

OFF-BALANCE-SHEET ACCOUNTING REFORM: IMPACT OF FASB INTERPRETATIONS 45 AND 46 ON SYNTHETIC DEBT

The accounting scandals triggered by the collapse of major energy and telecommunications corporations in 2001-02 focused greater scrutiny on legitimate applications of accounting regulations concerning off-balance-sheet finance that conveyed inaccurate impressions of corporate investments and liabilities. The questionable accounting usually involved corporate investments held by Special Purpose Entities (SPEs).

In 2002, the Financial Accounting Standards Board (FASB) responded with a high-priority program to tighten accounting regulations relating to off-balance-sheet finance. The program resulted in two new sets of accounting criteria: FASB Interpretation No. 45 concerning financial guarantees; and FASB Interpretation No. 46 concerning consolidation of assets and liabilities of legal entities related to Special Purpose Entities (SPEs) into the balance sheets of other entities.

FASB Interpretations 45 and 46 are significant considerations for businesses contemplating financings that involve SPEs. In the case of standard synthetic debt, which in its basic form involves two SPEs, the answers are simple: *neither Interpretation applies to any financial interest in the capital structure.*

It is easy to see why Interpretation No. 45 does not apply to the synthetic debt capital structure. Only leases with contingent concluding balloon payments that function as a guarantee of the resale value of the leased asset are within the scope of Interpretation No. 45. However, the basis for synthetic debt is a conventional net lease that does not provide for any balloon payment at the conclusion of the lease term.

The explanation of why Interpretation No. 46 does not apply to the synthetic debt capital structure is almost as straightforward. FASB recognized from the outset of its program that not all SPE balance sheets should be consolidated into the balance sheets of other entities. FASB also recognized that some entities other than SPEs may function similarly to SPEs and should have their balance sheets consolidated into the balance sheets of related business entities. Accordingly, in formulating criteria to distinguish between entities that should be consolidated and entities that should remain unconsolidated, FASB developed the new concept of Variable Interest Entity (VIE) and presented the criteria in terms of VIEs. Interpretation No. 46 does not apply to the synthetic debt capital structure because neither SPE in the capital structure is a VIE.

The basic reason that the SPEs in the synthetic debt capital structure are not VIEs is that the synthetic debt structure is an all-equity capital structure. Both the synthetic debt component SPE and the remainder equity component SPE are 100% funded by equity capital. There is one class of equity in the capital structure of each SPE and there is no security interest in either capital structure. For each SPE, the equity capital has 100% of the SPE investment risk and is entitled to 100% of all investment returns. It follows from the definition in FASB Interpretation No. 46 that the SPEs are not VIEs.

Lease-based synthetic debt allows the lessee to invest in leveraged leased property without consolidating either the property or the leverage on the lessee balance sheet. No modification to the synthetic debt structure is needed in response to the tightened off-balance-sheet accounting criteria in FASB Interpretations Nos. 45 and 46. Although the synthetic debt capital structure was designed long before FASB developed VIEs to curb off-balance-sheet accounting excesses, the capital structure is in compliance with the spirit as well as the letter of both FASB Interpretations.