Special Purpose Entities

Characteristics of SPE’s

• Engage in limited and well-defined set of business activities
• With a special purpose entity (SPE), an equity investor cedes financial control to variable interest in return for a guaranteed rate of return
• Before ARB #51, a company did not consolidate SPE’s because the relationship to the SPE was not based on voting rights, but on a variable interest
• Control is in contractual agreements with sponsoring firm who becomes the “primary beneficiary”
  o Leases, participation rights, guarantees, residual interests
    ▪ Risks and rewards are taken without owning voting shares
      • Since voting interests are obscured, one can fail to identify firm with interest in SPE
        o Off-balance sheet financing
        o Record profits on sales to SPE’s
        o Hide debt and manipulate earnings
  • The SPE’s may not be consolidated
• FIN 46 says that when control rests with the primary beneficiary, that entity is a variable interest entity
  o Direct or indirect ability to make decisions of SPE
  o Obligation to absorb expected losses of SPE
  o Right to receive expected residual returns
• FIN 46 deals with entities created for off-balance sheet financing
  o Trust, partnership, joint venture
    ▪ But no independent management
    ▪ Activities are to transfer assets, lease, hedging, R&D

Source of funding for SPE

• Small equity investment
  o Lenders would not lend at good rates on this basis
• Sponsor provides funds, loans or guarantees
  o This attracts lenders
  o I.E. sponsor guarantees SPE’s debt
• Limit returns to equity holders
  o Participation rights → risk and reward to sponsor
    ▪ Fortunes vary
    ▪ Increase of risk when resources provided increase
      • Firm will seek to influence decision making of SPE
        o Governing documents limit decisions
          ▪ Away from investors
Companies and Variable Interest Entities

- Whoever provides the support is the primary beneficiary
  - Must include assets, liabilities and results of activities of VIE in consolidated statements
- Qualifies as a VIE if:
  - Equity at risk is not sufficient to permit entity to finance activities without additional financial support
    - Equity at risk is < 10% of total assets (insufficient)
  - Equity investors in VIE lack one of the three characteristics of a controlling financial interest
    - Direct/indirect ability to make decisions by voting or similar rights
    - Obligation to absorb expected losses of entity
      - Another firm may guarantee return to equity investors
    - Right to receive expected residual returns
      - Investor’s return may be capped by entity’s governing documents or other arrangements

Uses of Variable Interest Entities

- Financing Receivables

<table>
<thead>
<tr>
<th>Business Receivables</th>
<th>SPE Note payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note receivable</td>
<td>Accounts receivable</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Note Payable</td>
</tr>
</tbody>
</table>

JE: Note receivable Accounts receivable Note Payable

- Financing of asset purchase

<table>
<thead>
<tr>
<th>SPE buys asset</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>xxx</td>
</tr>
</tbody>
</table>

JE: SPE buys asset xxx

- SPE leases asset to main company
- SPE creditors have specific collateral
  - Governed by restrictions in documents
  - Little need for stock
    - Governing agreements limit activities and guide decisions
      - Not a board of directors
    - Sponsor owns no stock
      - No need to consolidate

Cash

Long term debt

Cash from receivables

Accounts receivable

Interest expense and principle

Cash from receivable

- Not a board of directors
- Sponsor owns no stock
  - No need to consolidate
Initial Measurement Issues

- Usually have few assets and liabilities
- Assets = Liabilities + Non-controlling interest
  - Based on Fair Market Value with 2 exceptions
    - SPE’s assets that are transferred from primary beneficiary are measured as if not transferred
    - Asset valuation in FIN 46: rely on SFAS 141
      - Allocation of cost based on underlying FV
  - Implied value substitutes for acquisition cost
    - Assessed FV of assets > implied value
      - Assets are reduced
    - FV < implied value
      - Book an extraordinary loss

Procedures to Consolidate

- Valuations based on FMV with two exceptions
  - If any of SPE’s assets have been transferred from primary beneficiary, assets will be measured as if not transferred
  - VIE control is not by incurring a cost, but through governance agreements and contractual arrangements
    - Implied value substitutes for acquisition cost, sum of
      - Consideration paid by primary beneficiary plus the value of previously held interests
      - Fair value of newly consolidated liabilities and non-controlling interests
    - If assessed fair value of assets exceed implies value of VIE, then assets are proportionately reduced
    - If implied fair value of VIE exceeds assessed FV, difference is reported as extraordinary loss
    - No goodwill in consolidation of VIE

Disclosure requirements

- Primary beneficiaries – footnotes
  - Nature, purpose, size and activities of VIE
  - Carrying amount and classification of consolidated assets
  - Lack of recourse if creditors have no recourse to credit of primary beneficiary