

SPECIAL PURPOSE VEHICLE INSTITUTIONS: Their Business Natures and Accounting Implications*

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Special Purpose Vehicle (SPV) is an instrumental institution used for specific purposes by firms. The SPV is useful for tax planning, risk management, project financing and company restructuring. SPVs have benefits for economy and business, and involve usually large size of projects that vary from about US\$100 to US\$500 million per project. However, SPVs have also some bad records. Huge business, finance, and accounting scandals involve the use of SPVs. The drawbacks of SPVs are due to lack of regulatory measures relating the application of SPVs, so that SPVs are used for hiding identities, debts and hiding non-productive assets. SPVs are used to deceive investors so that they can not judge the value and risks of the firms and investments correctly.

The huge financial and accounting scandals such as Enron involved the use of SPVs for not reporting or undervaluing debt and overvaluing net worth. In Indonesia, there are some transactions that are under public scrutiny that use SPVs, such as the sales of the government stocks of BCA Bank, and PT Indosat. There are also many successful and beneficial uses of SPVs in Indonesia as well, such as those in energy development, oil refinery, and telecommunication projects.

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This paper explains the natures of SPVs and discusses the accounting implications of SPVs. This paper also discusses the use of SPVs in various projects such as in banking, insurance, natural resources, energy and Islamic banking. The important accounting implications of SPVs: consolidation of financial reports and disclosures of SPVs are analyzed in more details. The negative effects of SPVs may be reduced with enough regulation on consolidation of financial reporting and disclosures. With these regulations, SPVs cannot be used to deceive investors and also cannot be used for hiding identities, assets and liabilities.

Keywords: consolidation of financial reports; off balance sheet; project finance, and asset securitization; special purpose vehicle (SPV); variable interest entities (VIE)

Introduction

This paper discusses natures and accounting implications of special purpose vehicle institutions (SPVs) in business and financing structures. SPVs have been used extensively in national as well as international businesses. Companies such as PT Danareksa, JP Morgan, Citibank, PT Pertamina, PT PLN, and others use SPVs in their wealth management and investment. SPVs also involve large size multibillion transactions. I discuss the accounting implications based on practice and theoretical perspectives. I use legal and economic framework and existing accounting standards that define assets and liabilities to describe accounting treatment of assets and liabilities of SPVs. The business and accounting practice of SPVs are described based on literature and my observation on actual contracts and practices.

The objective of this paper is to provide information and suggestion to standard setters, to contribute to litera-

ture in business, economic and accounting with the practice of SPVs, to communicate problems and to find solutions relating to the practice. SPVs are institutions established, like its name, for specific purposes, such as setting up a structure to make certain accounts be off balance sheet, mitigating risk, improving credit rating, and tax planning. SPVs are also mentioned in slightly different terms such as special purpose company, special purpose entities, special purpose corporation (SPC), and recently they are called as Special Variable Enterprises (SVE). SPVs are very often related to (non-recourse and limited recourse) project financing and off-balance sheet transaction. Nevitt and Fabozzi (1995) define SPC as "an independent corporation with nominal capital which is a party to a project financing for purposes of holding title as a nominee or acting as a conduit of funds." SPVs usually also use specific regions with specific jurisdictions such as Cayman Island, Mauritius, Bormuda, and

Labuan. Those jurisdictions provide legal protection and tax incentives to attract investors to establish their formal contracting party in the region.

As a separate entity, or conduit, the SPVs are created by a commercial business or financial institution (the originator) to hold a pool of financial assets for the benefit of the security holders, or investors in an asset securitization. The SPVs are used in asset securitization, the selling of securities backed by the cash flow from a pool of financial assets, such as loans or leases. An SPV is structured such that it is prohibited from carrying on any other business activity and it is bankruptcy remote (the bankruptcy of the company selling the financial assets won't affect the entity). An investment bank specializing in securitization usually establishes the SPV and handles all the day-to-day transactions. The originator (the company selling the financial assets) generally acts as the collection agent for the receivables. The nature of the arrangement between the special purpose vehicle and the originator may vary depending on a variety of factors such as the need for credit rating by a rating agency, tax issues, and desired balance sheet effects.

Since the SPV does not have any significant capital of its own, the purchase or financing of receivables must be financed through an outside source such as the issuance of commercial paper or sale of ownership interests in the pool of receivables acquired by the vehicle. What distinguishes this type of financing from other types is the

requirement that it be self-liquidating. The special purpose vehicle cannot look to the originator for repayment. A letter of credit, surety bond, or other security may be used to enhance the credit quality of the pool, however. The special purpose vehicle allows a business to remove assets from the balance sheet for financial and accounting purposes, thereby freeing up equity capital that would be otherwise be used to support the assets.

In a broader role, SPVs may also be used as parts of a firm strategy to deal with regulatory and cultural problems. For example, a multinational company sets up a local domestically flavored company as a vehicle to do investment in a country to get a domestic cultural sentiment and sympathy that eventually will ease their marketing of their products. SPVs are also used to limit risk of a bundle of businesses included in the SPVs, and provide facilities limited profit or business sharing between multinational companies with potential partners. For example, a multinational company joins in a limited partnership entity (as an SPV) with local investors who have ability, or easier ways, to win a tender of projects, due to its existence as a local company.

The issue of SPVs is important for at least three reasons. *First*, recent financial scandals indicate that firms use mechanism such as SPVs to undervalue and hide (not disclosing) liabilities or non-performing receivables. Of course this happens because there is a legal structure and accounting standards that can be applied to support the

mechanism. This can be viewed as one of defects in the professions that need to be and in the process of being fixed.¹ The accounting treatment of SPV is now still in public debate: whether SPV should be consolidated to the parent companies, who are their parent companies, and to what extent the responsible companies should disclose the assets and liabilities of SPVs. These perspectives can not be interpreted in that the use of SPVs is not good, or SPV scheme is detrimental for macro national economy. There are many uses of SPVs that are positive for the company, such as that it is inducing investments and improve efficiency.

Second, public, regulators and interest groups have paid attention to issues relating to SPVs. They concern with the tax revenues and the extent to which firms comply with principles and values of social responsibility. The SPV system has been used for huge transactions. For example, the construction of a refining facility cost US\$300 millions, and a financial restructuring and selling of a state bank costs for more than US\$200 millions. Some cases relating to the use of SPV such as in Enron even involve billions of dollars of public money. In Indonesia, the use of SPVs in PT Danareksa in investment management (through OC Corporation and Evergreen Capital) also invites public debate, espe-

cially with regard to the consolidation and reporting issues of the SPVs.

Third, there has been almost none, or at least very small attention from academic on the issues of SPVs. Consequently resources for learning and research on this area are also very limited. This may be one implication of the gap between academy and practice. This paper closes the gap, improves the attention and attracts potential solutions to the problems.

Characteristics of SPVs

SPVs are different from normal firms in terms of their actual operation, their specific objectives and the contracting environment in which the SPVs are established. These differences implicate the natures of their assets, liabilities, revenues and expenses. SPVs are established under certain contract structure, mostly in non-recourse or limited recourse financing structure and project financing, to reduce risk or to facilitate indirect guarantees in the form of take-or-pay contracts, tolling contracts, put-or-pay contracts and long-term-operation contracts. SPVs are also used by ceding insurers to distribute and to diversify risk through capital market; and by bond issuers to avoid taxes to make the bonds more attractive to investors. I will discuss each of the purpose of the SPVs below.

¹ The issuance of Sorbance-Oxley Act in the US is one of the regulations issued to fix the defects. In Indonesia, Minister of Finance (MOF) Decree Number: 423/KMK.06/2002 and MOF Decree Number: 359/KMK.06/2003 are issued to more strictly regulate the auditing services provided by public accountants, that to some extents avoid frauds to occur.

Specific Jurisdiction

SPVs are established usually in an area with specific offshore jurisdiction that supports the objectives of the SPVs, such as Cayman Islands. Cayman Islands is one of offshore jurisdiction for securitization transaction (Belmontes 2004). Cayman Islands has become the leading offshore jurisdiction for the formation of SPV because of its many benefits, including:

1. Fiscal regime, with no income, capital, or corporate taxation whatsoever, whether direct or indirect holders of securities issued by the SPV or on the SPV itself.
2. Flexible and creditor-friendly legal and regulatory framework.
3. The depth of professional expertise available.
4. The low cost, ease, and high speed at which securitizations can be completed.

Cayman Islands even has its own stock exchange whose listing rules are designed specifically to facilitate the listing of special products, including special debt securities and derivative warrants. As at the end of 2003, there were more than 700 issues approved for listing with total market capitalization of over US\$44 billions.

Not all specific jurisdiction provides free taxation. Ireland is an example. Ireland has become an increasingly popular jurisdiction for the establishment of Special Purpose Vehicles (SPV) for securitization, repackaging, collateralized debt obligations (CDOs), warehousing and other struc-

tured finance transactions (Quirke and McGonagle 2005). However, the territory charges corporate tax on income arising from the activities of qualifying SPVs as the SPVs were treated as a trading company. Properly structured, the SPVs that earn a minimal profit is charged with a tax rate of 25 percent.

Project Financing

Project financing is a transaction in which lenders and investors look mostly on the project for their consideration on the repayment and incentives of the investment. In this structure, corporate financial position and equity condition of the borrower is not a major factor, and often represented by a trustee. Figure 1 illustrates the structure of a project finance to build a refinery plant in a developing country. The structure mainly consists of five contracts: off-take contract, product supply agreement, loan contract, trustee paying agreement, and advance payment agreement; and involving five parties (for simplicity, not all of the parties mentioned in the figure): the buyer or off-taker, project sponsor, trustee, borrower (represented by the SPV), and lenders.

Project sponsor owns the project and operates the project asset (in this case refinery). The project sponsor makes agreements to supply product to off-taker. Off-taker is the party who agrees to purchase goods from the project sponsor under take or pay arrangement. Under the purchase agreement, the off-taker makes payment to trustee that eventually distributes the

Figure 1. An example of Project Finance Structure with pure SPVs

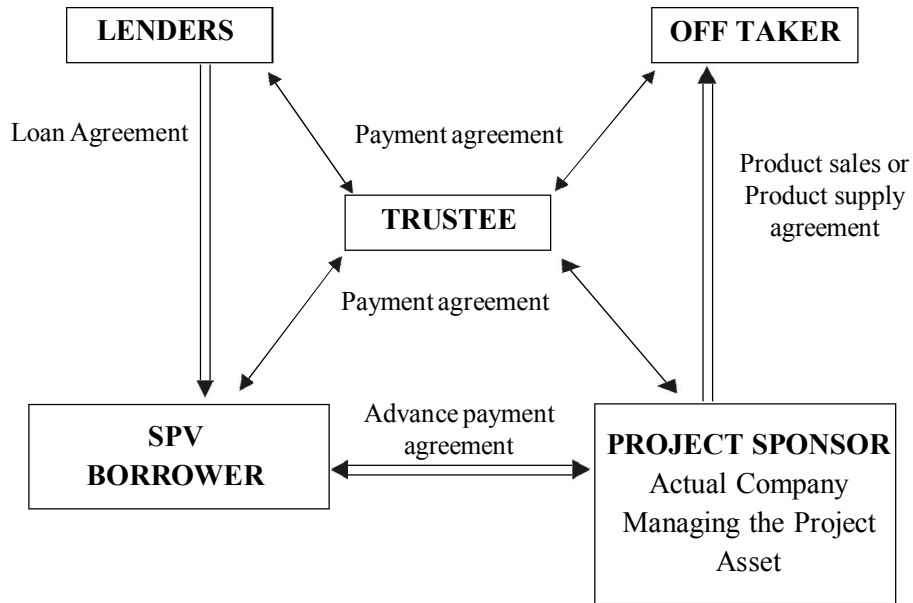
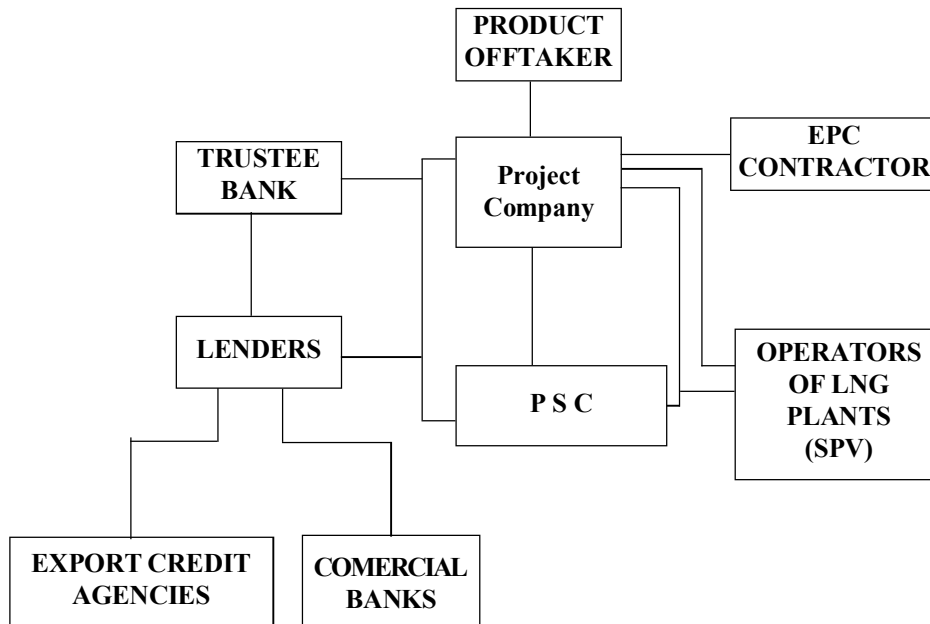


Figure 2. Project finance Scheme with SPVs Operate as Cost Centers



cash flows to make repayment of loan, reserve, and pay the rest to the project sponsor. The borrower in this project finance structure is conducted by SPV.

The establishment of SPV in this case is to reduce risk, to mitigate some legal constraints relating to strict financial regulation bound by the project sponsor, and to exclude the lending and borrowing scheme from the project sponsor corporate financial profile. There are many legal situations where firms should be very conservative so that they should avoid any direct exposure to potential risk. Multinational firms use SPVs as their formal organization for their operation in developing countries.

Figure 2 presents another type of project financing scheme using SPVs as operator of LNG plant, and using trustees to represent the borrower and lenders. The difference between the two figures, among others is that in Figure 2, there is a vehicle company organized as a joint entity among the project sponsors to operate a production plant, and treated as cost centers, while in figure one, the SPVs are pure SPVs meaning that they do not have any operations except paper works recording the transactions conducted by the companies represented.

Off-Balance-sheet Transaction

SPVs are also related to various off-balance sheet transactions. Big firms such as UAL Corp., J.P. Morgan Chase, and Electronic Data System have incentives to use SPVs to set up off-balance sheet transactions to pro-

vide favorable financial profile of their balance sheet (Henry et al. 2002). UAL Corp. only puts estimated present value of its US\$12.7 billion long-term debt due over 26 years on its footnote of the financial statement, while only US\$5 billion debt stated on the statement. This makes the financial leverage of the company looks lower than what actually is. Similarly, Electronic Data Systems only disclose US\$500 million potential liability for loan guarantees in financing of sales of their own products.

Off-balance-sheet transaction is created by companies using SPVs which absorb their debt or non-performing receivables. Those SPVs' ownership and control are structured in certain ways so that the "parent" company does not need to consolidate the SPVs into their balance sheet. This mechanism provides instrument for the firms to hide their loan or potential material liabilities from appearing explicitly in their financial statement. The consolidation of normal companies and SPVs had been an important issue being discussed by regulators and standards setters since 1990s, however it has not been settled. This issue will be discussed further in the section of accounting issues of SPVs of this paper.

Based on the discussion on SPVs in project financing and off-balance-sheet transaction, SPVs have no actual operation except acting as nominee of their holders as part of the cash flows and payment arrangement, and for that reason SPVs are also called as paper

companies. Various roles as nominees played by SPVs are seller or buyer in take-or-pay or put-or-pay contracts, borrower or lender in loan contracts. The reasons for using SPVs in these contracts are for reducing risk, exploiting the tax benefits, and mitigating legal constraints. A company in a developing country is exposed to higher country risk so that the company needs to establish an SPV in a better risk exposed country as a nominee in a loan contract.

Diversification and Distribution of Risk

In insurance business, SPVs are used to diversify and to distribute risk more widely in capital market (Hofmann 2002). A ceding insurer puts a book of risk into an SPV that then sells catastrophe bonds to investors. The cash generated by the proceeds are invested in high-quality instruments that are held by the SPV. If certain catastrophic events and losses occur, the SPV might liquidate the investments held and use the proceeds to pay the ceding insurer. If there is no triggering event, the bondholders get their principle back as well as the yield during the period of transaction. SPVs are also used as captive insurer firm to make the cost of managing risk and insurance more efficient. The captive SPVs are set up to provide insurance to a specific group. The efficiency of the SPVs are due to their flexibility in meeting the need of the group the SPVs serve.

There are also some variations of SPVs which objectives are to conduct certain works such as operator companies. In a long term project such as those in natural resources (oil and gas) business, a joint venture company may be created to conduct a joint operation in production. In this case, the SPV is exactly the same as a cost center for the holders of the venture.

Rights, Obligations and Risks

SPVs economically do not have exact rights, obligations and risks as do other firms. Most of their rights, obligation and risks are transferred to other institutions such as buyers, sellers, producers, project sponsors, lenders, and borrowers. Using an example of project financing in building a refinery plant in the previous section (Figure 1), the SPV used as the borrowing agent just acts as borrower that receive advance payment which fund is eventually used for paying the construction cost. The payment of the loan is not the responsibility of the SPV, but the trustee who will pay back the loan, who will receive the money from the buyer.

SPVs who have roles in other functions have similar characteristics. Most of them are just a vehicle with almost no assets, no liabilities, and no risk because they are transferred to other parties. If they do have rights and liabilities, most of them are temporary in nature which eventually transferred to other parties. In the insurance case, the investment made by SPVs actually

belongs to the ceding insurer who has the main responsibility to pay certain cost claimed by their clients. Similarly, the SPVs also do not have absolute obligation to pay back the bonds, because it will be paid by the insurers who provide guarantees to the bond.

SPVs and Debt Restructuring

SPVs are also used as an instrument in debt restructuring scheme. For an example, an SPV company, Philippine Newsteel Industry, Inc is created to take over the operating assets of the beleaguered steel firm, National Steel Corp. (NSC) (Torrijos 2004). The new company is established to revived the operations of NSC by selling, leasing, or operating the NSC's plant and other vital operating assets. Under the agreements of the shareholders and creditors of NSC, the secured creditors will convert 16 billion pesos out of their 18 billion in outstanding loans to NSC, into an 80-percent stake in the special purpose vehicle, while the remaining 20 percent stake will be held largely by NSC's majority owner, Hottick Investments Ltd. The minority owners, i.e., the state-owned National Development Co. and Marubeni Corp. of Japan, agreed to have their stake in the SPV diluted on a pro-rata basis. The two billions remaining loans of NSC is held by the SPV, with the payment of which depends on the cash inflows of the SPV and the sale of some NSC's assets. Of course the priority will be given to advances of the secured creditors, funding the current operation, unpaid interest on the loans, and the

excess will be distributed to the shareholders proportionally.

In Indonesia, SPVs are used for settlement of troubled financially distressed companies managed by the Indonesian Bank Restructuring Agency (IBRA). The SPVs are used to take over the assets, arranging contracts with other parties, financing and re-financing the troubled projects, and together with trustees arrange the payments of the debts.

SPVs as Government Financing Instruments

SPVs are also used by government as a financing instrument. Using SPVs provides government an access to capital market in financing government expenditures. Even SPVs are used for structuring syariah based finance and investment. The Malaysian Government's USD600 million Sukuk Al-Ijarah Trust Certificates is an example. The certificates were issued by Malaysia Global Sukuk Inc. (MGS), a Syariah-complaint financial instrument listed on Labuan International Financial Exchange (LFX). MGS is a Labuan incorporated Special Purpose Vehicle (SPV) owned by Minister of Finance, a body corporate established under the Ministry of Finance Act 1957 of Malaysia. In the case the Malaysian government needs to raise fund for financing a government project.

The SPV structure facilitates the government to maintain the governance structure of public corporations. The government does not need to have direct contracting with LFX market,

while the government should act as the supervisory agent for the market. The use of direct contracting between the government and LFX may result in a conflict of interest because the supervisory function of the government to the market. In some situations, lenders still request for government guarantee to secure such structure. However, good legal and economic conditions may be used for the government to reject such guarantee, reducing potential liabilities of the government.

Misconducts with SPVs

SPVs are instruments to do business that are actually normal and legal. They may also induce national economy, if they are used in a proper way. There are many cases of using SPVs in proper ways as they are illustrated in previous sections of this paper. However, there are many practices of using SPVs in improper ways, especially for hiding unproductive as-

sets or potential liabilities, and overstate earnings of the company in certain periods. Most of the misconducts with SPVs utilize ambiguities of accounting standards that provide the companies opportunities for not stating (hiding) assets or liabilities of SPVs in the consolidated financial statement to mislead or to deceive investors. Table 1 provides a summary of some examples of some typical uses of SPVs.

SPV sometimes is deemed as a “vehicle” to misconduct a creative accounting. The problem of creative accounting is not new, primarily due to the market that is unforgiving of companies that miss their estimates. Pressures to “make the numbers” often result in earnings management and a consequent decline in the quality of financial reporting. Companies try to meet or to beat expectations of analysts in order to increase market capitalization.

Table 1. Summary of Examples of Typical Uses of SPVs

Company	Type of SPV and Case
Danareksa	Wealth management and investment
JP Morgan	Off-balance sheet transaction
UAL Corps	Off-balance sheet transaction
PT Pertamina	Project finance
PT PLN	Project finance and debt restructuring
PT Telkom	Project finance
Electronic Data System	Off-balance sheet transaction
Philippine Newsteel Industry	Debt Restructuring
PT Indosat	Divestiture
Malaysia Global Sukuk, Inc	Government Financing Instruments

The Korean Times of 15th March 2002 carried a front cover story about companies (which were named) punished for manipulating accounting books (Ul Haq 2004). The Korean Financial Supervisory Commission (FSC) had taken powerful punitive actions against 13 companies suspected of having been involved in dubious accounting practices, the so-called “accounting fraud” or “window-dressing” settlements, during the 1999-2000 fiscal year. In the story, a senior FSC official expressed his anxieties over the illegal practices, saying, “The Korean fears of an Enron type scandal have become a reality. They tried to boost their corporate value through offshore funds and derivatives in the process of account settlements in the fiscal years of 1999 and 2000,” he explained.

On-balance sheet common technique of creative accounting. Arthur Levitt, former chairman of the US Securities and Exchange Commission, identified five of the more popular creative accounting techniques – “big bath” restructuring charges, creative acquisition accounting, “cookie jar reserves,” “immaterial” misapplications of accounting principles, and the premature recognition of revenue. Companies sometimes set up large charges associated with company restructuring. The charges help the companies “cleaning up” their balance sheet – giving them a so-called “big bath.” In recent years, whole industries have been rationalized through consolidations, acquisitions and spin-offs. Some

acquirers, particularly those using stock as an acquisition currency, have used this environment as an opportunity to engage in “Creative Acquisition Accounting.” In the purchase price allocation procedures, they classify a large portion of the acquisition price as “in-process” Research and Development, which can be written off in a “one-time” charge – removing any future earnings drag. Sometimes, large liabilities for future operating expenses are created to protect future earnings. Another form of creative accounting is *Miscellaneous “cookie jar reserves”* by using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in “cookie jars” during the good times and reach into them when needed in the bad times.

Another rabbit in the magician’s hat is the word “materiality.” Some companies misuse the concept of materiality. They “intentionally” record errors within a defined percentage ceiling. This is justified on the basis that the effect on the profit is too small to matter. When the management are questioned about these clear violations of accounting principles, they answer sheepishly, “It doesn’t matter. It’s immaterial.” Have you heard the story of a Fortune 500 company which had recorded a significant accounting error, and the auditors told them so. However, they still used a materiality ceiling of six percent earnings to justify the error. Materiality is not a bright line cut-off of three or five percent. It

requires consideration of all relevant factors that could impact an investor's decision. Finally, some companies try to boost earnings by manipulating the recognition of revenue.

Off balance sheet common techniques of creative accounting. The last few years have seen a number of attempts by companies to remove assets and liabilities from balance sheets through transactions that may obscure the economic substance of the company's financial position. There are three areas that warrant mention here, each of which has potentials to obscure the extent of a company's assets and liabilities: leasing transactions, securitization, and creation of unconsolidated entities.

In a capital lease transaction, a company that owns an asset, e.g. an aircraft, and finances the asset with corporate debt, reports an asset (the aircraft) and a liability (the debt). However, in most jurisdictions of existing accounting standards (including US, Singapore and International standards), a company that operates the asset under an operating lease structure reports neither the asset nor the liability. The balance sheet of the airline companies using operating lease without any aircrafts invite a debate regarding the extent to which the balance sheet presents the economic value of the firms.

In Securitization, a company that transfers assets (like loans or credit-card balances) through a securitization recognizes the transaction as a sale, and removes the amounts from its bal-

ance sheet. Some securitizations are appropriately accounted for as sales, but many of them remain exposing the transferors to many of significant risks and rewards inherent in the transferred assets and therefore should not be removed from the balance sheet.

In the case of creation of unconsolidated entities, a company that transfers assets and liabilities to a subsidiary company must consolidate the subsidiary to the parent company's financial statements. However, in many cases, using SPVs, the transferors are able to escape the consolidation requirement.

Common Techniques of Creative Accounting – Off-income Statement.

A company may pay for goods and services through the use of its own stocks or options on its stock, and may not record any cost for those goods and services in the income statement. The most common form of this stock-based transaction is the employee stock option.

Accounting Implications of SPVs

Off-balance sheet financing, an external funding not recognized on the issuing company's financial statements, has invited a significant public attention, primarily due to the collapse of the Enron Corporation. Enron's management extensively utilized a specific form of off-balance sheet financing, the creation of Special Purpose Entities (SPEs). Evidence suggests that the intent of these was to hide exten-

sive corporate liabilities from creditors, investors, and regulators. The scheme was so sophisticated, the deception that even knowledgeable investment analysts found it difficult to ascertain the true operating condition of the company and its subsidiaries.

The SPVs And Complexity Of Agency Problems

The issue of consolidating and disclosing the SPVs can be explained theoretically using agency theory. The SPV phenomena add the complexity of agency relationship between managers and principals. Agency theory explains agency problems that emerged due to the conflict of interests between various contracting parties such as shareholders, corporate managers, and debt holders (Jensen and Meckling 1976). In agency relationship agents who manage firms has more information about the firms than the principals who do not manage the firms. Due this information asymmetry, managers may make decision that is not at the best interests of shareholders or debt holders. The problems result in agency costs: monitoring costs, bonding costs and residual loss.

Agency theory has been used to analyze issues and approaches in management, accounting and finance area, namely – corporate structure, merger and acquisition, management compensation system, debt contracting, divi-

dend policy and disclosures. Most of the analysis focused to provide solutions to agency problems: moral hazard, earnings retention, risk aversion, and time horizon (McColgan 2001).

In accounting, agency theory has been used extensively to analyze issues relating to disclosures. This is because disclosures of information may reduce the information asymmetry, a fundamental cause of agency cost. Recent studies such as those by Welker (1995), and Lang and Lundholm (1993, 1996) show that disclosures reduce the level of information asymmetry. These indicate that disclosure is important phenomenon to reduce agency cost. These empirical evidences add supports for disclosure regulation by regulatory agencies to improve the capital market efficiency.² In other words, the regulation is applied to protect public (investors, creditors, government and others) from the potential costs otherwise would emerge.

Consistently, in term of the SPVs, the extent of disclosure and consolidation should be analyzed based on the benefit and cost of the policies for the public. A framework to decide the accounting treatment of SPVs can be set up based on at least two factors: legal background and business operation of the SPVs. Based on the legal background, the SPVs may exist as a blank institution that has no rights and liabilities. This happens because all

² In the United States, SEC requests disclosure of information items such as those in 10 K report, and recently the Sarbanes Oxley Act adds disclosure of certain information in public company financial report.

the rights and liabilities of the SPVs are passed on to other firms such as project companies, the original lenders and borrowers. The original lenders are parties who actually do expenditure for lending their fund for a project; while the original borrowers are parties who use the fund from the lenders for the project.

Based on their operation, SPVs exist in various degrees, from a merely paper company that has no assets and liabilities being managed, to a company with certain operations, a unit close to a cost center. A liquified natural gas plant organized under a contract scheme among multinational oil companies (contractors and producers) and a project company (one of the producers) is categorized as a cost center unit under the contractors and producers (see Figure 2).

Should SPVs be Consolidated?

The most important accounting issue relating to SPVs is that whether their financial position should be consolidated to related companies and to what extent the SPVs should be disclosed. The issue had become a public debate involving regulators and other interest groups, and had become more imperative since the scandals of Enron and others which involve the use of SPVs to hide material risks and liabilities. A complex transaction contract involving a transfer of assets to SPVs may also have an uneasy recognition and valuation process. However, in a simple contract, accounting matters

about SPVs, such as transaction recording, valuation and reporting, are more straight forward that they just follow the rules and agreements relating to the establishment of SPVs. An SPV that has a role of the borrower has accounting records only about the fund received from the lenders and passed through the project sponsor. In this case, the SPV does not have any recognition of profit.

Financial statements of two or more companies should be consolidated if they have controlling (such as parent and subsidiary) relationship. Consolidation means that the financial position and income statement of the companies are combined from two or more entities into one single entity. All transactions from third parties are added, while transactions among the parent and subsidiary are eliminated. The consolidation is conducted to avoid misunderstanding such as that liabilities of subsidiaries that are also the responsibilities of parents are reported in the consolidated statements. However, there are variations in practice of consolidation of financial statements. The AICPA's (1988) annual survey of accounting practices of 600 companies indicates that about 23 percent of the companies being surveyed did not consolidate their financial statement. The survey reported that typical subsidiaries that are foreign subsidiaries, finance-related companies, insurance, banks and leasing are excluded from consolidation.

Traditionally, the issue whether an entity should be consolidated to another firm is decided based upon whether the latter has controlling interest and power to the former entity. This control is usually considered based on voting rights of an investor (parent) to a subsidiary. An investor's direct or indirect ownership of more than 50 percent of an investee's outstanding common stock is considered as evidence to the existence of control to the investee (subsidiary), and thus, the investee financial report should be consolidated to the investor financial report. However, there is a complex argument in identifying the existence of control and the need of consolidation. The debate includes the existence of control in economic substance over legal form of a relationship between two or more entities.

In practice, various finance-related subsidiaries (bank, insurance, and leasing companies) are not consolidated to their conglomerate due to their unique features and argument of non-existence of control. The features of those companies exclude them from the control criteria which are defined by accounting standards based more on proportion of voting interests.

Statement of Financial Accounting Standards

The long debate about the consolidation issues indicate the importance of the issue. The following events provide some examples of the discussion on consolidation issues of SPVs. In 1999, FASB issued a new Proposed

Statement of Financial Accounting Standards, about Consolidation of Financial Statements that include implementation guidance for the consolidation of SPEs and trusts. Until this time, it was observed that a lot of SPVs have not been consolidated.

In 2002, FASB approved for issuance an Exposure Draft of a proposed interpretation that establishes accounting guidance for consolidation of SPVs. The draft argues that SPVs have valid business purposes, for example, by isolating assets or activities to protect the interests of creditors or other investors, or to allocate risks among parties involving in certain contracts. The draft also argues that consolidation of entities should not only based on the existence of parent-subsidiary relationship established through voting ownership interests, but also relationship through other means. In sum the FASB requires that the assets, liabilities and results of the activities of SPVs should be consolidated into the financial statements of the primary beneficiary of the SPVs.

In 2003 FASB issued Interpretation No. 46, Consolidation of Variable Interests. The interpretation provide guidance to improve financial reporting for SPEs, off-balance sheet structures and similar entities. The variable interest entities are referred to as a corporation, partnership, trust, or any other legal structure used for business purposes that either has equity investors or does not have equity investors with voting rights to support its activities. These are entities such as SPVs or

any off-balance sheet structures, and trusts. As discussed in the exposure draft, the interpretation requires a primary beneficiary company to consolidate an SPV subject to a majority of risk of loss from the SPV activities or entitled to receive a majority of the entity's residual returns or both. The consolidation include the assets, liabilities and results of activities of the SPVs.

The ruling of consolidation of variable entities cannot be separated from high profile accounting and finance scandals such that of Enron. Considering the scandals, both the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) increased their scrutiny on SPEs (Crawford and Frederick 2003) and FASB recently issued a ruling. FASB adopted *Financial Accounting Interpretation (FIN) 46*, effective on January 31, 2003, for newly created entities. More importantly, existing entities were not grandfathered and must comply with the ruling.

FIN 46 is broad enough and SPE structures are complex enough that it will take some times before accounting professionals fully understand the implications of the ruling. However, it is clear that all parties involved with SPV-type entities, including those without any nominal equity interest or voting rights, need to analyze their relationships to the SPV to determine if they must now consolidate.

FIN 46 divides legal entities into two groups: those need to consolidate

through "voting interests" (the original definition) and those need to consolidate through "variable interests." The acknowledgement of variable interest entities (VIEs) expands the requirement for consolidation. A firm that benefits from residual returns and covers expected losses of an entity is required to consolidate the entity on its financial statements. Further, the required outside equity for consolidation increased from 3 percent to 10 percent.

International Accounting Standards

International Accounting Standards (IAS) provide guidelines for consolidation of financial statements through IAS numbers 22 (revised 1998), 27, 37, and 38; and the Standing Interpretation Commission numbers 9, 12, and 22. The standards and the interpretations cover issues of business combination, mergers and acquisitions and consolidation of financial statements. The standards state that financial statement of entities under common control should be consolidated.

The issue of common control does apply to SPVs, which are created solely or largely for accomodating the others' needs such as financing, project construction and development, and securitization of financial assets. Since in many cases the SPVs are not owned, or majority owned, by the true sponsor company, consolidation standards that based only on ownership will provide

misleading information. On ownership basis the SPVs do not need to be consolidated because they are not majorly owned by the sponsor company. However, the SPVs may affect the sponsoring entities' financial strengths, because the latter, at the end, will absorb the benefit and risk of the SPVs. The sponsoring entities provide some guarantees in product deliveries (put or pay contracts), or in product purchase (take or pay contracts). Thus, not consolidating SPVs to sponsor companies would result in a "form over substance" decision.

SIC 12 provides specific guidances whether to consolidate SPVs to the sponsor entities based on the existence of effective control by the sponsors, although the latter has no majority ownership. SIC 12 suggests the existence of effective control and the consolidation when the following conditions exist:

1. The activities of the SPVs are conducted so as to provide the sponsor with the benefits thereof;
2. The sponsor in substance has decision making powers to obtain most of the benefits of the SPVs, or else an autopilot mechanism has been established such that the decision making powers have been delegated;
3. The sponsor has the right to obtain the majority of the benefits of the SPVs and consequently is exposed to risks inherent in the SPVs activities; or
4. The sponsor retains the majority of the residual or ownership risks of the SPVs or its assets, in order to

obtain the benefits of the SPVs activities.

Accounting Practice of SPVs in Indonesia

SPVs are used by Indonesian entities in relation to debt restructuring, project finances in infrastructure, power and energy projects. However, even there are a lot of SPVs used by Indonesian entities, there has not been significant attention to the SPVs' accounting issues. The accounting standards and the interpretations of the standards that have been codified and published (IAI, 2002) have not addressed the issues specifically and appropriately. Further, there has been very little publication in Indonesia discussing accounting issues relating to SPVs. The use of SPVs in selling of a portion of shares of state owned enterprises and selling of government shares in restructured companies by Indonesian Bank Restructuring Agency (IBRA) invites national debate, criticism and public scrutiny. Usually the public enquires about the credibility of the company sponsoring the SPVs (acting as the buyer) that is not fully disclosed (Kompas, 7 January 2003).

The use of SPVs in Indonesia is not much different from what it is in companies in other countries. The use of SPVs may involve not less than US\$500 million stream of cash flows of Indonesian companies each year. Lack of accounting standards regarding the SPV issues may result in potential problems in financial reporting and other control and monitoring

mechanism that mislead investors. There are many cases involving public questions on misappropriation of fund, non-performing loan, and fairness of sales of government assets, e.g. sales of 41,94 percent Indosat government shares, sales of Pertamina VLCC, and sales of assets by Indonesian Bank Restructuring Agencies (IBRA) involving SPV mechanism. For that reason it is important to consider the application of accounting standards and or interpretations that provide guidance to the accounting practice of SPVs.

Conclusion

SPVs have been used in business for various roles such as financing, sales and purchase contracting, insurance and investment. SPVs are used for a number of objectives such as setting up a structure of off balance sheet accounts, mitigating and distribution of risk, improving credit rating, and tax planning. SPVs are also used for attracting investments and supporting economic growth. Financial schemes for developing infrastructures and large size projects can only be done with the involvement of SPVs. Thus, the use of SPVs has a lot of benefit to business and economy.

However, there is also cost for the use of SPVs. Recent finance and accounting scandals involve SPVs. A

number of companies are found having huge values of liabilities, non-performing assets, and risks hidden in their SPVs. The non-consolidation of assets and liabilities of SPVs into their beneficiary companies deceive investors and misled them in judging the value of the companies.

Accounting treatment of SPVs becomes important issues due to the use of SPV mechanism to deceive investors indicated by a number of recent financial scandals. Regulatory bodies in various countries such SEC and FASB in the US, and IASC have issued guidance requesting consolidation of special variable entities to beneficiary companies. Considering the potential risks of lose standards of consolidation, it is worth for Indonesian Institute of Accountants and Indonesian Government to consider the consolidation policies to prevent any financial scandals. A number of factors need to be considered to measure consolidation and non-consolidation: (1) natures of the contracting scheme where a company and SPVs are involved; (2) the extent to which a company can control SPVs through economic means, not merely voting interests; and (3) potential risk absorbed by a company relating to SPVs business, such as uncollected receivables, defaulted liabilities, and business interruption.

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