Variable interest entities and repo 105 assignment

Business

Variable Interest Entities One topic that has generated much discussion and even some “ bad blood” in the accounting profession and business community as a whole is variable interest entities, formerly known as “ special purpose entities. ” One common definition of a variable interest entity is a legal business structure which does not have enough capital to support itself due to its lack of equity investors. The financial support for the variable interest entity is provided by an outside source, such as another corporation.

A variable interest entity is often created by a corporation to serve as a holding company, which will hold assets or debt for the creating corporation. A corporation can use such a vehicle to finance an investment without putting the entire firm at risk. In years past, this has cause considerable controversy because variable interest entities have been used inappropriately by large companies to hide “ bad assets” such as subprime mortgage exposure. In general, the creating of a variable interest entity serves three primary purposes for a company. . A variable interest entity can be used to reduce the cost of debt financing. For example, when a company securitizes an asset and needs financing to do so it can use a variable interest entity to increase their credit rating. The company seeking financing can sell assets that it has on its balance sheet to a variable interest entity as a temporary transaction. The variable interest entity obtains the funds to purchase the assets from the corporation by issuing securities. This is called an asset backed transaction.

Because the variable interest entity owns the assets, which are also the collateral for the securities issued, lenders evaluate the credit quality of the

collateral instead of that of the corporation. As a result, lower funding costs are achieved by the corporation. A non-investment grade issuer can obtain funding at investment-grade levels by isolating the assets in the variable interest entity. 2. The second primary purpose for creating a variable interest entity is that it can be used by a corporation to shift risk from itself to parties willing to accept it. This often occurs when a corporation is seeking unding for a major project. When a corporation uses a variable interest entity for this purpose, it is referred to as project financing. In a transaction such as this, the lenders to the project evaluate the cash flows from the project rather than that of the corporation seeking financing. 3. The third primary purpose of a variable interest entity is that it can be used to accomplish the transfer of tax benefits. This is done by implementing the use of a lease arrangement in which the lessor is entitled to the tax benefits associated with the ownership of the equipment if the lease qualifies as a true lease for tax purposes.

In so doing, a corporation that cannot use the tax benefits associated with ownership can transfer those benefits to another party by leasing the equipment to them. In exchange for the tax benefits, the lessor provides a lower-than-market leasing rate that is essentially less than the cost of borrowing funds in order to purchase the equipment. Variable interest entities are not always easy to identify, especially if the corporation is trying to hide something. This is because they can be very complex.

The complexity of issues surrounding the accounting treatment of variable interest entities is confirmed by the massive amounts of regulations and clarifications issued by standard setters and the interpretations of such

regulations. The most infamous is FIN 46, followed by FASB Staff Position No. FIN 46(R)-6, “ Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R). ” As defined in these documents, a variable interest entity can be formed by a simple relationship. A relationship that forms a variable interest entity is referred to as a variable interest relationship.

These relationships are basically any agreement that causes an entity to receive benefits and (or) causes an entity to be exposed to risks similar to those received from having a majority ownership interest in another company. Often times, these types of agreements result from a contract between two companies that is created to change with identified “ triggers” in the market. The most common types of contractual arrangements that result in the creation of a variable interest entity are options, leases with guarantee of value, guarantees of asset recovery values, and guarantees of debt repayment.

These contractual agreements may exist simultaneously with a less than majority ownership interest in a variable interest entity. Most variable interest entities are special purpose entities, which are legally structured entities which are created to serve a specific, predetermined, limited purpose. A special purpose entity may legally exist as a corporation, partnership, trust, or any other legal entity. Under FIN 46, the primary beneficiary of a variable interest entity must consolidate the VIE in its financial statements.

The primary beneficiary of a VIE is the entity that; will absorb a majority of the VIE’s expected losses (more than 50%), and (or) will receive a majority of

the VIE's expected residual returns (more than 50%). In certain situations, expected losses are given more weight than expected residual returns. In general, an entity is subject to consolidation if, by design, any of three conditions exist. (1) Equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support.

Sufficient financial support is defined as variable interests that will absorb some or all of an entity's expected losses, such as a debt guarantee, or an equity guarantee. In general, the equity at risk is determined to be sufficient if it is at least 10% of total assets. (2) An entity is subject to consolidation if the holders of the equity investment at risk collectively lack any of the following characteristics: the ability to make decisions about an entity's activities, the obligation to absorb the entity's expected losses, the right to receive the entity's expected residual returns. 3) An entity is subject to consolidation if certain disproportional ties exist among the equity investors. For example, if certain equity holders possess voting rights that are not proportional to their obligation to share the variable interest entity's losses. After determining whether or not a variable interest entity does in fact exist, accounting for these entities involves the disclosure of these relationships to shareholders. For primary beneficiaries of a variable interest entity there are three main items that must be disclosed. The first is a detailed description of the VIE.

This must include the nature, purpose, size, and specific activities of the VIE. The second disclosure required is the carrying value and classification of consolidated assets that are collateral for the variable interest entity's

obligations. Third, primary beneficiaries must disclose lack of recourse if creditors of a consolidated VIE have no recourse to the general credit of the primary beneficiary. In addition, anyone who holds significant interest in a variable interest entity must disclose the nature of involvement and when such involvement began.

Significant interest holders must also provide a description of the VIE: including nature, purpose, size, and activities; as well as the potential maximum exposure to loss as a result of its involvement with such an entity. At the center of the market crash that was followed by the economic crisis we have endured the past three years was the collapse of Lehman Brother, an American financial powerhouse. Controversy surrounds the collapse of this giant and the term “ Repo 105” has become synonymous with Lehman Brothers. Repo 105 is an accounting maneuver where a short-term loan is classified as a sale.

Under this maneuver, the cash obtained through the sale is used to pay down debt, allowing a company to appear to reduce its leverage, or risk, by temporarily paying down liabilities. This short term arrangement is only a temporary smoke cloud that lingers just long enough to be reflected on the company’s published balance sheet. After the company’s financial reports are published, the arrangement reverses; the company borrows cash and repurchases its original assets. One comical demonstration of this depicted a company trading a trashcan full of toxic assets for 50 billion dollars in order to show the cash to auditors and hide the trashcan.

After being audited, the company gave the 50 billion back to the lender and took back the trashcan full of toxic assets. This narration was a simplified simulation of what Lehman Brothers was doing in the reporting periods leading up to its collapse. This type of accounting maneuver is unethical because it deceives shareholders and creditors by misrepresenting the actual financial position of the company. Shareholders and creditors continue to invest in the company, expecting to continue to receive returns. Sources Cited

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