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Accounting for and Disclosure of Special Purpose Entities by Financial Holding Companies: Lessons from PNC Financial Services

In 2001 PNC Financial Services Group (PNC), a financial holding company (FHC), created three special purpose entities (SPEs) to which it transferred some of its non-performing loans and venture capital. SPEs are typically created by an asset transferor or sponsor for a specific limited purpose, with a limited life and limited activities to benefit a single company. PNC intended to structure the SPE transactions in a way that the financial records of the SPEs would not have to be consolidated with PNC's financial reports under generally accepted accounting principles (GAAP).

1. PNC Financial Services Group provides a range of services from personal banking to corporate finance and investment. See PNC, About Us, at http://www.pnc.com/aboutus/ (last visited Feb. 15, 2003).
2. In order for a bank holding company (BHC) to be classified as a financial holding company the BHC must make an effective election to become a financial holding company. Bank Holding Companies Act, 12 U.S.C. § 1843(l)(1)(C) (Supp. 2002); Federal Reserve System Board of Governors of the Federal Reserve System, 12 C.F.R. § 225.81(b)(3) (2002). Additionally, all depository institutions controlled by the BHC must be and must remain well capitalized and well-managed. 12 U.S.C §§ 1843(l)(1)(A)-(B); 12 C.F.R. §§ 225.81(b)(1)-(2); see infra notes 50 and 59.
5. "Generally accepted accounting principles" is defined as [a] technical accounting term that encompasses all the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. ... GAAP includes accounting principles and practices as well as the methods of applying them. Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance.


The categories of GAAP, in rank order [for nongovernmental entities], are as follows:
1. Accounting principles promulgated by bodies designated by the
NORTH CAROLINA BANKING INSTITUTE

approved the off-balance-sheet treatment of the SPEs. The Securities and Exchange Commission (SEC), however, alleged that PNC's accounting with respect to these transactions was improper under GAAP and that PNC made materially false and misleading disclosures in its quarterly filings and press releases because the volatile loans and related losses were not consolidated in PNC's financial statements, thus leading to an overstatement of PNC's earnings. As a result of the SEC action, PNC had to reduce its earnings for 2001 by $155 million when it was forced to consolidate the SPEs onto its balance sheet and recognize the asset losses. Additionally, PNC's management rating may be

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AICPA Council to establish such principles... Those principles are

- Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations
- Accounting Principles Board (APB) Opinions
- AICPA Accounting Research Bulletins [(ARB)]

2. FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position

3. AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force (EITF).

4. AICPA Accounting Interpretations, Implementation Guides (Qs and As) published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

5. Other accounting literature (nonauthoritative).

Id. at 410 and 411 • 3 to • 4. These pronouncements should be considered starting with the highest level of authority, and working down toward the lowest level. Id. at 410 and 411 • 6.


7. Id.


10. Patricia Sabatini, PNC Put Under 6-Month Watch; Agreement Ends
downgraded because of the SEC action alleging that PNC did not comply with GAAP.\textsuperscript{11} Since the passage of the Gramm Leach Bliley Act (GLBA), the consequences of downgrading the management rating are significant.\textsuperscript{12} If PNC does not correct the management issues satisfactorily within the statutorily prescribed time period, it may either have to divest its banking subsidiary, or it may have to divest its businesses that are "financial in nature"\textsuperscript{13} so that it is no longer a FHC and, thus, does not have to maintain a well-managed rating.\textsuperscript{14}

Financial institutions have been using SPEs for decades to monetize loans and receivables on their balance sheets.\textsuperscript{15} In light of current developments, however, financial institutions need to carefully scrutinize the way SPEs are structured to ensure that off-balance-sheet treatment of SPEs is in accordance with GAAP.\textsuperscript{16}

Part I of this Note will examine how PNC’s SPE transactions were structured.\textsuperscript{17} This Note will then examine accounting for SPEs in Part II.\textsuperscript{18} Part III of this Note will examine the Federal Reserve Board’s (FRB) scrutiny of PNC’s SPE transactions.\textsuperscript{19} Part IV of this Note will examine the SEC’s scrutiny of PNC’s SPE transactions.\textsuperscript{20} Finally, Part V of this Note will examine the lessons that can be drawn from PNC’s experience.\textsuperscript{21}

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12. See infra note 66 and accompanying text.


16. See infra notes 79-106 and accompanying text.

17. See infra notes 22-36 and accompanying text.

18. See infra notes 37-49 and accompanying text.

19. See infra notes 50-78 and accompanying text.

20. See infra notes 79-106 and accompanying text.

21. See infra notes 107-135 and accompanying text.
I. PNC’S SPECIAL PURPOSE ENTITY TRANSACTIONS

PNC entered into three different transactions sponsored\(^2\) by an insurance company, American International Group, Inc. (AIG),\(^2\) in the second, third and fourth quarters of 2001.\(^4\) In June 2001, AIG organized a SPE as a Delaware LLC (LLC I) through its subsidiary and received Class B stocks of the newly formed company.\(^2\) PNC contributed $365.8 million in cash through a non-bank subsidiary and received Class A preferred stock in exchange.\(^2\) AIG’s Class B common stock purported to give it control over LLC I including the authority to decide whether to declare dividends on PNC’s Class A preferred stock.\(^2\)

In its second quarter form 10-Q filing,\(^2\) PNC did not include the assets transferred to LLC I on its balance sheet but included the Class A preferred stock as securities available for sale.\(^2\) The second quarter 10-Q did not provide any disclosure concerning the LLC I transaction or recognize losses on $84 million in non-performing assets that PNC had transferred to LLC I.\(^2\) Similarly, in its third quarter 10-Q and press release, PNC did

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22. "Sponsor" is sometimes used to refer to the company that creates the SPE, which may or may not be the primary beneficiary of the SPE. Hartgraves & Benston, supra note 15, at 245 n.1.


25. Id. at 63,482. AIG received $36,576 of LLC I’s Class B common stock and $11,558,940 of its Class B preferred stock in exchange for its cash contribution. Id.

26. Id.

27. Id. at 63,483.

28. The SEC describes the Form 10-Q as a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company’s financial position during the year. The report must be filed for each of the first three fiscal quarters of the company’s fiscal year and is due within 45 days of the close of the quarter. See U.S. Sec. & Exch. Comm’n, Description of SEC Forms, at http://www.sec.gov/info/edgar/forms.htm (last modified May, 29, 2001).


30. PNC Fin. Servs. Group, Enforcement Release No. 1597, 7 Fed. Sec. L. Rep. (CCH) ¶75,112 at 63,485; see also PNC’s Second Quarter 10-Q Form, supra note 29
not disclose its transactions with LLC I and LLC II, but noted a decline in loans as a result of ongoing efforts to reduce lending leverage. PNC attributed this slide to a decline in commercial loans to downsize certain high-risk, non-strategic portfolios.

On January 17, 2001, after being informed by the FRB that non-consolidation of the assets transferred to the SPEs was inappropriate for bank holding company (BHC) reporting, PNC reported that it had reduced its institutional loan portfolio and venture capital assets through, among other things, sales of these assets to subsidiaries of a third party financial institution. The press release tabulated PNC's nonperforming assets by type and stated that the table did not include certain assets sold to subsidiaries of a third party financial institution, but those assets would be included in PNC's nonperforming assets in its BHC

(an analysis of the 10-Q Form shows that PNC did not disclose the LLC I transaction).


PNC disclosed the amounts of nonperforming assets sold to the three LLCs but did not consolidate the assets of the three limited liability SPEs into PNC's financial statements or set forth any reasons explaining why consolidation may be appropriate for its bank regulatory filing but not for its SEC filing. Finally, PNC did not disclose the impact of consolidation on its 2001 earnings per share.

II. ACCOUNTING FOR SPECIAL PURPOSE ENTITIES

Prior to the Enron debacle, many accountants were not familiar with the accounting standards that guide the accounting and financial reporting by companies who sponsor SPEs. Originally, SPEs were primarily used by banks and other companies to monetize the substantial amounts of consumer receivables on their balance sheet through off-balance-sheet securitization.

While SPEs are generally used for off-balance-sheet securitization, GAAP requires certain SPEs to be included on the balance sheet of the primary beneficiary of the transactions. For non-consolidation by the transferor to be appropriate, the majority owner of the SPE must be an independent third-party who has made a substantial capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the SPE's assets. The minimum amount acceptable under GAAP to

34. Id.
35. See id.
36. See id.
38. Id.
40. EITF ABSTRACTS, supra note 39, at 4970.
show substantive capital investment is three percent. Additionally, for some specified arrangements where assets and liabilities are not reported on the balance sheet, information about future obligations under the contracts must be disclosed in the notes to the financial statement.

Typically, a sponsor company creates the SPE to purchase specific assets from the sponsor. The sponsoring company could then convert receivables into cash. A third-party contributes a minimum three percent investment, representing a legal equity ownership interest in the SPE. In exchange for its investment, the third-party retains the substantial risks and benefits of its ownership of the SPE. Generally, a two-step approach is taken to determine whether an entity can be treated as an SPE under GAAP. The first step is to identify the sponsor and the second is to decide when SPEs should be consolidated on the financial statements of the sponsor.

PNC intended to structure its transaction with the LLCs as transfers to SPEs, but the SEC held that the SPEs did not qualify for off-balance-sheet treatment and that PNC should have consolidated the SPEs onto its balance sheet.

III. THE FEDERAL RESERVE BOARD'S SCRUTINY OF PNC'S SPECIAL PURPOSE ENTITY TRANSACTIONS

The FRB has supervisory and regulatory authority over BHCs and those BHCs that have qualified as FHCs. The FRB
“works with other federal and state financial authorities to ensure safety and soundness in the operation of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions.” Bank regulators assess the condition of financial organizations and their compliance with laws and regulations by monitoring, inspecting, and examining these organizations. If a financial institution is found to be in noncompliance, the FRB may use its supervisory authority to take formal or informal action requiring the institution to correct its problems.

In 2000, PNC was designated as a FHC under GLBA. On October 23, 2001, the staff of the Federal Reserve Bank of Cleveland sent PNC a letter raising various accounting issues, and requesting additional information regarding the formation of LLC I. Shortly before sending its response addressing only the LLC I transaction, PNC informed the Reserve Bank that it had closed the LLC III transaction.

On January 11, 2002, the FRB directed PNC to consolidate the transactions with the three LLCs on its BHC regulatory reports for 2001 and on January 15, 2002, in a meeting with PNC's senior management, the FRB staff explained the basis for the FRB’s...
directive and advised PNC that non-consolidation was inappropriate.\footnote{Id; see PNC Press Release Announcing Revised 2001 Results, supra note 8.}

In July 2002, the FRB and the Office of the Comptroller of the Currency (OCC) announced that the PNC holding company and the bank were no longer in compliance with the FHC standards set forth in GLBA.\footnote{See Rob Garver, Activist Agencies, Changing Market; How Regulators Turned a Single Phrase from GLB Into Policy Lever, AM. BANKER, July 22, 2002, at 1.} The FRB said that PNC was no longer “well-managed”\footnote{Bank Holding Companies Act, 12 U.S.C. § 1843(l)(1)(B) (Supp. 2002); Federal Reserve System Board of Governors of the Federal Reserve System, 12 C.F.R. § 225.81(b)(2) (2002). A company or depository institution is well-managed if, at its most recent examination or subsequent review by the appropriate federal banking agency, the company receives (i) at least a satisfactory composite rating and (ii) at least a satisfactory rating for management, if such a rating is given. 12 U.S.C. § 1843(l)(2); 12 C.F.R. § 225.82(d). If the company or depository institution has not received an examination rating, the FRB may determine that the company or institution is well-managed after reviewing the managerial and other resources of the company and in consultation with the appropriate federal and state banking agencies. 12 U.S.C. § 1843(l)(3); 12 C.F.R. § 225.82(d).} from an accounting and risk management standpoint.\footnote{See Garver, supra note 58, at 1. GLBA has more or less objective requirements for CRA and capital, but the determination of whether a BHC is “well-managed” is subjective and regulators have made it clear that accounting and risk management are important factors in determining whether a BHC is “well-managed.” Id. “Regulators have made it clear in recent months that responsibility for accounting practices rests at the highest levels of bank management, and recent actions at PNC make it clear that regulators view accounting problems as a sign of management trouble.” Id.} Therefore, pursuant to GLBA, the FRB notified PNC in writing that it was not in compliance with the applicable requirements of a FHC.\footnote{See PNC Fin. Servs. Group, Written Agreement, http://www.federalreserve.gov/boarddocs/press/enforcement/2002/20020718/attachment.pdf (F.R.B. July 12, 2002) (last visited Feb. 15, 2003).}

Once a company receives notice that it is not in compliance, it has forty-five days to execute an agreement acceptable to the FRB to comply with all applicable capital and management requirements.\footnote{See 12 U.S.C. § 1843(m)(2); 12 C.F.R. § 225.83(c).} The agreement must:

- Explain the specific actions that the company will take to correct all areas of non-compliance;
- Provide a schedule within which each action will be taken;
- Provide any other information that the FRB may require; and
- Be acceptable to the FRB.63

Until the FRB determines that the company has corrected the conditions described in the notice, it may impose any limitations or conditions on the conduct or activities of the company or any of its affiliates that the FRB finds to be appropriate and consistent with the purposes of the Bank Holding Companies Act.64 Additionally, the company and its affiliates may not commence any additional activities or acquire control or shares of any company without prior approval of the FRB.65 If the company fails to correct the unacceptable conditions within 180 days of receipt of the notice, the FRB may require it to either divest ownership or control of any depository institution owned or controlled by it, or cease to engage in any financial activities not permitted for a BHC.66 PNC is the first major U.S. institution to be threatened with the loss of FHC status since the enactment of GLBA.67

PNC entered into a written agreement with the FRB that severely restricts PNC's ability to enter into GLBA related activities including management consulting services,68 providing services to mutual funds,69 and owning shares on the securities exchange70 without regulatory approval.71 Under the agreement with the FRB, PNC must engage a corporate consultant with the approval of the FRB.72 The consultant will review the structure and functioning of PNC's management and the manner in which

63. 12 U.S.C. § 1843(m)(2); 12 C.F.R. § 225.83(c).
64. 12 U.S.C. § 1843(m)(3); 12 C.F.R. § 225.83(d).
65. 12 U.S.C. § 1843(m)(3); 12 C.F.R. § 225.83(d).
66. See 12 U.S.C. § 1843(m)(4); 12 C.F.R. § 225.83(e). If PNC loses its FHC status, it may have to divest some of its businesses such as those that relate to providing services to mutual funds, owning shares of a securities exchange and providing management consulting services. See 12 U.S.C. § 1843(m)(4); 12 C.F.R. §§ 225.86(a)–(c).
67. Schmelkin & Garver, supra note 11, at 1.
68. See supra note 66.
69. Id.
70. Id.
71. See Schmelkin & Garver, supra note 11, at 1.
PNC's board of directors oversee management activities, and provide a written report with recommendations.\textsuperscript{73}

As a consequence of this agreement, PNC cannot amend or rescind any approved plans, policies and procedures without prior written approval of the FRB.\textsuperscript{74} Additionally, PNC is now required to pay for deposit insurance, a benefit that is free to more than ninety-two percent of U.S. banks at present.\textsuperscript{75} Finally, as a result of the SEC action, various class action lawsuits have been brought by PNC shareholders alleging that they had overpaid for PNC stock because the price was based on inflated profits.\textsuperscript{76}

In December 2002, PNC announced that it had met every requirement laid out by the regulators under a 180-day supervisory period set to expire in January of 2003.\textsuperscript{77} Some observers, however, report that the imposition of the supervisory period has resulted in "tremendous internal turmoil" that has distracted PNC from its regular sales activities.\textsuperscript{78}

IV. SECURITIES AND EXCHANGE COMMISSION'S SCRUTINY OF PNC'S SPECIAL PURPOSE ENTITY TRANSACTIONS

The SEC commenced administrative proceedings against PNC alleging that PNC's accounting for the three SPE transactions did not conform to GAAP.\textsuperscript{79} The SEC alleged that PNC portrayed a false and misleading picture of its reduction of loan portfolio exposure in its second and third quarter 10-Q forms and attendant press releases.\textsuperscript{80} Further, the SEC claimed that PNC

\textsuperscript{73} Id. The company will also have to report regularly to the BHC supervisors regarding the management's adherence to PNC's policies and procedures. Id. at 3.

\textsuperscript{74} See id.

\textsuperscript{75} Schmelkin & Garver, supra note 11, at 1.

\textsuperscript{76} Berzof, supra note 6, at A1.


\textsuperscript{79} SEC Press Release, supra note 9.

offered and sold securities by means of registration statements that incorporated the misleading 10-Q forms by reference, and the prospectus presented an inaccurate picture of financial performance. The SEC also alleged that PNC recklessly made materially false and misleading disclosures in its January 17, 2002 press release concerning its financial condition. Finally, the SEC stated that PNC failed to maintain accurate books and records because it did not consolidate the assets transferred to the three limited liability companies on its balance sheet, and thus its balance sheet was inadequate.

The SEC found that PNC's transactions with the SPEs did not meet the GAAP provisions because of the structure of the limited liability transactions. PNC intended to structure the transaction so that it was the transferor to the SPE, and AIG was the three percent third-party investor required by GAAP. The SEC alleged, however, that PNC, and not AIG, had substantive risks and rewards of ownership. The SEC alleged that the agreements for each of the LLC transactions provided that AIG's investment was substantially protected from loss by the investment grade assets to which AIG had priority in case of liquidation. Additionally, because the agreements provided that AIG would have preference on reserves taken from the income of the LLCs to secure payment of its management fees, the SEC contended that this would result in AIG recouping its investment in the limited liability entities in four years. Further, AIG did not enjoy any

82. Id.
83. See Id.
85. See supra note 41 and accompanying text.
87. Id. AIG's cash contribution was used to purchase investment grade assets and its Class B preferred stock was entitled to a variable dividend consisting of the cash earnings of the investment grade securities purchased with its contribution. Id. at 63,482.
88. Id. at 63,488. The SEC also contended that the fact that AIG received an annual management fee of 0.75 percent of the assets for doing very little while PNC conducted the principal activities of the entities by servicing the loans and other assets they held for an annual servicing fee of 0.5 percent suggests that the annual
gains from the loans and other assets transferred by PNC to the entities because PNC had effective control over the liquidation of the entities. PNC bore a substantial risk on the loans because the dividends on its preferred stock were non-cumulative and payable only if the loans performed or were sold and then only after payment of, among other things, the management fees of AIG.

Finally, the SEC contended that the requirement in the LLC agreement that the management fee be paid at the time of closing reduced AIG's actual investment to less than the three percent required by EITF Topic No. D-14. Thus, AIG's investment in the LLCs was not substantive under GAAP. The SEC alleged that because the PNC transactions did not satisfy the criteria for non-consolidation under GAAP, PNC should have consolidated these entities in its financial statement.

In its press release, PNC asserted that it had implemented a corporate strategy of reducing its exposure to commercial lending and the attendant risks. The SPE transactions were a part of this strategy, but PNC did not specifically mention these transactions in either the press releases or the 10-Q forms. The SEC alleged, however, that because of the way the SPE transactions were structured, PNC continued to bear the risk of loss as to troubled or non-performing loans and venture capital assets transferred by PNC. The SEC did not bring criminal charges against PNC.

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89. Id. at 63,483.
90. Id. at 63,488.
91. Id.; see supra text accompanying note 41.
93. Id.
95. PNC Fin. Servs. Group, Enforcement Release No. 1597, 7 Fed. Sec. L. Rep. (CCH) ¶75,112 at 63,489; see also PNC's Second Quarter 10-Q Form, supra note 29.
96. PNC Fin. Servs. Group, Enforcement Release No. 1597, 7 Fed. Sec. L. Rep. (CCH) ¶75,112 at 63,489. PNC's Class A preferred stock was non-cumulative, nonvoting, and convertible. Id. at 63,482. While no Class A common stock was issued at the time of closing, PNC could convert its Class A preferred stock at any time into Class A common stock giving it 99.99 percent of the common shares. Id.
because the case was a difference of opinion between the bank regulators and PNC's accountants, and the SEC felt that "there wasn't sufficient reason to impose penalties." Additionally, "criminal sanctions are reserved for abusive treatment." But "[t]his was a case of a close-call accounting interpretation that is very common.... [t]here was no attempt to defraud the public." That is also probably why the SEC did not bring any sanctions against AIG or PNC's auditors, Ernst & Young.

The SEC held that even if PNC thought that its accounting for the SPEs was in accordance with GAAP, PNC was required to evaluate the material accuracy and completeness of the presentation made by its financial statements, as well as its disclosure obligations under the SEC's rules and regulations. GAAP also requires full and fair disclosure of the organization's financial position and the results of the organization's operation.

Both PNC and Ernst & Young maintained that the SPEs qualified for non-consolidation under GAAP. The SEC and PNC agreed to settle the matter, and PNC consented to a cease and desist order without admitting or denying the accounting

These shares, however, could only be used to cause an orderly liquidation of LLC I.

98. Id. (quoting Bill Strench, a securities attorney for Frost Brown Todd).
99. Id. (quoting Bill Strench, a securities attorney for Frost Brown Todd).
100. See In re Caterpillar Inc., 50 S.E.C. 903, 910 (1992) (finding that Caterpillar's "Management's Discussion and Analysis of Financial Conditions and Results of Operations" disclosures were deficient under Regulation S-K which requires disclosure of information necessary to understand the registrant's financial statements). But see Garver, supra note 58, at 1. Karen Shaw Petrou, the managing partner with Federal Financial Analytics stated that,

The Securities and Exchange Commission "broke new ground that must be frightening to all publicly traded companies" by finding that, even though PNC met generally accepted accounting principles "and then still restated earnings, it had violated the securities laws because the reports did not provide investors with a full picture of the material risks to which the company was subject."

Id.
102. See Berzof, supra note 6, at A1.
violations alleged by the SEC.103 Ernst & Young maintains that PNC accounted for the SPEs appropriately.104

The SEC’s action “demonstrates that the [SEC] will closely scrutinize transactions with special purpose entities,” and “[p]ublic companies engaged in transactions with special purpose entities not only must rigorously comply with GAAP, but also must assure that they accurately portray the material elements of the economic risks and realities that they face as a result of these transactions.”105 PNC would not have faced any sanctions for not disclosing the SPE transactions on its balance sheet if it had sold the loans to companies in which it had no substantial financial interest.106

V. LESSONS LEARNED FROM PNC

Transactions with SPEs are complex transactions, and the accounting principles applied to PNC were not clear. Whether PNC or AIG bore the risk of ownership of the SPEs is a matter of opinion between PNC’s accountants and the SEC.107 PNC interpretation of the GAAP rules was later second-guessed by the FRB and the SEC.108

The rules for consolidation of SPEs are being re-examined in the light of PNC, Enron and other concerns regarding the

105. PNC Settles SEC Enforcement Action Over Treatment of $762M in Loans, ANDREWS SEC. LITIG. & REG. REP. (July 31, 2002), WL 8 No. 4 ANSLRR 11 (quoting Stephen M. Cutler, the agency’s enforcement director).
107. See supra notes 97 – 99 and accompanying text.
108. See supra note 99 and accompanying text.
misuse of SPEs. The Financial Accounting Standards Board (FASB) has issued a Proposed Interpretation of ARB No. 51. The proposal would apply to "any business enterprise that has an ownership interest, contractual relationship or other involvement with an SPE." When one or more parties hold equity investments that meet certain conditions, voting interests determine whether consolidation is required, and provisions of the proposed interpretation do not apply. "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 [ten] percent of the SPE's total assets." The American Accounting

109. See infra note 111 and accompanying text.


111. FIN. ACCT. STANDARDS BD., PROPOSED INTERPRETATION, CONSOLIDATION OF CERTAIN SPECIAL-PURPOSE ENTITIES, AN INTERPRETATION OF ARB No. 51 (June 28, 2002) (on file N.C. Banking Institute) [hereinafter PROPOSED INTERPRETATION]. ARB No. 51 establishes the broad requirements for companies to fully consolidate majority-owned subsidiaries. See AM. INST. OF CERTIFIED PUB. ACCT., ACCOUNTING RESEARCH AND TERMINOLOGY BULLETIN: FINAL EDITION 41 (1961). Under the current version of ARB No. 51, the usual condition for a controlling financial interest is ownership of a majority voting interest. See id.

112. PROPOSED INTERPRETATION, supra note 111, at 3. SPEs qualifying under FASB Statement No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, and employee benefit plans subject to other FASB provisions do not have to be consolidated. Id.

113. Id. at 4. These conditions are:
   a. The nominal owner or owners have voting rights or similar rights that convey the current ability to make decisions and manage the SPE's activities to the extent they are not predetermined by the establishing documents of the SPE or by contracts or other arrangements.
   b. The amount of the equity investment is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders. . . .
   c. The equity investment . . . . is subject to loss . . . . and its return is not limited or guaranteed . . . . by the SPE or other parties involved with the SPE.
   d. The assets exchanged for the equity interest are not subordinated beneficial interests in another SPE . . . .
   e. The equity investment was not provided directly or indirectly by the SPE or other parties with variable interests . . . .

Id.

114. Id. at 5.
Association's Financial Accounting Standards Committee warns against specific quantitative guidance such as the ten percent minimum level of equity investment to avoid the same consequences as the three percent rule currently in effect.\textsuperscript{115}

Under the proposed interpretation, an SPE will be consolidated with a business enterprise if the business enterprise provides "significant financial support" to the SPE, and no other party provides financial support to the SPE or if the business enterprise provides the majority of or significant portion of the total financial support to the SPE.\textsuperscript{116} The proposed interpretation identifies ways in which a business enterprise is deemed to have provided financial support to the SPE, thus gaining a variable interest in the SPE.\textsuperscript{117} These factors influencing consolidation decisions should be reconsidered at each reporting date.\textsuperscript{118} The Financial Institutions Accounting Committee (FIAC) has expressed concern that it will be almost impossible to implement the variable interests approach in practice.\textsuperscript{119} The FIAC contends that it would be unrealistic to expect a variable interest holder to determine whether they qualify under this interpretation for each

\textsuperscript{115} AM. ACCT. ASSOC. FIN. ACCT. STANDARDS COMMITTEE, RESPONSE TO FASB EXPOSURE DRAFT, PROPOSED INTERPRETATION: CONSOLIDATION OF CERTAIN SPECIAL PURPOSE ENTITIES 8, http://accounting.rutgers.edu/raw/aaa/about/committee/fasc/ProposedInterpretation.pdf (last visited Feb. 15, 2003) [hereinafter AAA COMMENTS].

\textsuperscript{116} PROPOSED INTERPRETATION, supra note 111, at 5. The interpretation defines variable interest as the interest through which an entity provides financial support to the SPE, such as by holding a subordinate debt. \textit{Id.} at 3. An entity that holds the majority or a substantial majority of the variable interests in the SPE is the primary beneficiary of the SPE, and is deemed to be the parent and is required to consolidate the SPE. \textit{Id.} at 3-4.

\textsuperscript{117} \textit{Id.} at 7. Some of the ways in which a business enterprise is deemed to have provided financial support are: (1) Its ownership interests do not amount to voting interests; (2) It provides the SPE with subordinate debt, leases property to the SPE, or guarantees debt or asset values; (3) It enters into management or service contracts, referral agreements, purchase contracts, or options to acquire assets; (4) It provides overcollateralization of assets to the SPE. \textit{Id.}

\textsuperscript{118} \textit{Id.} at 6.

\textsuperscript{119} FIN. INSTITUTIONS ACCT. COMMITTEE, COMMENTS TO FASB EXPOSURE DRAFT, PROPOSED INTERPRETATION: CONSOLIDATION OF CERTAIN SPECIAL PURPOSE ENTITIES, http://www.fmsinc.org/cms?pid=2437 (last visited Feb. 15, 2003) [hereinafter FIAC COMMENTS]; see also AAA COMMENTS, supra note 115, at 5 (expressing concern that the guidelines provided by FASB defining variable interests are unclear).
reporting period. The American Accounting Association's Financial Accounting Standards Committee has suggested that the FASB should adopt a principle-based approach that would require disclosures that allow users to understand management's motives for employing SPEs and their financial reporting choices rather than a rule-based approach.

The comment period for the proposed interpretation ended on August 30, 2002. FASB issued the final interpretation in January 2003. The effective date of the final interpretation will be as of the fiscal periods beginning after June 15, 2003 for existing entities. Under the new interpretation, the assets, liabilities, and non-controlling interests of newly consolidated SPEs would be measured at carryover basis unless carryover basis is difficult to determine, in which case the measurement would be at fair value.

As the PNC issue has demonstrated, even if a FHC complies with GAAP, bank regulators may require the FHC to account for its transactions differently for its BHC reporting. This will result in the risk that the SEC will require greater disclosure in financial statements in hindsight as it did in the case of PNC.

A FHC that creates a SPE is also open to special risks because it must comply with statutory requirements to maintain its FHC status. In addition to an embarrassing reduction of earnings and the enforcement action by the SEC, the Federal Reserve Board as a FHC regulator has the power to substantially alter the FHC's fundamental business model if the FHC does not

120. FIAC COMMENTS, supra note 119.
121. AAA COMMENTS, supra note 115, at 3. Disclosures should be such that investors can assess the extent and nature of the risks and rewards of ownership. Id. at 7.
122. PROPOSED INTERPRETATION, supra note 111.
124. See id. at 40.
125. Id.
126. See supra note 57 and accompanying text.
127. See supra notes 79 – 106 and accompanying text.
128. See supra note 50 and accompanying text.
return to compliance with FHC requirements and satisfy all other FRB conditions within the required time period. Additionally, as in the case of PNC, a FHC may be open to lawsuit by investors if it has to reduce earnings as a result of regulatory action. Finally, as PNC demonstrated, even if the company returns to compliance with the FHC requirements, it may be at the cost of its focus on ongoing operations. Therefore, FHCs may want to err on the side of additional disclosures related to SPEs to ensure that their decisions are not second-guessed at a later date by bank regulators or the SEC.

The SEC wants more complete disclosure of off-balance-sheet liabilities of banks and other companies. Following Enron and other ever-widening accounting scandals, banks have started disclosing more details about their off-balance-sheet exposures on their 10K filings. Although the SEC does not insist on the amount of detail now given by many banks in their 10Ks, it encourages extensive disclosures. This, however, creates greater risk of regulatory action for FHCs that are not making additional disclosures, because if some FHCs include more details about their off-balance-sheet exposures on their 10Ks, the regulators would eventually expect all FHCs to include similar disclosures. Finally, GAAP and SEC Regulations require that companies make full and fair disclosures to enable investors to make informed decisions, and the SEC appears to be policing this issue more stringently since the accounting scandals broke.

VI. CONCLUSION

While the use of SPEs is allowed under GAAP for off-balance-sheet securitization, companies, especially FHCs, should

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129. See supra note 66 and accompanying text.
130. See supra note 76 and accompanying text.
131. See supra note 78 and accompanying text.
133. Alissa Schmelkin, Preferred Issues: Disclosure Up in 10Ks, But What's It All Mean?, AM. BANKER, March 18, 2002, at 9. Wachovia Corporation is taking the lead in this area. Id.
134. Id.
135. See supra notes 100–101 and accompanying text.
be careful about the way these transactions are structured to ensure that they do not run afoul of the SEC or the FRB.\textsuperscript{136} If the FRB determines that a FHC is not in compliance with GAAP, it may take action against the institution and severely restrict the institution's ability to continue activities as a FHC.\textsuperscript{137} As the PNC situation illustrates, the FRB can take action even if it is simply a matter of opinion whether a transaction is in accordance with GAAP.\textsuperscript{138} Additionally, it is unclear whether the SEC would have taken action against PNC if the FRB had not raised the issue of its accounting for the SPEs.\textsuperscript{139} Therefore, the actions that the FRB takes against financial institutions may also lead to action by other regulatory bodies including the SEC.

The SEC has made it clear that it will scrutinize transactions involving SPEs very closely in the post-Enron era.\textsuperscript{140} For example, PNC arguably had complied with GAAP in structuring the LLCs.\textsuperscript{141} It remains to be seen whether the SEC will also take action in other areas of accounting where there is a difference of opinion between the SEC and companies and their auditors on how to account for certain transactions. Additionally, the impact of the various accounting rule changes is not yet known.

Financial institutions must ensure that if they create SPEs for off-balance-sheet transactions, an independent third party should own at least three percent of the SPE (ten percent under the new interpretation).\textsuperscript{142} Additionally, the financial institution should not be the entity bearing the risks and rewards of ownership of the SPE.\textsuperscript{143} Finally, the financial institution should have minimal or no control of the SPE.\textsuperscript{144} The new interpretation

\begin{footnotes}
\footnotetext[136]{See, e.g., Garver, supra note 58, at 1; see also supra note 100.}
\footnotetext[137]{See supra note 66 and accompanying text.}
\footnotetext[138]{See supra note 57 and accompanying text.}
\footnotetext[139]{See supra notes 55–58, 79 and accompanying text.}
\footnotetext[140]{See supra note 105 and accompanying text.}
\footnotetext[141]{See supra note 99 and accompanying text.}
\footnotetext[142]{See supra notes 41 and 114 and accompanying text.}
\footnotetext[143]{See supra note 46 and accompanying text.}
\footnotetext[144]{See supra note 40 and accompanying text.}
\end{footnotes}
of ARB No. 51 will likely clarify some confusion regarding the accounting for SPEs.\textsuperscript{145}

Generally, in all accounting issues, even if companies account for their transactions in accordance with GAAP, they should ensure that they make adequate disclosures on their financial statements so that investors can make informed decisions.\textsuperscript{146} This may mean that companies, especially FHCs, should disclose all transactions that may later be questioned by either the bank regulators or by the SEC, to avoid allegations that the company has failed to accurately portray its financial position. It is fair to assume that the SEC will take action against a company if it determines that the company is attempting to deceive investors by not disclosing all relevant information about the company's economic condition.

JOYITA R. BASU

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145. See supra notes 111–121 and accompanying text.
146. See supra note 101 and accompanying text.