International Corporate Governance

Chapter Objective:

This chapter discusses corporate governance structures, which vary a great deal across countries, reflecting divergent cultural, economic, political, and legal environments.
Chapter Outline

- Governance and the Public Corporation: Key Issues
- The Agency Problem
- Remedies for the Agency Problem
- Law and Corporate Governance
- Consequences of Law
- Corporate Governance Reform

Governance and the Public Corporation: Key Issues

- The public corporation, which is jointly owned by a multitude of shareholders protected with limited liability, is a major organizational innovation of vast economic consequences.
- It is an efficient risk sharing mechanism that allows corporations to raise large amounts of capital.

Governance and the Public Corporation: Key Issues

- A key weakness is the conflict of interest between managers and shareholders.
- In principle, shareholders elect a board of directors, who in turn hire and fire the managers who actually run the company.
- In reality, management-friendly insiders often dominate the board of directors, with relatively few outside directors who can independently monitor the management.

Governance and the Public Corporation: Key Issues

- In the case of Enron and other dysfunctional corporations, the boards of directors grossly failed to safeguard shareholder interests.
- Furthermore, with diffused ownership, most shareholders have strong enough incentive to incur the costs of monitoring management themselves.
  - It’s easier to just sell your shares a.k.a. “The Wall Street Walk”.

The Agency Problem

- Shareholders allocate decision-making authority to the managers.
- That’s why they are hired in the first place.
- Many shareholders are not qualified to make complex business decisions.
- A shareholder with a diversified portfolio would not have the time to devote to making the numerous decisions at each of his many companies anyway.

The Agency Problem

- Having the short-term control of the firm’s assets, managers might be tempted to act in the manager’s short-term best interest instead of the shareholder’s long-term best interest.
  - Consumption of lavish perquisites is one example.
  - Outright stealing is another example.
    - Some Russian oil companies are known to sell oil to manager-owned trading companies at below market prices.
    - Even at that, they don’t always bother to collect the bills!
The Agency Problem at Enron

- Enron had about 3,500 subsidiaries and affiliates
- Many of these were run and partly owned by Enron executives.
- In retrospect, conflict of interest should have been an obvious concern.
  - The partnerships did hundreds of millions of dollars of transactions with Enron itself, in some cases buying assets from the company or selling assets to it.
- The problem is this: Where did the executives' loyalties lie? Are they trying to negotiate the best deal for the company that employs them and the shareholders who own the company, or the best deal for the partnership where they had an ownership stake?

The Agency Problem at Enron

- The board of directors claimed that these partnerships with executive ownership allowed the firm to speed up contracting.
- To protect itself in dealings with these partnerships, the company says that it set up safeguards that required top company officers and the board to review and approve deals between Enron and the partnerships.
- Clearly these safeguards were insufficient.

Remedies for the Agency Problem

- In the U.S., shareholders have the right to elect the board of directors.
- If the board remains independent of management, it can serve as an effective mechanism for curbing the agency problem.

Corporate Boards

- The structure and legal charge of corporate boards vary greatly across counties.
  - In Germany the board is not legally charged with representing the interests of shareholders, but is rather charged with representing the interests of stakeholders (e.g. workers, creditors, etc.) as well as shareholders.

Corporate Boards

- The structure and legal charge of corporate boards vary greatly across counties.
  - In England, the majority of public companies voluntarily abide by the Code of Best Practice on corporate governance.
  - It recommends there should be at least three outside directors and the board chairman and the CEO should be different individuals.

Corporate Boards

- The structure and legal charge of corporate boards vary greatly across counties.
  - In Japan, most corporate boards are insider-dominated and primarily concerned with the welfare of the keiretsu to which the company belongs.
Incentive Contracts

- It is difficult to design a compensation scheme that gives executives an incentive to work hard at increasing shareholder wealth.
- Accounting-based schemes are subject to manipulation.
  - Arthur Andersen’s involvement with the Enron debacle is an egregious example.
- Executive stock options are an increasingly popular form of incentive compatible compensation.

Executive Stock Options

- Executive Stock Options exist to align the interests of shareholders and managers.
- Executive Stock Options are call options (technically warrants) on the employer’s shares.
  - Inalienable: the option can’t be sold.
  - Typical maturity is 10 years.
  - Typical vesting period is 3 years.
- Executive Stock Options give executives an important tax break: grants of at-the-money options are not considered taxable income. (Taxes are due if the option is exercised.)

Valuing Executive Compensation

- FASB allows firms to record zero expense for grants of at-the-money executive stock options.
- However, the economic value of a long-lived call option is enormous, especially given the propensity of firms to reset the exercise price after drops in the price of the stock.
- Due to the inalienability, the options are worth less to the executive than they cost the company.
  - The executive can only exercise, not sell his options. Thus he can never capture the speculative value—only the intrinsic value.
- This “dead weight loss” is overcome by the incentive compatibility for the grantor.

Concentrated Ownership

- Another way to alleviate the agency problem is to concentrate shareholdings.
- In the United States and the United Kingdom, concentrated ownership is relatively rare.
- Elsewhere in the world, however, concentrated ownership is the norm.

Debt

- If managers fail to pay interest and principal to creditors, the company can be forced into bankruptcy and managers may lose their jobs.
- Borrowing can have a major disciplinary effect on managers, motivating them to curb private perquisites and wasteful investments and trim bloated organizations.
- Excessive debt creates its own agency problems, however.

Overseas Stock Listing

- Companies domiciled in countries with weak investor protection can bond themselves credibly to better investor protection by listing their stocks in countries with strong investor protection.
The Market for Corporate Control

- If a management team is really out-of-control over time the share price will decline.
- At some point, a corporate raider will buy up enough shares to gain control of the board.
- Then the raider either fires the feckless managers and turns the firm around or he sells everything for the break-up value.
- Either way, the old managers are out of a job.
- The threat of this may keep them in line.

Law and Corporate Governance

- Commercial legal systems of most countries derive from a relatively few legal origins.
  - English common law
  - French civil law
  - German civil law
  - Scandinavian civil law
- Thus the content of law protecting investors’ rights varies a great deal across countries.
- It should also be noted that the quality of law enforcement varies a great deal across countries.

Consequences of Law

- Protection of investors’ rights has major economic consequences.
- These consequences include
  - The pattern of corporate ownership and valuation.
  - Development of capital markets.
  - Economic growth.

Ownership and Control

- Companies domiciled in countries with weak investor protection many need to have concentrated ownership as a substitute for legal protection.
- This is not without costs, with concentrated ownership, large shareholders can abuse smaller shareholders.

Capital Markets and Valuation

- Investor protection promotes the development of external capital markets.
- When investors are assured of receiving fair returns on their funds, they will be willing to pay more for securities.
- Thus strong investor protection will be conducive to large capital markets.
- Weak investor protection can be a factor in sharp market declines during a financial crisis.

Economic Growth

- The existence of well-developed financial markets, promoted by strong investor protection, may stimulate economic growth by making funds readily available for investment at low cost.
- Several studies document this link.
- Financial development can contribute to economic growth in three ways:
  - It enhances savings.
  - It channels savings toward real investments in productive capacities.
  - It enhances the efficiency of investment allocation.
Corporate Governance Reform

- Scandal weary investors around the world are demanding corporate governance reform.
- It’s not just the companies’ internal governance mechanisms that failed; auditors, regulators, banks, and institutional investors also failed in their respective roles.
- Failure to reform corporate governance will damage investor confidence, stunt the development of capital markets, raise the cost of capital, distort capital allocation, and even shake confidence in the capitalist system itself.

The Sarbanes-Oxley Act

- Major components:
  - Accounting regulation
  - Audit committee
  - Internal control assessment
  - Executive responsibility
- Many companies find compliance onerous, costing millions of dollars.
- Some foreign firms have chosen to list their shares on the London Stock Exchange instead of U.S. exchanges to avoid costly compliance.

**INTERNATIONAL FINANCE IN PRACTICE**

When Boards Are All in the Family

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That is all to the good, as Mr. Ellison attended fewer than half of Apple’s board meetings anyway. Bill Campbell, another director, is nominally independent but may not be truly so. Mr. Campbell, who chairs the company’s audit committee, qualifies as an independent director, because he is not currently connected with Apple. But he formerly worked at Apple and sold his software company, Claris, to Apple.

Another example is Apple, whose board I was once asked, briefly, to consider joining. Apart from Steve Jobs, the CEO, the board currently has only four members while Mr. Jobs searches for a replacement for his friend Larry Ellison of Oracle, who resigned from Apple’s board in September.

Another member of Apple’s audit committee, Jerome York, is the chief executive of MicroWarehouse, whose Mac Warehouse catalogue was responsible for nearly $150m of Apple’s $5.4bn sales in 2001. As a former chief financial officer for International Business Machines and Chrysler Mr. York is well qualified but his presence on the all-important audit committee had to be treated as an exceptional circumstance by the Nasdaq market.
Such choices, to my mind, can yield bad judgment. In January 2000, for example, Apple’s board awarded Mr. Jobs 20m shares, worth $550m if the share price increased 5 percent over 10 years. They also authorised the company to buy a $90m Gulfstream jet for him. The share price sank, putting Mr. Jobs’s options under water. So the board granted him 7.5m more shares. At the time of the grant, Apple shares were underperforming other stocks in their industry sub-class by 28 percent.

There is plenty of evidence that public scrutiny and a spotlight can help improve corporate governance. The California Public Employees’ Retirement System began pressing underperforming companies to change the composition of their boards in 1993. Calpers drew up a list of corporate governance standards: make independent directors a majority on boards; let these directors meet the chief executive separately three times a year; make boards perform an annual assessment of their own performance, and so on.

A study by Wilshire Associates looked at the performance of 62 companies named by Calpers as poor performers. These companies’ stocks underperformed the Standard & Poor’s 500 index by an average of 89 percent in the five years before they were singled out. After the spotlight was shone on them, they outperformed the index by an average of 23 percent over five years.

This does not, of course, mean all companies will fail without a model board of directors. At Warren Buffett’s Berkshire Hathaway, the seven directors include Mr. Buffett’s wife, his son, his business partner Charlie Munger, a partner at his company’s law firm and a co-investor with Berkshire Hathaway in other companies.

Mr. Buffett makes a persuasive argument that the best directors may well be those who have the greatest personal economic stake in the company. But the correlation of seduced boards with underperforming or ethically flawed enterprises suggests that independent overseers are much less likely to give into temptation or corruption.
Chapter 18
Corporate Governance and the International Market for Corporate Control

18.1 The Terminology of Mergers and Acquisitions
18.2 Corporate Governance
18.3 The International Market for Corporate Control
18.4 The International Evidence on Mergers and Acquisitions
18.5 Summary

Corporate governance

- Corporate governance refers to the way in which stakeholders exert control over the corporation
- There are 3 ways to obtain control over another firm’s assets
  - acquisition of another firm’s assets
  - acquisition of another firm’s stock
  - merger or consolidation
- Mergers and acquisitions are becoming increasingly important

Corporate governance systems

- **Market-based**
  - Australia
  - Canada
  - Ireland
  - U.K.
  - U.S.

- **Bank-based**
  - Germany
  - Japan

- **Families or the State**
  - Family/State: Indonesia, S. Korea, Saudi Arabia
  - Family: Mexico, Italy, Spain
  - State: China, Singapore

### Investment-based market entry

**Mergers and acquisitions**

- FDI: plant expansions
- FDI: new investment

Source: Ernst & Young

### Corporate governance systems

<table>
<thead>
<tr>
<th>Country</th>
<th>Equity concentration</th>
<th>Bank ownership of equity</th>
<th>Supervisory board</th>
<th>Hostile acquisitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>High - lead bank</td>
<td>Unlimited equity ownership</td>
<td>Outside directors, bankers, labor representatives</td>
<td>Rare - approval of lead bank and 75% of shareholders</td>
</tr>
<tr>
<td>Japan</td>
<td>High - main bank, keiretsu or business partners</td>
<td>Limited equity ownership (5% maximum)</td>
<td>Inside managers, bankers, keiretsu members, business partners</td>
<td>Rare - blocked by cross-holdings with keiretsu or business partners</td>
</tr>
<tr>
<td>United States</td>
<td>Low</td>
<td>No direct equity ownership</td>
<td>Inside managers, outside directors</td>
<td>Proxy contests and tender offers</td>
</tr>
</tbody>
</table>

Source: Butler / Multinational Finance, Chapter 18 Corporate governance & the international market for corporate control
Financial modernization in the U.S.

- Gramm-Leach-Bliley Financial Services Modernization Act (1999)

  Repealed Glass-Steagall separation of
  - commercial banking
  - investment banking
  - insurance
  - brokerage

Universal banking in Germany

- German banks offer a wide range of financial services, including
  - commercial banking
  - investment banking
  - insurance
  - brokerage

Japanese keiretsu

- Types
  - Horizontal keiretsu
  - Vertical keiretsu

- Characteristics
  - Extensive share cross-holdings
  - Personnel swaps
  - Strategic coordination
  - Commercial transactions

Japanese keiretsu

- Types
  - Horizontal keiretsu
  - Vertical keiretsu

- Characteristics
  - Extensive share cross-holdings
  - Personnel swaps
  - Strategic coordination
  - Commercial transactions

Mitsubishi’s horizontal keiretsu

<table>
<thead>
<tr>
<th>Mitsubishi Corporation</th>
<th>Bank of Tokyo-Mitsubishi</th>
<th>Mitsubishi Heavy Industries</th>
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<tbody>
<tr>
<td>Automotive</td>
<td>Finance &amp; insurance</td>
<td>Industrial equipment</td>
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<tr>
<td>Mitsubishi Fuso Truck Bus</td>
<td>DC Card</td>
<td>Mitsubishi Electric</td>
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<td>Mitsubishi Motors</td>
<td>Diamond Lease</td>
<td>Mitsubishi Kako</td>
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<td>Deere &amp; Caterpillar Mitsubishi</td>
<td>Mogi Life</td>
<td>Mitsubishi Precision</td>
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<td>HIT</td>
<td>Mitsubishi Auto Credit</td>
<td>Toyoh Engineering Work</td>
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<td>Electronics &amp; Telecom</td>
<td>Mitsubishi Securities</td>
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<td>IT Frontier</td>
<td>Mitsubishi Trust &amp; Banking</td>
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<td>Mitsubishi Research Inst</td>
<td>Tokyo Marine &amp; Fire</td>
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<td>Nikon</td>
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<td>Resources &amp; energy</td>
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<td>Gas &amp; Oil</td>
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<td>Mitsubishi LPG</td>
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<td>Mitsubishi Nuclear Fuel</td>
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<td>Mitsubishi Paper Mills</td>
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<td>Real estate &amp; construction</td>
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<td>Mitsubishi Estate</td>
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<td>F. S. Mitsubishi</td>
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The post-war keiretsu

**Mitsubishi**
Bank of Tokyo-Mitsubishi
Mitsubishi, Nikon, Kirin Beer

**Sumitomo**
Sumitomo Bank
NEC

**Mitsui**
Sakura Bank
Toshiba

**Fuyo**
Fuji Bank
Marubeni

**Dai-Ichi**
Dai-Ichi Kangyo Bank
Nissan, Canon

**Sanwa**
Sanwa Bank
Kobe Steel

Financial modernization in Japan

- Mitsubishi Tokyo Financial Group
  - Bank of Tokyo-Mitsubishi

- Mizuho Holding Financial Group
  - Dai-Ichi Kangyo Bank (Dai-Ichi Keiretsu)
  - Fuji Bank (Fuyo Keiretsu)
  - Industrial Bank of Japan

- Sumitomo Mitsui Banking Corp
  - Sumitomo Bank (Sumitomo keiretsu)
  - Sakura Bank (Mitsui keiretsu)

- UFJ - United Financial of Japan
  - Sanwa Bank (Sanwa keiretsu)
  - Tokai Bank (Tokai keiretsu)
Similarities in executive turnover

- Cross-border similarities in top executive turnover
  - Higher executive turnover in firms suffering a sharp decline in equity value
  - Higher executive turnover in firms reporting poor earnings performance

Differences in executive turnover

- Cross-border differences in top executive turnover
  - In bank-based systems, turnover tends to be initiated by the lead bank (Germany) or the principal shareholders (Japan)
  - In market-based systems, control contests are held through proxy contests or directly in the marketplace through tender offers
Cross-border financial service M&A

- Commercial banking
  - 2001 Citigroup buys Grupo Financiero (Mexico) for $12.8b
  - 2000 HSBC buys Credit Commercial de France for $11.1b
  - 1998 Deutsche Bank buys Bankers Trust for $9.7b
- Investment banking
  - 2000 UBS AG (Swiss) buys PaineWebber Group for $16.5b
  - 2000 Credit Suisse buys Donaldson Lufkin Jenrette for $13.5b
- Insurance
  - 2001 Fortis (Belgium) buys Fortis (Netherlands) for $12.5b
  - 1999 Aegon NV (NL) buys TransAmerica for $10.8b
  - 1998 Allianz AG Holding (Germany) buys Assurances Generales de France for $10.0b

Privatizations and equity market growth

Privatizations of state-owned enterprises in transition economies

- Privatizations of state-owned enterprises are usually conducted as a
  - Voucher program
  - Management buyout (MBO)
  - Mass privatization program (MPP)
- Effective legal and corporate governance systems are prerequisites for a successful transition to a market economy

Russia’s troubled privatization

- Russia: 1992 through 1996
  - State-owned enterprises were privatized through vouchers distributed to Russian citizens
  - Managers repurchased these shares and retained controlling interests in most firms
  - Fraud was rampant, and foreign investors were often disenchanted
  - Financial oligarchs established control over Russia’s commercial banks and natural resource firms
- Russia’s privatization program had trouble because it was conducted without concurrent reforms in Russia’s legal, regulatory, and administrative systems

Relatively successful privatizations

- Poland: 1991 through 1995
  - Poland promoted the growth of free enterprise
  - State-owned assets were slowly sold to investors
  - Strong labor unions monitored managers
- Czech Republic: 1991 through 1995
  - Assets of 350 state-owned firms were sold to investors
  - 1,809 firms were privatized through vouchers
  - Most vouchers were reinvested in diversified investment funds that promised to monitor managers
- These transitions were relatively successful because these countries developed institutions that promoted good corporate governance
The winners and losers

• Target firms
  – Target firms shareholders receive large gains during the announcement period

• Bidding firms
  – The shareholders of U.S. acquirers may or may not win
  – The shareholders of acquirers from outside the United States are more likely to win

Contributing factors

• Method of payment - Cash offers are more likely to benefit bidding firm shareholders
• Free cash flow - Firms with free cash flow often waste it
• The tax environment - M&A can facilitate the transfer and realization of tax benefits
• Real exchange rates - A strong domestic currency helps domestic acquirers

The benefits of multinationality

• A firm’s multinationality contributes to its success in cross-border M&A
  – Multinationality increases the value of firm-specific, intangible assets
  – Multinationality increases the value of cross-border acquisitions in related businesses
  – Prior international experience increases the value of entry into new markets

Caveat

• Further research will surely modify and extend the conclusions reported here
• Indeed, increasing competitiveness in the international market for corporate control is likely to change some of the conclusions

Topics in International Financial Reporting

International financial disclosure and transparency issues
Incentives for off-balance sheet liabilities
Hedge accounting
Lease accounting
Footnote disclosures
Intercorporate equity investments
International financial reporting differences and inflation

Cases for MS&E 247S International Investments Summer 2006

Topic 8: International Financial Innovations
Case—Deutsche Bank: Discussing the Equity Risk Premium.
Case—Swedish Lottery Bonds.
Case—Bank Leu’s Prima Cat Bond Fond.
Case—Catastrophe Bonds at Swiss Re.
Case—Mortgage Backs at Ticonderoga.
Case—KAMCO and the Cross-Border Securitization of Korean Non-Performing Loans.
Case—Nexgen: Structuring Collateralized Debt Obligations (CDOs).
Case—The Enron Odyssey (A): The Special Purpose of SPEs.
The board has asked Ron Tolbert, an employee in the Risk Assessment and Control Group, to analyze three SPE transactions executed by Enron executives: the Destec, Rhythms, and Fishtail/Bacchus transactions, which were prominently featured in the Examiner’s Report in the ensuing Enron bankruptcy. Tolbert’s job is to assess why Enron used SPEs for these transactions, whether risk was successfully transferred off the balance sheet, and whether risk transfer was the only motivation.

**Learning Objective:**
To learn about structured finance.

**Subjects Covered:**

**Setting:**
Houston, TX; Energy; $100 billion revenues; 50,000 employees; 2001

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**The Enron Odyssey (A): The Special Purpose of “SPEs”**

**Subjects Covered:**

**Setting:**
Houston, TX; Energy; $100 billion revenues; 50,000 employees; 2001

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**SPE “Special Purpose Entity”**
Yes, Many of them!!!

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**The Enron Odyssey (A): The Special Purpose of “SPEs”**

**Description:**
Enron had set its sights much more than a successful utility company and energy trading firm. By hiring the most talented professionals and providing them with the autonomy to lead the company and sell markets, Enron aimed at becoming the world’s leading company.12 To do this, management felt it was important to stay flexible and mobile; this meant moving away from the traditional asset-intensive model most companies of its kind operated on.13 Enron entered into a new market as an intermediary, it did not want to hold a significant net position “long” or “short” in that market’s underlying commodity.14 Investments in long-term physical assets were fixed by nature, required costly financing, and made the company vulnerable for changes in market prices.15 The firm’s objective was to be a “market maker,” evolving efficiencies that were not available before, and to be hedged appropriately with respect to market risk. The Enron positions Enron was willing to take were those on the strength of its employees and on the benefits available from market deregulation.

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**Special Purpose Entities (SPEs)**

Offers the most effective route to achieving a goal in a straight line. Achieving economic or business objectives in the most direct and expeditious way with unpredictable consequences for a company’s balance sheet or tax position. By taking advantage of opportunities offered through inceptions in the capital markets, a company can use more easily approach to achieving commercial objectives, without compromising shareholder value. The advantage will be realized from trading, but not change. Simply opening up an alternative source of funding or not transfer may reduce costs.16

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The term “special purpose entity” applies to certain legal structures that were used to achieve a variety of goals in complex fashion. A special purpose entity (SPE) is, synonymously, a special purpose vehicle (SPV) into a pipeline-like legal entity created by a firm to carry out a particular activity or series of transactions. Whatever the “special purpose.” In other words, an SPE typically had no other purpose than carrying out the set of transactions it was created for. SPEs came in a variety of forms such as limited partnerships, limited liability companies, trusts, and corporations. They were typically created and operated in “business-friendly” jurisdictions (e.g., Delaware and the Cayman Islands when setting up companies was relatively simple and corporate taxes were advantageous for the SPE’s control investors.
Watch where all the cash flows went!

Securitization—Skilling says that Enron can convert these contracts [assets and liabilities] to cash anytime it choose by "securitizing" them, or selling them off to a financial institution.

Securitization

Accounting standards mandate that Enron's assets and liabilities from its wholesale business be "marked to market"—that is, at their market price, at a point in time. Changes in the valuations are reported in profits. But these mark-to-market cash flows at the moment they are recorded. Skilling says that Enron can convert these contracts [assets and liabilities] mentioned above to cash anytime it chooses by "securitizing" them, or selling them off to a financial institution. Let the modern "securitization" be a way of taking advantage of the balance sheet. If all that the rate of exchange, changes in the valuations of the assets and liabilities will then be transferred to the investor.

—Barry McCaffrey, Enron
Synthetic Lease

Under an operating lease, a company was able to recognize its payments toward the property as an expense rather than having them show up on its balance sheet as long-term debt. This made the balance sheet and certain leverage ratios appear more favorable to the common investor.

However, in a synthetic lease structure, the company was also able to claim for tax purposes that it was the owner of the property. Therefore, it would be able to deduct its payments for the property as interest payments on debt (rather than as a rent expense).

The bet is that financial accounting standards will honor the transactional form of a lease at the same time that the federal income tax law will perceive that the tenant has made an investment in a depreciable asset with borrowed funds.

A synthetic lease worked as follows: an SPE was created for the sole purpose of borrowing funds, purchasing a new piece of property, and leasing it to a company (the “lessee”). The SPE borrowed from a bank or investors to raise the necessary funds to purchase a property. It’s ability to raise capital was tied to the future lease payments coming from the lessee.

In simplified form, a synthetic lease worked as follows: an SPE was created for the sole purpose of borrowing funds, purchasing a new piece of property, and leasing it to a company (the “lessee”). The SPE borrowed from a bank or investors to raise the necessary funds to purchase a property. It’s ability to raise capital was tied to the future lease payments coming from the lessee. Typically, the SPE was able to obtain a lower rate than the lessee because the financial instruments used to finance the property were viewed as different from the lease agreements. The SPE was able to receive a lower rate because it was viewed as the owner of the property.

However, the lease terms were specifically designed to avoid capitalization under the criteria imposed by the Financial Accounting Standards Board (FASB) Statement No. 13 (the accounting standard to be applied to determine whether a lease is an operating lease or a capital lease). In particular, the lease term was less than 75% of the useful life of the asset, and the present value of minimum lease payments was less than 90% of the fair value of the asset. Additionally, there would be no automatic transfer of asset to lessee. Hence, the property would not be shown on the balance sheet of the lessee, and the lessee would instead report its lease only as an operating expense for accounting purposes.
Off Balance Sheet Accounting

SPE Accounting Conditions

On September 29, 2000, the FASB issued Statement No. 140 as a replacement for Statement No. 125. The statement, titled “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” consolidated and updated many of the existing guidelines governing the use of SPEs in securitization transactions. According to the guidance in FASB 140, the transfer of assets could be accounted for as a sale if the following three conditions were met:

1. The transferred assets had been isolated from the transferor and its credit, even in the hands of the SPEs or other recipients.
2. Each transferee had the right to pledge or retransfer the assets for its own protection. The condition both relieved the transferee of taking advantage of its right to pledge or retransfer and provided more than token protection for the transferee.
3. The transferor did not maintain effective control over the transferred assets through either (a) an agreement that both entitled and obligated the transferee to retransfer or repurchase or reclaim from before maturity, or (b) the ability to significantly affect the holder to return the specific assets, other than through a clean sale.

These conditions allowed a company to use SPEs to achieve “off-balance sheet” accounting. In other words, if these conditions were met, a company was not required to report the assets and liabilities of the SPE in its financial statements.

Among other changes, the Emerging Issues Task Force (of EITF Issue Number 90-15) “consensus suggested that a “qualified special purpose entity” (QSPE) needed to have a minimum investment of third-party “outside equity” equal to 3% of the SPE’s assets’ value. This minimum investment assured that there was an actual transfer of risk taking place and that the residual economics of the assets were held by investors “outside” of the assets’ sponsor/transferor. Furthermore, EITF 90-15 specified that an outside party must have a controlling financial interest in the SPE (i.e., 50% or more of the voting interest).

Evolution of lease accounting: Overview of the two approaches

Stained Financial Innovations

Contribution: Many Loopholes Are Now Closed