing various tranches of debt and 10 percent equity. As the asset manager, the bank receives a "market-based" fee and can be terminated after one year and annually thereafter by a majority vote of the debt holders. The bank also provides a liquidity backstop that protects the debt holders against delayed payments, up to some limit. The backstop does not protect the equity holders.

In this example, the bank does not control the assets; it is merely acting as an asset manager for the benefit of other stakeholders in the structure. The presence of the guarantee, while exposing the bank to some risk, is no different than the types of guarantees that banks issue to other companies. Thus, the Committee believes that the bank does not retain effective economic control over the SPE. That is, it has not retained the risks and benefits of ownership, and should not consolidate the SPE. Here, the objective should be to provide high-quality disclosure about the risks accepted by the bank. (See, for example, the Committee's letter to the FASB on the Exposure Draft, *Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others*, available at http://www.aaa-edu.org, or the related article published in *Accounting Horizons* [AAA FASC 2003a]).

## HOW DOES THE ED COMPARE WITH OUR PERSPECTIVE ON A PRINCIPLES-BASED CONSOLIDATION STANDARD?

This section outlines specific strengths and weaknesses of the ED relative to the Committee's views on a principles-based consolidation standard.

### Strengths

The Committee believes that the ED moves accounting for SPEs from a rules-based standard toward a principles-based standard. This is consistent with our preferred approach for a general consolidation standard and with our July 2002 letter commenting on conceptual standards, available at http://www.aaa-edu.org, or the related article published in *Accounting Horizons* (AAA FASC 2003b). If approved, the ED would likely result in more SPEs being consolidated by the entities that have effective control over their operations, consistent with our general approach to consolidation. The Committee favors moving the basis for consolidation from an emphasis on legal control to a notion of effective economic control, based on the concepts of variable interests and primary beneficiary. This move toward an economic definition of control should improve financial reporting by enhancing the representational faithfulness of financial statements in those circumstances where the risks and benefits of ownership are retained.

**Weaknesses**

The Committee believes the ED has five potential weaknesses, which we discuss in turn:

- its limitation to specific transactions and its scope exceptions,
- a lack of clarity in the variable interests constructs,
- the inclusion of a bright-line rule for defining sufficient equity investment,
- the limited implementation guidance, and
- the absence of enhanced disclosure requirements.

***Limitation to Specific Transactions and Scope Limitations***

The Committee's perspective on a principles-based standard applies in situations where consolidation is appropriate regardless of the form of the specific transaction. The ED deviates from this perspective in that it is limited to transactions involving SPEs. Although the Committee understands that recent events pushed SPE consolidation issues to the forefront, we view the limited scope of the ED as a major weakness. Because this limited-scope ED is not a comprehensive attempt to resolve issues related to consolidation policy, it adds another piece to the complex mosaic that comprises current consolidation rules.

Another concern with a piecemeal approach is that it may lead to unnecessary additional complexity and open loopholes for firms to avoid consolidation. For example, each standard dealing with a narrowly defined segment of consolidation policy includes scope exceptions designed to exclude business arrangements that are the purview of other standards dealing with different aspects of consolidation policy. The current ED adopts a principles-based approach, but it limits its application to SPEs that are not QSPEs (per SFAS No. 140 [FASB 2000]) and creates a new class of SPEs called *financial SPEs*, or *FSPEs*.

Such scope exceptions increase the complexity of the standards and provide firms with an opportunity to "play the system" by identifying stylized arrangements that fall between the cracks. Proposals to do so are already circulating through the business community. For example, in a presentation available on their website, Deloitte & Touche (2002) give a simple example of a multiseller commercial paper conduit in which a bank establishes an SPE that purchases receivables from multiple transferers and issues commercial paper. Each transferer receives money on the initial transfer and has the right to any excess cash related to its transferred receivables after bank fees and repayment of commercial paper. This SPE arrangement results in the transferer consolidating a silo of receivables and associated liabilities. Given the underlying secured financing nature of the arrangement between the transferor and the SPE, this outcome seems reasonable and consistent with our conceptualization of a principles-based consolidation standard. However, the example shows that the outcome changes when the facts and circumstances are altered to insert a QSPE between each transferer and the conduit SPE. Although the underlying economics of the transaction remain essentially unchanged, the primary beneficiary changes to the bank that administers the SPE, which consolidates the SPE. Such outcomes do not appear desirable in high-quality reporting standards.

***Variable Interests Constructs***

Although the Committee supports the move to a principles-based consolidation standard, we are unclear about certain aspects of the ED's definitions of primary beneficiary and variable interests—constructs central to the notion that entities with effective economic control should consolidate SPEs. First, the ED begins with the idea that consolidation should be a function of controlling interests (para. 1 and para. 4). Then the ED uses financial support to get to the variable interests construct (para. 6). Later, in para. 20, how the sizes of variable interests help determine the primary beneficiary is explained in terms of expected losses, which is a risk/reward concept. Thus, the ED implicitly translates effective control into expectation of losses. While the Committee generally believes such links exist, we also believe that the links between these concepts are not clearly explained in the ED. Specifically, what assumptions are made to get from the concept of economic control to financial support to expected losses?

Additionally, the Committee suspects there are situations where determination of the primary beneficiary according to rules in the ED is inconsistent with the effective economic control construct. Thus, the ED may result in consolidation of SPEs by entities that do not possess effective control over the SPE. The Committee believes that the second example under the heading "Application of a Principles-Based Consolidation Standard to SPEs" might lead to such inappropriate consolidation. In that example, the SPE is *not* a QSPE per SFAS No. 140 and, as such, it is subject to the ED. (If the SPE is determined to be a QSPE, it is not consolidated.) Because it meets criteria *a*—it actively manages the SPE's assets on behalf of the other stakeholders—and *b*—it provides a guarantee—of paragraph 23 of the ED, the SPE would be consolidated even though, in the Committee's view, the bank does not retain the risks and benefits of ownership.

The Committee also sees difficulties in implementing the rules defining variable interests. For example, "primary beneficiary" is defined as the party with the largest variable interests. In the case of ties, primary beneficiary status is to be determined by virtue of the "specific risk to which a variable interest is subject." Leaving aside the practical issue of measuring variable interests, we question the conceptual basis for this position. How is one to assign primary beneficiary status on the basis of variable interests in an SPE that is designed to allocate different sorts of risks, such as credit risk, interest rate risk, and prepayment risk, to different variable interest holders? The major risk of one variable interest holder may be irrelevant to another. Suppose entity A holds 100 percent of the prepayment risk, entity B holds all the interest rate risk, and the remaining risks are widely held. Will both A and B consolidate? Neither one?

***Inclusion of a Bright-Line Rule for Defining Equity Investment***

Although the committee views the ED as a move away from rules-based standards, there is one bright-line rule in the standard. Paragraph 12 of the ED states, "An equity investment shall be presumed to be insufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders unless the investment is equal to at least 10 percent of the SPE's total assets." Although in paragraph B9 the ED attempts to clarify that 10 percent may not be sufficient in all cases, it is apparent from a reading of professional accounting firms' guidance to their clients that they will treat 10 percent as a bright-line rule. For example, KPMG (2002, 5) refers to the FASB's "10 percent test of whether an independent third party's substantive equity investment at risk is sufficient." PricewaterhouseCoopers (2002, 2) refers to the "minimum level of third-party equity required" of 10 percent. They concede that the amount "could even exceed 10 percent." Nonetheless, the Committee feels that any stated minimum level of equity is arbitrary in a conceptual standard and will only lead to *de facto* bright-line treatment. Furthermore, the 10 percent level seems as politically dangerous as the infamous 3 percent rule because the average layperson is likely to find a 10 percent investment as trivial as a 3 percent investment.[5]

***Implementation Guidance***

Because the ED focuses on consolidation of entities using a basis other than voting equity interests, it represents a dramatic shift from current practice. Well-accepted consolidation procedures that exist when consolidation is based on voting equity interests no longer apply. Preparers are

[5] We do, however, agree that clearly stating that the 3 percent guidance of EITF 90-15 is not applicable is worthy of inclusion.

likely to have questions about implementing the new ED. For example, how is minority interest to be computed and valued when voting equity interests do not form the basis for consolidation? How is the minority interest in an SPE to be represented? How are gains and losses on consolidation and deconsolidation to be treated? That is, when assets are transferred to and from SPEs, should gains and losses on such transfers be recognized by the entity making the transfer? If so, how should such gains and losses be measured and classified? Companies are not experienced in applying consolidation procedures in such circumstances and generally accepted accounting practice is virtually nonexistent. Yet the ED is virtually silent with respect to the consolidation procedures the primary beneficiary should follow.

The majority of the Committee views this as a weakness of the ED that could be solved by providing examples. The examples should not be *de facto* rules, but rather serve to illustrate general procedures in this murky area. We recommend that the FASB refrain from attempting to resolve procedural issues for each unique situation, and require enhanced disclosures so that investors can understand the consolidation and valuation procedures used. Other members of the Committee believe that a clearly written principles-based standard need not provide examples or implementation guidance. That is, a standard that articulates the economics of the transactions or situations it is designed to capture need not include such guidance. Notwithstanding their viewpoint on this issue, these members support the need for sufficient disclosures to enable the user to understand the underlying economics and the financial reporting as elaborated upon next.

### *Noncomparability and Need for Disclosure*

One of the potential downsides of moving to a principles-based standard is that it leaves room for different interpretations of the underlying principles. Thus, even with implementation guidance, well-intentioned firms are likely to come to different conclusions when applying the ED to the same facts and circumstances, impairing comparability across firms. However, different interpretations need not be viewed negatively, as they may reflect fundamental differences in the way that entities view the transactions in question, or how those transactions fit into the existing entities. Efficiently trading off the cost of lower comparability against enhanced insight necessitates adequate disclosure. Disclosure also is needed because, by definition, consolidating SPEs with the "parent" masks information relative to the separate statements of these two entities.

## RECOMMENDATIONS

Although the FASB may need to implement a short-run solution to accounting for SPEs, the Committee recommends that the FASB pursue the ultimate goal of producing a comprehensive consolidation standard that incorporates the notion that consolidation is appropriate when one entity retains most of the risks and benefits of ownership of another through the exercise of effective economic control. This approach is consistent with the FASB's 1995 and 1999 exposure drafts on consolidation (FASB 1995, 1999). The committee views the need for a comprehensive consolidation standard as critical for several reasons:

(1) Broad guidance governing consolidation policy when control is achieved through means other than a majority voting equity interest is needed in situations other than those involving SPEs.

(2) A piecemeal approach will result in additional unnecessary complexity in what already promises to be a complex standard or set of standards. Additionally, conflicts and inconsistencies are more likely to arise among standards dealing with consolidation policy and procedures when a piecemeal approach forms the basis for consolidation policy.

(3) Scope exceptions in narrowly scoped standards increases the probability that firms will "play the system" by identifying stylized arrangements that fall between the cracks.

In the meantime, the Committee generally supports the "SPE consolidation" ED, with certain changes. First, we suggest that the ED better clarify the links among the underlying constructs—effective control, financial support, and expected losses. Second, we recommend dispensing with specific quantitative guidance such as the 10 percent minimum level of equity investment to avoid the same consequences attributed to the infamous 3 percent rule. Additionally, the committee suggests that the standard be expanded to include examples of consolidation procedures, such as recognition and valuation of noncontrolling interest, when voting interests do not form the basis for consolidation. Such examples may reduce confusion in the ED's language for determining items such as "expected losses" and "dominant risk."

Finally, the Committee recommends that the FASB require disclosures that help users to understand management's reasons for using SPEs and for making specific financial reporting choices. Sufficient disclosure should be provided to allow investors to assess the extent to which the entity bears the risks and rewards of ownership, and the nature and magnitude of the risks involved. Sufficient information should be required to enable *pro forma* consolidation of the reported financial information for unconsolidated SPEs when investors believe the assets and liabilities of the SPE are assets and liabilities of the entity. Appropriately enhanced and uniform disclosures will enable managers to compare their corporate reporting choices with those made by other firms in their industry and in the capital markets at large, thereby encouraging financial reporting practice to converge to comparable and consistent high-quality reporting.

## RELATED RESEARCH

This section reviews streams of research related to three major areas of the ED: consolidation, off-balance-sheet financing, and disclosure versus recognition.

### Consolidation and SFAS No. 94

Prior research examines the association between the decision to consolidate and various economic circumstances before SFAS No. 94 as well as the effect of mandated consolidation once SFAS No. 94 was in place. Mian and Smith (1990a) find that firms are more likely to voluntarily consolidate when there are greater operating, financial, and informational interdependencies between the parent and the subsidiary. They conclude that firms with unconsolidated subsidiaries do not employ unconsolidated subsidiaries as off-balance-sheet financing vehicles. This conclusion flows from their finding that firms with unconsolidated subsidiaries are *not* more likely to use other off-balance-sheet vehicles, such as operating leases or unfunded pension plans, than firms that do not have unconsolidated subsidiaries. Mian and Smith (1990a) conclude that firms choose not to consolidate for economic reasons and the decision is not simply a window dressing issue.

By extension, if the ED results in firms having to consolidate SPEs where they do not have effective control, the ED may discourage firms from using SPEs for sound economic reasons. However, an important distinction between the SFAS No. 94 setting and the ED exists. SPEs are often central to the operations of the potential consolidator—they might involve the operating assets of a synthetic lessee—whereas SFAS No. 94 focuses on entities involved in activities considered fundamentally different from the activities of the parent company. The argument was made that, in certain cases, combining the activities of the parent and a nonhomogeneous subsidiary reduces the informativeness of the financial statements, such as combining the financial statements of a manufacturer and its captive finance subsidiary. But, it is important to note that unconsolidated subsidiaries predated extensive SPE usage and, before SFAS No. 94, some unconsolidated subsidiaries performed functions similar to those now performed by SPEs—securitization of receivables, for example.

In contrast to the conclusions of Mian and Smith (1990a), other research documents evidence of firms reorganizing their business activities in response to a change in financial accounting standards. For example, Mian and Smith (1990b) find that firms subsequently forced to consolidate previously unconsolidated subsidiaries are more likely to sell, close, or reorganize the subsidiary, retire debt, or securitize assets. Imhoff and Thomas (1988) report that after the inception of SFAS No. 13 (FASB 1976), *Accounting for Leases*, many companies restructured their leases to achieve operating lease status and avoid capitalization. Similarly, Beatty et al. (1995) document that important motives for the formation of R&D limited partnerships and corporations are the economic benefits, such as better terms of debt renegotiation, that arise from the financial reporting for such arrangements.

These results suggest that if costs like debt covenant violations and regulatory sanctions associated with consolidation are sufficiently high, firms will restructure their relationships to avoid consolidation. Moreover, in contrast to the conclusion presented in Mian and Smith (1990a), firms may employ off-balance-sheet investments to window dress their balance sheets. Firms previously taking advantage of the flexibility in GAAP to avoid consolidation may incur costs when renegotiating their debt contracts after a new rule that requires consolidation of previously unconsolidated entities. However, Frost and Bernard (1989) indicate that the cost of technical default due to mandated GAAP changes may be small, and Mohrman (1996) reports that the incidence of debt contracts that call for GAAP at the inception of the contract to be used throughout the life of the contract is prevalent and increasing over time.

Although the evidence is not definitive, if one considers the covenant violation costs to be low, this research suggests that there is a balance sheet management motivation behind accounting choices. Moreover, it is apparent from the business literature on SPE-related vehicles such as synthetic leases, that vendors of such arrangements tout their off-balance-sheet benefits. This, of course, begs the question of whether such balance sheet management misleads users of financial statements.

**Do Financial Statement Users Consider Off-Balance-Sheet Items?**

Considerable research indicates that users incorporate off-balance sheet information provided in financial statement footnotes. As Lipe (2001) and this Committee noted in its 2001 evaluation of the lease accounting proposed in a G4+1 Special Report (AAA FASC 2001), analysts since Graham and Dodd (1934) and credit rating agencies like Standard & Poor's (2002) are aware of off-balance-sheet items and maintain that they adjust for them in their analyses. Academic research suggests that market measures of equity risk and the market value of equity are associated with liabilities estimated from footnote disclosures of operating lease obligations (Ely 1995; Imhoff et al. 1993, 1995).

In the area of off-balance-sheet R&D partnerships, Shevlin (1991) reports that footnote disclosure allows capital markets to assess the value of R&D partnerships, and that markets appear to value both the underlying assets and liabilities of the partnerships. However, he maintains that the valuation coefficients are sensitive to assumptions underlying their measurement, and he calls for improving the detailed disclosures to help investors get a better handle on such off-balance-sheet transactions.

There is limited anecdotal evidence—the recent PNC Bank situation, for example (see Rosenberg 2002)—that regulators consider SPE obligations in determining capital adequacy. If consolidation did lead to additional costs in the form of higher required capital, it could be attributed to two reasons. First, regulators may have assessed the risks posed by SPEs prior to the new consolidation standard and decided the risks were low enough to omit SPEs when assessing capital adequacy. After the new consolidation requirements, the regulator includes the SPEs not because the risk assessment has changed, but rather because the regulator wants to increase the required level of capital. Second, the regulators may not have been as aware of the SPEs or their use as they claimed. In either case, if bank regulators impose higher capital requirements, it is not the "fault" of GAAP. In the former case, there is a regulatory failure/abuse. In the latter, more complete accounting facilitates regulators' decision making. Thus, any new costs imposed on the previously nonconsolidating regulated entities are simply transfers of costs that were unknowingly borne previously by others.

Literature that examines the valuation implications of footnote disclosures about pensions and postretirement benefit obligations (Barth 1991; Choi et al. 1997) also highlights the usefulness of footnote disclosure on disaggregated information lying behind numbers recognized in the financial statements. Finally, recent research by Kothavala (2002) suggests that when joint venture income is separately disclosed in the financial statement footnotes by U.K. and Canadian companies, it is not valued any differently than other elements of net income for such firms. This suggests that recognition and disclosure are substitutes.

Based on this evidence, one could argue that even if consolidation is appropriate, adequate SPE disclosures alert the capital markets to their implications for firm value, and may render the act of recognition through consolidation redundant. However, we caution that the research discussed previously assumes market efficiency and that several papers document instances of market inefficiency related to both accounting and nonaccounting information. Footnote disclosure may have the effect of creating or enhancing opportunities for subsets of users to identify and exploit market inefficiencies. Foster (1979, 1987) documents the market reaction to published analysis by Abraham Briloff. Research by Fairfield and Whisenant (2001) reports that analysts from the Center for Financial Research and Analysis successfully identify overvalued firms by analyzing the full set of disclosures provided in firms' SEC filings. Any recommendations for recognition over disclosure of off-balance-sheet items involve trade-offs between costs and benefits of various user groups, as well as preparers. Some research on specific implications of recognition versus disclosure is discussed next.

**Do Financial Statement Users Distinguish between Recognized and Disclosed Information?**

The previously mentioned research finds associations between footnote disclosures and market-based assessments of risk and value. Other work suggests that at the individual user level, recognition and disclosure are not substitutes. For example, Hirst and Hopkins (1998) find that professional analysts are more likely to discover earnings management when its components are clearly reported in a performance statement than when they need to be determined through fundamental analysis. Hirst et al. (2002) report that analysts' valuation judgments distinguish more between high- and low-risk banks under an accounting regime that reports fair value changes for all financial assets and liabilities in a performance statement rather than a piecemeal approach in which fair value changes for some assets are reported in a performance statement and fair value changes for other financial assets and financial liabilities are disclosed in footnotes.

Espahbodi et al. (2002) find that the market reaction to exposure drafts proposing to require recognition of stock option compensation costs is significantly different from the market reaction to FASB's subsequent reversal mandating only disclosure of such costs. One interpretation of this evidence is that capital markets value disclosure and recognition differently. Aboody (1996) reports that stock market participants react differently to asset write-downs recognized in the financial statements of oil and gas firms adopting the full cost method, than they do to firms using the successful efforts method that are required only to disclose unrealized gains and losses on assets. These findings, together with Shevlin's (1991) results, suggest that attention be paid not only to whether SPE data are disclosed, but also to where and how these data are disclosed. The ED's objective of consolidating more entities, and making it easier for users to assess the complete economic picture of the entity, seems appropriate in those circumstances where the risks and benefits of ownership are retained. Nevertheless, the importance of clear and complete SPE disclosures cannot be overemphasized.

Given the research suggesting that enhanced and transparent disclosure facilitates users' risk assessments and equity valuation judgments, we encourage the Board to add additional disclosures to the ED. The disclosures should allow users to understand the business purpose of an SPE. Is it to satisfy a fundamental business objective like funding or transfer of risk, or is the primary objective to achieve off-balance-sheet treatment of assets and liabilities or some other financial reporting goal? If consolidated, what line items are affected? If unconsolidated, where, if anywhere, are the SPE-related activities reported? What risks were passed on? What residual risks, recourse risks, credit enhancement exposures, etc., remain? These disclosures should also address the possibility of voluntary recourse, especially when it is customary for SPE-structured transactions to continue in the future. This occurs, for example, when a primary beneficiary is expected, but not required, to enhance the credit risk of an SPE that securitizes credit card receivables, because it wishes to maintain funding opportunities in future periods. Finally, the disclosures should clarify the methods used to estimate any fair value amounts and to value retained risks. They should explain the "gain-on-sale" impacts and the effects of estimation on reported figures and indicate where the gains or losses on consolidation or deconsolidation of the SPE are recorded.

Although some firms are already likely to voluntarily disclose certain of these items and others may be required under existing GAAP, we believe that financial reporting is improved when related information is presented in one place and not scattered among the footnotes.

Overall, the research evidence suggests that entities make consolidation choices for multiple reasons. In some cases, firms appear to consolidate in order to enhance the information content of their reports by more faithfully representing the relations between entities in the group. In other cases, evidence of balance sheet management is apparent. Although evidence exists that off-balance-sheet activities are considered by market participants, additional evidence points to general efficiencies gained by clear and transparent disclosures. That is, although disclosures influence market prices, disclosure and recognition are not perfect substitutes and not all forms of disclosure are created equal.

The Committee believes that in the absence of agreement on fundamental issues regarding consolidation policy, high-quality disclosures that allow users to assess management's motives and choices with regard to SPE consolidation are critical. Such disclosures should allow users to assess on- and off-balance-sheet risks and their implications for the nature, extent, and timing of future cash flows.

## SUMMARY

The Committee views the Exposure Draft as a short-run solution for reporting for SPEs. The Committee supports the notion of variable interests in that it moves practice toward guidelines intended to capture economic substance as opposed to legal form. However, the Committee disagrees with the "quick-fix" approach of the ED that avoids the bigger issue of consolidation policy in general. In the short run, the Committee believes the ED needs to be revised to eliminate the arbitrary 10 percent ownership guidelines, provide increased discussion of the underlying constructs and links among these constructs, add guidance regarding consolidation procedures, and add further disclosure guidance. The longer run demands a comprehensive consolidation policy standard without scope limitations.

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