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Off Balance Sheet Entities: A Preliminary Look at the Effects of Interpretation 46

Executive Summary

On January 17, 2003 the Financial Accounting Standards Board (FASB) issued *Interpretation No. 46 – Consolidation of Variable Interest Entities*. Given companies' widespread use of VIEs (formerly SPEs) to finance their capital needs, the Interpretation will significantly affect the financial statements of numerous companies. Most significantly, the Interpretation will require primary beneficiaries to consolidate the assets and related debt of their VIEs rather than maintaining such balances and risk off of their balance sheets.

This report summarizes the guidance provided in Interpretation 46 and identifies several firms that will need to consider whether certain off-balance-sheet entities may need to be consolidated. For most of the firms reviewed, limited disclosures did not permit us to quantify the effects of consolidation. When effective in 2003, new disclosures will make it easier to assess the financial statement effects of unconsolidated entities.

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Financial Reporting and Analysis Lab

The DuPree College of Management Financial Reporting and Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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On January 17, 2003 the Financial Accounting Standards Board (FASB) issued *Interpretation No. 46 – Consolidation of Variable Interest Entities*. FASB asserts that the objective of the Interpretation is “not to restrict the use of variable interest entities but to improve financial reporting by enterprises involved with variable interest entities.” However, given the heightened financial reporting requirements the Interpretation prescribes, its requirements may indeed deter many companies from establishing variable interest entities or possibly cause them to dissolve existing variable interest entities.

As explained in the Interpretation, FASB’s objective is threefold:

1. FASB contends that the Interpretation should achieve a more consistent application of consolidation policies to variable interest entities, thus improving comparability between enterprises engaged in similar activities even if some of those activities are conducted through variable interest entities.
2. Including the assets, liabilities, and results of activities of variable interest entities in the consolidated financial statements of their primary beneficiaries will provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise. Essentially, the risk of the variable interest entity that has resided off the balance sheet item will be brought on to the balance sheet.
3. The Interpretation’s required disclosures about variable interest entities in which an enterprise has a significant variable interest but does not consolidate will help financial statement users assess the enterprise’s risk.

Interpretation No. 46

Variable Interest Entity

Because some entities that have been commonly referred to as “special purpose entities” (SPEs) may not be subject to the Interpretation and other entities that have not commonly been referred to as SPEs may be subject to this Interpretation, the Board decided to use the term *variable interest entity* (VIE) to describe any entity subject to the Interpretation.

The initial determination of whether an entity is a variable interest entity is made on the date at which an enterprise becomes involved with the entity. Involvement is considered to be an ownership interest, contractual interest, or other monetary interest that may be determined to be variable interests.

Primary Beneficiary

The enterprise that consolidates a variable interest entity is referred to as the *primary beneficiary* of the variable interest entity. The primary beneficiary absorbs a majority of the variable interest entity’s expected losses, receives a majority of its expected residual returns, or both, as a result of holding the variable interest(s).

Consolidation

The Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities *do not effectively disperse risks* among the parties involved. Primary beneficiaries of variable interest entities are thus required to consolidate under the following conditions:

1. The equity investment at risk is not sufficient to permit the variable interest entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
 - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights.
 - b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities.
 - c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.

While the FASB Emerging Issues Task Force 90-15 specified an independent equity is at risk if the independent third-party owner(s) of record made an initial substantive residual equity capital investment of *at least three percent*, under Interpretation No. 46, an equity investment of *at least ten percent* is required to be considered at risk. This statutory increase from three to ten percent will cause a number of previously unconsolidated SPEs to be consolidated as variable interest entities on the financials of their primary beneficiary.

Seeking to provide more financial reporting guidance than specific directions, Interpretation 46 was less of a rules-based document than most issued by the FASB. One might even go so far as to call it an early installment of a "principles-based approach" to accounting standards setting. What will be very interesting to watch is whether companies will be encouraged to consolidate off balance sheet entities that do not fulfill the letter of the Interpretation but that do fulfill its spirit.

Valuation and financial reporting

Assets, liabilities, and noncontrolling interests of *newly consolidated variable interest entities* generally will be initially measured at their *fair values* except for *assets and liabilities transferred to a variable interest entity* by its primary beneficiary, which will *continue to be measured as if they had not been transferred*. The measurement date is the date the enterprise first becomes the primary beneficiary. This date is the first date on which, if the enterprise issued financial statements, it would report the entity in its consolidated financial statements. If recognizing those assets, liabilities, and noncontrolling interests at their fair values results in a *loss* to the consolidated enterprise, the loss will be *reported immediately as an extraordinary item*. If recognizing those assets, liabilities and noncontrolling interests at their fair values at the measurement date would result in a *gain* to the consolidated enterprise, then that amount will be *allocated* to

reduce the amounts assigned to assets in the same manner as if consolidation resulted from a business combination.

Disclosure

The *primary beneficiary* of a variable interest entity is required to disclose:

1. The nature, purpose, size, and activities of the variable interest entity.
2. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations.
3. Any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary.

Effective Date

The Interpretation applies *immediately to variable interest entities created or obtained after January 31, 2003*. As for variable interest entities held prior to February 1, 2003, the Interpretation applies in the first fiscal year or interim period beginning after June 15, 2003.

The Interpretation may be applied *prospectively with a cumulative-effect adjustment* as of the date on which it is first applied *or by restating previously issued financial statements for one or more years* with a cumulative-effect adjustment as of the beginning of the first year restated.

Qualifying SPE

The most pervasive instances of SPEs are those established for the purpose of securitizing accounts receivables. However, these SPEs are likely to be considered qualifying SPEs ('QSPEs'), and are not covered under this Interpretation. Statement of Financial Accounting Standards No. 140 defines a QSPE and the specific conditions it must meet. Because QSPEs are not consolidated, they are often only described in the notes to the financial statements, and their related risk is carried off the balance sheet.

As an example of a QSPE and its respective accounting, consider the following excerpt from the notes to the financial statements of Land o Lakes.

Land O Lakes Inc.

Form 10-K For the year ending 12/31/01 (03/29/02 filing date)

OFF-BALANCE SHEET ARRANGEMENTS

In order to reduce overall financing costs, the Company entered into a revolving receivables securitization program with CoBank in December 2001 for up to \$100 million in advances against eligible receivables. Under this program, Land O'Lakes, Inc., Land O'Lakes Farmland Feed LLC and Purina Mills, LLC sell feed, seed and certain swine receivables to LOL Farmland Feed SPV, LLC, a limited purpose wholly-owned subsidiary of Land O'Lakes Farmland Feed. **This subsidiary is a qualifying special purpose entity ("QSPE") under applicable**

accounting rules. The QSPE was established for the limited purpose of purchasing and obtaining financing for these receivables. The transfers of the receivables to the QSPE are structured as sales and, in accordance with applicable accounting rules, these receivables are not reflected in the consolidated balance sheets of Land O'Lakes Farmland Feed LLC or Land O'Lakes, Inc.

Financial Statement Impact

The capital needs of a number of companies have motivated the use of VIEs as a cheaper alternative to leasing, purchasing or developing property with traditional loans. Such VIEs, most often formed to hold assets under synthetic lease agreements, are typically established by a financial institution that sets up the VIE to borrow money from the institution to build a facility or purchase an existing one for a company. The VIE holds title to the property and leases it to the respective lessee company, known also as the VIE's sponsor. Treated as an operating lease for book purposes and a capital lease for tax purposes, a synthetic lease allows the lessee to reap the tax benefits of owning real estate, while keeping the assets' related debt off its balance sheet. For accounting purposes, the owner is the VIE. However, for tax purposes, the owner is the company leasing the space. With low borrowing costs, synthetic leases are a cheaper way to finance real estate than purchasing real estate financed with debt.

Balance Sheet. As a result of the Interpretation such VIEs that had not been consolidated on the books of their sponsor will now be consolidated and thus significantly impact the sponsor's balance sheet. In particular, assets and liabilities will be added to the sponsor's balance sheet, but shareholders' equity will remain unchanged. Noncontrolling interest (minority interest) would be increased for the equity ownership in the VIE of a third party. Leverage measures would increase, while return measures would decrease, thus potentially jeopardizing a sponsor's credit quality.

Income Statement. The consolidation would effectively change the accounting for synthetic leases for book purposes from operating to capital. Thus, rent expense would be replaced with interest and depreciation. Expenses would tend to be higher in the earlier term of the leases' lives and lower later, though cumulative expenses would be unchanged.

Cash Flow Statement. The Interpretation also impacts the statement of cash flows, and will increase operating cash flow due to capital lease treatment for a lease that had previously been accounted for as an operating lease. Under capital lease treatment, rent expense will be replaced with interest expense and depreciation. Only the interest portion will reduce operating cash flow. As a non-cash item, depreciation expense will have no effect on operating cash flow. Instead, a portion of capital lease payments will serve to reduce lease liability principal, a financing use of cash.

Consider the following excerpt from the notes to the quarterly financial statements of General Motors Corp.

General Motors Corp.

Form 10-Q For the six months ending 06/30/02 (08/14/02 filing date)

GM leases real estate and equipment from various SPEs which have been established to facilitate the financing of those assets for GM by nationally prominent, creditworthy lessors. These assets consist principally of office buildings, warehouses, and machinery and equipment. The use of SPEs allows the parties providing the financing to isolate particular assets in a single entity and thereby syndicate the financing to multiple third parties. This is a conventional financing technique used to lower the cost of borrowing and, thus, the lease cost to a lessee such as GM.

Assets in SPEs were as follows (dollars in millions):

	June 30, 2002 -----	Dec. 31, 2001 -----
Automotive, Communications Services, and Other Operations -----		
Assets leased under operating leases	\$2,530	\$2,412

If GM were to consolidate the SPE, the company's assets and liabilities would increase by the fair market value of the assets and related debt of the SPE with no change in GM's shareholders' equity. Noncontrolling interest would increase for the equity amount held in the SPE by its equity investor(s).

The Sample

A sample of companies disclosing the presence of special purpose entities was gathered from a search of financial statement filings with the SEC between December 31, 2001 and February 1, 2003.

Only VIEs that we think may be impacted by the Interpretation have been included in the sample. It should be noted that we had insufficient information to determine if the companies included here will be forced to consolidate previously unconsolidated entities. Because the Interpretation does not apply to QSPEs, and the rules for these types of SPEs remain unchanged, examples of QSPEs have been excluded from the sample. These include VIEs that are used to hold securitized accounts receivable. Such entities are of lower risk to the sponsoring company given the careful on-going review of the credit quality of the receivables sold and their accompanying reduced risk of loss.

Prior to the release of the Interpretation, sponsors were not required to disclose details of the assets held in VIEs, thus investors were left to speculate. However, the disclosure

requirements of the Interpretation should result in the assets and activities of VIEs becoming more transparent.

As examples of companies disclosing the use of VIEs, consider the following excerpts from company financial statements. In anticipation of the release of the Interpretation, some companies even mentioned uncertainty regarding the Interpretation's potential impact on their financial statements.

Del Monte Foods Co.

Form 10-K For the year ending 06/30/02 (09/30/02 filing date)

In November 1998, we entered into a build-to-suit lease arrangement to finance the construction of four warehouse facilities (the "Facilities") adjacent to our Hanford, Kingsburg and Modesto, California, and Plymouth, Indiana production plants. The construction of the Facilities was financed by a special purpose entity sponsored by certain lending institutions (the "Lenders"). The special purpose entity is not affiliated with us and is not consolidated in our consolidated financial statements. We have accounted for this arrangement as an operating lease in accordance with SFAS 13, "*Accounting for Leases*", as amended.

Dow Chemical Co.

Form 10K405 For the year ending 12/31/01 (03/20/02 filing date)

The Company uses a number of special purpose entities ("SPEs"), none of which involve Dow equity instruments. Some of the SPEs are used to finance non-operating assets, such as railcars and office buildings. Others are used to provide advantageous financing for manufacturing facilities.

Federal Express

Form 10-Q For the nine months ending 02/28/02 (04/12/02 filing date)

Capital Resources

Certain of our aircraft operating leases were arranged using special purpose entities under terms that are considered customary in the airline industry. In accordance with accounting principles generally accepted in the United States, our operating leases are not recorded in our balance sheet; however, the minimum lease payments related to these leases are disclosed in the footnotes to our annual report and in the table below. The FASB is currently evaluating criteria for consolidation of special purpose entities, which could affect the accounting for certain of our operating leases. However, credit rating agencies routinely use the information concerning our operating leases to calculate our debt capacity, and our debt covenants would not be adversely affected by the capitalization of some or all of our operating leases. Therefore, we do not expect a change in the views by outside agencies of our financial condition if accounting rules should be revised and we are required to capitalize some of our operating leases.

We believe the capital resources available to us provide flexibility to access the most efficient markets for financing capital acquisitions, including aircraft, and are adequate for our future capital needs.

Hershey Foods Corp.

Form DEF 14A For the date 04/30/02 (03/15/02 filing date)

The Corporation has entered into three off-balance sheet arrangements for the leasing of certain warehouse and distribution facilities. The operating lease arrangements are with special purpose trusts ("SPTs") whereby the Corporation leases warehouse and distribution facilities in Redlands, California; Atlanta, Georgia; and Hershey, Pennsylvania, as discussed below. The SPTs were formed to facilitate the acquisition and subsequent leasing of the facilities to the Corporation. The SPTs financed the acquisition of the facilities by issuing notes and equity certificates to independent third-party financial institutions. The independent third-party financial institutions who hold the equity certificates are owners of the SPTs. The Corporation's transactions with the SPTs are limited to the operating lease agreements and the associated rent expense is included in cost of sales in the Consolidated Statements of Income. The Corporation has not entered into any other arrangements involving special purpose entities.

Home Depot Inc.

Form 10-K For the year ending 02/03/02 (04/19/02 filing date)

We use capital, operating and other off-balance sheet leases to finance about 20% of our real estate. Off-balance sheet leases include three leases created under structured financing arrangements to fund the construction of certain stores, office buildings and distribution centers. Two of these lease agreements involve a special purpose entity which meets the criteria established by generally accepted accounting principles and is not owned by or affiliated with the Company, its management or officers. Operating and off-balance sheet leases are not reflected in our balance sheet in accordance with generally accepted accounting principles.

Kroger Co.

Form 10-Q For the three quarters ending 11/09/02 (12/20/02 filing date)

LIQUIDITY AND CAPITAL RESOURCES

Debt Management

We are a party to a financing transaction related to 16 properties constructed for total costs of approximately \$202 million. We became a party to this transaction as part of the Fred Meyer merger. Under the terms of the financing transaction, which was structured as a synthetic lease, a special purpose trust owns the properties and leases them to subsidiaries of Kroger. The lease expires in

February of 2003. We pay a variable lease rate that was approximately 2.2% at November 9, 2002.

The synthetic lease qualifies as an operating lease and the owner of the special purpose trust has made a substantive residual equity investment. The transaction, therefore, is accounted for off-balance sheet and the related costs are reported as rent expense. As of November 9, 2002, the assets and liabilities of the special purpose trust were composed primarily of the properties and \$187 million of bank debt used to fund the construction of the properties.

Mastercard Inc.

Form 10-Q For the six months ending 06/30/02 (08/14/02 filing date)

Special purpose entity ("SPE") — MCI is the lessee in one synthetic lease transaction involving an SPE that acts as lessor. The SPE was set-up for a single, discrete purpose. It is not an operating entity, has no employees and has a limited life...MasterCard's synthetic lease is for its Winghaven transaction processing facility located in O'Fallon, Missouri that was structured by creating an SPE, which constructed and owns the facility...The decision whether or not to consolidate the SPE, or record the facility on the balance sheet, depends not only on the applicable accounting principles for SPEs and the treatment of the lease as operating or capital, but also on a determination regarding the nature and amount of the investments made by third parties in the SPE. Consideration is given, for example, to whether a third party has made substantive equity investment in the SPE; which party has voting rights; who makes decisions about the assets in the SPE; and who is at risk for loss. The SPE is not consolidated because, under the applicable accounting principles, MasterCard does not exercise control over the risks and rewards of the assets in the SPE. The Financial Accounting Standards Board is currently reviewing the consolidation requirements of SPEs. Such review may result in more stringent requirements for the consolidation of SPEs.

Petsmart Inc.

Form 10-K For the year ending 02/03/02 (04/15/02 filing date)

Structured Lease Facilities

We have entered into lease agreements for certain stores as part of structured lease financing. The structured lease financing facilities provided a special purpose entity, not affiliated with us, with the necessary financing to complete the acquisition and construction of new stores. Once construction has been completed, another special purpose entity, also not affiliated with us, leases the completed stores to us for a five-year term. After the five-year term has expired, we are required to pay off the balance of the financing, provide for the sale of the properties to a third party, or pay a guaranteed residual amount.

The Financial Accounting Standards Board is currently deliberating the issuance of an interpretation of Statement of Financial Accounting Standards No. 94, *"Consolidation of All Majority-Owned Subsidiaries"*, to provide additional guidance to assist companies in identifying and accounting for special purpose entities, including when special purpose entities should be consolidated by the investor or beneficiary. The interpretation would introduce a concept that consolidation would be required by the primary beneficiary of the activities of a special purpose entity unless the special purpose entity can meet certain substantive independent economic substance criteria. It is not possible to determine at this time what conclusions will be included in the final interpretation; however, the result could impact the accounting treatment of the remaining lease.

Krispy Kreme Doughnuts, Inc.

The anticipation of the release of the Interpretation and its potential impact on financial statements may have deterred several companies from proceeding with plans to establish SPEs to meet their capital and financing needs. Krispy Kreme Doughnuts is one example of a company that decided against financing its capital needs with a special purpose entity. In its 10-K for the year ending 02/03/02, Krispy Kreme disclosed its 2001 entrance into a synthetic lease agreement, however in its 10-Q for the nine months ending 11/03/02 it disclosed the termination of the lease.

Krispy Kreme Doughnuts, Inc.

Form 10-K For the year ending 02/03/02 (05/07/2002 filing date)

SYNTHETIC LEASE. On April 26, 2001, the Company entered into a synthetic lease agreement in which the lessor, a bank, had agreed to fund up to \$35 million for construction of the Company's new mix and distribution facility in Effingham, Illinois (the "Facility"). Under the terms of the synthetic lease, the bank was to pay all costs associated with the construction of the building and the equipment to be used in the manufacturing and distribution processes. No "special purpose entity" was a party to this transaction.

Under a synthetic lease, neither the cost of the Facility, nor the payment obligations are shown as an asset or as debt, respectively, on the Company's consolidated balance sheet. Therefore, the synthetic lease is often referred to as "off-balance sheet financing." We entered into the synthetic lease: 1) due to the attractiveness of the interest rate associated with the lease which, because of competition among the financial institutions proposing on the synthetic lease transaction, was lower than longer-term financing at the time we began construction of the Facility; 2) due to the flexibility the synthetic lease afforded us at the end of its term as we could purchase the facility with cash, enter into another synthetic lease or enter into traditional financing; and 3) because it allowed us to preserve cash as our monthly lease payments were only covering

interest costs on the Facility, as opposed to principal and interest, resulting in a lower monthly payment.

Form 10-Q For the nine months ending 11/03/02 (12/18/2002 filing date)

\$33 Million Term Loan

On March 21, 2002, the Company entered into a credit agreement with a bank ("Credit Agreement") to provide funding of up to \$35,000,000 for the initial purchase and completion of the Company's new mix and distribution facility in Effingham, Illinois (the "Facility"). Construction of the Facility began in May 2001 and was originally funded through a synthetic lease agreement with a bank.

The Company terminated the synthetic lease and purchased the Facility from the bank with the proceeds from the initial borrowing under the Credit Agreement of \$31,710,000.

Partnership Interests

The Interpretation may even affect companies holding certain partnership interests by requiring consolidation of the debt and assets of the interests. As an example, consider Southern Company and its related entity, Mississippi Power Company's ("MISSISSIPPI") interest in Escatawpa Funding, L.P. ("Escatawpa"). Given the provisions of the Interpretation, Southern Company anticipates it will have to consolidate Escatawpa.

Southern Co.

Form 10-Q For the six months ending 06/30/02 (08/12/02 filing date)

Off-Balance Sheet Financing Arrangements

In May 2001, MISSISSIPPI began the initial 10-year term of an operating lease agreement signed in 1999 with Escatawpa Funding, Limited Partnership ("Escatawpa"), a special purpose entity, to use a combined-cycle generating facility located at MISSISSIPPI's Plant Daniel. The facility cost approximately \$370 million...In June 2002, the FASB issued an exposure draft for comment on a proposed interpretation on "Consolidation of Certain Special-Purpose Entities," an interpretation of Accounting Research Bulletin No. 51. It is expected that the exposure draft would be finalized by year end, with an effective date for existing transactions subject to the interpretation, including MISSISSIPPI's lease transaction, to be implemented on April 1, 2003. This interpretation is in draft form; the final pronouncement may differ from the draft. However, in its current draft form, MISSISSIPPI would be deemed to be the "primary beneficiary" of its lease arrangement with Escatawpa and would be required to consolidate the leased asset and related debt on its books or to restructure the existing arrangement to comply with the final rules. Until final rules are approved by the FASB, MISSISSIPPI will continue to analyze the impact of the exposure draft. MISSISSIPPI's current operating lease arrangement with Escatawpa has been

reviewed and approved by the Mississippi PSC and is reflected and approved for recovery in both its retail and wholesale rate jurisdictions. Consolidation of the leased asset and related debt could require MISSISSIPPI to seek additional regulatory review.