Educational Piece—Transactions with Special Purpose Entities in the Wake of Enron (1/7/02)

In the aftermath of the Enron financial restatements and subsequent Chapter 11 filing, many questions have arisen. While the facts are far from clear and the investigation is ongoing, there has been a feeding frenzy for information about what happened at Enron and whether or not other companies may be next. What has been disclosed to date revolves around related party transactions and off-balance sheet treatment for significant, material special purpose entities. Another type of off balance sheet transaction that is frequently used by companies is the use of operating leases. Operating leases and the opportunities for financial shenanigans in how leases are accounted for are discussed in our educational report entitled “Accounting for Leases”, dated August 9, 2001. This piece focuses on the accounting for special purpose entities:

- What is a special purpose entity (“SPE”) and what is the financial statement impact of an unconsolidated SPE?
- What opportunities exist for financial shenanigans?
- When should SPE’s be consolidated as part of the “sponsor’s” financial statements?
- What information should an analyst seek from a company when it discloses a relationship with an SPE?

What is a special purpose entity (“SPE”) and what is the financial statement impact of an unconsolidated SPE?

In testimony before Congress on December 12, 2001, the Chief Accountant of the Securities and Exchange Commission, Robert Herdman, defined a SPE as “an entity created by a sponsor to carry out a specified purpose or activity, such as to consummate a specific transaction or series of transactions with a narrowly defined purpose.” SPE’s are often established as financing mechanisms to allow companies to execute certain transactions (see below for example) while keeping the majority of the details and results off of the books. There are quite legitimate reasons for a Company to consider utilizing an SPE as a financing vehicle as it may provide the Company with a lower cost of capital and it can, depending on the company’s overall income tax position, provide tax incentives as well.

Example: A Company wants to construct an asset, such as real estate properties. However, management would prefer to keep any additional borrowings from being presented on its balance sheet. In order to obtain this off-balance sheet treatment, the Company sponsors the establishment of an SPE which will “own” the asset and lease it to the Company once construction is complete. This approach results in the Company controlling the asset during construction, and financing the transaction off of its balance sheet.

While there may be benefits to the Company for utilizing an SPE, the impact of an unconsolidated SPE to the analyst and investor is that the assets of the SPE and, more significantly, the liabilities of the SPE are not reflected on the balance sheet of the Company which sponsored the establishment of the SPE. Additionally, the profits or losses of the unconsolidated SPE are excluded from the income statement of the sponsor. When Enron restated their financial statements for the last three years, it was due in large part to the conclusion that two SPE’s should have been consolidated since 1997. The retroactive consolidation of these two SPE’s resulted in a $500 million restatement downward of previously recognized earnings.

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What opportunities exist for financial shenanigans?

There are opportunities to improve a company’s reported financial position by failing to consolidate the activities of an SPE. Most often, this means that a company’s earnings, assets and liabilities may all be misstated. The risk of misstatement is not confined only to the time period surrounding the inception of the SPE, as the consolidation decision must be revisited throughout the life of the SPE.

When should SPE’s be consolidated as part of the “sponsor’s” financial statements?

Accounting rules addressing when SPE’s should be consolidated are quite complex. If the SPE qualifies as a “business” in and of itself, consolidation is determined in the same manner as it would any other equity investment. If the SPE meets the criteria for a “qualifying” SPE (e.g. an independent third-party owns more than 10% of the SPE, and that the nature and scope of the SPE’s activities are restricted as is prescribed in FASB Statement 140), it is not consolidated. However, in many of the cases, the SPE neither qualifies as a “QSPE” nor as a “business”. What are the factors impacting the consolidation determination in this instance?

The accounting literature most often referenced in answering this question deals with the specific instance when an SPE is established to lease assets to the sponsoring Company. The factors determining when this type of SPE is consolidated have also been utilized when deciding if other SPE’s should be consolidated. Extending the consolidation rules for SPE lessors by sponsor lessees to all companies which sponsor SPE’s, an SPE should be consolidated by the sponsor company when ALL of the following three conditions are met. (See Figure 1.)

Figure 1: Conditions Necessary to Require Consolidation of SPE (Note: All three must be met in order to require consolidation)

1. **Single Entity:** Substantially all of the SPE’s activities involve assets or activities derived from or are with a single entity.
2. **Benefits and Risks Remain with Sponsor:** The expected substantive residual risks and substantially all of the residual rewards of the SPE’s assets and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the sponsoring entity.
3. **Independent Equity At Risk:** The SPE’s independent third-party owner(s) of record has not made an initial substantive residual equity capital investment (at least 3%) which is at risk during the entire term of the SPE.

Each of these conditions can pose major hurdles toward reaching a conclusion and whether consolidation is appropriate. Some of the details which can impact the decision include whether the majority of all the activities of the SPE accrue to the benefit of one company [Condition 1], whether the debt of the SPE is directly or indirectly guaranteed by the sponsor [Condition 2], and whether the SPE’s owner-investors return on investment is guaranteed by the sponsor or some other related party [Condition 3].

What information should an analyst seek from a company when it discloses a relationship with an SPE?

The following information should be sought in order to help evaluate whether the SPE could have a material adverse affect on the financial position of the company. Sometimes this information could be disclosed by the Company or it may be available through filings with local, state and/or federal authorities as the SPE is established. Once the SPE is established, the SPE’s financial statements should be obtained, if available.

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1 From FASB Emerging Issues Task Force Issue 90-15 (EITF 90-15) and EITF 96-21.
• What is the business purpose of the SPE?
• What is the expected life (term) of the SPE?
• Who are the parties affiliated with the SPE and what is each one's function: sponsor, owner, lender etc.?
• Who among the parties disclosed is a related party?
• Is the SPE consolidated?
• What is the ownership structure of the SPE?
• Is there at least 3% of the SPE owned by an independent (i.e. non-related) third party?
• Is this investment by the independent party at risk throughout the life of the SPE, or is the investor's rate of return guaranteed in some fashion?
• Why was an SPE structure utilized as opposed to other types of financing available to the company?
• Is the debt of the SPE guaranteed by the sponsor or a party related to the sponsor?
• Are any activities of the SPE which are restricted or prohibited?

Other factors, both qualitative and quantitative, have been identified by the SEC staff which could be integral in helping to determining whether SPE's should be consolidated. (See Figure 2.)

Figure 2: SEC Staff-Recommended Factors to Consider²

<table>
<thead>
<tr>
<th>Qualitative Factors:</th>
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<tbody>
<tr>
<td>1. Business purpose of SPE</td>
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<td>2. Name of the SPE</td>
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<td>3. Nature of SPE’s transactions</td>
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<td>4. Referral rights for transfers to/from SPE</td>
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<td>5. Ability to control asset acquisition for the SPE</td>
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<td>6. Ability to provide services for SPE and ability to change service provider</td>
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<td>7. Ability to place debt obligations for the SPE</td>
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<table>
<thead>
<tr>
<th>Quantitative Factors:</th>
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<tbody>
<tr>
<td>1. Disposition of residual profits/losses of SPE</td>
</tr>
<tr>
<td>2. Fee arrangements (management fees, debt placement, trustee services, etc.)</td>
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<tr>
<td>3. Credit facilities</td>
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² Excerpted from Speeches by the Staff of the Office of the Chief Accountant through December 6, 2001: Factors to Consider in determining sponsor of SPE. www.sec.gov/info/accountants/speechoutline.htm.