Contentious Road to Reporting Off-Balance-Sheet Entities

➤ **TWO YEARS AFTER ENRON'S FRAUD**ulent special-purpose entities that hid debt and inflated cash were revealed, the Financial Accounting Standards Board (FASB) has sought to close loopholes with a major rewriting of accounting standards that requires off-balance-sheet transactions to be consolidated in financial statements so investors and creditors can assess their risks.

The ruling, FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN No. 46), was significantly revised in late December 2003. The new version requires companies who bear most of the risks or get the majority of the benefits of special-purpose entities (SPEs) to consolidate them in financial statements for periods after December 15, 2003. It applies only to entities created after February 1, 2003. The ruling also requires all other types of variable interest entities to be reported for periods after March 15, 2004.

FIN No. 46 defines "variable interests" as contractual, ownership, or other money interests in an entity that change with changes in the entity's net asset value. Typical variable interests include equity, debt, and partnership interests.

The story of how FIN No. 46 came to be revised and finalized includes the various objections by issuers, auditors, and industry observers who thought the original exposure draft (ED) was confusing and difficult to carry out, as well as the subsequent revisions the FASB made.

When the FASB issued the original exposure draft in January

IMAGE: DIGITAL VISION

2003, it wanted FIN No. 46 to improve financial reporting for variable interest entities, which are off-balance-sheet structures that often have highly complex arrangements. But the ED was immediately criticized for being too complex, and the project evolved into an intensive examination of complex financial structures, some legitimate, used to diversify risks and issue securities.

"A lot of people believe the FASB could not have done a worse job even if they had tried," Lynn Turner, the former chief accountant for the Securities & Exchange Commission (SEC), reportedly said.

Turner, now head of research for San Francisco-based Glass Lewis, a proxy advisory company, surveyed more than 500 large-cap businesses and discovered that "financial executives and auditors have found FIN No. 46 and its principle-based approach difficult to understand, resulting in a lack of uniform adoption and occasional liberal application of the standard." Moreover, some companies took advantage of the rule's vagueness to employ aggressive accounting practices to eliminate transactions from the balance sheet, Turner wrote in a report about the survey.

A Credit Suisse First Boston report estimated that FIN No. 46 could force companies in the S&P 500 to move $400 billion in assets and debts onto their balance sheets. It also said the accounting rule would result in millions of dollars in one-time charges for companies forced to consolidate money-losing SPEs.

"But at the end of the day most people know what the Board is really trying to do," Turner said, and the Board simply should "go do it."

The FASB, after trying to clarify its intentions by issuing several staff positions, decided in early October 2003 to delay the effective date of the ruling from the third quarter to the fourth quarter of 2003 and to seek further comment.

One comment, from PricewaterhouseCoopers, urged an additional delay because of unresolved questions. "We are concerned that there will be insufficient time for financial statement preparers and their auditors to adequately evaluate and implement FIN No. 46. We urge the Board to reconsider an additional deferral of the effective date of FIN No. 46 for public entities."

Responding to this and more than 100 other comments, the Board, at its December 10, 2003, meeting, agreed to exempt companies that can't obtain the information necessary to decide whether an entity created before December 31, 2003, should be consolidated, among other concessions. Previously, the so-called "information out" loophole applied to entities formed before February 1, 2003.

Still, big accounting firms, trade groups, and individual companies called for another postponement of its implementation into this year.

Then Congress ordered the SEC to report on off-balance-sheet activity in 2004. SEC Chief Accountant Donald Nicolaisen had said at a meeting of the AICPA that one delay is enough, at least for "notorious SPEs that have been off the balance sheet" where investors can't see them. He added that he wasn't inclined to override the FASB, but "they do need to finish the process," preferably by the end of 2003.

The FASB did just that at its meetings on December 17 and December 24, reissuing FIN No. 46, which is 92 pages, almost twice as long as the original. The revision allows some more time—from three months to a year—for companies to apply the consolidation rule to off-book vehicles that have never been considered special-purpose entities or vehicles that were set up for a unique, narrow purpose, such as raising financing.

Moreover, the FASB responded to preparers' concerns about non-SPEs falling into the scope of the consolidation rule. Banks, for example, had argued against making renegotiation of troubled debt a triggering event for potential consolidation. Such renegotiations, they had said, generally don't expose lenders to additional risk, a criterion for consolidation. The FASB agreed that arrangements involving restructuring of troubled debt shouldn't be a reconsideration event for consolidation under FIN No. 46. Also, franchisers had urged the FASB to exempt them from consolidating their franchisees' financial statements on their books. Franchises are technically variable interest entities. The FASB clarified that certain franchisees—but not all—could be exempted from FIN No. 46. ■