

**American Accounting Association’s Financial Accounting Standards Committee
Response to FASB Exposure Draft, “Proposed Interpretation: Consolidation of Certain
Special-Purpose Entities”**

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The Financial Accounting Standards Committee of the American Accounting Association (“the Committee”) is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB Exposure Draft on Proposed Interpretation: Consolidation of Certain Special-Purpose Entities (hereafter, the ED). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response is presented in five sections. First, in order to evaluate the ED we describe the Committee’s perspective on a principles-based general consolidation standard. In the second section, we evaluate the ED within the rubric of this principles-based standard. The third section describes the Committee’s general comments and recommendations on the proposals in the ED. The fourth section summarizes relevant academic accounting research findings that form the basis for the Committee’s views. This research does not directly investigate the consolidation of SPEs, but addresses related issues including off-balance sheet financing, consolidation, and general disclosure issues. The Committee’s opinion on SPEs is based on inferences from related research, as well as the Committee’s understanding of the FASB’s Conceptual Framework. The final section summarizes our position.

I. A Perspective on a Principles-Based Consolidation Standard

Basis for Consolidation

At the outset, the Committee recognizes that there remains considerable disagreement over what principles should govern the development of an appropriate consolidation policy standard (see, for example, the issues raised in FASB 1991a). In past comment letters, the Committee has sided with the economic unit concept of consolidated financial statements and the broader definition of effective economic control as the basis for consolidation (AAA FASC 1994, 1995, 1996). Effective economic control is a function of the facts and circumstances of the situation. The Committee consistently has rejected legal control as a basis for consolidation. We continue to maintain these positions here and expand upon them in this section.

In the Committee’s view, a principles-based consolidation standard should follow from the definitions of assets and liabilities. FASB Statement of Concepts #6 defines an asset and a liability as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (para. 25)

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

The Committee's perspective on a principles-based standard requires the financial statement preparer to exercise judgment in determining whether the risks and benefits of ownership have been retained through an ability to exercise effective economic control regardless of the form of the specific transaction. The Committee believes the effective-control approach generally is consistent with the definition of an asset since an entity's assets are consolidated with the "parent's" only if the "parent" retains the risks and benefits of ownership through the exercise of effective economic control. Because the liabilities of an entity require a probable future sacrifice of the entity's assets, the obligations of an entity are appropriately consolidated with the "parent" if its assets are appropriately consolidated with the "parent."

Effective economic control need not be defined solely as a function of voting rights. It is conceivable, even common, that the risks and benefits of ownership are essentially retained in the absence of voting control (or even voting shares). For example, if total equity is trivially small (say, insufficient for an entity to operate on its own), then effective economic control may be held by an enterprise with no equity but that has guaranteed significant portions of the entity's debt or the residual value of its assets. In return for bearing those risks, the non-equity holding party may be in a position to manage the assets of the entity and earn a return commensurate with the risks being taken. In other words, the enterprise may have retained the risks and benefits of ownership through its effective economic control of the entity. To capture such transactions and situations, a principles-based consolidation standard would move beyond the notion of voting control and move to a broader notion of effective economic control.

Evidence of effective economic control of the risks and benefits of ownership may be direct or indirect. For example, an entity may have an ongoing direct ability to make decisions regarding asset use. We refer to this as direct evidence of control. Direct evidence is not a necessary condition for effective economic control to exist, however. It is possible to conceive of situations where the entity has no *ongoing* decision making control over asset use and yet implicit or indirect evidence of such a relationship exists. For example, the sponsoring entity may put into place at the inception of an SPE (or other entity) contracts and/or binding agreements that dictate the future operating activities of the SPE in a manner intended to safeguard the risks and benefits of ownership retained by the sponsoring entity. We refer to this as potential indirect evidence of control.

A principles-based standard would provide guidance related to characteristics that help distinguish between cases that indicate (via direct or indirect evidence) that effective economic control exists. Professional judgment by preparers and auditors also is necessary to evaluate whether effective control exists given the facts and circumstances. Such judgment would be based on the facts and circumstances. For example, simply because the sponsor of an SPE set restrictions on the SPE's future operating activities would not necessarily constitute indirect

evidence of effective economic control. The SPE may be truly independent of the sponsor such that it would be inappropriate to consolidate it. This could be the case where the facts and circumstances indicate that an entity has, in all meaningful economic senses, truly sold assets to an SPE. On the other hand, the presence of recourse provisions in otherwise similar circumstances might lead to the conclusion that the asset “sale” to the SPE was a means to reduce the cost of secured financing. In that case, consolidation of the SPE seems appropriate, even though the sponsoring entity may not retain decision-making authority over the SPE's ongoing activities by virtue of contracts or agreements specifying the SPE's operations.

A significant advantage of a principles-based standard using effective economic control as the basis for consolidation is that consolidation could not be avoided by elaborate schemes undertaken to obscure the underlying economics of the transaction. However, under a principles-based standard, implementation guidance and sufficient disclosure are critical. The standard would need to provide general examples so that preparers could apply it in good faith as consistently as possible across time and entities. It would provide guidance in the areas of evaluating direct and indirect evidence for the purpose of identifying where effective economic control is present, identifying the risks and rewards of ownership, measuring minority interest on consolidation, and so on. Additionally, because principles-based standards are likely to be interpreted differently even by well-intentioned managers, a principles-based consolidation standard would require sufficient disclosure to allow users to understand and evaluate management's consolidation choices.

Finally, in considering a broad standard for consolidation, harmonization with international standard setting bodies is an important issue. IAS standards currently recommend proportionate consolidation in some instances, e.g., joint ventures. It is reasonable to envision future IAS standards that may recommend proportionate consolidation for special purpose entities. Some members of the Committee believe that using proportionate consolidation in the case of SPEs (and other entities) is advantageous in that the balance sheets of several entities collectively will reflect the assets and liabilities of the SPE. This approach precludes companies from structuring transactions to avoid recognition and would eliminate “orphan” SPE's that show up on no entities' financial statements. However, proportionate consolidation is not consistent with the Committee's views of effective economic control as a basis for consolidation; thus, the majority of the Committee does not support proportionate consolidation.

Application of a principles-based consolidation standard to SPEs

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

Consider, too, the following example. A bank creates a SPE to purchase loans or debt instruments from the marketplace. The assets are not top grade and require active management. The SPE funds its purchases by issuing various tranches of debt and 10% equity. The bank is the asset manager, receives a “market based” fee and can be terminated after one year and annually thereafter by a majority vote of the debt holders. The bank also provides a liquidity backstop that protects the debt holders for the timing of payments, up to some limit. The backstop does not protect the equity holders.

In this example, the bank does not control the assets; it is merely acting as an asset manager for the benefit of other stakeholders in the structure. The presence of the guarantee, while exposing the bank to some risk, is no different than the types of guarantees that banks issue to other companies. In this case, the Committee believes that the bank does not retain effective economic control over the SPE. That is, it has not retained the risks and benefits of ownership. As such, it should not consolidate the SPE. Rather, the focus should be to provide high quality disclosure about the risks accepted by the bank.

II. How does the ED Compare with our Perspective on a Principles-Based Consolidation Standard?

In this section, we outline specific strengths and weaknesses of the ED relative to the Committee’s conception of a principles-based consolidation standard.

Strengths

The Committee believes that the ED moves accounting for SPEs from a rules-based standard toward a principles-based standard. This is consistent with our approach for a general consolidation standard and with our July 2002 letter commenting on conceptual standards (AAA FASC 2002). The ED, if approved, would likely result in more SPEs being consolidated by the entity that has effective control over their operations, consistent with our general approach to consolidation. The Committee views the move from an emphasis on legal control to some concept of effective economic control (incorporated into the ED via the concepts of variable interests and primary beneficiary) as the basis of consolidation as favorable. In principle, a move toward an economic definition of control should enhance financial reporting by enhancing the representational faithfulness of financial statements in those circumstances where the risks and benefits of ownership are retained.

Weaknesses

The Committee believes there are five potential weaknesses of the ED: its limitation to specific transactions and its scope exceptions, a lack of clarity in the variable interests constructs, the inclusion of a bright-line rule for defining sufficient equity investment, the limited implementation guidance, and the absence of enhanced disclosure requirements. We discuss each of these in turn.

Limitation to specific transactions and scope limitations

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

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

The existence of such scope exceptions increases the complexity of the standards and provides firms with an opportunity to “play the system” by identifying stylized arrangements that fall between the cracks. Such proposals are already circulating through the business community. For example, in a presentation available on their website, Deloitte & Touche (2002) provide a simple example of a multi-seller commercial paper conduit that results in the consolidation of a silo of receivables and associated liabilities by the transferor. Given the underlying secured financing nature of the arrangement between the transferor and the SPE this outcome seems reasonable and consistent with our conceptualization of a principles-based consolidation standard. However, in the example, the outcome changes when the set of facts and circumstances is altered to insert a QSPE between each transferor and the conduit SPE. Although the underlying economics of the transaction remain essentially unchanged, the primary beneficiary changes and the SPE administrator is now the likely primary beneficiary (consolidator). Such outcomes do not appear desirable in high quality reporting standards.

Variable interests constructs

Although the Committee supports the move to a principles-based consolidation standard, we are unclear about certain aspects of the ED’s definitions of primary beneficiary and variable interests—constructs central to the attempt at having entities that hold effective economic control consolidate SPEs. First, the ED begins the idea that consolidation should be a function of controlling interests (para. 1 and para. 4). Then the ED uses financial support to get to the variable interests construct (para. 6). Later, in para. 20, the size of variable interests in determining the primary beneficiary is defined in terms of expected losses (a risk/reward concept). Thus, the ED implicitly translates effective control into expectation of losses. While the Committee generally believes such links exist (see the previous discussion in section I), we believe the links between these concepts are not clearly delineated in the ED, specifically what assumptions are made in going from the concept of economic control to financial support to expected losses.

Additionally, the Committee suspects there are situations where determination of the primary beneficiary according to rules in the ED would be inconsistent with the effective economic control construct. Thus, the ED may result in consolidation of SPEs by entities that don't possess effective control over the SPE. The Committee believes that the second example under the heading "Application of a principles-based consolidation standard to SPEs" might lead to such inappropriate consolidation. (In particular, the SPE is not a QSPE per SFAS No. 140, and meets the criteria a and b of paragraph 23 of the ED.)

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

Inclusion of a bright-line rule for defining equity investment

Although the committee views the ED as a move away from rules-based standards, there is one area where there exists what might be considered a bright-line rule. Paragraph 12 of the ED states, "An equity investment shall be presumed to be insufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders unless the investment is equal to at least 10 percent of the SPE's total assets." Although in paragraph B9 the ED attempts to clarify that 10 percent may not be sufficient in all cases, it is apparent from a reading of professional accounting firms' guidance to their clients that they will be treating 10 percent as a bright line rule. For example, KPMG (2002, 5) refers to the FASB's "10 percent test of whether an independent third party's substantive equity investment at risk is sufficient." PricewaterhouseCoopers (2002, 2) refers to the "minimum level of third-party equity required" of 10 percent. They concede that the amount "could even exceed 10%." Nonetheless, the Committee feels that any stated minimum level of equity is arbitrary in a conceptual standard and will only lead to *de facto* bright line treatment. Furthermore, the level seems as politically dangerous as the infamous 3% rule.¹ That is, the average layperson is likely to find a 10% investment just as trivial as a 3% one.

Implementation guidance

Since the ED focuses on consolidation of entities on a basis other than voting equity interests, it represents a dramatic shift from current practice. Well-accepted consolidation procedures that exist when consolidation is based on voting equity interests no longer apply. Preparers are likely to have questions about implementation of the new ED. For example, how is minority interest to be computed and valued when voting equity interests do not form the basis for consolidation?

¹ We do, however, agree that clearly stating that the 3% guidance of EITF 90-15 is not applicable is worthy of inclusion.

How is the minority interest in an SPE to be represented? How are gains and losses on consolidation and deconsolidation to be treated? Companies are not experienced in applying consolidation procedures in such circumstances and generally accepted accounting practice is virtually nonexistent. Yet the ED is virtually silent with respect to the consolidation procedures the PB should follow.

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

Noncomparability and need for disclosure

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

III. Recommendations

Although the FASB may need to implement a short-run solution to accounting for SPE's, the committee recommends that the FASB revisit consolidation policies and procedures in a broad context with the ultimate goal of producing a comprehensive consolidation standard that incorporates the notion that consolidation is appropriate when one entity essentially retains the risks and benefits of ownership of another through the exercise of effective economic control. The committee views this as critical for several reasons:

- (1) Broad guidance pertaining to consolidation policies when control is achieved through means other than a majority voting equity interest is needed in situations other than those involving SPEs.
- (2) A piecemeal approach will result in additional unnecessary complexity in what already promises to be a complex standard or set of standards.

- (3) The existence of necessary scope exceptions in narrowly scoped standards increases the probability that firms will “play the system” by identifying stylized arrangements that fall between the cracks.
- (4) Conflicts and inconsistencies are more likely to arise between standards dealing with consolidation policies and procedures when a complex web of standards form the basis of consolidation policy and procedure standards.

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

Finally, the Committee recommends that the FASB require disclosures that allow users to understand management’s motives for employing an SPE and their financial reporting choices. Sufficient disclosure should be provided to allow investors to assess the extent to which the entity bears the risks and rewards of ownership, and the nature and magnitude of the risks involved. Sufficient information should be required to allow investors to adjust the reported financial information for unconsolidated SPEs should the investor deem the assets and liabilities of the SPE to be assets and liabilities of the entity. Appropriately enhanced and uniform disclosures will allow managers to compare their corporate reporting choices with other firms in their industry and in the capital markets at large, thereby encouraging financial reporting practice to gravitate to comparable and consistent high quality reporting.

IV. Related Research

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

Consolidation and SFAS 94

Prior research examines the association between the decision to consolidate and various economic circumstances (pre-SFAS 94) as well as the effect of mandated consolidation (post-SFAS 94). Mian and Smith (1990a) argue and find that firms are more likely to voluntarily consolidate when there are greater operating, financial, and informational interdependencies between the parent and the subsidiary. They conclude that firms with unconsolidated subsidiaries do not employ unconsolidated subsidiaries as an off balance sheet financing vehicle. They base this conclusion on their finding that firms with unconsolidated subsidiaries are *not* more likely to use other off balance sheet vehicles such as operating leases or unfunded pension plans than firms without unconsolidated subsidiaries. This implies firms choose not to consolidate for economic reasons and the decision is not simply a window dressing issue.

By extension, if the ED results in firms having to consolidate SPE's where they do not have effective control, the ED may discourage such activities even when the firm is motivated to employ an SPE for economically viable reasons. An important distinction between the SFAS 94 setting and the ED exists, however. SPEs are often central to the operations of the potential consolidator (e.g., they involve the operating assets of a synthetic lessee) whereas SFAS 94 was geared toward entities involved in activities considered fundamentally different from the activities of the parent company. The argument was made that, in certain cases, combining the activities of parent and a nonhomogeneous subsidiary would reduce the informativeness of the financial statements (i.e., combining the financial statements of a manufacturer and its captive finance subsidiary). At the same time, however, it is important to note that unconsolidated subsidiaries predated extensive SPE usage and prior to the change in the consolidation rules brought about by SFAS 94, in some instances unconsolidated subsidiaries performed functions similar to those now performed by SPEs—securitization of receivables, for example.

In contrast to the conclusions of Mian and Smith (1990a), other research has documented evidence of firms restructuring business activities in response to a change in financial accounting standards. For example, Mian and Smith (1990b) find that firms subsequently forced to consolidate previously unconsolidated subsidiaries are more likely to sell, close, or reorganize the subsidiary, retire debt, or securitize assets. Additionally, Imhoff and Thomas (1988) find that subsequent to the passage of SFAS 13 (*Accounting for Leases*), many companies restructured their leases to achieve operating lease status and avoid capitalization. Research by Beatty, Berger and Magliolo (1995) examines motivations for forming R&D financing organizations and document that financial reporting benefits, in particular, benefits from better terms of debt renegotiation represent an important motive for formation of R&D limited partnerships and corporations.

These results suggest that if the costs (e.g., debt covenant violations, regulatory issues) associated with consolidation are sufficiently high, firms may be motivated to restructure their relationships to avoid consolidation. These results also suggest that, in contrast to the conclusion presented in Mian and Smith (1990a), firms are motivated to employ off balance sheet investments to window dress their balance sheets. Firms previously taking advantage of the flexibility in GAAP to avoid consolidation may incur costs associated with renegotiating their debt contracts in response to a change in policy that leads to the consolidation of previously unconsolidated entities. However, Frost and Bernard (1989) indicate that the cost of technical default due to mandated GAAP changes may be small and Mohrman (1996) provides evidence that the incidence of debt contracts with fixed GAAP provisions (that is, GAAP at the inception of the contract is used throughout the life of the contract which eliminates the likelihood of technical default due to mandated GAAP changes) is prevalent and increasing over time.

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

Do financial statement users consider off-balance-sheet items?

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

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

There is limited anecdotal evidence (e.g., the recent PNC Bank situation) that regulators consider SPE obligations in determining capital adequacy. If consolidation did lead to additional costs (i.e., higher required capital), it could be attributed to two reasons: first, regulators were aware of the SPEs in the past and use the technical violation of capital requirements post-ED to enforce higher standards or second, the regulators were not as aware of the SPEs or the extent of the use of SPEs as they claimed. In either case, if higher capital requirements are requested, it is not the 'fault' of GAAP. In the former case, there is a regulatory failure/abuse. In the latter, more complete accounting facilitates regulators in their decision making. As such, any new costs imposed on the previously non-consolidating regulated entities are simply transfers of costs that were unknowingly borne by others previously.

The literature that examines the valuation implications of footnote disclosures about pensions and post retirement benefit obligations (e.g., Barth 1991, Choi et al. 1997) also indicates the usefulness of footnote disclosure on disaggregated information relating to recognized numbers in the financial statements. Finally, recent research by Kothavala (2002) suggests that joint venture income separately disclosed in the financial statement footnotes by UK and Canadian companies while important for valuation is not valued any differently than other net income for such firms. This suggests that recognition and disclosure are substitutes.

Based on this evidence, one could argue that even if consolidation is appropriate, with adequate disclosure on the SPEs, capital markets may take into account their implications for firm value thereby rendering the act of consolidation (i.e., recognition) redundant. However, we should caution that the research discussed above assumes market efficiency and several papers in the finance and accounting literature document instances of market inefficiency with respect to both accounting and non-accounting information. Footnote disclosure may have the effect of creating or enhancing opportunities for subsets of users to identify and exploit market inefficiencies. Foster (1979, 1987) documents the market reaction to published analysis by Abraham Briloff. Research by Fairfield and Whisenant (2001) reports that analysts from the

Center for Financial Research and Analysis successfully identify overvalued firms by analyzing the full set of disclosures provided in firms' SEC filings. Any recommendations for recognition as opposed to disclosure of off-balance sheet items may involve trade-offs between costs and benefits of various user groups, as well as the preparers. Some research on specific implications of recognition versus disclosure is discussed below.

Do financial statement users distinguish between recognized and disclosed information?

The previously mentioned research finds associations between footnote disclosures and market-based assessments of risk and value. Other work suggests that at the individual user level, recognition and disclosure are not substitutes. For example, Hirst and Hopkins (1998) find that professional analysts are more likely to discover earnings management when its components are clearly reported in a performance statement than when they need to be determined through fundamental analysis. Hirst, Hopkins, and Wahlen (2002) report that analysts' valuation judgments distinguish more between high and low risk banks under an accounting regime that reports fair value changes on a comprehensive basis in a performance statement than a piecemeal basis in the statement of changes in equity—this despite the fact that the underlying data were all available in SFAS 107/119 footnotes. Espahbodi et al. (2002) show that the market reaction to the issuance of Exposure drafts proposing to require recognition of stock option compensation costs is significantly different from the market reaction to FASB's subsequent reversal in mandating only disclosure of such costs. One interpretation of this evidence is that capital markets value disclosure and recognition differently. Aboody (1996) provides further evidence on this point. He shows that stock market participants react differently to asset write downs that are recognized in the financial statements by oil and gas firms adopting the full cost method than for firms using the successful efforts method that are required only to disclose asset write downs. These findings, together with Shevlin's (1991) results suggest that attention should be paid not only to whether, but also to where and how SPE data are disclosed. The ED's objective of consolidating more entities, thus, making it easier for users to assess the complete economic picture of the entity seems appropriate in those circumstances where the risks and benefits of ownership are retained. Nevertheless, the importance of clear and complete disclosures on the SPEs cannot be overemphasized.

Given the research that suggests enhanced and transparent disclosure facilitates user's risk assessments and equity valuation judgments, we encourage the Board to add additional disclosures to the ED. The disclosures should allow users to understand the business purpose of the SPE. Is it to satisfy a fundamental business objective (e.g., funding or risk transfer) or is the primary benefit to achieve off-balance-sheet treatment of assets and liabilities or some other financial reporting goal? If consolidated, what line items are affected? If unconsolidated, where, if anywhere, are the SPE-related activities reported? What risks were passed on? What residual risks, recourse risks, credit enhancement exposures, etc. remain? These disclosures should also address the possibility of voluntary recourse, especially in the case where it is customary for SPE-structured transactions to continue in the future (e.g., where a primary beneficiary may be expected—but not required—to enhance the credit risk of an SPE that securitizes credit card receivables, because they wish to maintain funding opportunities in future periods). Finally the disclosures should clarify the methods used to establish the fair value figures and the valuation of

retained risks. What are the gain on sale impacts and effects of estimation? Where are gains or losses on consolidation or deconsolidation of the SPE recorded?

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

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

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

V. Summary

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

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