Current Issues in Consolidation Policy in Wake of Enron

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Why has the FASB taken so long to get the rules on consolidations?

Imagine a parent company such as General Electric, who owns 100 percent of the shares of a subsidiary, which collects accounts receivables. Let’s call the sub GE Collection Services (GECS). The subsidiary purchases GE’s receivables, then attempts to collect the cash from those who owe. Collecting receivables is a specialized business, in which the subsidiary has developed experience and expertise.

GE formed GECS by contributing $2,000 cash to GECS for its common shares. GE sends to GECS accounts receivable, which GE has recorded for $8,100. GE transfers debt with book value of $8,000 to GECS. GE records a loss or expense of $100—the equivalent of the fee it pays to GECS for doing the collection work.

GECS is now in business with $2,000 cash, $8,000 of receivables, $8,000 of debt, and $2,000 of owners’ equity, contributed by GE. If the collections are so low that GECS cannot pay off the $8,000 of debt with those collections, then it exhausts the $2,000 of cash, and still cannot pay off all the debt, then GE has promised to make good the difference.

Now, think about GE’s financial statements. The parent company has shed from its balance sheet $8,100 of assets and $8,000 of debt, while recording expense of $100. This will improve GE parent company’s debt/equity ratio, making it look less leveraged, having new debt capacity.

But the transfers to GECS are to a company that GE controls and owns, so GE will prepare consolidated financial statements, in which GE shows the receivables of the sub, the debt, even though transferred to the sub, and will eliminate the collection expense. The consolidated statements will show the economic entity as though there had been no subsidiary at all. It’s all one economic entity which GE owns and controls.

Sidebar on Special Purpose Entities. If GE were able to persuade some other company to contribute the $2,000 cash to GECS for its ownership shares and take on the risks of paying for debt service shortfalls and, in return, reap the profits from efficient collection activities, we would no longer call GECS a subsidiary of GE, but could call it a Special Purpose Entity (SPE), formed by GE, but not part of GE. This illustrates an SPE, but does not give a comprehensive definition, nor an exhaustive list of SPE types.

Now, let’s complicate matters. Suppose, instead, that Xerox Corporation acquires 40 percent of GECS for $800 cash. GE owns 60 percent of GECS and Xerox owns 40 percent. GE transfers $4,800 of debt and receivables with book value of $4,860, both 60
percent of the numbers in the example above. Xerox transfers $3,200 of debt and $3,240 of its receivables to GECS, both 40 percent of the numbers above. Xerox and GE each separately agree to make good, with cash payments, any shortfall in debt service payments GECS suffers because collections on the receivables it sold to GECS and its cash contribution cannot cover debt service requirements. [This exact fact pattern is unlikely to occur, but I use it to isolate the issues.]

Now, think about GE’s financial statements. GE owns a controlling interest in GECS. Suppose you want to know how well GE’s management has done with the assets entrusted to it. What should we show on GE’s consolidated financial balance sheet to help you answer that question? GE must show all the assets of GECS and all of the debt. Its equities will show a Minority Interest in Ownership of consolidated subsidiaries, Xerox’s share. GE controls all the assets and we show all those assets under GE’s management control. This is current GAAP.

What about Xerox’s financial statements? It has shed assets and debt from its balance sheet. Its 40-percent ownership share gives it, let’s assume, not control, but significant influence, over the operations of GECS.

What do you want Xerox’s balance sheet to show? If you focus on control, then you don’t need to see these receivables and debt, because Xerox has relinquished control of the assets to the management of GECS, controlled by GE. Xerox can [and does under current GAAP] show just its investment in the equity of GECS of $800; in addition, its notes will disclose the contingent obligation to make good on GECS’s debt service payments in the unlikely event that GECS has to make a cash call on Xerox because collections plus cash contribution cannot cover 40 percent of GECS’s debt service payments.

Now, here’s the punch line. Suppose you focus on, not control, but debt capacity—the ability to borrow. Xerox has not increased its ability to borrow by transferring its receivables and debt to GECS. If we want to know about the debt capacity of Xerox, we want to know about that old debt, which Xerox has guaranteed. We can see that debt on Xerox’s balance sheet only if Xerox consolidates its portion of GECS. Our jargon calls that proportional consolidation, which is currently not part of GAAP.

Think about GE again. If you’re interested in its debt capacity, do you want to see the consolidated financial statements with 100 percent of GECS’s debt or proportional consolidated financial statements with only 60 percent of GECS’s debt? I think 60 percent is the right answer.

Accounting rule makers and financial statement users have not agreed at this level of detail on the purpose—report on stewardship or report on debt capacity—of financial reporting in consolidated statements.

[1] Stewardship. If we want to know how well has management done with the assets under its control, we like to see consolidated statements, consolidating all of majority owned subs.
[2] Debt Capacity. If we want to know about the current leverage of the company, then we'd like to see proportional consolidated statements.

No one set of financial statements suits both purposes. The FASB has wrestled with these and related, murkier questions [e.g., when does control become more important than ownership in deciding when to consolidate?] for over a decade and hasn't come to an answer in part because no one answer will satisfy all users. It has to make a judgment and various users pound the table equally hard.

Given the proclivity of management over the past several decades to get debt off the balance sheet, I'd vote for proportional consolidation. You can be a reasonable person and disagree. But unless you agree and help us get proportional consolidation, we won't see all a company's [think Enron's] transactions that lower its debt capacity on its balance sheet.
Roadmap To Investments

Nature of Investment
- Active
  - Parent Reports In income it's share of Affiliate's (or Subsidiary's) Income
  - >50% Yes
  - <50% Uncertain
- Passive
  - Realized Gains and Losses to Income

Control?
- Fraction Purchased
  - >100%
  - <100%

Accounting for Acquisition:
- Purchase
- Consolidation of Acquired Company's Book Value (Ch. 13)

Consolidation of Fair Market Value at Acquisition (Ch. 13)

Equity Method
- [Report Share of Income; Dividends Reduce Investment, Ch. 13]

Debt Securities With Both Ability and Intent to Hold To Maturity
- [Report on Balance Sheet at Amortized Acquisition Cost, Ch. 10]
- Trading Securities
  - [On Balance Sheet at Market Value - Changes in Market Value to Income; Dividends to Income, Ch. 7]
- Securities Available For Sale
  - [On Balance Sheet at Market Value - Changes NOT in Income, but Direct to Owners' Equity Account; Dividends to Income, Ch. 7]

Credit revenue with our share of their income and debit the Investment account. Debit Cash or Dividends Receivable with our share of dividends and debit Investment account.

At time of cash receipt or of adjusting entry, compute book value times historical interest rate. Debit that amount to asset account and credit it to revenue; if cash payment received, debit cash and credit asset account.

Realized gain or loss on sale is selling price less book value at start of period of sale.

Realized gain or loss on sale is selling price less original cost.
## Statement of Earnings

<table>
<thead>
<tr>
<th></th>
<th>General Electric Company and consolidated affiliates</th>
<th>GE</th>
<th>GECS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For the years ended December 31 (in millions; per-share amounts in dollars)</strong></td>
<td>2001</td>
<td>2000</td>
<td>1999</td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
<td>$52,677</td>
<td>$54,286</td>
<td>$47,765</td>
</tr>
<tr>
<td>Sales of goods</td>
<td>18,722</td>
<td>16,006</td>
<td>16,983</td>
</tr>
<tr>
<td>Sales of services</td>
<td>1,009</td>
<td>1,006</td>
<td>1,006</td>
</tr>
<tr>
<td>Other income (note 2)</td>
<td>235</td>
<td>367</td>
<td>729</td>
</tr>
<tr>
<td><strong>Earnings of GECs before accounting changes</strong></td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>GECs revenues from services (note 3)</td>
<td>14,289</td>
<td>56,463</td>
<td>40,764</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>151,573</td>
<td>127,853</td>
<td>111,030</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>56,278</td>
<td>26,454</td>
<td>24,554</td>
<td>12,418</td>
<td>30,172</td>
<td>26,578</td>
</tr>
<tr>
<td>Cost of services sold</td>
<td>13,419</td>
<td>12,114</td>
<td>11,104</td>
<td>13,658</td>
<td>12,765</td>
<td>11,721</td>
</tr>
<tr>
<td>Interest and other financial charges</td>
<td>11,062</td>
<td>11,219</td>
<td>10,013</td>
<td>10,917</td>
<td>11,111</td>
<td>10,318</td>
</tr>
<tr>
<td>Insurance losses and policyholders' and annuity benefits</td>
<td>15,082</td>
<td>14,999</td>
<td>11,078</td>
<td>8,618</td>
<td>9,812</td>
<td>9,412</td>
</tr>
<tr>
<td>Provision for losses on financing receivables (note 13)</td>
<td>2,461</td>
<td>2,045</td>
<td>1,971</td>
<td>2,441</td>
<td>2,045</td>
<td>1,871</td>
</tr>
<tr>
<td>Other costs and expenses</td>
<td>28,162</td>
<td>30,893</td>
<td>27,018</td>
<td>8,637</td>
<td>8,392</td>
<td>7,237</td>
</tr>
<tr>
<td>Minority interest in net earnings of consolidated affiliates</td>
<td>305</td>
<td>427</td>
<td>360</td>
<td>189</td>
<td>213</td>
<td>176</td>
</tr>
<tr>
<td><strong>Total costs and expenses</strong></td>
<td>115,122</td>
<td>111,407</td>
<td>98,053</td>
<td>92,716</td>
<td>92,353</td>
<td>87,063</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Earnings before income taxes and accounting changes</strong></th>
<th>19,486</th>
<th>19,456</th>
<th>15,567</th>
<th>18,824</th>
<th>18,824</th>
<th>15,373</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings before accounting changes</strong></td>
<td>19,486</td>
<td>19,456</td>
<td>15,567</td>
<td>18,824</td>
<td>18,824</td>
<td>15,373</td>
</tr>
<tr>
<td><strong>Cumulative effect of accounting changes (note 1)</strong></td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Net earnings</strong></td>
<td>$19,489</td>
<td>$19,457</td>
<td>$15,568</td>
<td>$18,825</td>
<td>$18,825</td>
<td>$15,374</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Per-share amounts (note 8)</strong></th>
<th>2001</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per-share amounts before accounting charges</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Diluted earnings per share</td>
<td>$1.41</td>
<td>$1.27</td>
<td>$1.07</td>
</tr>
<tr>
<td>Basic earnings per share</td>
<td>$1.42</td>
<td>$1.29</td>
<td>$1.09</td>
</tr>
<tr>
<td>Per-share amounts after accounting changes</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Diluted earnings per share</td>
<td>$1.37</td>
<td>$1.27</td>
<td>$1.07</td>
</tr>
<tr>
<td>Basic earnings per share</td>
<td>$1.38</td>
<td>$1.29</td>
<td>$1.09</td>
</tr>
<tr>
<td><strong>Dividends declared per share</strong></td>
<td>$0.65</td>
<td>$0.57</td>
<td>$0.40</td>
</tr>
</tbody>
</table>

In the consolidated data on this page, "GE" means the basis of consolidation as described in note 1 to the consolidated financial statements; "GECs" means General Electric Capital Services, Inc. and all of its affiliates and associated companies. Transactions between GE and GECs have been eliminated from the "General Electric Company and consolidated affiliates" columns on page 42.

## Consolidated Statement of Changes in Share Owners' Equity

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>2001</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes in share owners' equity (note 9)</strong></td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Balance at January 1</td>
<td>$10,432</td>
<td>$42,254</td>
<td>$36,889</td>
</tr>
<tr>
<td>Dividends and other transactions with share owners</td>
<td>(3,529)</td>
<td>(3,044)</td>
<td>(4,032)</td>
</tr>
<tr>
<td><strong>Changes other than transactions with share owners</strong></td>
<td>13,684</td>
<td>12,235</td>
<td>10,217</td>
</tr>
<tr>
<td>Increase attributable to net earnings</td>
<td>13,684</td>
<td>12,235</td>
<td>10,217</td>
</tr>
<tr>
<td>Investment securities—net</td>
<td>(396)</td>
<td>(592)</td>
<td>(1,776)</td>
</tr>
<tr>
<td>Currency translation adjustments</td>
<td>(563)</td>
<td>(584)</td>
<td>(632)</td>
</tr>
<tr>
<td>Derivative qualifying as hedges</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total changes other than transactions with share owners</strong></td>
<td>11,625</td>
<td>10,959</td>
<td>8,819</td>
</tr>
<tr>
<td><strong>Balance at December 31</strong></td>
<td>$43,624</td>
<td>$43,196</td>
<td>$42,557</td>
</tr>
</tbody>
</table>

The notes to consolidated financial statements on page 67-92 are an integral part of these statements.
## Statement of Financial Position

<table>
<thead>
<tr>
<th></th>
<th>General Electric Company and consolidated affiliates</th>
<th>GE</th>
<th>DECS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and equivalents</td>
<td>$ 9,082   $ 8,315</td>
<td>$10,447 $ 7,210</td>
<td>$ 7,316  $ 6,052</td>
</tr>
<tr>
<td>Investment securities (note 5)</td>
<td>107,017 91,359</td>
<td>879 $ 1,099</td>
<td>190,138 90,330</td>
</tr>
<tr>
<td>Current receivables (note 16)</td>
<td>9,500 9,502</td>
<td>$ 5,055 8,927</td>
<td>— —</td>
</tr>
<tr>
<td>Intangibles (note 11)</td>
<td>8,063 7,062</td>
<td>8,285 7,116</td>
<td>270 666</td>
</tr>
<tr>
<td>Financing receivables (investments in time sales, leases and financing leases) — net (notes 12 and 13)</td>
<td>174,322 143,209</td>
<td>— —</td>
<td>174,322 143,209</td>
</tr>
<tr>
<td>Insurance receivables (note 14)</td>
<td>27,517 23,802</td>
<td>— —</td>
<td>27,517 23,802</td>
</tr>
<tr>
<td>Other GECS receivables</td>
<td>11,105 11,714</td>
<td>— —</td>
<td>13,267 13,206</td>
</tr>
<tr>
<td>Property, plant and equipment (including equipment leased to others) — net (note 15)</td>
<td>— —</td>
<td>28,190 23,002</td>
<td>— —</td>
</tr>
<tr>
<td>Intangible assets — net (note 16)</td>
<td>31,041 27,441</td>
<td>12,322 12,474</td>
<td>18,717 15,917</td>
</tr>
<tr>
<td>All other assets (note 17)</td>
<td>80,520 73,882</td>
<td>25,086 24,029</td>
<td>55,888 59,398</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$495,023 $472,046</td>
<td>$156,733 $98,755</td>
<td>$425,458 $370,636</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Liabilities and equity</strong></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term borrowings (note 18)</td>
<td>$153,576 $131,160</td>
<td>$1,722 840</td>
<td>$160,041 $123,922</td>
</tr>
<tr>
<td>Accounts payable, principally trade accounts</td>
<td>88,159 148,053</td>
<td>6,980 6,163</td>
<td>13,705 10,439</td>
</tr>
<tr>
<td>Progress collections and price adjustments accrued</td>
<td>11,751 8,271</td>
<td>11,751 8,271</td>
<td>— —</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>1,787 1,596</td>
<td>1,787 1,596</td>
<td>— —</td>
</tr>
<tr>
<td>All other current costs and expenses accrued</td>
<td>14,132 12,219</td>
<td>14,132 12,219</td>
<td>— —</td>
</tr>
<tr>
<td>Long-term borrowings (note 18)</td>
<td>78,906 82,122</td>
<td>787 841</td>
<td>79,051 81,379</td>
</tr>
<tr>
<td>Insurance liabilities, reserves and annuity benefits (note 19)</td>
<td>114,223 108,159</td>
<td>— —</td>
<td>114,223 108,159</td>
</tr>
<tr>
<td>All other liabilities (note 20)</td>
<td>32,923 26,481</td>
<td>18,039 14,840</td>
<td>16,647 13,451</td>
</tr>
<tr>
<td>Deferred income taxes (note 21)</td>
<td>9,110 8,959</td>
<td>1,013 452</td>
<td>9,517 9,239</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>434,506 393,358</td>
<td>53,961 45,325</td>
<td>502,827 474,546</td>
</tr>
<tr>
<td>Common stock (8,825,533,600 and 9,035,000,000 shares outstanding at year-end 2001 and 2000, respectively)</td>
<td>6,568 4,836</td>
<td>944 662</td>
<td>4,267 3,966</td>
</tr>
<tr>
<td>Accumulated gains/(losses) — net</td>
<td></td>
<td>1 1</td>
<td>1 1</td>
</tr>
<tr>
<td>Investment securities</td>
<td>(232) 74</td>
<td>(232) 74</td>
<td>(348) 4</td>
</tr>
<tr>
<td>Currency translation adjustments</td>
<td>(3,135) (2,574)</td>
<td>(3,135) (2,574)</td>
<td>(656) (657)</td>
</tr>
<tr>
<td>Derivatives qualifying as hedges</td>
<td>(515) —</td>
<td>(515) —</td>
<td>(515) —</td>
</tr>
<tr>
<td>Other capital</td>
<td>16,033 15,155</td>
<td>16,033 15,155</td>
<td>5,899 2,752</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>68,711 81,572</td>
<td>68,701 71,572</td>
<td>24,076 21,222</td>
</tr>
<tr>
<td>Less common stock held in treasury</td>
<td>(39,916) (24,444)</td>
<td>(29,916) (24,444)</td>
<td>— —</td>
</tr>
<tr>
<td>**Total shareowners' equity (notes 24 and 25)</td>
<td>58,856 50,402</td>
<td>54,824 50,492</td>
<td>28,959 23,622</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$495,023 $472,046</td>
<td>$156,733 $98,755</td>
<td>$425,458 $370,636</td>
</tr>
</tbody>
</table>

The sum of accumulated gains/(losses) on investment securities, currency translation adjustments, and derivatives qualifying as hedges constitutes "Accumulated unrealized gains other than earnings," as shown in note 24, and was $4,320 in 2001 and $2,000 in each of 2000, 2001, and 2002, respectively.

These amounts have been reclassified to "Total liabilities and equity" and "Minority interest in equity of consolidated affiliates (note 22)"

The notes to consolidated financial statements on pages 57-82 are an integral part of this statement.
### Statement of Cash Flows

For the years ended December 31 (in millions)

<table>
<thead>
<tr>
<th>General Electric Company and consolidated affiliates</th>
<th>2001</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows—operating activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings</td>
<td>$13,684</td>
<td>12,715</td>
<td>10,717</td>
</tr>
<tr>
<td>Adjustments to reconcile net earnings to cash provided from operating activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative effect of accounting changes</td>
<td>444</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Depreciation and amortization of property, plant and equipment</td>
<td>5,370</td>
<td>5,099</td>
<td>4,908</td>
</tr>
<tr>
<td>Amortization of goodwill and other intangibles</td>
<td>1,119</td>
<td>2,817</td>
<td>1,783</td>
</tr>
<tr>
<td>Earnings (before accounting changes) retained by GECS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>1,426</td>
<td>1,153</td>
<td>1,502</td>
</tr>
<tr>
<td>Decrease (increase) in GE current receivables</td>
<td>107</td>
<td>(537)</td>
<td>143</td>
</tr>
<tr>
<td>Decrease (increase) in other receivables</td>
<td>(465)</td>
<td>(924)</td>
<td>266</td>
</tr>
<tr>
<td>Provision for losses on financing receivables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All other operating activities</td>
<td>3,581</td>
<td>3,701</td>
<td>3,616</td>
</tr>
<tr>
<td>Cash from operating activities</td>
<td>32,105</td>
<td>22,683</td>
<td>24,593</td>
</tr>
</tbody>
</table>

| Cash flows—investing activities                       |      |      |      |
| Additions to property, plant and equipment            | (11,520) | (13,907) | (15,620) |
| Dispositions of property, plant and equipment         | 3,324 | 3,767 | 8,262 |
| Net increase in GECS financing receivables           | (11,832) | (10,703) | (12,628) |
| Payments for principal businesses purchased           | (4,429) | (2,332) | (11,854) |
| Cash used for investing activities                    | (15,115) | (35,063) | (42,179) |

| Cash flows—financing activities                       |      |      |      |
| Net increase (decrease) in borrowings (maturities of 90 days or less) | 20,407 | 8,249 | 5,171 |
| Newly issued debt (maturities longer than 90 days)    | 32,071 | 42,464 | 40,158 |
| Repayments and other reductions (maturities longer than 90 days) | (37,004) | (32,762) | (27,539) |
| Net dispositions (purchase) of GE shares for treasury | (2,435) | 469 | (3,002) |
| Dividends paid to shareholders                        | (5,358) | (4,141) | (1,567) |
| All other financing activities                        | 2,067 | 12,947 | 627 |
| Cash from (used for) financing activities             | 8,695 | 14,659 | 21,823 |

| Increase (decrease) in cash and equivalents during year | 2,322 | 5,110 | 925 |
| Cash and equivalents at beginning of year            | 1,656 | 6,954 | 3,317 |
| Cash and equivalents at end of year                   | $8,052 | $6,193 | $3,554 |
| Supplemental disclosure of cash flows information     |      |      |      |
| Cash paid during the year                              | $(11,125) | $(11,671) | $(13,078) |
| Cash recovered (paid) during the year for income taxes | (1,457) | (2,064) | (1,592) |

The notes to consolidated financial statements on pages 77-78 are an integral part of this statement.

In the consolidating data on this page, "GE" means General Electric Company, "GECS" means General Electric Capital Services, Inc., and "GE and GECS" means General Electric Company and associated companies. Transactions between GE and GECS have been eliminated from the "General Electric Company and consolidated affiliates" columns on page 46.
REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE

OF THE

BOARD OF DIRECTORS OF ENRON CORP.

William C. Powers, Jr., Chair
Raymond S. Troubh
Herbert S. Winokur, Jr.

Counsel
Wilmer, Cutler & Pickering

February 1, 2002
I. **BACKGROUND: ENRON AND SPECIAL PURPOSE ENTITIES**

During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan: buy or develop an asset, such as a pipeline or power plant, and then expand it by building a wholesale or retail business around the asset. During the period from 1996 to 1998, we are told, approximately 60% of Enron’s earnings were generated from businesses in which Enron was not engaged ten years earlier, and some 30% to 40% were generated from businesses in which Enron was not engaged five years earlier.

Much of this growth involved large initial capital investments that were not expected to generate significant earnings or cash flow in the short term. While Enron believed these investments would be beneficial over a period of time, they placed immediate pressure on Enron’s balance sheet. Enron already had a substantial debt load. Funding the new investments by issuing additional debt was unattractive because cash flow in the early years would be insufficient to service that debt and would place pressure on Enron’s credit ratings. Maintaining Enron’s credit ratings at investment grade was vital to the conduct of its energy trading business. Alternatively, funding the investments by issuing additional equity was also unattractive because the earnings in the early years would be insufficient to avoid “dilution”—that is, reducing earnings per share.

One perceived solution to this finance problem was to find outside investors willing to enter into arrangements that would enable Enron to retain those risks it believed it could manage effectively, and the related rewards. These joint investments typically were structured as separate entities to which Enron and other investors contributed assets or other consideration. These entities could borrow directly from
outside lenders, although in many cases a guaranty or other form of credit support was required from Enron.

Enron’s treatment of the entities for financial statement purposes was subject to accounting rules that determine whether the entity should be consolidated in its entirety (including all of its assets and liabilities) into Enron’s balance sheet, or should instead be treated as an investment by Enron. Enron management preferred the latter treatment—known as “off-balance-sheet”—because it would enable Enron to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies. Enron engaged in numerous transactions structured in ways that resulted in off-balance-sheet treatment. Some were joint ventures. Others were structured as a vehicle known as a “special purpose entity” or “special purpose vehicle” (referred to as an “SPE” in this Report). Some involved both.

From the early 1990s through 2001, we understand that Enron used SPEs in many aspects of its business. We have been told that these included: synthetic lease transactions, which involved the sale to an SPE of an asset and lease back of that asset (such as Enron’s headquarters building in Houston); sales to SPEs of “financial assets” (a debt or equity interest owned by Enron); sales to merchant “hedging” SPEs of Enron stock and contracts to receive Enron stock; and transfers of other assets to entities that have limited outside equity.

There is no generally accepted definition of SPEs to distinguish them from other legal entities, although the staff of the Financial Accounting Standards Board (“FASB”) has used the concept of entities whose activities and powers are significantly limited by
their charter or other contractual arrangement. An SPE may take any legal form, including a corporation, partnership, or trust. At the margin, it may be difficult to determine whether an entity is or is not an SPE; key considerations in the accounting literature include how long the entity is intended to be in existence, and the restrictions placed on its activities.

The accounting literature provides only limited guidance concerning when an SPE should be consolidated with its sponsor for financial statement purposes. Much of the literature developed in the context of synthetic lease transactions, in which an SPE acquires property or equipment and leases it to a single lessor. The accounting objective of these lease transactions was to finance the acquisition of an asset while keeping the corresponding debt off of the acquiring company's balance sheet. SPEs later came to be used in other non-leasing transactions, largely to obtain similar accounting results. Over time, in part because of SEC staff concerns that there was no standard practice in dealing with the consolidation of SPEs, the FASB Emerging Issues Task Force released several statements attempting to clarify the relevant principles. By the late 1990s, several generally recognized consolidation principles had been established.

To begin, "[t]here is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies . . . ." FASB, Accounting Research Bulletin No. 51, Consolidated Financial Statements (1959). Ordinarily, the majority holder of a class of equity funded by independent third parties should consolidate (assuming the equity meets certain criteria dealing with size, ability to exercise control,
and exposure to risk and rewards). If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SPE or its sponsor should consolidate the SPE.

This presumption in favor of consolidation can be overcome only if two conditions are met:

First, an independent owner or owners of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction. Where there is only a nominal outside capital investment, or where the initial investment is withdrawn early, then the SPE should be consolidated. The SEC staff has taken the position that 3% of total capital is the minimum acceptable investment for the substantive residual capital, but that the appropriate level for any particular SPE depends on various facts and circumstances. Distributions reducing the equity below the minimum require the independent owner to make an additional investment. Investments are not at risk if supported by a letter of credit or other form of guaranty on the initial investment or a guaranteed return.

Second, the independent owner must exercise control over the SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature on partnership control rights for guidance in making this evaluation.

Of the many SPEs utilized by Enron over the past several years, some were involved in the transactions between Enron and related parties that are the subject of this
Report. We have only looked at these SPEs. The unconsolidated SPEs involved in Enron's related-party transactions present issues on both aspects of the non-consolidation test: whether any outside investor had more than 3% residual capital at risk in the entities, and whether any investor other than Enron exercised sufficient control over the entities to justify non-consolidation. We discuss these issues below in connection with specific entities and transactions.
II. CHEWCO

Chewco Investments L.P. is a limited partnership formed in 1997. Transactions between Enron and Chewco are a prologue for Enron's later dealings with the LJM partnerships. Chewco is, to our knowledge, the first time Enron's Finance group (under Fastow) used an SPE run by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements.

Enron's dealings with Chewco raise many of the same accounting and corporate governance issues posed by the LJM transactions we discuss below. Like the LJM partnerships, Chewco's ownership structure was a mystery to most Enron employees, including many who dealt with Chewco on behalf of Enron. Like LJM, the transactions between Enron and Chewco resulted in a financial windfall to an Enron employee. Some of this financial benefit resulted from transactions that make little apparent economic or business sense from Enron's perspective. But there is also an important distinction: The participation of an Enron employee as a principal of Chewco appears to have been accomplished without any presentation to, or approval by, Enron's Board of Directors.

Chewco played a central role in Enron's November 2001 decision to restate its prior period financial statements. In order to achieve the off-balance sheet treatment that Enron desired for an investment partnership, Chewco (which was a limited partner in the partnership) was required to satisfy the accounting requirements for a non-consolidated SPE, including having a minimum of 3% equity at risk provided by outside investors. But Enron Management and Chewco's general partner could not locate third parties willing to invest in the entity. Instead, they created a financing structure for Chewco.
that—on its face—fell at least $6.6 million (or more than 50%) short of the required third-party equity. Despite this shortfall, Enron accounted for Chewco as if it were an unconsolidated SPE from 1997 through March 2001.

We do not know why this happened. Enron had every incentive to ensure that Chewco met the requirements for non-consolidation. It is reasonable to assume that Enron employees, if motivated solely to protect Enron’s interests, would have taken the necessary steps to ensure that Chewco had adequate outside equity. Unfortunately, several of the principal participants in the transaction declined to be interviewed or otherwise to provide information to us. For this reason, we have been unable to determine whether Chewco’s failure to qualify for non-consolidation resulted from bad judgment or negligence, or whether it was caused by Enron employees putting their own economic or personal interests ahead of their obligations to Enron.

When the Chewco transaction was reviewed closely in late October and early November 2001, both Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity, and that it should have been consolidated into Enron’s financial statements. As a result, Enron announced in November that it would restate its prior period financial statements from 1997 through 2001. The retroactive consolidation of Chewco—and the investment partnership in which Chewco was a limited partner—had a huge impact. It decreased Enron’s reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron’s reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.
EITF 90-15: Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions

EITF 90-15 Dates Discussed

EITF 90-15 References
FASB Statement No. 13, Accounting for Leases
FASB Statement No. 23, Inception of the Lease
FASB Statement No. 29, Determining Contingent Rentals
FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries
FASB Statement No. 98, Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases
FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
FASB Interpretation No. 19, Lessee Guarantee of the Residual Value of Leased Property
SEC Staff Accounting Bulletin No. 57, Views concerning Accounting for Contingent Warrants in Connection with Sales Agreements with Certain Major Customers

EITF 90-15 ISSUE
A company (lessee) enters into a lease that has been designed to qualify as an operating lease under Statement 13, as amended; however, certain characteristics of the lease have raised questions as to whether operating lease classification is appropriate:

1. Lessee residual value guarantees and participations in both risks and rewards associated with ownership of the leased property
2. Purchase options
3. Special-purpose entity (SPE) lessor that lacks economic substance
4. Property constructed to lessee’s specifications
5. Lease payments adjusted for final construction costs.

The issue is whether either operating lease treatment or another method of accounting is appropriate for leases with all or some of the characteristics described above.

EITF 90-15 DISCUSSION
The Task Force reached a consensus that a lessee is required to consolidate a special-purpose entity lessor when all of the following conditions exist:

1. Substantially all of the activities of the SPE involve assets that are to be leased to a single
The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as
a. The lease agreement
b. A residual value guarantee through, for example, the assumption of first dollar of loss provisions
c. A guarantee of the SPE’s debt
d. An option granting the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor’s sales proceeds in excess of a stipulated amount

3. The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease.

If the above conditions exist, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee’s financial statements. This conclusion should be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet the aforementioned conditions. In those cases, the consolidation by the lessee should begin at the inception of the lease, as defined in Statement 15 and amended in Statement 23, rather than the beginning of the lease term.

A lease containing the general characteristics described in the issue above that does not meet conditions for consolidation noted above, may qualify for operating lease treatment. However, it was noted that it is necessary to evaluate the facts and circumstances of each lease in relation to the requirements of Statement 13, as amended, to determine the appropriate lease classification. In particular, the Task Force noted that determining the existence of an economic penalty that results in reasonable assurance of the lessee’s renewal of the lease beyond the initial lease term must be assessed based on the facts and circumstances of each lease.

At the July 11, 1991 meeting, the Task Force Chairman announced that he had received a letter from the acting Chief Accountant of the SEC outlining the SEC staff position on a number of recent implementation questions relating to this issue. Those questions and the SEC staff responses are as follows:

**Question No. 1**

Did the EITF consensus resolve the SEC staff's concerns with respect to the leasing transactions discussed in various SEC staff announcements in EITF minutes?

**Response**

The SEC staff believes the consensus, along with appropriate disclosures, provides timely guidance with respect to certain leasing transactions involving SPEs that were of the most concern to the SEC staff. These included sale-leaseback transactions involving personal property, real property when the property is built to the lessee’s specifications, and property meeting the specifications of the lessee that is purchased by the lessor.

All leasing transactions should be carefully analyzed, particularly those including any potential
penalties or involving special-purpose property, in accordance with Statement 13, as amended. Registrants' disclosures should include a general description of the leasing arrangements as required by paragraph 16(d) of Statement 13. The SEC staff believes such disclosures should include the significant terms of leasing arrangements, including renewal or purchase options, escalation clauses, obligations with respect to refinancing of the lessor's debt, significant penalties (as defined in Statement 98), and the provisions of any significant guarantees, such as residual value guarantees.

In addition, Financial Reporting Codification Section 501, Management's Discussion and Analysis, requires disclosure of any known demands, commitments, events, or uncertainties that will result in or that are reasonably likely to have a material impact (or for which management cannot make such determination) on the registrant's liquidity, capital resources, or income from continuing operations or would cause reported financial information not to be indicative of future operating results or of future financial condition. In addition, Article 5 of Regulation S-X requires disclosure of all material commitments and contingent liabilities.

**Question No. 2**

Is the guidance in Issue 90-15 applicable to SPEs utilized in transactions other than those specified in the consensus?

**Response**

The Working Group (which was specifically formed to work with the SEC staff to study this issue and propose a consensus to the Task Force) only considered the SPE issue as it relates to leasing transactions. These transactions may vary significantly from other types of SPE transactions in structure and in terms of risks and rewards. Accordingly, the consensus did not include nonleasing transactions in its scope.

The views expressed by the SEC staff at the February and May 1989 EITF meetings are still applicable to SPE transactions other than those addressed by Issue 90-15. The SEC staff notes that the conditions identified in Issue 90-15 are consistent with the views on SPEs previously expressed by the SEC staff. The Issue 90-15 conditions focus on the risks and rewards and substantive nature of the SPE, which are critical to consolidation. Accordingly, the conditions set forth in Issue 90-15 may be useful in evaluating other transactions involving SPEs.

The SEC staff would expect to resolve these other nonleasing transactions on a case-by-case approach. Consistent with SAB Topic 5K (SAB 57), the SEC staff recommends that registrants discuss such unusual transactions with the SEC staff on a pre-filing basis.

**Question No. 3**

What is meant in the consensus by the term expected substantive residual risks? Does it mean the 90 percent threshold specified in paragraph 7(d) of Statement 13?

What amount qualifies as a substantive residual equity capital investment (condition (3) of the consensus)?

**Response**
In these transactions, the significant elements of management and control over the leased asset generally are specified by contract when the lease is negotiated and the SPE is established. Certain of these elements of management and control raise concerns on the part of the SEC staff with respect to who possesses the risks and rewards of ownership of the leased asset. These include elements such as a non-substantive lessor without equity at risk, a lessee who has the ability to realize all appreciation and bears substantial risk of depreciation, and a lessee who acts as the construction agent and selling agent and who is at more than nominal risk. In determining if a registrant has substantive residual risks and rewards of the leased asset (condition (2) of the consensus), the SEC staff would review a transaction to determine if the lessee has these or similar elements of management and control. If the lessee would reasonably be expected to bear the substantive residual risks and receive rewards due to such elements, the SEC staff would consider condition (2) to be met. This would be a judgmental decision based on the specific facts and circumstances of each transaction, and does not involve the 90 percent determination as set forth in Statement 13.

The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

As the consensus states, the investment should be at risk with respect to the leased asset for the entire term of the lease. The investment would not be considered to be at risk, for example, if the investor were provided a letter of credit or other form of guarantee on the initial investment or return thereon. An investor note payable issued to the SPE would not qualify as an initial substantive residual equity investment at risk.

Question No. 4

If the initial substantive residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles (GAAP), is the investor required to make an additional capital investment?

Response

The SEC staff understands that the Working Group discussed this question and concluded that the answer is no.

Question No. 5

May the investor withdraw its initial minimum required equity investment prior to the expiration of the lease term?

Response
There may be circumstances in which an investor makes an investment in excess of the minimum required equity investment. In those circumstances, the investor may withdraw its initial investment in excess of the minimum required equity. However, the EITF included in condition (3) of the consensus, a requirement that the initial minimum equity investment be at risk during the entire term of the lease. Accordingly, that minimum amount could not be withdrawn either directly or indirectly. The SEC staff understands that the Working Group believed that transactions would include documentation that would enable the lessee to determine the lessor had maintained its capital at risk.

**Question No. 6**

If an SPE contained a building whose value increased such that the equity of the SPE increased on an appraised fair value basis, could the investor withdraw its initial capital to the extent of the increase in the fair value of the property?

**Response**

No. Condition (3) requires the initial investment to be at risk during the entire term of the lease. As noted in Question 4 above, the minimum investment is not required to be increased for GAAP losses and it is not permitted to be withdrawn for appraisal increases.

**Question No. 7**

Does the consensus apply to previous transactions within its scope?

**Response**

EITF consensuses are applied on a prospective basis unless a consensus specifically addresses transition. Accordingly, the SEC staff believes the guidance in the consensus should be applied on a prospective basis to the transactions within its scope.

The SEC staff has made various announcements regarding leasing transactions that have been included in the EITF meeting minutes. These announcements focused on the same issues as the conditions in Issue 90-15, but were more general in nature. Registrants should have followed the guidance in the announcements and the SEC staff's prior position as set forth therein, when filing financial statements that include material leasing transactions involving an SPE and that were completed prior to January 10, 1991 (the date of the consensus).

**Question No. 8**

If a previously formed SPE has an existing lease in it and has not been consolidated (for example, due to immateriality or because it would not have required consolidation pursuant to the SEC staff announcements or Issue 90-15), and if a new lease is put in the SPE so that the SPE meets the conditions in Issue 90-15 for consolidation, can only the new lease be consolidated on a pro rata basis? Since the SPE was formed prior to the consensus, is the SPE and any future transactions it participates in grandfathered?

**Response**
The SEC staff does not permit pro rata consolidation except in limited circumstances (those specifically provided for in the authoritative literature), which do not include a leasing SPE. Neither the SPE nor its future transactions would be considered to be grandfathered, and accordingly, the entire SPE should be consolidated on a prospective basis.

**Question No. 9**

May an existing nonsubstantive SPE become a substantive entity by having an investor put in sufficient capital to meet condition (3) of the consensus and accordingly be unconsolidated?

**Response**

Yes. However, if an investor puts in additional capital, it may result in changes in the lease terms, including perhaps the lease payments. The SEC staff believes a lease entered into with a consolidated SPE, which is then unconsolidated when a substantive equity investment is made, is analogous to a sale-leaseback transaction and results in a new lease that should be assessed pursuant to the conditions of Issue 90-15 at the time the changes are made. The lessee would also need to evaluate the lease in accordance with Statement 13, as amended, and Statement 98 for transactions within its scope.

The SEC staff would apply the same guidance when an existing nonsubstantive SPE enters into significant substantive leases with other unrelated lessees accordingly no longer meets condition (1) of the consensus.

**EITF 90-15 STATUS**

A related issue was discussed in Issue No. 96-20, "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities." That Issue deals with whether the new control/financial-components model introduced by Statement 125 has an effect on how the existing guidance on consolidation of SPEs is applied in securitization transactions. See Issue 96-20 for details on the consensuses reached.

Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," provides responses to several additional questions that relate specifically to conditions (1) and (3) of Issue 90-15. The questions relate to the following issues: multiple properties within a single SPE-lessee, multi-tiered SPE structures, payments made by lessee prior to beginning of lease term, payments to equity owners of an SPE during the lease term, fees paid to owners of record of an SPE, source of initial minimum equity investment, equity capital at risk, payment to owners of record of an SPE prior to the lease term, costs incurred by lessee prior to entering into a lease agreement, and interest-only payments.

Another related issue was discussed in Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities." The categories of issues are: (1) environmental risk, (2) non-performance-related default covenants, and (3) depreciation. Categories (1) and (2) apply to leasing transactions irrespective of whether the lessor is an SPE. Category (3) applies when the lessor is an SPE. (See Issue 97-1 for details of the consensuses reached.)
Synthetic lease could provide advantages

Tom Eriason

With so many software and biotech firms in the area on the verge of explosive growth, and with space for lease hard to come by, the build-to-suit option is starting to look better than ever.

A sophisticated method of financing that build-to-suit results when a company enters into a synthetic lease agreement with a lending institution which acquires title to the real estate. It's an arrangement that enables the lessee to derive tax, accounting and rent advantages as well as the opportunity to buy the property at a favorable, predetermined rate.

The synthetic lease has been sweeping California, from Silicon Valley in the north to the biomedical instrumentation centers of San Diego County in the south. Like other ideas that seem to germinate in California, the synthetic lease appears destined to catch on in the Puget Sound area.

The synthetic lease is especially enticing for publicly owned companies, where shareholders tend to look askance at investments in bricks and mortar rather than in the core business.

That's one of the reasons cash-rich Cisco Systems, a San Jose, Calif., based provider of networking hardware and software, has taken to...
Synthetic lease could provide advantages - 1998-09-14 - Puget Sound Business Journal (S... Page 2 of 3

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synthetic leases with gusto, creating several leases on more than 2.5 million square feet of space valued at more than $600 million.

A synthetic lease is an off-the-balance-sheet lease that allows the company to control the real estate without being required to show the real estate asset on its financial statements. But at the same time, the company derives benefits associated with real estate ownership by depreciating the improvements for tax purposes. In short, the synthetic lease provides the advantages of owning property with the benefits of an operating lease.

"The synthetic lease is an excellent tool for a publicly traded company concerned with the balance sheet ratios of their financial statement and the impact these ratios have on Wall Street," said Rod Petrenchak, senior vice president and regional manager of U.S. Bank's commercial real estate division in Seattle.

The off-the-balance sheet lease provides some significant advantages over a conventional lease.

- Occupancy costs are lower than with a conventional lease. Further, the real estate asset doesn't appear on the tenant's balance sheet and no depreciation is charged against earnings for Securities and Exchange Commission reporting purposes.

- The lease structure allows improvements to be depreciated for tax purposes, thus providing the benefit of a tax shelter.

- For all practical purposes, the company controls the real estate and at any time can exercise its option to buy the property at a predetermined price. This is a far cry from traditional sale-leaseback arrangements that include purchase options that set the purchase price at the market value at the time the option is exercised.

- Off-balance sheet leases do not include rental escalators based on the consumer price index or percentage rent based on sales.

- The off-balance sheet lease can be funded 100 percent by debt, as opposed to a conventional lease which is usually funded by at least 20 percent equity. For a lessee with strong credit, this can result in an effective capitalization, or cap, rate of 1 percent to 2 percent below that in a traditional sale-leaseback.

By far the biggest element of uncertainty surrounding the synthetic lease arrangement is what happens at the end of the lease. The company has

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three options: It can buy the property at the pre-established fixed price, roll over the lease or pay a penalty in the form of a substantial amount of the original cost in supplemental rent to get out of the lease.

Clearly, the incentives on the lessee's part are to either buy the property at the end of the lease or to refinance.

Problems arise if the company is on shakier financial ground at the end of the lease than it was when the lease was created. Or worse yet, if the real estate market is weaker than it was at the start of the lease, the company will wind up paying a premium whether it re-leases or buys.

Yet another downside risk would be the possibility that the Internal Revenue Service or the Financial Accounting Standards Board would retract the ability to have an operating lease off the balance sheet while at the same time deriving the tax benefits of depreciation.

Clearly, the synthetic lease isn't for everyone. The banks have to buy into the business plan. It isn't the kind of lease that a biotech or software firm just emerging from the home garage has the kind of leverage to pull off.

In fact, it helps if the company is already public because in some cases the banks have been known to ask for collateral in the form of marketable securities equal to the loan.

For some, the synthetic lease has resulted in significant cost savings. Cisco Systems, for one, concluded its first deal when a standard lease in San Jose was about $1 per square-foot a month. The synthetic structure enabled it to get the space for 40 cents a square foot.

TOM ERLANDSON is a broker with the David Alexander Co., a Seattle-based commercial real estate brokerage.
The Synthetic Lease: Off-Balance Sheet Financing of Real Property
April 10, 1998

By James B. Hodge

I. INTRODUCTION

The synthetic lease (also known as an "off-balance-sheet lease," an "off-balance loan," or a "master lease") is a financing structure used by many public companies to finance 100% of the cost of acquisition of certain real and personal property at cost. It is a structure with a split personality — it is accounted for as an operating lease but treated for economic and tax purposes as a financing transaction, and it gets favorable treatment in each case. As a result, it can satisfy a number of apparent inconsistent needs.

Real property and the debt and expense associated with it are usually undesirable to the financial statements of a company. Under generally accepted accounting ("GAAP"), the "end-user" in a synthetic lease transaction, that is, the entity that property and becomes the tenant, does not carry the asset or the debt on its financial statements (making it off-balance sheet). Because neither the asset nor the debt associated with it is carried on the balance sheet, the balance sheet is freed of a producing real estate asset and the burden of the attendant debt. The debt-to-equity and other financial ratios derived from the balance sheet are improved. The effect to enhance the company's borrowing capacity and its stock price. Few accounting securities disclosures are required. Because the property does not appear on the income statement, for GAAP accounting purposes, neither interest deductions nor depreciation are deducted from revenues. Rental payments are deducted, but the tax of those payments is lower than the sum of the items that are not included. The income statement is to increase reported earnings. This improves return on return on assets and debt coverage ratios, and may also increase share price, etc.

On the other hand, for tax-cash-flow, economic and operational purposes, the
treats the transaction as if it has borrowed the funds necessary to purchase and the property, and as if it owns the property. It depreciates the property and takes interest deduction for federal income tax purposes, instead of taking the rental. The effect is to increase deductions, concomitantly to drive down taxable income liability, and therefore to increase cash flow. In addition, the end-user gets full development, construction, management and disposition of the property and the economic benefit of any appreciation of the property, advantages not usually enjoyed by tenant.

As a third benefit, the lease structure has many of the advantages of a so-called "structured financing," that is, a financing structure in which the real estate asset is separated from the bankruptcy risks of the owner—or the former owner—of the property. This feature makes the transaction more attractive to the capital markets and the total cost of the financing, which makes the synthetic lease one of the cheapest real estate financing. The rate may be two to three hundred basis points (the percentage points) lower than if the transaction were priced as a conventional prime rate. One hundred percent of the cost of the project (including acquisition and construction costs, soft costs and the cost of personal property acquisition) is financed, and often the lease payments are equal to interest-only on the amount financed. This all means increased income (which may increase and better cash flow for the end-user. Because of the complexity and the struct transaction costs, synthetic lease transactions are generally large. It is difficult to find a synthetic lease structure for an acquisition of less than $10 million, although as professionals are becoming more familiar with synthetic leases, and more facile in structuring and documenting them, the transaction costs are declining. The synthetic lease is not limited to the acquisition or construction of only one facility. A synthetic lease can be structured for a number of different properties under the same financing thereby driving down costs on a per-property basis and making feasible the lease of expensive single properties. And in at least one transaction, a synthetic lease provided nearly one-third of the financing for a $1.8 billion acquisition of one company.

The synthetic lease structure is approved by the Financial Accounting Standards Board ("FASB"), the group that sets the standards for the accounting industry, and by the Securities and Exchange Commission.

There has been some concern regarding the status of the accounting treatment synthetic leases, but the two most recent announcements of the FASB’s Emerging Issues Taxation Committee ("EITC") provide a safe harbor for the special purpose entity to the end-user. This has given practitioners additional and should significantly increase the volume of synthetic lease transactions.

This article will describe the parties to the synthetic lease transaction, investigate how the synthetic lease is structured in order to achieve its apparently inconsistent benefits.
discuss what motivates the source of capital to structure a transaction as a synthetic lease. It finishes with a discussion of the risks of the structure to the parties and how they may be minimized.

II. HISTORICAL DEVELOPMENT OF THE SYNTHE TIC LEASE

The synthetic lease was originally developed and used to finance heavy equipment, aircraft, railroad rolling stock and cargo vessels. This was its primary use through the 1980s. End-users have traditionally financed real estate by borrowing money at repayment of which is secured by a mortgage or deed of trust in the property, or by leasing their property in transactions that left them with little or none of the benefits of owning the property. Along with the risk of nonpayment, the lender or the landlord in real estate transactions bears all or a substantial portion of the risk of a decline in the value of the property. The lender also bears a significant risk in the event of bankrupt borrower.

During and after the real estate recession in the late 1980s and early 1990s, securitization happened. Perhaps most fundamentally, lenders, landlords and others in the commercial real estate markets, hurt by drastic declines in the value of property, generally backed away from amortization periods, nonrecourse financing and high loan-to-value ratios that were customary in real estate transactions. Some withdrew from the commercial real estate market altogether, creating what would not burden the financial statement of the end user at a reasonable cost. The synthetic lease, familiar to equipment lenders, provided structure to eliminate the operational risk (such as increases in real estate operating expenses and repairs and the risk of loss relating to building condemnation or other similar risks) and the residual risk (that is, the risk of a loss in the value of the property at the financing term) inherent in real estate lending. It also met the need for corpora borrowers to maintain attractive financial ratios and to increase stock value.

At the same time, the successful move to securitize real estate and gain access to capital markets, which was spearheaded by the Resolution Trust Corporation, made capital available for real estate transactions that were properly structured. All of these factors combined to make the synthetic lease structure an attractive option for the commercial real estate industry.

III. THE PARTIES TO THE SYNTHE TIC LEASE TRANSACTION

There are two central groups of players in synthetic lease transactions: tenants users and capital sources.

A. Tenant or End-User

Most tenants in synthetic lease transactions are publicly traded corporations, all of these have a growing move toward synthetic leases by companies that are intende
public as well. While for-profit companies have been the primary players in the nonprofit companies are also beginning to appreciate the benefits of the structure nearly all synthetic lease transactions, the tenant is an "investment grade credit been given a favorable credit rating by one of the four nationally known rating:

The end-user has a specific and identifiable real estate need and is willing to engage in a build-to-suit transaction. The end-user may also need equipment, fixtures or other property. The company typically is capable of managing the development of the property wants to finance as much of the cost of the project as possible, and would like to own the property. It also must be willing to accept a significant portion, if not all, of going and residual risks of ownership.

Fast growing high technology companies are making significant use of the synthetic structure and have gained most of the public attention relating to synthetic lease however, supermarket chains, financial institutions, health care providers, many retailers, distributors and other less-exotic companies of all kinds also find the structure attractive.

**B. Capital Sources**

The other central players in the transaction are the capital sources. The synthetic structure requires a source of capital willing to fund the transaction on terms and conditions that differ from the traditional financing transaction. Most of the funds for synthetic leases have come from commercial banks, who often fund the equity debt through their subsidiaries. The balance of the funds are provided by the capital markets. If the source of capital is not an institutional lender, it will arrange the negotiate for the credit support facility or provide the credit support facility itself any commercial paper that is issued, administer the program, and take a portion residual value risk.

The capital source is looking for a transaction in which it can transfer a significant if not all, of the residual risk of loss in value of the property to another party. The income from the deal are not as large as they might be from a riskier or more transaction. As a result, if the capital source is a lender it may look for a portion of the compensation from fees charged to other institutions with which it might share from securitization of the structure. In addition, the capital source must be willi assume some of the risks relating to recharacterization.

**C. Other Players**

A synthetic lease transaction may include a broker, who has arranged the transaction and a developer, who is responsible for development and servicing of the property.

**IV. THE STRUCTURE OF THE SYNTHETIC LEASE**
The following diagrams of two possible transactions will provide a context for the explanation of the synthetic lease that follows.

A. The SPE

The capital source, whether a lender, the underwriter or the developer, will in a case form what is known as a "special purpose vehicle" or a "special purpose entity "SPE") to acquire the property, although in some simple transactions, the capital acquire the property directly, and occasionally a lender may use a leasing subordinated. The SPE's only function is to acquire, develop and construct the property to lease it to the tenant, and its only capital is a minimal equity contribution and b funds. Its owners or beneficiaries have no obligation to provide additional capital.

The SPE (which may be a corporation, a limited partnership, a limited liability or a limited liability company, but is most often a grantor trust) is a bankruptcy entity, the charter documents, organization, and ownership of which are designed to make more difficult for it to seek bankruptcy protection or be forced into bankruptcy the SPE and not the end-user that holds fee title to the property, the risk that a bankruptcy of the end-user will affect the recourse of the lender and the risk that will seek bankruptcy protection or be forced into bankruptcy are reduced, although eliminated. This is an important element of the deal for the capital source and c affects both the structure and the pricing of the transaction.

The lender or a third party makes an equity investment in the SPE, which, for reasons discussed in Section V, below, is equal to 3% of the capital that it will r the deal. This 3% equity investment usually carries a higher cost than the 97% advanced by the lender, since, as equity, it is paid after the return of the debt f

B. Terms of Lease

At the beginning of the transaction, the SPE, as lessor, and the end-user, as lessee, noncancelable lease. Under the terms of the lease, the SPE agrees to acquire from a third party and to develop the facility according to the requirements of the user. Most synthetic lease transactions involve the construction of the improvement project does require construction, the SPE, or a third party developer who gets with the end-user, builds the property to suit for the end-user. Often the transaction includes the acquisition of equipment or other personal property as well. The lease and the rent usually begin upon completion of the construction of the project, at that they may begin at the inception of the transaction. The lease term is shorn to provide maximum security to the lender, and to shift as much of the risk of ownership including the residual risk of loss of value of the property that appears at the end of the transaction, to the end-user, while still satisfying the accounting and tax rules that give the transaction its beneficial treatment. As a result, the end-user also gets all of the benefits of ownership.
The lease is triple net: the end-user pays the rent and all cost of operation and management of the facility. In addition, the SPE and the lender shift most or all of environmental conditions, damage, destruction and condemnation to the end-user has full responsibility for and the obligation to manage, maintain and care for the property.

Lease or rent payments usually begin when the project is completed and the end-user makes rent payments to the SPE. The SPE uses the rent payments to pay the debt service and other costs of the loan. Whatever the debt service and other costs are, they are set to pay those amounts and is generally no higher.

During the lease term, the end-user has some flexibility. At certain times during the term, subject to credit approval and the SPE's extension of or recasting of the term with the investors and the lender. In addition, the end-user may purchase the property during the lease term for the unamortized portion of the funded cost and all other costs due under the lease, usually defined as 100% of the initial project cost. Alternatively, certain times during the term of a floating-rate lease (and again at the end of the term), the end-user may refinance the property with a third party and terminate the lease. This is done by assigning the end-user's option to purchase the property to the third party.

The end of the lease term creates a special situation. In most cases, the end-user takes on the risk that the property may decline in value at the end of the term. But the transaction residual risk must meet specific accounting guidelines. Would those guidelines of the lease give the end-user any one of the following options to be exercised at the end of the lease term:

(1) The end-user can elect to extend the term, subject to the end-user's credit and the ability of the end-user to extend or restructure the debt and equity tranche with the investors and lenders.

(2) The end-user can purchase the property for the unamortized portion of the debt and any accrued but unpaid interest on the outstanding loans and yield on the equity interests. Because, for accounting purposes, the purchase price cannot be a "bargain sale," an appraisal is required at the beginning of the lease, stating that the purchase price is not a bargain price. The end-user generally finances the purchase by borrowing from a third party.

(3) If the end-user does not extend the lease term or purchase the property, it must sell the property. The property is sold to a third party unaffiliated with the end-user and the SPE. Often it is the end-user, as agent for the SPE, which is required to sell the property and to bear all the costs of the sale. The end-user is obligated to pay a commission that will give the lessor up to 85% of the "funded cost," that is, the amount still owed to the lender after taking into account any amortization of the loan over its term, as "liability of Chicago C&S"
rent" to cover any loss to the SPE and the lender. If the sale proceeds are not enough to pay the funded cost, the end-user gets the excess. If the sale proceeds are enough to pay the funded cost, the end-user is required to make up the shortfall amount not to exceed the contingent rent obligation. Sometimes the contingent rent at the end of the lease term in advance of the sale, and any proceeds of sale not the lender and the SPE to repay the funded costs are paid to the end-user. The rent is the end-user's capped guaranty to the SPE that the lender will receive full regardless of the value of the property. There is always the risk that the surety amortization during the term, plus the sale price of the property, plus the continuation of up to 85 percent of the original funded cost will not cover the obligations due the lender. However, this will only occur if there has been no amortization and the property has declined to 15 percent of its original value. The lender still takes the risk that the end-user will not be able to make the lease payments or the contingent payments, but residual value insurance is available to cover even this minimal risk.

The result of this structure is that the lender has shifted the risk of loss to the end-user. The end-user takes the risk of decrease in value, but gets the benefit of any increase in value of the property from the time of the appraisal at the beginning of the lease.

C. Financing Aspects

1. Pricing

To a large extent, the pricing of the financing depends upon the source of the funds and the structure of the transaction.

In some cases a single lender will lend all of the funds to the SPE. It may then syndicate a portion of the loan to other lenders. If the lender offers all of the current under the lease is usually equal to interest-only payments on the loan based on the spread over a floating London Inter-Bank Offered Rate ("LIBOR") or a Treasury bond. The spread will depend on the end-user's credit rating. Based on that credit rating, the user may be required to enhance the credit with some sort of surety bond, letter of guaranty, or give the lender a security interest in the property and the lease.

The end-user may be able to get a fixed rate rather than a floating rate by entering into an interest rate swap. This fixed rate will be higher as a function of the reduced risk taken by the SPE. An investment grade end-user may get a spread of thirty to forty basis points above LIBOR if the lender takes a security interest in the property, and a spread of one hundred fifty basis points if the lender does not take a security interest and relies solely on the end-user's credit. The lender or broker may also charge an up-front fee, a fee incorporated into the lease rate for the residual value risk, and a fee for administrative services. The pricing compares favorably to revolving or other types of straight corporate financing.
2. Securitization

By using the SPE and creating a bankruptcy remote, or structured, borrower, it also can gain access to the capital markets, and the transaction can be securitized otherwise offered to a broader range of investors. This broader access makes it possible for commercial paper backed up by a revolver facility and a bank letter of credit to construct the project. Upon completion of the construction, the SPE can finance the debt through the commercial paper market. In other cases, the SPE can use the funds necessary to acquire and develop the property as provided in the lease on a nonrecourse basis, with a loan equal to the length of the term of the lease.

All of the costs of acquisition and all of the hard and soft costs of development, construction, and the cost of the property, are funded by the capital sources. The property is usually delivered to the end-user at the time of completion of the project.

V. ACCOUNTING TREATMENT

A. Operating Lease Versus Capital Lease

The accounting for leases under GAAP is based on the view that a lease transaction transfers substantially all of the benefits and risks of ownership should be accounted for in the acquisition of the asset and the incurrence of an obligation by the tenant. It is characterized by the tenant as a "capital lease." This treatment requires that the obligation associated with it be carried on the balance sheet of the company. In other cases, the tenant should account for the lease as an "operating lease," or in some arrangement.17

FASB No. 13 provides that if a particular lease meets any one of the following four criteria, it is a capital lease:

(1) The lease transfers ownership of the property to the tenant by the end of the lease term.

(2) The lease contains an option to purchase the leased property at a bargain price.

(3) The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property. The synthetic lease is structured to fail this test by limiting the lease, usually to five to seven years, renewable under certain conditions.

(4) The present value of rental and other minimum lease payments equals or exceeds the fair market value of the leased property. This test is failed by structuring the transaction so that the present value of the rental and other minimum lease payments is less than the fair market value.
including the terminal residual payment due upon lease termination, is less than the fair market value of the real estate.18

If none of the four criteria is met, the tenant treats the lease as an operating lease. Effect of characterizing the lease as an operating lease for accounting purposes does not appear on the balance sheet (although the lease obligation does appear in the financial statements). All lease payments appear on the income statement as currently deductible operating expenses.19 Thus, if structured correctly, the lease improves the end-user's return on equity, return on assets, and debt coverage.

B. Consolidated Income Statement and Balance Sheet

There are two other concerns that must be addressed from an accounting point of view: a synthetic lease. Under certain facts, the end-user and the lessor must consolidate (i.e., combine) their income statements and their balance sheets for GAAP reporting purposes. This would eliminate the off-balance sheet advantage of the transaction to the SPE. The question here is whether the SPE lacks economic substance, and is therefore not part of the entity from the end-user for accounting purposes.

The EITF has issued guidelines that apply to leasing transactions in which an SPE is a lessee. Under the guidelines, a tenant should consolidate its income statement and balance sheet with the SPE when each of the following tests is met:

(1) Substantially all of the activities of the SPE involve assets that are leased to the tenant. This test is passed in virtually every synthetic lease transaction.

(2) The expected residual risks and rewards of the leased assets and the obligations imposed by the underlying debt of the SPE rest on the tenant. This test is also passed.

(3) The owner of record of the SPE has not made an "initial substantive residual capital investment that remains at risk during the entire lease term."20

Since all of the tests must be met in order for the consolidation requirement to apply, they must be structured to fail this last test. The amount initially invested actually at risk of loss by the owners of the SPE must be substantive. There is no way to determine what an initial substantive residual equity capital investment is. Interpretations of the rule, and the application discussed in the guidelines themselves, seem to indicate that a 3% minimum initial equity investment will be enough to pass this test, and this is followed by most practitioners.21

C. Sale and Leaseback

The second risk from an accounting point of view is that the transaction may be


3/22/2002
characterized as a sale and leaseback, again eliminating the accounting benefits of the transaction. Statement 98 of the FASB22 provides that the seller in a transaction precluded from recognizing a sale if it retains an option to purchase or provides or other provisions that constitute continuing involvement with the property. Be provisions like those are central to the synthetic lease structure, the end-user must not have obtained title to the leased property, including the land, prior to the transaction. Purchases the property directly from a third party, the sale and leaseback problem is avoided. It is also necessary that the end-user avoid guarantees or commitments to the construction period that would make it, in substance, the owner of the project during that period.

VI. TAX TREATMENT

For federal income tax purposes, the objective is to structure the transaction so that the end-user is characterized as the owner of the leased property, and the transaction is treated as a financing/conditional sale. If the end-user is characterized as the owner of the property, it will be able to deduct interest payments and depreciate the improvements to the property. The tax standards that must be satisfied are not as clear-cut as the accounting standards are.

Although there are a number of factors considered by the courts and by the Internal Revenue Service (the "IRS"), the most important factor is determining whether landlord or the tenant has the significant benefits and burdens of ownership. The courts look through the form to the substance of the transaction. If, after e.g., who retains the benefits and burdens of ownership, it appears that the transaction is an arrangement of financing, and that the end-user has acquired the property through a conditional sale, it is likely that the transaction will be taxed as a sale. The courts have found for the taxpayer. The court emphasized the need to examine all the circumstances of the transaction to determine its real substance:

Where...there is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features, meaningless labels attached, the Government should honor the allocation of the duties effectuated by the parties. Expressed another way, so long as the lessor significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties govern[s] for tax purposes.24

Subsequent case law and IRS rulings have followed the Lyon case by considering the relationship of the parties to one another, and the reasonable expectations of the parties. IRS rulings, while not necessarily controlling, do give guidance. In Rev Proc 55-540, the IRS discussed the characterization of equipment transactions as leases, or as sales. The IRS said that the characterization depends on the intent of the parties and that, in the absence of compelling persuasive factors to the contrary,
Off Balance Sheet Loan Proposal (SAMPLE)

JetLease is pleased to present the following Aircraft Lease Proposal for your review.

Lessor: JetLease, its assignee or nominee (Lessor), Cleveland, OH.

Lessee: XYZ CORP.

Guarantor: To be determined by Lessor (if any).

Equipment: 1999 Citation Bravo, Serial Number TBD. Anticipated cost $4,795,000.00 not to Exceed Fair Market Value, subject to appraisal.

Location of Equipment: United States

Collateral: A first priority security interest in the leased equipment.

Commitment Date: It is anticipated that the Off Balance Sheet Loan will be executed as soon as possible.

Date: ____________________________

Loan Fee: One percent (1.00%) of the funded amount.

Terms: Off Balance Sheet Loan

Lessee shall make 60 monthly payments of .94835% ($45,475.30) of the equipment cost of the equipment cost the first of which shall be due and payable on the delivery and closing date. Index is 5 year Treasury as of June 15, 1999 at 5.79%.

Lessee incurs all costs including but not limited to, ongoing maintenance, fuel, insurance, pilots, hangar, local and state taxes and other miscellaneous expenses.

Good Faith Deposit: $5,000.00 in the aggregate. The Good Faith Deposit will be deposited with JetLease of Cleveland, Ohio. The Good Faith Deposit, less any out-of-pocket expenses incurred by JetLease, will be refunded if JetLease does not approve the transaction on substantially the terms outlined herein. If JetLease approves the proposed transaction or alternative transaction, then the Good Faith Deposit, less out-of-pocket expenses would be applied to the initial payment of rent under the lease. The Good Faith Deposit will not be otherwise refundable.

End of Term Options:

A. At the end of the renewal period, Lessee may purchase the equipment for a price equal to 80% of the equipment cost.
B. If neither purchase nor sale options are exercised in accordance with section (A) or (B) above, then on the last day of the term the Lease will be renewed for a period of 12 months at a rental factor equal to 5.24014% of the equipment cost.
C. If Lessee elects not to purchase the equipment the Lessee shall sell
the equipment in a commercially reasonable manner or, at Lessee’s request; the equipment will be sold by Lessor as agent for Lessee. In no event will Lessee sell the equipment for less than 80% of the equipment cost without Lessor’s prior written consent. If the equipment is sold for more than 80% of the equipment cost the Lessee will keep the excess. However, if the net proceeds of the sale are less than 80% of the equipment cost the Lessee will pay the Lessor the difference up to a maximum of 20% of the equipment cost.

**Early Termination:** Upon Lessors Approval

**Options:** To be discussed at time of Lease.

**Security Deposit:** A Security Deposit of (0%) will be required during the term of the lease.

**Security/Engines:** A non-refundable security deposit of $0.00 shall be required by Lessor during the term of the Lease to initiate the Jet Support Engine contract.

**Good Faith Deposit:** $5,000.00 in the aggregate. The Good Faith Deposit will be deposited with *JetLease* of Cleveland, Ohio. The Good Faith Deposit, less any out-of-pocket expenses incurred by *JetLease*, will be refunded if *JetLease* does not approve the transaction on substantially the terms outlined herein. If the proposed transaction or alternative transaction is approved by *JetLease*, then the Good Faith Deposit, less out-of-pocket expenses would be applied to the initial payment of rent under the Lease. The Good Faith Deposit will not be otherwise refundable.

**Depreciation:** For the account of the Lessee.

**Documentation:** All Legal matters and all legal documents executed in connection with this transaction shall be satisfactory in form and substance to Lessor, counsel and assignee.

This letter is not a formal commitment to undertake this Lease. A commitment can be issued only after full credit and pricing review and subsequent approval by the appropriate officers of Lessor or assignee.

If you have any questions, please advise.

Sincerely,

*JetLease*

The foregoing proposal is accepted this ___ day of _______________________, 199__, and we have authorized Lessor to proceed with this transaction as outlined above.

By: ____________________________

Title: ____________________________

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