



SCHOOL OF LAW
THE UNIVERSITY OF TEXAS AT AUSTIN

727 East Dean Keeton Street • Austin, Texas 78705 • (512) 471-5151 • Facsimile (512) 471-6988

April 21, 2016

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Guarantees of Variable Interest Entities' Obligations

ASC Topic 810-15-14

Dear Sirs & Madams:

I write to request that current accounting standards, ASC Topic 810-15-14, be amended to prohibit a reporting firm from booking revenue from a receivable from a Variable Interest Entity ("VIE") if the reporting firm has guaranteed the VIE debt. Enron relied heavily on inflated revenue from sales to VIEs, then called Special Purpose Vehicles. FASB reacted by raising the standards on reporting revenue from VIEs and consolidation of VIE debt on the consolidated balance sheet. Still, FASB standards do, but should not allow the reporting firm to book the VIE receivable if it has guaranteed the VIE obligation.

A guarantee of VIE debt prevents accounting from resting on real bargains between adverse parties to determine revenue. With the guarantee, the outside creditor's loan neither proves the value of the property nor that it would be willing to lend to the VIE independently. Auditors then must try to ascertain whether VIE equity is sufficient to ensure payment as a counter-factual, which is especially difficult when the assets are hard to value without a true bargain. If the assets are not comparable to assets traded on a broad market, are illiquid, and have a broad range of possible future cash flows, the auditor needs to have an arm's length creditor to verify the sale price. If there were no guarantee of VIE debt, the creditor's willingness to lend would show the adequacy of the VIE equity, and the adequacy of the VIE equity would prove the arm's length sale price. The guarantee destroys a wonderful system of accounting relying on arm's length bargaining, and that works for the benefit only of financial engineering and manipulation.

Assume, for discussion, a transaction in which the reporting firm sells illiquid, hard-to-value assets to a VIE for \$100 million. Assume the sold assets cannot be valued by reference to quotes on an established market and the estimates of future cash flows amount to guesses over a broad range of possible outcomes. The VIE borrows \$90 million from unrelated creditors, which is paid over in cash to the reporting entity in the purchase. If the reporting firm does not have voting control of the VIE, and unrelated parties have an equity stake in the VIE of at least 10 percent of assets (\$10 million) and the equity stake is also sufficient that the VIE could obtain financing on its own, then the reporting firm may book revenue of \$100 million from sale of the

assets and exclude the \$90 million VIE debt from its balance sheet. If the VIE does not qualify under the standards, the transaction makes commercial sense as a loan directly to the reporting firm from a consolidated entity. The \$90 million is included in the reporting firm's balance sheet liabilities and the VIE may not book \$100 million revenue.

Reliable accounting to prevent inflation of earnings depends upon whether we can trust the sale as an arm's length bargain. If the VIE equity is not sufficient for the VIE to get financing independently, then we cannot not trust the value. When the reporting firm guarantees the VIE debt, none of the parties care if the sale price is inflated and the auditor must try to determine whether the sale price is inflated without any help from the transaction or the parties.

When the VIE debt is guaranteed, the outside creditors can look to the guarantee for their repayment. If the asset sold is not worth the purchase price, or if the equity contributed by VIE owners is not adequate, then loan is not fully collateralized, but the creditors can and will still then rest on the deep pocket of the reporting firm. The creditors then do not need to have the VIE be able to repay the debt on its own, nor show sufficient equity to justify the financing, if the reporting firm will repay it.

If the outside creditor does not demand substantial VIE equity, the reporting firm most certainly will not. An aggressive reporting firm willing to undertake some financial engineering will sell assets for an inflated price to the VIE. The reporting firm is the seller – hardly adverse to inflated purchase price, and a seller will never cross examine itself on the details of risks and faults of the asset it is selling. Since the transaction makes commercial sense as a loan to the reporting firm, the reporting firm will also not care about the quality of the equity commitment to the VIE. If the creditor does not care about the inflation of the purchase price because of the guarantee, the reporting firm will not either and the purchase price on sale to VIE is then inevitably inflated by firms that manage earnings.

A guarantee does not prevent separate entity status for the VIE under current financial accounting reporting standards.¹ Under Financial Accounting Standards 5, guarantees that are more likely than not to require payment need to be reported as losses. Guarantees that are not more likely than not, but are greater than remote, and guarantees of financial assets need to be disclosed in footnotes, but are not reported on income statements as losses nor on the balance sheet as liabilities. The guarantee does not prevent booking the revenue from the VIE nor require consolidating VIE debt, but for reasons stated, it should.

The auditor can sometimes tell that the VIE equity is not large enough to justify the loan to the VIE, but sometimes it cannot, and especially for hard-to-value enterprises that are being sold. If the creditor does not enforce sufficient equity in fact, then the reporting firm and creditor will tolerate perhaps, even initiate decay of the equity. Refundable equity, equities never quite contributed, overvalued property in equity contributions, equity that the reporting firm

¹ Agreeing with this conclusion are Al Hartgraves and George J. Benston, *The Evolving Standards for Special Purpose Entities and Consolidations*, 16 ACCOUNTING HORIZONS 245, 252 (2002); Bala Dharan (of Harvard and Rice Universities), *Financial Engineering with Special Purpose Entities* at 8 (2005), <http://staff.washington.edu/widdison/Articles/Special%20Purpose%20Entities.pdf>.

itself provided indirectly and equity consisting entirely of reporting company stock are fine according to the reporting firm. If the reporting firm is trying to inflate sales, it will initiate some very clever schemes that undercut the substance of the \$10 million equity. What equity VIE owners do put in, for instance, might well amount to the purchase of an option, with such low chance of being exercised. If, for example, there is a modest 5 percent chance of the \$100 million illustrative asset becoming worth more than \$290 million, the option value for VIE equity is worth over the \$10 million put in, even though, in 95 percent of the cases, the sold assets will become worthless.² The VIE owners do have to be compensated for whatever equity they put in, but if both creditor and reporting firm do not care about the level of equity, they can be compensated, perhaps on the sly, without providing adequate equity.

If the reporting firm has guaranteed the debt, the auditor will be trying to apply a counter-factual standard when it determines whether VIE equity is sufficient and the receivable price bona fide. The VIE did not, then, borrow without the guarantee. If the asset is illiquid, not comparable to marketed assets, and has a broad range of possible outcomes, determining whether the sale price is inflated, when the reporting firm and the creditors do not care, is very, very hard. The question is much like asking, “if your Mother were a bus, would she stop in Walla Walla?” when she is not a bus and has never been to Walla Walla. FASB should never ask auditors to apply a hard, counter-factual standard against a paying client.

If the reporting party does not guarantee the VIE debt, by contrast, the outside creditor will enforce the standard that VIE equity is sufficient because it wants to get paid. The auditing public accountant will know that the VIE equity was sufficient to obtaining financing because the VIE *did* obtain financing on its own from an adverse creditor. Absence of a guarantee is the lynch pin of a fine mechanism to maintain a standard of adequate equity to prevent inflation of earnings by an adverse party. The guarantee by the reporting firm destroys the system.

Generalizing beyond VIEs, the rock of Gibraltar for financial accounting is real bargains between adverse independent parties, and the debt guarantee destroys that foundation. Accounting reliance on bargains shows up over and over. Accounting maintains historical cost prior to a bargained sale to avoid basing accounting on unreliable appraisals of value that are subject to accounting engineering and manipulation. But allowing guarantees of VIE debt requires accounting to be based on such unreliable appraisals. A bargain is sufficient for booking: Delivery of goods and services for a contract price represents a real bargain and is booked as revenue even if the buyers have not yet delivered cash. Accounting has disapproved of pooling accounting for acquisitions because even when stock is used for an acquisition, the buyer and seller of the business have settled price by adverse bargaining. The standards for VIEs need to be brought into the more general norm and rely on real bargains by prohibiting VIE guarantees.

This is not just hypothetical surmising, although this letter does look at earnings management as if it were a game. The lesson of Enron is that an aggressive reporting firm will manipulate transactions to fit a standard as vague as “could the VIE obtain financing on its own?” and an auditing accountant cannot enforce it. In Enron’s case, the VIEs (then called

² The expected “option value” of the equity position is $5\% * (\$290^+ \text{ million} - \$90 \text{ million}) = \$10^+ \text{ million}$.

Special Purpose Entities (“SPE”), the earlier name) were treated as if they were adverse unrelated parties in purchasing Enron assets and hedging Enron’s losses, when they did not act as unrelated. Enron massively overstated revenue on sale of illiquid, difficult to value enterprises by selling to thousands of SPEs. The expert examiner report in Enron’s bankruptcy concluded that Enron’s balance sheet should have been reported as \$22.1 billion looking to the substance of what Enron was responsible for, rather than the \$10.2 billion it in fact reported. The examiner also concluded that “96% of Enron’s reported net income and 105% of its reported funds flow from operations” in 2000 were attributable to accounting engineering manipulation, primarily transactions with special purpose vehicles.³ Enron, for instance, overstated its revenue and understated its liabilities on sale of Bammel oil storage and pipeline assets by \$232 million in 2000.⁴ Enron reported \$57 million profit from a sale of a movie-streaming endeavor to a SPE that has yet to deliver any unit of product.⁵ Above and beyond inflated price sales with its SPEs, Enron also reported trading losses as hedged by VIEs, when the VIE obligation was funded only with Enron stock.⁶ When only stock secured the hedge, Enron was effectively hedging itself. Enron excluded the SPE debt from its consolidated balance sheet, even though it had guaranteed 97 percent of the debt, with “total return swaps” that required Enron to pay the VIE as its debt was due.⁷

Arthur Anderson, Enron’s auditor, could not or at least did not enforce accounting to reflect the economic substance of Enron’s reporting. The Emerging Issues Task Force had stated that nonconsolidation and sales recognition by the reporting entity were appropriate only if “an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE.”⁸ If the SPE made only a nominal capital investment, or the substantive risk and rewards of the asset rest with the reporting firm, by contrast then consolidation and nonreporting of revenue was required.⁹ Arthur Anderson used a “heard-on-the-street” rule of thumb that 3 percent of assets was sufficiently substantial equity investment to comply with the EITF requirement.¹⁰ The 3 percent rule shows up in the authoritative literature only in the form of SEC questioning of the rule: In a Q&A at the end of an EITF session, an SEC staff member reported that “some members” thought that 3 percent was sufficient capital but the SEC thought that was not adequate in every case.¹¹ Arthur Anderson then tolerated or did not find material violations of the

³ Neal Batson, Court-Appointed Examiner, Second Interim Report, Newby v. Enron, No. 4:01CV03624 (S. D. Texas, Jan. 21, 2003).

⁴ *Id.* at 116-120.

⁵ *Id.* at 33-37.

⁶ William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr. Report of The Special Investigative Committee of the Board of Directors of Enron Corp. at 82 (Feb. 1, 2002) (“Rhythm” transaction).

⁷ Batson, *supra* note 3, Appendix B (Accounting Standards) at 32-38.

⁸ Emerging Issues Tax Force, Topic No. D-14, Transactions involving Special-Purpose Entities (as revised through May 31, 1990)

⁹ *Id.*

¹⁰ Batson, *supra* note 3, Appendix B (Accounting Standards) at 32-38 details contacts with SEC staff that gave some support to Enron’s reliance on the 3 percent rule, but concludes that Enron’s use of the 3 percent rule bore little resemblance to the underlying economic substance.

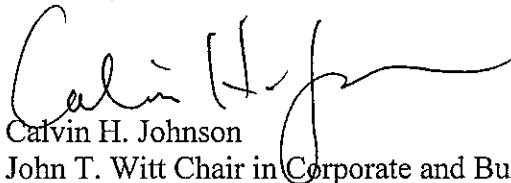
¹¹ “SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary

3 percent rule.¹² Arthur Anderson treated sales of illiquid assets not quoted on an established market as bona fide based on the VIE purchase price, and the VIE purchase price was not bona fide.

In reaction to the Enron scandal, FASB has improved the VIE standards without however taking out the fatal guarantee allowance. Current standards (ASC Topic 810-15-14) now provide that to avoid consolidation, the VIE must have enough of an equity investment to be able to obtain financing on its own without any additional capital. An equity investment at risk of less than 10 percent of the legal entity's total assets is per se insufficient. The VIE equity must be large enough to absorb all expected losses based on reasonable expected quantitative evidence, and must be at least as large as other entities have for similar assets. (ACS Topic 810-15-45) "Often no single factor is sufficient evidence" that the VIE's equity is sufficient. (ACS Topic 810-15-47). The bad reputation, "Special Purpose Vehicle" also got a name change to "variable interest entity." Still, the new standard is especially hard to apply to assets that are not traded nor like those traded on an established market and which might have a very large range of possible future cash flows. Without adverse bargaining between the reporting entity and the VIE, firms dedicated to financial engineering will manipulate the rule to inflate revenue and understate debts, and the auditing accountant will have trouble applying the rule to paying customers. FASB needs to end the guarantees of the buyer VIE's debt.

Please call on me if I can provide any further aid or information.

Sincerely,



Calvin H. Johnson
John T. Witt Chair in Corporate and Business Law
512-232-1306
cjohnson@law.utexas.edu

Cc: James Schnurr, Chief Accountant
Office of Chief Accountant, SEC
100 F Street, NE
Washington, DC 20549
(202) 942-8088

depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property." EITF 90-15, Q&A Supplement.

¹² See eg. Batson, *supra* note 3, Appendix B at 29-32.