

Case 92-6

Build-Lease Transaction

Discovery Chemical Corporation (DCC) is a multinational chemical manufacturer with world-wide operations. DCC is contemplating entering into a "build-lease" transaction to finance the construction of a Polyvinyl Chloride (PVC) manufacturing facility. The facility is expected to have an economic life of 30 years and would be constructed on property owned by DCC adjacent to the customer and to the primary raw material source. The transaction would be structured whereby the lessor would be a special-purpose entity (SPE) formed to be both the owner and lessor of the facility. The SPE will be a subsidiary of a substantive corporation unrelated to DCC, which will make an equity investment in the SPE of 3% of the construction cost of the facility. The equity investment in the SPE would be made during the construction of the facility and would not be withdrawn for the term of the lease. DCC would proceed as agent for the SPE to manage construction and engineering to ensure that the facility meets design specifications. The SPE would fund the construction by issuing notes to third-party lenders and raising an investment in the form of equity from independent third parties.

Upon completion of construction, DCC would lease the facility from the SPE. The principal provisions of the lease would be as follows:

- The lease payments will be equal to the principal and interest due on the notes plus a return on the equity invested by the third-party investors.
- The initial lease term is expected to be 10 years. The lease will contain ordinary renewal options giving DCC the right to extend the lease term for additional periods.
- At the end of the lease term, DCC has an option to purchase the facility for the fair value at the option exercise date. Fair value at the end of the lease term will be established by an independent appraisal at lease inception. This amount will equal the balance of the lessor's equity and notes outstanding, and will approximate 25% of the initial cost. If DCC chooses not to exercise this option, it must make a residual guarantee payment. In the event that DCC does not exercise its purchase option, the SPE will sell the facility to repay the notes and recover its equity.

DCC, while not the legal owner, will be the tax owner for federal income tax purposes.

Because of the relative significance of the transaction, DCC would prefer not to record a liability on its balance sheet. DCC is, therefore, concerned about how the transaction would be accounted for under FASB Statement No. 13. DCC is also concerned about the consensus reached in EITF Issue No. 90-15 which requires that an SPE be consolidated when all of the following conditions exist:

- 1) Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.
- 2) The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as, for example:
 - a) The lease agreement.

- b) A residual value guarantee through, for example, the assumptions of first dollar of loss provisions.
 - c) A guarantee of the SPE's debt.
 - d) An option granting the lessee a right to purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or, alternatively, the lessee may receive any of the lessor's sales proceeds in excess of a stipulated amount.
- 3) The owner of record of the SPE has not made a substantive residual equity capital investment that is at risk during the entire term of the lease.

In addition to the above, you have learned that DCC does not believe that the location or any other attribute of the facility makes it more valuable to DCC than to other parties. Further, DCC does not believe that economic penalties exist that may cause it to extend the lease.

Required:

- How should DCC account for the SPE?
- How should DCC account for the lease with the SPE?