ENRON AND THE SPECIAL PURPOSE ENTITY – Use or Abuse? – The Real Problem – the Real Focus

I. INTRODUCTION

In December of 2001, Enron Corporation, one of the nation's largest energy and gas providers, filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code; one of the largest corporate bankruptcy filings at that time[1]. A myriad of scholarship, books, and articles have been written on Enron's meteoric rise and fall. The failure in oversight that permeated Enron's corporate gatekeepers such as Enron's Board of Directors and upper management, its public accountants Arthur Andersen, the Securities and Exchange Commission, and other professionals who were tasked to navigate the Enron empire, was disturbing and disconcerting on a number of levels; not the least of which being the blow to investor confidence; the foundation on which the capital markets are built.

On the heels of Enron's debacle came the Sarbanes Oxley Act of 2002[2]; the far reaching legislative reform which in theory was designed to "shore-up" the accounting and corporate governance shortfalls that the legislature and the investing public believed was what allowed Enron to do what it did unabated. Supplementing the reforms set forth in the Sarbanes Oxley Act are a number of accounting rules, guidelines, and interpretations, which in theory are designed to curtail the type of accounting fraud Enron perpetrated through its use (or more accurately abuse) of what are referred to as Special Purpose Entities ("<u>SPEs</u>", or Special Purpose Entities). Although much has been written chronicling and analyzing the various aspects of the Sarbanes Oxley Act, little has been written analyzing the accounting guidance related to special purpose entities.

Since the Enron debacle, a dark cloud has been cast over the Special Purpose Entity by the investment and financial community. The line distinguishing the difference between Special Purpose Entity use and Special Purpose Entity abuse has been blurred to the point where the use of such entity and its abuse are considered one in the same; i.e. that special purpose entities by their very nature are these ominous, nefarious, inherently evil entities whose only purpose is to defraud, obfuscate and manipulate financial statements. The purpose of this piece, among other things, is to challenge this assumption and conclusion.

THESIS

The focus for this paper is to take a look at both the new accounting rules in the "post-Enron" era that have been enacted, in significant part, due to what happened with Enron and its SPE use, as well as the accounting rules in effect during both the "pre" and "post-Enron" eras related to SPEs. This article examines the accounting reforms and legislative approaches currently being taken regarding accounting for and disclosures of SPEs. This piece questions whether or not those approaches are in fact the correct ones. The argument being that the accounting practices Enron exercised with its financial reporting was not due to deficiencies in the rules that were in effect at the time, but were

[1] Richard A. Oppel Jr. & Andrew Ross Sorkin, *Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 1, 2001, § A at 1.

[2] Sarbanes Oxley Act of 2002, 15 U.S.C.A. 7201.

due to persons within the Enron organization that were determined to circumnavigate those rules regardless of their sufficiency.

The article will examine closely the method and manner by which Enron perpetrated such fraud, with the goal of demonstrating that it wasn't a lack of accounting rules or deficient interpretive accounting guidance that resulted in Enron's improprieties related to SPEs, but instead was dishonest and fraudulent behavior by Enron management that was the real problem. The next part of the piece will cite and critique both current rules and some proposed accounting reforms being considered, analyzing their current and potential effectiveness, with the goal of highlighting reasons why the proposed reforms may not meet their desired or stated objectives. Finally, the piece will explore and suggest some alternative approaches once the issue has been reframed. In the alternative, this piece, in essence, suggests that enforcement efforts should be focused on the SPE abusers instead of the SPEs themselves.

The overall goal of this piece is to question whether we should be taking a different approach to financial fraud in the area of Special Purpose Entities than the path currently being taken; the end result being that we will ultimately be making it more difficult and more costly for the myriad of legitimate Special Purpose Entity use that may or may not be able to continue in light of the accounting and disclosure requirements currently in place and that have been enacted to a large degree in response to what occurred with Enron.

II. WHAT IS A SPECIAL PURPOSE ENITY?

A. SPEs Historically

To understand why or more importantly how Enron perpetrated the financial accounting fraud that it did, we must first understand from a general standpoint what an SPE is, and more importantly, how it works. "Until recently, many people in the accounting profession, including accounting educators, never heard of SPEs. Some who heard of these esoteric financing vehicles knew little about how they operated or the accounting standards that guided the accounting and financial reporting by companies who sponsor SPEs. Reports in the popular press that preceded Enron's Chapter 11 filing in December 2001 introduced many accountants for the first time to the topic of SPEs and sent many CPAs scrambling to understand the generally accepted accounting principles (GAAP) related to these entities. Even though SPE financing vehicles have been around for about two decades, they failed to capture the attention of many participants in the mainstream of accounting discourse. A search for references to SPEs in financial accounting textbooks yields virtually no results, and a search of the academic and professional accounting literature provides, at best, a limited explanation of this accounting area.[3]

[3] Bob Jensen, *Bob Jensen's Overview of Special Purpose Entities*, http://www.trinity.edu/rjensen/theory/00overview/speOverview.htm (last visited Feb. 21, 2006).

B. What are SPEs? – A Look at the Various Forms

Though SPEs are considered to be complex and complicated entities, the general premise of a special purpose entity is simple. An SPE is an entity formed for a discreet and isolated purpose; to adhere to a specific business or economic objective; a simple premise or starting off point from which the concept builds.

The idea behind the Special Purpose Entity is to narrow the scope of risk to the assets and liabilities placed in the special purpose entity, such that potential investors or equity holder's fortunes or misfortunes will be based entirely and exclusively on what occurs with respect to the assets and liabilities placed within the SPE. Note, this is the general idea but there are a number of variations on this single theme.

Generally, SPEs fall into three categories, the joint venture, the synthetic lease, and the asset securitization or "off-balance sheet financing". Granted, their can be a number of variations on these three major themes, but the vast majority of SPE transactions fall in one of the three. Each type will be discussed in turn.

(i) The Joint Venture:

The Joint venture. Perhaps the most basic and straight-forward SPE type. In a joint venture, two or more parties come together and engage in a "venture" that is separate and apart from the respective entities[4]. The conduit through which such ventures can occur is the SPE. This conduit can take any number of forms, a partnership, a corporation, a trust, an LLC, etc. Understand, it's the entity's purpose, not its legal form from which the SPE moniker is derived. A typical joint venture may be the construction of a gas pipeline for example to conduct off-shore oil drilling.[5] In this instance, the entire scope of the venture will be transferred to a separate and discreet business entity apart from the respective companies. The SPE will own both the assets and liabilities associated with the project.

As was mentioned earlier, the SPE is designed to conduct just that one pre-specified and isolated activity. Accordingly, potential investors in the venture are attracted to the venture because the cash flows and risks of the venture are clearly specified by design and are isolated from any risks associated with the respective corporations as a whole.[6] By contrast, where one makes an investment in a fully integrated corporation, the corporate management can engage in a variety of endeavors and activities that were not specified by prior agreement with the investor[7], thereby

4 *See* Cornell Law School Legal Information Institute, http://www.law.cornell.edu/wex/index.php/Joint_venture (giving an overview of a joint venture) (last visited Feb. 21, 2006).

5 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 104 (Julia Brazelton, ed.).

6 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 104 (Julia Brazelton, ed.).

7 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 104 (Julia Brazelton, ed.).

making the investor vulnerable to the corporation's fortunes as a whole; market downturns, unprofitable divisions, ineffective management, poor expansion choices, etc.

Accordingly, when it comes time to invest in a project with well-defined risk and return parameters, many investors prefer the isolated and uniquely identifiable nature of an SPE to a more diffusely defined corporate form[8]. For this reason, SPEs have been used for some time as a preferred form of financing for large international projects and other projects with well-defined cash flows and risk characteristics[9]. To insure that the SPE operates in the manner the venturing parties contemplated, the chartering documents (such as the articles of incorporation, the partnership agreement, or the operating agreement as applicable), will narrow the SPEs scope to only those permitted activities.

Key things to observe with the SPE used in the joint venture context. The first is that with the joint venture, the business purpose and rationale for entering into such ventures are clear. The design and structure of such ventures and what they are trying to do and accomplish, for the most part make sense as well. Provided proper formation occurs and proper protocols are followed, the use of the SPE in the joint venture context is a legitimate and non-controversial use of the Special Purpose Entity.

(ii) **Synthetic Leases**:

(a) **The Typical Synthetic Lease Structure**

The second category where we see SPEs used as an integral part of a transaction is what is referred to as the synthetic lease. A typical synthetic lease example; ABC Company wants the use of a building for its corporate offices for the next 20 years. The land and building would cost $100 million to buy. Alternatively, ABC forms a separate legal entity, an SPE to purchase the building. The SPE in turn borrows the necessary funds to acquire the building. The financial institution may loan the SPE up to 90% of the fair market value of the real estate. The loan is secured by the building. The remaining 10% of the cost is put up by an outside equity investor. The outside investor owns 100% of the shareholder equity in the SPE which results in all of the outside equity being owned by someone other than the sponsoring corporation.

Corporate Motivation behind the Synthetic Lease

The synthetic lease (also known as an "off-balance-sheet lease," or "off-balance-sheet loan," or a "master lease") is a financing structure used by many public companies to finance up to 100% of the cost of acquisition of certain real and personal property at a favorable cost. It is a structure with a split personality — it is accounted for as an operating lease, but treated for economic and tax purposes as a financing transaction, and

8 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 104 (Julia Brazelton, ed.).

9 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 104 (Julia Brazelton, ed.).

it gets the most favorable treatment in each case. As a result, it can satisfy a number of apparently inconsistent needs.[10]

The tension in the synthetic leasing area is this. Real property and the debt and expense associated with it are usually undesirable additions to the financial statements of a company. Under GAAP, the "end-user" in a synthetic lease transaction, that is, the entity that leases the property and becomes the tenant does not carry the asset or the debt on its financial statements, hence the term “off-balance sheet.” Because neither the asset nor the debt associated with it is carried on the balance sheet, the balance sheet is freed of a non-producing real estate asset and the burden of the attendant debt. The debt-to-equity ratio and other financial ratios derived from the balance sheet are improved as a result. The effect may be to enhance the company’s borrowing capacity and its stock price. Few accounting and securities disclosures are required. Because the property does not appear on the end-user’s income statement, for GAAP accounting purposes, neither interest deductions nor book depreciation are deducted from revenues. Rental payments are deducted, but the amount of those payments is lower than the sum of the items that are not included. The effect on the income statement is to increase reported earnings. This improves return on equity, return on assets and debt coverage ratios, and may also increase share price, especially if the company is in an industry such as high technology, where the corporation’s share price is sensitive to a price-earnings multiplier.[11]

On the other hand, for tax cash-flow, economic and operational purposes, the end-user treats the transaction as if it has borrowed the funds necessary to purchase and develop the property, and as if it owns the property. It depreciates the property and takes the interest deduction for federal income tax purposes, instead of recording the payments as rental expense. The effect is to increase deductions, concomitantly to drive down taxable income and tax liability, and therefore to increase cash flow. In addition, the end-user gets full control of development, construction, management and disposition of the property and the real economic benefit of any appreciation of the property, advantages not usually available to a tenant.[12]

As a third benefit, the lease structure has many of the advantages of a so-called "structured financing," that is, a financing structure in which the real estate asset is

[10] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[11] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[12] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

separated from the bankruptcy risks of the owner or the former owner of the asset. This feature makes the transaction more attractive to the capital markets and drives down the total cost of the financing, which makes the synthetic lease one of the cheapest sources of real estate financing. The rate may be two to three hundred basis points (that is, two to three percentage points) lower than if the transaction were priced as a conventional loan at prime rates. Up to one hundred percent of the cost of the project (including acquisition, development and construction costs, soft costs and the cost of personal property acquisition) is financed, and often the lease payments are equal to interest-only payments on the amount financed. This all means increased income (which may increase stock price) and better cash flow for the end-user.[13]

Because of the complexity and the structuring and transaction costs, synthetic lease transactions are generally large. It is difficult to justify a synthetic lease structure for an acquisition of less than $10 million, although as real estate professionals are becoming more familiar with synthetic leases, and more facile in structuring and documenting them, the transaction costs are declining.[14] The synthetic lease structure is not limited to the acquisition or construction of only one facility. A transaction can be structured for a number of different properties under the same financing facility, thereby driving down costs on a per-property basis and making feasible the leasing of less expensive single properties. And in at least one transaction, a synthetic lease was used to provide nearly one-third of the financing for a $1.8 billion acquisition of one company by another.[15]

(b) Accounting Treatment for Synthetic Leases

(1) Operating vs. Capital Lease

The accounting for leases in general under GAAP is based on the view that a lease transaction that transfers substantially all of the benefits and risks of ownership should be accounted for as the acquisition of the asset and the incurrence of an obligation by the tenant. Such a lease is characterized by the tenant as a "capital lease." This

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13 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

14 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

15 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

treatment requires that the asset and the obligation associated with it be carried on the company's balance sheet.[16]

In other cases the tenant should account for the lease as an "operating lease," or a true rental arrangement.[17]

FASB No. 13 provides that if a particular lease meets any ONE of the following classification criteria, it must be accounted for as a capital lease:

(1) The lease transfers ownership of the property to the tenant by the end of the lease term.

(2) The lease contains an option to purchase the leased property at a bargain price. The synthetic lease is structured to fail this and the previous criterion by providing a fixed, market-rate purchase price at the end of the lease term.

(3) The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property. The synthetic lease is structured to fail this test by limiting the term of the lease, such that the lease term does not exceed 75 percent of the leased property's economic life.

(4) The present value of rental and other minimum lease payments equals or exceeds 90% of the fair market value of the leased property. This test is failed by structuring the transaction so that the present value of the rental and other minimum lease payments, including the terminal residual payment due upon lease termination, is less than 90% of the fair market value of the real estate.[18]

If none of the four criteria are met, the tenant treats the lease as an operating lease. The effect of characterizing the lease as an operating lease for accounting purposes is that the debt does not appear on the corporation's balance sheet (although the lease obligation does appear as a footnote in the financial statements). All lease payments appear on the income statement as currently deductible operating expenses.[19] Thus, if structured

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[16] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section V discussing accounting treatment) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[17] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (citing FASB no. 13, summary) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[18] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (citing FASB no. 13, summary) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[19] Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 at note 19 (Section V of the article – commenting on the accounting treatment for capital leases – "If the lease cannot pass these testes for operating leases in FASB No. 13, FASB No. 13 provides that the lease will be treated for accounting purposes as a capital lease. Accountants recognize capital lease interests as an asset on a

correctly, the synthetic lease improves the end-user's return on equity,[20] return on assets,[21] and debt coverage ratios.[22]

(2) Consolidated Income Statement and Balance Sheet Issues

There are two other concerns that must be addressed from an accounting point of view for a synthetic lease. Under certain facts, the end-user and the lessor must consolidate (or combine) their income statements and their balance sheets for GAAP reporting purposes. This would eliminate the off-balance sheet advantage of the transaction to the tenant. The question here is whether the SPE lacks economic substance, and is therefore not a separate entity from the end-user for accounting purposes.[23]

The EITF (Emerging Issues Task Force)[24] has issued guidelines that apply to leasing transactions in which an SPE is the lessor. Under the guidelines, a tenant should consolidate its income statement and balance sheet with the SPE when EACH of the following tests is met:

(1) Substantially all of the activities of the SPE involve assets that are leased to a single tenant. This test is passed in virtually every synthetic lease transaction as most synthetic lease transactions are structured in this manner.

(2) The expected residual risks and rewards of the leased assets and the obligations imposed by the underlying debt of the SPE rest on the tenant. This test is also always passed.

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balance sheet, which must be off-set by a recognition of the payment obligation) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

20 The "Return on Equity" measures the ratio of net income in relation to owner's equity…return on equity measures how successfully management is in utilizing the owner's capital. ACCOUNTING FOR LAWYERS, 344 (David R. Herwitz & Matthew J. Barrett eds., Foundation Press 3d ed. 2001).

21 The "Return on Assets" ratio measures a business's profitability relative to its total assets, usually expressed in terms of average assets, however defined. Most simply, analysts define average assets as the average of beginning and ending assets for the period. ACCOUNTING FOR LAWYERS, 344 (David R. Herwitz & Matthew J. Barrett eds., Foundation Press 3d ed. 2001).

22 The "Debt Coverage" ratio determines how many times a business can cover both interest and the current portion of long-term debt. ACCOUNTING FOR LAWYERS, 340 (David R. Herwitz & Matthew J. Barrett eds., Foundation Press 3d ed. 2001).

23 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section V, B) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

24 The Emerging Issues Task force is an organization formed in 1984 by the Financial Accounting Standards board to provide assistance with timely financial reporting. The EITF holds public meetings in order to identify and resolve accounting issues occurring in the financial world.

(3) The owner of record of the SPE has NOT made an "initial substantive residual equity capital investment that remains at risk during the entire lease term."[25]

Since all of the tests must be met in order for the consolidation requirement to apply, the transaction must be structured to fail the third test. The amount initially invested and actually "*at risk*" of loss by the owners of the SPE must be "*substantive*." There is no safe harbor or bright line test to determine what an initial substantive residual equity capital investment is. Most interpretations of the rule, and the application discussed in the guidelines themselves, seem to indicate that a 3% minimum initial equity investment will be enough to fail the test, and this is followed by most practitioners.[26]

(3) Sale and Leaseback

The second risk from an accounting point of view is that the transaction may be characterized as a sale and leaseback, again eliminating the accounting benefits of the transaction. Statement 98 of FASB 22 provides that the seller in a transaction is precluded from recognizing a sale if it retains an option to purchase or provides guarantees or other provisions that constitute continuing involvement with the property. Because provisions like those are central to the synthetic lease structure, the end-user must avoid obtaining title to the leased property, including the land, prior to the transaction. If the SPE purchases the property directly from a third party, the sale and leaseback problem is avoided. It is also necessary that the end-user avoid guarantees or commitments during the construction period that would make it, in substance, the owner of the project during that period.[27]

(c) Tax Treatment for Synthetic Leases

For federal income tax purposes, the objective is to structure the transaction so that the end-user is characterized as the owner of the leased property, and the transaction is treated as a financing/conditional sale. If the end-user is characterized as the owner of the property, it will be able to deduct interest payments and depreciate the improvements

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25 Sheppard, Mullin, Richter & Hampton LLP*, The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section V, B) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

26 *See infra.* Part III (in-depth discussion of issued involving the 3% minimum equity rule).

27 Sheppard, Mullin, Richter & Hampton LLP*, The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section V, C) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

to the property. The tax standards that must be satisfied are not as clear-cut as the accounting standards.[28]

Although there are a number of factors considered by the courts and by the Internal Revenue Service (the "IRS"), the most important factor is determining whether the landlord or the tenant has the significant "benefits and burdens of ownership". The IRS and the courts look through the form of the transaction and focus on the transaction's economic substance. If, after examining who retains the benefits and burdens of ownership, it appears that the transaction actually is an arrangement of financing, and that the end-user has acquired the property through a conditional sale, it is likely that the transaction will be taxed as a sale. In the court case dealing with this issue, the court found for the taxpayer. The court emphasized the need to examine all the facts and circumstances of the transaction to determine its real substance.[29]

Where…a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of the rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties govern[s] for tax purposes.[30]

Subsequent case law and IRS rulings have followed the *Lyon* case by considering motive, intent, the relationship of the parties to one another, and the reasonable expectation of the parties. IRS rulings, while not necessarily controlling, do give guidance. In *Revenue Ruling 55-540*, the IRS discussed the characterization of equipment transactions as purchases and sales, or as leases. The IRS said that the characterization depends on the intent of the parties and that, in the absence of compelling persuasive factors to the contrary, an intent to treat the transaction as a purchase and sale may exist if, for example, some portion of the payments is recognizable as the equivalent of interest, or if the total rental payments and any option price paid approximated the price that would have been paid for a purchase at the time of entering into the agreement, plus interest.[31]

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[28] Sheppard, Mullin, Richter & Hampton LLP*, The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section VI) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[29] Sheppard, Mullin, Richter & Hampton LLP*, The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (The case referred to in Section VI is *Frank Lyon Co. v. United States*, 435 U.S. 561, (1978)). (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

[30] Frank Lyon Company v. United States, 435 U.S. 561, 583–84 (1978).

[31] Internal Revenue Ruling 55-540, 1955-2 C.B.

The economic reality of the synthetic lease transaction favors treatment of the end-user as the owner. The only real risk to the lessor is that the property will lose substantially all of its residual value. The consensus today is that the transaction will be taxed as the financing of a purchase and development of the property, although this is not a certain result by any means.[32]

If the right tax characterization is not reached, the transaction will be viewed as a lease (with the SPE as the lessor and the end-user as the lessee), rather than a conditional sale from the SPE to the end-user. If the end-user is treated as a lessee by the IRS, it can deduct the lease payments for income tax purposes, but it will not be able to deduct interest payments nor, more importantly, will it be able to depreciate the improvements to the property. It will, in effect, have lost the income tax advantage of the dual character of the synthetic lease structure.[33]

(d) The Argument for Harmonizing the Dual Treatment for Tax and Accounting Purposes

Regarding synthetic leases and the dual treatment for tax and accounting purposes, there is sentiment in the field of academia that this "transactional sleight of hand"[34], should not be permitted. Admittedly, there is a discordant paradox when you have a company that can take the very same transaction and categorize it one way for financial accounting purposes, and another for tax purposes even though the economic substance of the transaction is the same. Some have advocated that the Financial Accounting Standards Board ("*FASB*"), the governing body that sets accounting standards, eliminate the "bright line" tests used for financial reporting purposes and follow the "benefits and burdens" test that the Internal Revenue Service follows; the argument being that the "benefits and burdens" test is based on classifying the transaction based on its economic substance versus an arbitrary classification that conforms to bright-line tests of form.[35]

Likewise, the SEC has noted similar issues in its assessment of the bright-line tests set-forth in determining capital vs. operating treatment for leases. The crux of the

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32 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section VI) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

33 Sheppard, Mullin, Richter & Hampton LLP, *The Synthetic Lease: Off-Balance Sheet Financing of Real Property*, http://www.smrh.com/publications/pubview.cfm?pubID=116 (Section VI) (last visited Feb. 21, 2006) (originally published in the California Real Property Journal, official publication of the Real Property Law Section, State Bar of California, spring 1998).

34 Donald J. Weidner, *Structured Finance, Financial Accounting and Tax Ownership*, 25 J. Corp. L. 445, 486 (2000).

35 Donald J. Weidner, *Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445, 466 (2000).

SEC's argument being that transactions that are similar in terms of economic substance can have very different accounting treatments based on slight variations in the transaction's actual form. For example, the SEC notes, the difference between a lease that commits an issuer to payments equaling 89% of an asset's fair value vs. 90% of an asset's fair value results in different accounting treatment, one qualifying as an operating lease and the other relegated to the less favored status of being accounted for as a capital lease.[36]

In spite of some in the field of academia, as well as the SEC's recognition of the current problems with the existing rules, the SEC nonetheless acknowledges that it would be difficult to change those rules given that lease structuring based on the current accounting guidance is so prevalent. Such efforts to change would likely be met with strong resistance, both from preparers who have become accustomed to designing leases that achieve various reporting goals and from other parties that assist those preparers.[37]

To quantify that number, as of December 31, 2003[38], it is estimated that 63% of the total population of issuers reported having operating leases as a part of their operations, and an estimated 22% reported having capital leases.[39] In terms of the dollar amounts, an estimated $1.2 trillion dollars are tied up in operating leases with another estimated $45 billion tied up in capital leases.[40] With the prospect of all or a significant portion of these operating leases being re-classified resulting in debt recognition on an issuer's balance sheet, it is clear why there would be resistance to significant changes to the current accounting rules. In spite of these interesting issues related to synthetic leases, such is not this article's focus. In explaining SPEs in general, however the piece would not be complete without some discussion of synthetic lease transactions and the current issues related to synthetic leases.

But this article focuses on SPE *abuse*; i.e. a look at an issuer's failure to follow *existing* accounting guidance, which does not appear to be prevalent in the synthetic lease context. The issues with the synthetic lease transaction deal with whether the current accounting regime related to synthetic lease transactions are appropriate even where the

[36] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 63 (2005).

[37] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 63 (2005).

[38] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 29 (2005).

[39] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 64 (2005).

[40] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 64 (2005).

letter of the law is followed explicitly. In sum, the synthetic lease discussion is here to illustrate yet another common transaction in which the SPE is used, and to point out the fact that in spite of some issues that are in flux, SPE use in forming synthetic leases is nonetheless another legitimate use of the SPE structure.

(iii) <u>Asset Securitizations – [Off Balance Sheet Financing] –</u>

Finally, there is the Special Purpose Entity used in the context of Asset Securitizations.

(a) How Asset Securitizations Work

A company that wants to obtain financing through securitization begins by identifying assets that can be used to raise funds.[41] These assets typically represent rights to payments at future dates and are usually in the form of "receivables."[42] The company that owns the receivables is usually called the "originator" or "sponsor". The risk that these payments may not be made on time is an important factor in valuing the receivables. As long as the originator can reasonably predict the aggregate rate of default, however, it can securitize even those receivables that present some risk of uncollectability. Therefore, a statistically large pool of receivables due from many obligors, for which payment is reasonably predictable, is preferable to a pool of a smaller number of receivables due from a few obligors.[43]

After identifying the assets to be used in the securitization, the originator transfers the receivables to the newly formed special purpose corporation, trust, or other legally separate entity. As discussed earlier, the transfer is intended to separate the receivables from risks associated with the originator.[44] For this reason, the originator will often structure the transfer so that it constitutes a "true sale," a sale that is sufficient under bankruptcy law to remove the receivables from the originator's bankruptcy estate.[45] The concept of asset transfers and proper accounting treatment for those transfers will be discussed in later sections.

To raise funds to purchase these receivables, the SPE issues securities in the capital markets. The SPE, however, must be structured as "bankruptcy remote" to gain acceptance as an issuer of capital market securities. Bankruptcy remote in this context means that the SPE is unlikely to be adversely affected if the originator files for

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41 Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

42 "Receivables can be short term (typically due in 30 days), such as trade receivables, which represent the right to payment for goods sold or services rendered, or they can be long term, such as payments due over a period of years under loans, leases, licenses, management contracts, etc." Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 n.7 (1994).

43 Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

44 Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

45 Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

bankruptcy.[46] Insuring that the transaction is structured so that the assets placed in the SPE are bankruptcy remote can be a key factor in inducing investors to buy the securities the SPE issues.

To achieve bankruptcy remoteness, the SPE's organizational structure strictly limits its permitted business activities. The goal is to prevent creditors (other than holders of the SPE's securities) from having claims against the SPE[47] that would enable them to file an involuntary bankruptcy petition against the SPE. Furthermore, an SPE that is owned or controlled by the originator is usually required to have one or more independent directors. The SPE must also attempt to observe all appropriate third party formalities with the originator. These additional steps help to reduce the risk that the originator, if bankrupt, will either cause the SPE to voluntarily file for bankruptcy or persuade a bankruptcy court, in the exercise of its equitable powers, to substantively consolidate the assets and liabilities of the SPE with those of the originator.[48]

(b) How Companies Benefit from Securitization

Through the securitization process described above, the SPE raises funds by issuing securities--usually debt or debt-like securities--and uses the receivables purchased from the originator to repay investors in the future. The investors, therefore, are concerned only with the cash flows coming due on these receivables, and care little about the originator's financial condition as the originator's financial condition has no bearing on a properly formed SPE that is separate and distinct from its originator.[49]

Securitization is most valuable when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the SPE's securities, is less than the cost of the originator's other, direct sources of funding. The SPE's lower cost of funds is passed on to the originator through a higher selling price for the originator's receivables. The goal of securitization, therefore, is to obtain low cost capital market funding by separating all or a portion of an originator's receivables from the risks associated with the originator.[50]

The interest rate necessary to entice investors to purchase the SPE's securities is often a function of the "rating" that the SPE's debt securities receive. Such ratings are determined by various independent private companies that have gained widespread investor acceptance as "rating agencies."[51] Given that most investors, except certain institutional investors in private placement transactions (discussed below), have neither

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[46] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

[47] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 136 (1994).

[48] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 136 (1994).

[49] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 136 (1994).

[50] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 136 (1994).

[51] The most well-known and widely accepted rating agencies are Standard and Poor's Rating Group ("S&P") and Moody's Investors Service, Inc. ("Moody's"). Duff and Phelps and Fitch Investors Service, Inc., are also nationally prominent." Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 n.14 (1994).

the time nor the resources to fully investigate the financial condition of the companies in which they invest, these ratings take on special significance. Investors rely on the assigned ratings to determine the minimum return that they will accept on a given investment.[52]

Companies whose debt securities are rated "investment grade"[53] can usually issue securities in the capital markets at interest rates competitive with, or even lower than, other generally available sources of funds, such as bank loans. The higher the company's rating within the investment grade categories, the lower the company's cost of funds. This reduced cost is a result of the lower interest rate necessary to induce investors to buy the company's securities.[54]

A securitization transaction can provide obvious cost savings by permitting an originator whose debt securities are rated less than investment grade or whose securities are unrated to obtain funding through an SPE whose debt securities have an investment grade rating. Even an originator with an investment grade rating may derive benefit from securitization if the SPE can issue debt securities with a higher investment grade rating and, as a result, significantly decrease the originator's interest costs.[55]

One might expect securitization to be of greatest benefit to riskier companies. This expectation, however, is only partly true. As a company moves toward the extremes of financial instability and towards the brink of bankruptcy, securitization is less of a benefit. At this point, the SPE has a higher than normal risk of being challenged by the originator's trustee in bankruptcy and risk-averse investors tend to avoid these transactions.[56]

Asset securitization does, however, afford companies with acceptable risk levels the possibility of real cost savings. To determine whether an originator will achieve an overall cost savings from securitization, one must assess the interest savings possible (as discussed above) against the costs of the securitization transaction. A company considering securitization should compare (i) the expected differential between interest payable on non-securitized financing and interest payable on securities issued by an applicable SPE with (ii) the expected difference in transaction costs between the alternative funding options. Whether or not the originator will achieve a cost savings partially depends on the way in which the originator structures the securitization because transaction costs can vary over a wide range.[57]

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[52] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994).

[53] "An investment grade rating typically is BBB- or higher from S&P or Bqq3 or higher from Moody's, or the equivalent from the other rating agencies. Such a rating reflects a rating agency's prediction that the securities will be paid on a timely basis. Short term securities, such as commercial paper, are assigned equivalent short term ratings. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 137 n. 15 (1994).

[54] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 137 (1994).

[55] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 137 (1994).

[56] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 137 (1994).

[57] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 138 (1994).

(c) Some Controversial Aspects of Asset Securitizations

Both off-balance sheet financing and gain-on-sale accounting, which result from the peculiarities of SPE accounting are the "hot buttons" with respect to asset securitizations and are the areas from which most of the controversy in this area stems.[58] As securitization evolved into a multi-billion dollar industry, the possible misuse of the accounting provision for SPE reporting has also attracted the attention of accounting regulators and standard-setters. In addition, while the early development of SPEs were focused on the securitization and sale of or transfer of financial assets such as accounts receivables and mortgage receivables, and later leases, the 1990's saw further development of the use of SPEs from the securitization and transfer of many other types of financial assets, derivatives and commitments, such as long-term commitments to buy or sell energy (energy derivatives), broadband capacity, metals and mineral rights, etc.[59]

Despite the accounting questions raised by their use, SPEs have been generally recognized as legitimate financial tools because of the vital role they have played in helping several companies raise capital at reasonable costs. In the United States, the market for asset-backed securities, including mortgage-backed securities (MBS), has grown rapidly over the last three decades.[60] In 2000 for example, more than $400 billion in MBS and an equal amount in other asset-backed securities were issued. The market for MBS and ABS is also large in Europe and Asia. For example, about $150 billion of MBS and ABS capital was raised in Europe in *2000*.[61]

The Proper Accounting Treatment for Asset Transfers

From the very beginning, the use of SPEs by the finance industry has been associated with questions on what should be the proper accounting for transfer of assets to an SPE. The questions revolved around whether an SPE was truly independent from the sponsoring company for the sponsoring company to treat the transfer of its financial assets to the SPE as a "sale." For example, if bank A transfers $100 million of its loan receivables to an SPE at a market value of $110 million, it could recognize a $10 million gain immediately, provided the transfer qualifies as a sale. Otherwise, the bank is forced to recognize the gains over the time it takes the SPE to collect on the receivable.[62]

58 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

59 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

60 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

61 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

62 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

In the 1990's, questions about aggressive use of the gain-on-sale accounting arose with respect to the SPEs of several financial institutions, including, for example, Conseco, Inc. The finance arm of Conseco, called Green Tree Financial Corporation, was acquired by Conseco in mid-1998. Prior to Conseco's acquisition, Green Tree had made heavy use of gain-on-sale accounting for several asset transfers. The income recognized in these transactions had to be later written down by Conseco when the collections on receivables proved to be far less than initially assumed.[63] In early 2000, Conseco took a $350 million write off, which led to a large drop in Conseco's stock price. Several so-called "sub-prime" lenders also faced questions during the 1990s on how they accounted for the transfer of financial assets to SPEs. Examples include Mercy Finance Co. and Delta Financial Corp.[64] These examples illustrate that SPEs can be motivated either by a genuine business purpose, such as risk sharing among investors and isolation of project risk from company risk, or by a specific financial disclosure goal[65], such as gain-on-sale accounting treatment to enhance revenue recognition.

Gain-on-sale accounting has been fingered as the main culprit in the manipulation of earnings and asset values that led to the failures of many sub-prime lenders and mortgage companies in the 1990s. The accounting objective of earnings management[66] was a fundamental motivation for several of the complicated transactions arranged by Enron with SPEs, which will be discussed in detail in section V.

III. ACCOUNTING FOR SPECIAL PURPOSE ENTITIES –"pre-Enron"

With a good overview of the most common ways in which SPEs are used, the next part of the equation is becoming familiar with the proper accounting treatment for special purpose entities. At the outset, we want to keep focus on the competing tensions between the issuers that structure these transactions and the standard-setters whose goal is to insure that SPE transactions are accounted for and disclosed properly.

Generally speaking, with the synthetic lease and asset securitization transactions, the main motivation is to structure the transaction such that 1) the SPE bears the debt obligation instead of the sponsoring corporation; and 2) the sponsoring company is not otherwise required to record the obligation by including the SPE on the sponsor's financial statements on a consolidated basis; and 3) if at all possible, the sponsoring company will record the asset transfer as some form of revenue if the transfer qualifies for such treatment under GAAP.

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63 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 108 (Julia Brazelton, ed.).

64 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 109 (Julia Brazelton, ed.).

65 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 109 (Julia Brazelton, ed.).

66 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 113 (Julia Brazelton, ed.).

Accordingly, we will take a look at the accounting rules relevant to these aspects of the transaction. There are at least two sets of accounting rules that are relevant. The first deals with *balance sheet consolidation* – whether or not SPEs such as synthetic leases or asset transfers should be consolidated or reported separately from the sponsoring entity. The second deals with *sales recognition* – when should the transfer of assets to an SPE be reported as a sale and when should they be reported as a secured financing. These issues typically arise in the asset securitization context in determining whether the sponsor's asset transfer to the SPE should be accounted for as a sale or as a secured financing. Of the two, the more controversial accounting rule is the one dealing with SPE consolidations. This is addressed next.

A. SPE Consolidations – When and under what circumstances is consolidation required – The Consolidation Criteria – "Pre-Enron"

The threshold question with SPEs and the issue with which Enron dealt (although in most cases improperly) is whether or not the SPE must be reported on a consolidated basis with the sponsoring company, understanding that one of the primary motivations behind SPE use is so that the sponsor can raise capital without incurring and recording additional liabilities in the process.

The explosive growth in the use of SPEs has led to debates among managers, auditors and accounting standards-setters as to whether and when SPEs should be consolidated. This is because the intended accounting effects of SPEs can only be achieved if the SPEs are reported as unconsolidated entities separate from the sponsoring entity. In other words, the sponsoring company needs to take care and structure the transaction so that reporting the SPE on a consolidated basis is not required.

In the US, the involvement of the FASB in developing the accounting standards for SPE consolidation effectively started in 1977, when it issued lease capitalization rules to control the use of off-balance sheet financing with leases. Corporate management intent on skirting the new lease capitalization rules appeared to have led to the rapid evolution of SPEs to do synthetic lease transactions (discussed earlier)[67]. In the first of several accounting rules directed at SPEs, in 1984 the Emerging Issues Task Force (EITF) of the FASB issued EITF no. 84-15, "Grantor Trusts Consolidation." However, given the rapid growth of SPEs and their ever-widening range of applications, standard setters were always a step or two behind and were being reactive rather than proactive in developing accounting rules to govern proper accounting treatment and use.[68]

The question of whether a sponsoring company should consolidate an SPE took a definitive turn in 1990 when the EITF, with the implicit occurrence of the SEC, issued a guidance called EITF 90-15. This guidance and the related EITF publication called Topic D-14 *Transactions Involving Special Purpose Entities,* are currently the primary sources for the acceptance of the now infamous three percent rule for SPE non-

[67] Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 114 (Julia Brazelton, ed.).

[68] Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 114 (Julia Brazelton, ed.).

consolidation.[69] The rule states that an SPE need not be consolidated if at least three percent of its equity is owned by outside equity holders who bear ownership risk. Subsequently, the FASB formalized the above SPE accounting rule with Statement No. 125, issued in June 1996, which was later replaced with Statement No. 140 in September 2000.[70]

To understand the specific motivation behind the adoption of the three percent rule, it would be useful to review the regulator's strong concerns about the potential use of SPE financial engineering, as can be seen in the following material from EITF Topic D-14:

> "The SEC Observer announced that the SEC staff is become increasingly concerned about certain receivables, leasing, and other transactions involving special-purpose entities. Certain characteristics of those transactions raise questions about whether SPEs should be consolidated (notwithstanding the lack of majority ownership) and whether asset transfers to the SPE should be recognized as sales. Generally, the SEC staff believes that for non-consolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals). Conversely, the SEC staff believes that non-consolidation and sales recognition are not appropriate by the sponsor or transferor when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor's or transferor's behalf, and the substantive risks and rewards of the assets or the debt of the SPE rest directly or indirectly with the sponsor or transferor".[71]

It does not appear from this discussion of the SEC position that the SEC or the FASB was leaning toward adoption of the loose consolidation standard for SPEs. Nevertheless, the EITF discussion 90-15, which was subsequently issued, made note of the acceptance of the three percent rule. Excerpts from EITF 90-15, mentioning the three percent guideline, are as follows:

> "The initial substantive residual equity investment [for the purposes of non-consolidation of the investment] should be comparable to that expected from a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members

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[69] Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 (Julia Brazelton, ed.).

[70] Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 (Julia Brazelton, ed.).

[71] "Excerpted from FASB EITF Topic D-14, discussed February 23, 1989; May 18, 1989; May 31, 1990." Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 n.8 (Julia Brazelton, ed.).

> believe that three percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances”[72].

An analysis of the above EITF discussion shows that the three percent rule was an ad hoc solution to a specific issue faced by the FASB’s Emerging Issues Task Force and was intended as a short-term band-aid, certainly no more than a guideline of “minimum acceptable investment,” and yet has somehow been transferred by the financing industry and SPE users into a standard practice and permanent fix. More importantly, the rule, in many ways, was a major departure from the normal consolidation rules used for other subsidiaries and entities.[73]

In the US, we generally require full consolidation if a company owns (directly or indirectly) 50 percent or more of the outstanding voting shares of an entity. Thus the three percent rule is a major loosening of the normal consolidation rules[74] and arguably a significant departure from what seems fundamental under GAAP. The motivation (or perhaps justification) for this seems to have been that the SPEs were restricted in their activities by the provisions contained in their chartering documents and thus the parent company could claim lack of control. The parent company only had to show that some other investors did indeed join the SPE venture with a significant exposure (signified by the three percent equity investment) in order to make the SPE economically real[75] and thus obviate the need for the sponsor to report the SPE on a consolidated basis.

Given such liberal criteria for avoiding consolidation, in the “*Pre-Enron*” era, it would seem that issuers who wished to avoid consolidation of their affiliated SPE’s could do so without much effort. Accordingly, had Enron followed these rules as prescribed, their case for innocence would have been much stronger. However, as we will explore in Section IV, Enron’s problems stemmed from departing from these rules (as liberal as they were), as they existed, which subsequently prompted changes in the criteria under which a corporation must consolidate affiliated SPEs. This piece in later sections will examine what these changes entail.

B. FAS 140 – [Sales Recognition - A Sale or a Secured Financing?]

The second aspect of the SPE transaction is the accounting treatment at the juncture where the asset is transferred from the sponsoring entity to the SPE. The two alternative forms of accounting treatment depending on how the transaction is structured

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72 “Excerpted from FASB EITF Discussion 90-15, discussed July 12, 1990; September 7, 1990; November 8, 1990; January 10, 1991; July 11, 1991.” Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 n.9 (Julia Brazelton, ed.).

73 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 (Julia Brazelton, ed.).

74 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 115 (Julia Brazelton, ed.).

75 Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, *in* Enron Meltdown: Facts, Analysis and Recommendations 103, 116 (Julia Brazelton, ed.).

is either 1) recording the asset transfer as a sale; or 2) recording the asset transfer as a secured financing. Again, to understand the competing tensions; if the asset transfer qualifies for sales recognition, then the sponsor can record the proceeds from the transfer as revenue, which in turn increases net income; an overall financial statement enhancement.

On the other hand, if the asset transfer does not qualify for sales recognition, the transaction is then a secured financing. Under this scenario, proper accounting treatment would be to record the proceeds received in exchange for the transferred assets as a debt obligation on its balance sheet. Also, the Originator would be required to record those proceeds as "proceeds from financing activities" on the Originator's cash flow statement.

Sales Treatment vs. Secured Financing

What determines sales versus secured financing treatment is the terms under which the asset transfer occurs. Under Financial Accounting Standard 140, Sales treatment vs. Secured financing is premised upon "control"; who acquires or retains control of the transferring asset. If the Originator retains some form of control over the transferred asset, then sales treatment is not proper.[76] The idea here is that the ties between the Originator and the assets must be severed before sale treatment is proper.

Under this set of accounting rules the potential for abuse is evident. The Originator is looking to reduce his financing costs by isolating a discreet set of assets. The third party "lender" is looking for a profitable investment, by purchasing assets at a relative discount and realizing the profit once collection on the transferred assets occurs and is realized. When structured as designed, everything works well. The Originator enjoys an infusion of needed capital, and the investor enjoys a profit when the revenues from the transferred assets are realized.

But what happens when the motivation for such transactions change? What happens when the motivation for such transactions are merely to achieve accounting results versus real business objectives? What happens when the transferred assets aren't credit worthy at all but the transferor still wants to conduct such transactions to enhance financial statement presentation through improper sales and revenue recognition? What would induce a lender into financing an SPE based on assets whose realization was questionable? This is the backdrop that sets the stage in exploring Enron's SPE abuse.

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[76] Financial Accounting Standards Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125, http://www.fasb.org/st/summary/stsum140.shtml (issued Sept. 2000) (last visited Feb. 23, 2006).

IV. ENRON ~~'S SPE ABUSE~~ AND ITS SPE ABUSE – Painting a (false) Financial Portrait with the SPE Brush

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Almost overnight, the fall of Enron wiped out $70 billion of shareholder value and resulted in default on tens of billions of dollars of debt.[77]

A. How Did This Happen~~-~~? Their Corporate Culture; a Climate for Pushing the Envelope

The Enron story began with the merger of two gas pipeline companies, Houston Natural Gas and InterNorth. Its purpose was to be an interstate natural gas pipeline company.[78] Deregulation in the utilities industries created significant challenges for the new company. Enron was losing its exclusive rights to distribute its products. Kenneth Lay, the first CEO, believed ENE needed to develop a new business strategy to remain competitive.[79] Lay hired McKinsey & Company, management consultants, to help develop a new business strategy. Jeffrey Skilling was one of the consultants who began to work with Enron.[80] Skilling proposed a radical plan. Enron would buy gas from suppliers and resell it to users, *charging a small fee for handling the transactions*. Deregulation would allow ENE to take the roll of "*middle man*", matching supply and demand for gas.[81] Enron would buy gas from a network of suppliers, sell it to a network of consumers, and contractually guarantee both the supply and the price. In doing so, ENE created a new product and a new paradigm for the industry…the energy derivative.[82] Skilling's plan was successful, and Lay hired him from McKinsey to work for Enron. It is claimed that Skilling changed the corporate culture at Enron. Skilling adopted an employee ranking system, the Performance Review Committee ("PRC").[83] The PRC gained the reputation of having been the harshest employee-ranking system in the country.[84] They ranked everyone against their peers. There was no limit on the

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77 Nancy B. Rapoport & Bhala G. Dharan, *Enron – Corporate Fiascos and Their Implications, in* THE ENRON BANKRUPTCY 303, 303 (Charles J. Tabb ed. 2004)

78 *Enron Timeline*, HOUS. CHRON., Dec. 13, 2005, *available at* www.chron.com/cs/cda/printstay.mpl/special/Enron/timeline/2342585 (last visited Jan. 30, 2006).

79 Nancy B. Rapoport & Bhala G. Dharan, *Enron – Corporate Fiascos and Their Implications, in* Enron – The Primer 3, 11 (Jeffrey D. Van Niel ed. 2004)

80 *Jeffrey K. Skilling timeline*, HOUS. CHRON., Feb. 20, 2004, *available at* www.chron.com/cs/cda/printstay.mpl/special/enron/2412024 (last visited Jan. 30, 2006).

81 Nancy B. Rapoport & Bala G. Dharan, *Enron – Corporate Fiascos and Their Implications*, *in* ENRON – THE PRIMER 3, 11 (Jeffrey D. Van Niel ed., 2004).

82 Nancy B. Rapoport & Bala G. Dharan, *Enron – Corporate Fiascos and Their Implications*, *in* ENRON AND ETHICAL CORPORATE CLIMATES 187, 196 (Lynne L. Dallas ed., 2004).

83 Nancy B. Rapoport & Bala G. Dharan, *Enron – Corporate Fiascos and Their Implications*, *in* ENRON AND ETHICAL CORPORATE CLIMATES 187, 196 (Lynne L. Dallas ed., 2004).

84 Anastasia Kurdina, *The Collapse of Enron: Managerial Aspect*, http://www.personal-writer.com/enron/ ("The Implication of poor managerial performance for the collapse of Enron Corporation" section) (last visited Mar. 1, 2006).

bonuses paid to the top performers. However, up to 15% of the bottom performers were fired each year.[85] Fierce internal competition prevailed and immediate gratification was prized above long-term potential. Secrecy became the order of the day. The performance review process created incentives to "do the deal" at all costs.[86] Enron had a mandate. That mandate was to make sure that Enron's stock price continued to rise by ensuring that key financial ratios remained on a steady climb. Such was the corporate culture. The breeding ground that spawned the innovative and creative use of the Special Purpose Entity that was later revealed to be mere fraud; only exacted at a very high level and done in a manner that no one had seen before.

B. How the Enron SPEs were structured, highlighting where Enron Departed from GAAP

By this point, those who are even remotely interested in what happened with Enron have read the well documented accounts of the LJM1, and LJM2, partnerships, Chewco, Raptors, etc. These are the SPEs that made the headlines and were the entities with which the casual observer is most familiar.[87] But those SPEs merely scratched the surface. Enron's SPE abuse was pervasive, covering a period from approximately 1999 through 2001 where Enron consummated hundreds of SPE transactions of various forms and sizes which accounted for a significant portion of their reported revenue during that same period, right up until Enron filed for bankruptcy in December, 2001.[88]

(i) The FAS 140 Transaction in General

This part of the piece examines a specific SPE transaction type that Enron used repeatedly which, in the year 2000 (i) increased Enron's reported net income by $351.6 million, 36% of its total reported net income; (ii) increased its reported funds flow from operations by $1.2 billion, 38% of its total funds flow from operations; and (iii) improperly kept $1.4 billion of debt off its balance sheet.[89] This transaction type was referred to as the *FAS 140* transaction, patterned after and designed to comply with

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[85] Nancy B. Rapoport & Bala G. Dharan, *Enron – Corporate Fiascos and Their Implications*, *in* ENRON AND ETHICAL CORPORATE CLIMATES 187, 196 (Lynne L. Dallas ed., 2004).

[86] Nancy B. Rapoport & Bala G. Dharan, *Enron – Corporate Fiascos and Their Implications*, *in* ENRON AND ETHICAL CORPORATE CLIMATES 187, 196 (Lynne L. Dallas ed., YEAR).

[87] *See generally* Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., William C. Powers, Jr., Chair (Released Feb. 1, 2002).

[88] In re Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003 (Second Interim Report of Neal Batson, Court Appointed Examiner, Sept 21, 2002, page 49). For example the chart shows a 96% downward Net Income adjustment once the inflated effects of the SPE transactions are deducted from net income.

[89] *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 39).

Financial Accounting Standard 140 which sets forth the accounting guidelines related to asset transfers in connection with structured financings.[90]

In sum, the FAS 140 technique involved Enron's purported sale of an asset to an SPE that was not consolidated in Enron's financial statements. In most cases, the SPE financed its acquisition of the asset by borrowing 97% of the purchase price and issuing equity for the remaining 3%, (thus attempting to comply with the 3% equity investment rule discussed earlier).[91] Enron obligated itself to repay the loan through what is referred to as a Total Return Swap.[92] Through the Total Return Swap and the other agreements employed in this technique, Enron retained substantially all the economic benefits and risks of asset ownership, notwithstanding the purported sale to the SPE.[93] In the following section, the FAS 140 transaction will be dissected in detail, highlighting where Enron's accounting treatment departed from GAAP.

(ii) The Structure of a Typical FAS 140 Transaction Dissected

A typical Enron FAS 140 Transaction began with the contribution by the Sponsor of an asset to an "Asset LLC".[94] The Asset LLC would then issue two classes of stock. Class A and Class B. The class A stock represented the Asset LLC's voting interests, whereas the Class B shares represented the economic interest in the LLC.[95] The Class A interests would be issued to the Enron Subsidiary from which the asset was transferred, and the Class B economic interests would usually be issued to a special purpose entity, generally a Share Trust (the "Trust"), that Enron would also have a hand in forming[96]. The Class B Interests sold to the Trust were entitled to no voting rights but were entitled to substantially all of the economic interests in the Asset LLC. In exchange for a payment in the amount of the special distribution to be made by the Asset LLC to the Sponsor.[97]

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90 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 58).

91 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 39).

92 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 40 note 100).

93 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 40).

94 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 59).

95 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 59–60).

96 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 60).

97 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 60).

The Trust financed the purchase price of the Class B Interest by selling an equity interest in itself to a third party, often an affiliate of one of its Lenders, and by borrowing under a credit facility provided by those lenders. The equity was generally entitled to be repaid the amount of its investment plus an annual rate of return. Generally, the amount of the equity was equal to at least 3% of the purchase price for the Class B Interest, plus the amount of fees due to the Lenders. The right of the equity-holder to receive payment with respect to its equity was subordinated to the right of the Lenders to receive the payment that was advanced under the credit facility. The amounts due to the equity-holder were not supported by the Total Return Swaps.[98]

At the closing of the FAS 140 transaction, upon the Trusts payment to the Asset LLC of the purchase price for the Class B Interests, the Asset LLC would typically use those funds to make the special distribution to the Sponsor, thus immediately conveying the full proceeds of the transaction to the Sponsor.[99] A diagram detailing the typical FAS 140 transaction is set forth in Appendix A. –

In looking at the transaction as a whole, perhaps the most important part of the equation is the movement of money from the lenders through the conduits of the Trust and the Asset LLC on through to Enron or an Enron subsidiary. And even more interesting, how Enron accounted for and disclosed that movement in its financial statements. On the other end of these FAS 140 transactions were the lenders. Typical participants "loaning" money in these FAS 140 transactions were institutions such as Canadian Imperial Bank of Commerce (CIBC), JP Morgan Chase & Co., CitiGroup, and Morgan Stanley[100] ("Lenders").

The Lenders would transfer money into the Enron formed Share Trusts, who would in turn transfer the proceeds from the Trust to the Asset LLC, who would in turn transfer the money and the Class A interest in the Asset LLC in exchange for the transferred asset (again see diagram at Appendix A).[101]

(iii) Forensics of the FAS 140 – Keeping the Lenders Comfortable

It is at this juncture where we stop and do a forensic of the FAS 140 transaction. In a typical FAS 140 transaction, the values at which Enron would assess these transferred assets would be anywhere from $10 million to four or five hundred million dollars.[102] Accordingly, with these FAS 140 transactions exists a situation where you

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98 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 60).

99 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 61).

100 BNA.com, CIBC to Pay $2.4 Billion to Settle Enron Stockholder Suit, http://pubs.bna.com/ip/BNA/srlr.nsf/is/a0b1e4x0z4 (last visited Feb. 24, 2006).

101 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 61).

102 For example, in a FAS 140 transaction referred to as the Cerberus Transaction, Enron transferred a block of stock it owned of EOG Resources, Inc. worth approximately $500 million. *In re* Enron Corp.,

have a financial institution loaning an Enron formed Share Trust up to $500 million dollars based on the strength, or creditworthiness of a transferred asset whose realization is doubtful at best.

The logical inquiry that follows is what would then induce a financial institution to lend money to an Enron formed share trust under these circumstances? The answer is in the final piece of the FAS 140 puzzle, the Total Return Swap (the "Swap"). The Swap in this context is, in essence a guarantee. With the FAS 140 transactions, Enron would guarantee on behalf of the share trust, the payment's the share trust was obligated to pay the Lenders so that whatever short-fall that stemmed from the transferred asset not generating the requisite cash to service the debt obligation, Enron, through the total return swap, guaranteed those payments to the Lenders.[103] In even the most general of terms, under GAAP where one party obligates itself to a debt obligation, GAAP requires that the obligor record and disclose that financial obligation. With Enron, in most of the transactions structured in this manner, they did not.

(iv) Improper Revenue Recognition

Next is Enron's accounting treatment in connection with the transferred asset. With its FAS 140 transactions, Enron would record these asset transfers as sales thereby improperly inflating revenue on its income statement.[104] Also, depending upon the assets involved, Enron would recognize cash flow from these activities as cash flows from operating activities.[105] With structured financings, for such accounting treatment to be proper and in accordance with FAS 140, the transferring entity must completely relinquish itself from any rights to profits that could be realized from the transferred asset once the presumptive sale occurs. Likewise, the transaction must be structured in a way such that the sponsoring entity is absolved from any potential liability if the SPE fails to realize the payments from the transferred assets.[106]

A look at a conventional structured finance will illustrate this point. In the conventional structured finance, once the transferring entity "sales" the account receivables (for example) to the SPE, it is only proper for the Sponsor to record the transfer as a sale if and only if the SPE has no recourse against the Sponsor related to the

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No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 64).

[103] *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 64).

[104] *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 53).

[105] *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 53).

[106] *See* Financial Standards Accounting Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125, http://www.fasb.org/st/summary/stsum140.shtml (issued Sept. 2000) (last visited Feb. 23, 2006).

transferred assets. If a structured finance is designed in this manner, the sponsor may record the asset transfer as a sale, and likewise record the cash proceeds from that sale as either cash received from operations – (depending on whether this was something they did in the normal course of its operations), or cash proceeds received from investing activities. Only where the transferring entity has relinquished both the risks and rewards of ownership is accounting for the transferred assets in this manner proper.

But in Enron's case, accounting for the asset transfers as sales was not proper for several reasons. First, Enron maintained control of the transferred asset through its ownership of the Class A voting membership interests in the LLC to which the asset was transferred. Second, Enron guaranteed payment through the Total Return Swaps in the (likely) event the payment streams from the transferred assets were insufficient to repay the Lenders. The underlying point here again. The rules were clear. Enron merely chose to depart from those rules to report the financial results they desired, despite the fact that their reported results veered significantly from what was actually occurring.

(v) (Improper) Valuation of the Transferred Assets

Another aspect of Enron's accounting treatment related to its FAS 140 transactions is the questionable circumstances surrounding some of Enron's valuation of the transferred assets. Enron's asset valuations were designed to maximize the "gain on sale" accounting treatment for those transferred assets. As was discussed earlier, in many instances, the assets Enron transferred were "A-typical" for use in a structured financing as these were assets not normally traded on any open market where a fair market value for those assets could be derived, nor were they your garden variety trade or account receivables where the time line for payment and valuations are discernible.[107] Accordingly, Enron would make its own valuation and attach that Enron assessed value to those transferred assets. Upon the asset's transfer, Enron would take the difference between the Enron assessed value and the actual proceeds from the asset and record the difference as a gain on sale.[108] Therefore, through improper asset valuations coupled with improper revenue recognition, Enron was able to paint a picture of steady earnings and cash flow in operations that did not reflect the true financial position of its operations.

C. Complicit Fraud Rather than Ambiguous Accounting Rules

With these transactions viewed through a transparent lens, the conclusion at which one arrives is that Enron's improper SPE reporting had little to do with ambiguity or lack of accounting literature and guidance in the area. The improper accounting treatment was intentional and the SPE abuse was merely the method of choice.

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[107] For example typical asset types used in these FAS 140 transactions were common stock warrants, partnership interests, membership interests in limited liability companies, or interests in trusts formed in connection with other financial transactions undertaken by Enron - *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 111).

[108] *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 53).

Enron tried to structure and conform these transactions to justify Enron's desired accounting treatment. But their desired accounting treatment didn't reconcile with the true economic substance of these transactions. "Sale" treatment and revenue recognition were inappropriate because Enron still maintained both control of and residual obligations for the transferred assets by virtue of Enron's ownership of the Class A voting interests and the total return swaps. But the total return swap guarantees were the only way that the Lenders would be convinced to loan money to the Share Trusts due to the poor quality of the assets involved in the transfers.

In concluding this portion of the piece, the overarching point to appreciate is that Enron's mis-accounting had nothing to do with ambiguities in the accounting literature and everything to do with the complicit and coordinated efforts of Enron and those involved with its financial reporting process to achieve the accounting results that were a departure from the true economic substance of the underlying transactions that Enron's financial reporting purported to reflect.

V. THE ACCOUNTING AND LEGISLATIVE RESPONSE – (Treating the Symptom vs. Tackling the Problem)

The accounting and interpretive guidance that has been enacted in the "post-Enron" era are rules that merely treat the symptoms of SPE abuse but fail to address the actual problem. There have been a number of significant events related to the financial accounting and disclosure since the passage of the Sarbanes-Oxley Act. The two most relevant pieces of accounting guidance that addresses these issues are (1) Financial Accounting Standard 140 ("FAS 140") Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – which gives guidance on when a transaction may be recognized as a sale, versus a secured borrowing or financing[109]; and (2) Consolidation of Variable Interest Entities (revised December 2003) – an interpretation of ARB No. 51 ("Interpretation No. 46(R)")[110], which requires a "risks and rewards" approach to consolidation of "variable interest entities" as opposed to an approach based on control by ownership of legal authority. Interpretation No. 46(R) was designed to address, among other things, some of the concerns with the failure of issuers under earlier guidance to consolidate certain special purpose entities.

This portion of the piece will focus on these two bodies of accounting literature and interpretive guidance, explaining first how FAS 140 and FIN 46(R) work, then highlighting the goals these two pieces of accounting guidance are trying to achieve, and finally showing that in spite of the intentions of these two pieces of accounting guidance

109 Financial Standards Accounting Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125, http://www.fasb.org/st/summary/stsum140.shtml (issued Sept. 2000) (last visited Feb. 23, 2006).

110 Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—sn interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (last visited Feb. 24, 2006).

which in theory seem well meaning and hopefully effective, still fail to address the core problem that is at the root of Enron and similar SPE abuse cases that have been or will be perpetrated.

A. FAS 140

As alluded to earlier, FAS 140 deals with that situation where a corporation (the "Originator"or "Sponsor") transfers assets to a special purpose entity. The key issue to resolve being whether that transfer can be treated as a sale, which bolsters financial reporting, or as a secured financing which would prevent the Originator from not only recording the asset transfer as a sale, but would require the Originator to recognize a debt obligation as well.[111] In essence, in accordance with FAS 140, the Originator may record the asset transfer as a "sale" if and only if all the following conditions are met.

a. The transferred assets have been isolated from the transferor-put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

b. Each transferee has the right to pledge or exchange the assets it receives, and no condition both constrains the transferee from taking advantage of its right to pledge or exchange and proves more than a trivial benefit to the transferor.

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets.[112]

Cutting through the accounting verbiage, the key question to determine is whether or not the Originator has relinquished both the risks and rewards of ownership of the transferred assets. Only when the bond between the assets and the Originator has been severed, is it proper for the Originator to recognize such transfers as sales. When using these accounting principles as the backdrop for assessing a representative Enron transaction, what results is accounting guidance that is clear as to its criteria, and a corporation, irrespective of such clarity, recording transactions in direct contravention of such guidance and clarity.

Enron's Departure from FAS 140 and Generally Accepted Accounting Principles

As discussed at length in the previous section, Enron transferred assets to the Asset LLC and improperly recorded such assets as sales, in spite of the fact that Enron

[111] Financial Standards Accounting Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125, http://www.fasb.org/st/summary/stsum140.shtml (issued Sept. 2000) (last visited Feb. 23, 2006).

[112] Financial Standards Accounting Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125, http://www.fasb.org/st/summary/stsum140.shtml (issued Sept. 2000) (last visited Feb. 23, 2006).

failed to relinquish both the risks and rewards of ownership in two ways. The first by virtue of guaranteeing the Trust's payment obligations to its Lenders, by virtue of the total return swaps, entered into in connection with these transactions[113], and second by virtue of Enron maintaining voting control through its ownership of the Class A membership interests.[114] Where the Originator of the transferred asset guarantees payment against the collection or realization of the transferred assets, the risks and rewards of ownership have not been relinquished and recording the transaction as a sale is not proper. Again, the key points to emphasize here is that the problems with the transactions had nothing to do with ambiguities or gaps in the accounting literature, and everything to do with Enron management being narrowly focused on distorting its financial picture.

B. FINACIAL INTERPRETATION 46(R) – The New Consolidation Criteria [Changes in the Financial Reporting Regime since the Passage of the Sarbanes-Oxley Act –An attempt to close the 3% loophole and require consolidation based on economic substance vs. legal form.]

FIN 46(R) in essence deals with the situation where Company A has some sort of Financial Interest in Company B. FIN 46(R) outlines when and under what circumstances, the relationship between Company A and Company B is such that Generally Accepted Accounting Principles would require the two to be reported on a consolidated basis. The usual investment with which we are most familiar would be Company A's investment in Company B through stock ownership. Prior to guidance that was developed in the SPE arena, entities would be required to consolidate only in the instance where Company A had majority ownership in Company B through A's ownership of B's stock. This test was generally treated as a "bright-line" test where consolidation would be required only at the point where Company A was a majority owner of Company B's Stock. (i.e. greater than 50%).[115]

As a result of this bright line test, corporations would avoid the consolidation requirement by controlling the entity through some means other than stock ownership and would avoid consolidation, thereby keeping both the assets and more importantly, any underlying liabilities off Corporation A's books.[116] As was discussed earlier, with respect to SPEs, the consolidation criteria was loosened further with EITF 90-15, where the sponsoring corporation could avoid consolidation if the SPE equity owner has made

113 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 39).

114 *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 20032) (First Interim Report of Neal Batson, Court Appointed Examiner, Sept. 21, 2002, page 59).

115 ACCOUNTING FOR LAWYERS, 521 (David R. Herwitz & Matthew J. Barrett eds., Foundation Press 3d ed. 2001).

116 For example, the sponsoring company may control the special purpose entity by narrowly defining the scope of the SPEs permitted activities and placing such limitations in the SPEs chartering documents, such as its Articles of Incorporation.

an initial substantive residual capital investment that is at risk during the entire term of the lease.[117] FIN 46(R) among other things is aimed at closing this loophole.

Variable interest entities include SPEs and can be generally described as entities in which the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support.[118] These characteristics are meant to identify arrangements in which control of the entity would not be achieved through voting stock ownership, but through some other method.[119] FASB Interpretation No. 46(R) requires consolidation of a variable interest entity by a party that has a majority of the risks and rewards associated with the entity.[120] Interpretation No. 46 also establishes a methodology for determining which party associated with a VIE should consolidate the VIE. Essentially, the requirement is that the party exposed to a majority of the variation in the outcome of the performance of a VIE, both positive and negative, should consolidate the VIE, because such exposure is likely to be indicative of control.[121] Interpretation No. 46(R) refers to such a party as the "primary beneficiary" of the VIE.[122]

An issuer's involvement or interest in with a VIE can manifest itself in debt instruments, guarantees, service contracts, written put options, total return swaps, etc.[123] These arrangements with a VIE can put the issuer in a position akin to an equity holder in that the issuer bears the same risks and rewards of the VIE as an equity holder would. For example, consider an issuer that owns 49% of the voting stock of another entity and is the sole guarantor of debt of the entity. Before Interpretation No. 46(R), such an issuer may not have been required to consolidate the other entity based upon voting control.

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[117] Financial Standards Accounting Board, EITF 90-15: Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions. http://accounting.cba.uic.edu/Articles/Off-Balance-Sheet/FASB%20EITF%2090-15.htm Although not stated specifically in EITF 90-15, industry practice had evolved to the point where 3% equity investment is sufficient "at-risk" equity investment to avoid consolidation.

[118] Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Summary section) (last visited Feb. 24, 2006).

[119] *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Reason for Issuing this Interpretation section) (last visited Feb. 24, 2006).

[120] *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Consolidation Based on Variable Interest section) (last visited Feb. 24, 2006).

[121] *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Consolidation Based on Variable Interest section) (last visited Feb. 24, 2006).

[122] *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Definition of Terms section) (last visited Feb. 24, 2006).

[123] *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Variable Interests and Interests in Specified Assets of a Variable Interest Entity section) (last visited Feb. 24, 2006).

However, subsequent to the promulgation of Interpretation No. 46(R), if this same entity is deemed to be a VIE, then the issuer would likely be required to consolidate due to the issuer's additional risk of loss from the outstanding guarantee.[124]

C. Moving Forward with the New Accounting – Lack of Accounting Rules Were Not the Problem

Having set the salient accounting guidance out in some detail, an assessment can now be made as to how effective such new guidance would have been or will be in preventing "Enron-like" SPE abuse. The crux of FIN46(R) is a redefining of the criteria under which an entity should be reported on a consolidated basis. FIN 46(R) switches that criteria from one where consolidation was required only when the SPE in question did not have at least a 3% equity investment from an outside third party to now requiring the entity that has the majority of risk or rewards related to that SPE to report that SPE on a consolidated basis.[125]

In theory, such a change has merit. Arguably, with a broadened set of criteria under which consolidation would be required, financial reporting in this area would be more transparent as entities that would have avoided consolidation prior to FIN46(R) would now be pulled onto the balance sheet on a consolidated basis thereby resulting in a more transparent and accurate representation of a corporation's true financial picture. In practice, however, there is evidence suggesting that such measures as expanding the consolidation criteria would from an overall standpoint result in an exercise in futility.

First, when we look at what happened at Enron, as discussed earlier, Enron's failure to consolidate or otherwise disclose obligations that it otherwise had, had nothing to do with any ambiguity or shortcomings in the accounting literature. What Enron did with most of the SPEs that it used was simple fraud.[126] For example when we refer back to the FAS 140 example discussed earlier, we can see that Enron violated the then existing accounting guidance on a number of fronts. First, contrary to FAS 140, Enron recorded the asset transfers as sales even though Enron retained control of the transferred assets through their Class A voting membership interests.

Second, Enron failed on several occasions to record the debt obligations related to the FAS 140 transactions which was in fact Enron's obligation. Again, the failure to disclose had nothing to do with shortfalls in the accounting literature, but more so having

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124 *See* Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Consolidation Based on Variable Interests section) (last visited Feb. 24, 2006).

125 Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (Expected Losses and Expected Residual Returns section) (paragraph 9 explains that at a Minimum, the equity investment must be at least 10%, instead of the previous 3%) (last visited Feb. 24, 2006).

126 For example, for the year 2000, 96% of Enron's reported net income was due to improper reporting of funds channeled to Enron through Special Purpose Entities. *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (Second Interim Report of Neal Batson, Court Appointed Examiner, Jan. 21, 2003, page 39).

to do with Enron's intent on obfuscation and omission. The Total Return Swaps into which Enron entered in connection with these transactions were Enron's unequivocal guarantee to repay the debt in the event the cash value of the monetized assets was not realized. The major point to emphasize here is that no accounting guidance is going to counteract the deliberate intent to obfuscate and defraud.

Further, and equally important, there is evidence to suggest that new accounting guidance will only cause issuers to restructure their transactions once again to avoid the new accounting criteria.[127] In anticipation of the implementation of Interpretation No. 46(R), a number of entities have restructured their arrangements with potential VIEs such that they would not require consolidation.[128] The SEC notes anecdotally that many arrangements with potential VIEs were restructured such that the entity either would not be considered a VIE or such that no party would be required to consolidate the VIE. The effect of such changes is difficult to measure. However, in some cases, it appears that the changes made involved substantive changes to the economics of the variable interests or to the decision-making capabilities of the investors, while in other cases, the changes may have been less substantive.[129]

D. Implementation Costs

Although Interpretation No. 46(R) arguably constitutes an improvement over the previously existing consolidation guidance, a number of interpretive questions remain. Many users of Interpretation No. 46(R) find it theoretically and practically challenging to apply.[130] In fact, the actual application of FIN 46(R) is complicated and time consuming to implement. Further, the calculations under FIN 46(R) have to be recalculated each reporting period as one's variable interests in an entity may change between financial reporting periods.[131] Currently, the FASB is considering ways to resolve an issue originally discussed by the EITF in issue 04-07, Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity. A consensus on this EITF issue

[127] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 94 (2005).

[128] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 94 (2005).

[129] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

[130] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

[131] Financial Standards Accounting Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, http://www.fasb.org/st/status/statpg-fin46.shtml (last visited Feb. 24, 2006).

may change how some issuers apply Interpretation No. 46(R).[132] But in its current form properly applying FIN 46(R) will be a winding maze through which issuers are now being forced to navigate.

The resulting situation is that company resources will be diverted toward making sure their variable interest entity transactions are in compliance with FIN 46(R). Although not quantified in this piece, we already see the added burden upon a corporation's internal accounting function in calculating and accounting for its variable interest entities. Likewise the issuer will incur additional costs to be paid to the issuer's public accountants as they will require additional man hours to sort through and determine whether the issuer's VIE disclosures are proper.

It is understood that proper financial reporting should not be compromised or sacrificed just because additional costs will be incurred. The additional costs would be justified, however IF the additional burdens were focused on the identified problem. But here it is arguable whether FIN 46(R) is or will effectively address the problem of SPE abuse.

VI. A STEP BACK – A TIME TO ASSESS

It is human nature to, when we find something that we perceive as broken, to utilize the most expedient measures at our disposal to fix the problem. Here, is no exception. But what happens when the focus of the problem has been redirected from the weapon (meaning the special purpose entity) to the one's pulling the trigger. Quite naturally, what should come from a refocusing of the problem is a refocusing of the means by which that problem should be addressed.

It is understandable that during the rising tide of public outcry in the wake of the Enron debacle, there was a collective call for action to be taken, and Congress and the relevant standard-setters in the accounting world in their quest to stem that tide and restore investor confidence in our public markets reacted quickly with the passing of the Sarbanes-Oxley Act. Likewise, the FASB followed suit with its revamping of the rules on consolidation with the issuance of FIN 46(R). But now that the investing public's collective memory of the Enron "sting" has faded, we have the luxury of taking a thoughtful look at what is really happening in cases like Enron, and accordingly take a more focused approach at trying to prevent future Enrons from occurring in the future.

A. Scope of the Problem

First and foremost, the standard-setters need to make a more focused assessment of the problem. Is Enron like SPE abuse widespread and prevalent or was Enron a unique and isolated set of circumstances? How wide spread is special purpose entity use

[132] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

in its various forms? And more importantly how widespread is the abuse of special purpose entities? Narrower still, is anyone, other than Enron, engaging in the type of deliberate, contrived, prevalent, proprietary and abusive use of special purpose entities that Enron used to misrepresent its financial position? Answers to these questions would go a long way in crafting a more pointed and tailored response to curtailing SPE abuse. Research reveals that there are some instances of SPE abuse occurring in the "post-Enron" era, but nothing as wide-spread, complex, and contrived as what occurred with Enron.[133]

B. The SEC Attempts to Address the Problem

To its credit the SEC set out to do something along these lines, that is, attempt to quantify the extent to which public companies are utilizing Special Purpose Entities. But their research did not take it as far as trying to determine SPE abuse. In 2005, the SEC issued a report that addressed two primary questions: (1) the extent of off-balance sheet arrangements including the use of special purpose entities; and (2) whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements.[134] The Report was informative and insightful and shed light on a number of different and important aspects as they relate to Special Purpose Entities and how they are being disclosed amongst the approximately 10,100 publicly held companies in the U.S.[135]

Regarding the first question, the mandate was to assess the extent to which public companies were using off-balance sheet arrangements, and more to the point, special

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133 For example – An online LexisNexis search for companies engaging in SPE abuse yielded the following:

1. PNC Financial, a leading US bank, agreed to pay $115 Million in penalties and restitution to spare itself from prosecution over its efforts to hide hundreds of millions of dollars in non-performing assets. The agreement marks the SEC's first enforcement action involving the misuse of special-purpose vehicles. Joshua Chaffin & Gary Silverman, *PNC Pays Fine to Escape Threat of Prosecution*, FINANCIAL TIMES, June 3, 2003 (USA Edition).

2. The world's largest insurance company, American International Group, was facing a criminal investigation by the U.S Justice Department into allegations that it helped a major banking client move bad loans off its books. The allegation was that AIG sold PNC (Pittsburgh-based PNC Financial Services Group) as the idea of creating special-purpose entities for these bad loans – The allegations alleges that PNC avoided consolidating $762 Million in bad loans onto its balance sheet, effectively inflating its profit by $155 Million. PNC agreed to pay $90 Million to compensate shareholders and $25 Million in penalties to state-related charges after the Justice Department said that the special-purpose entities in question did not qualify for non-consolidation and therefore should have been included in its financial statements. Charlie Gibson, *AIG Facing Criminal Probe Over Loan Deal*, EVENING STANDARD, Sept. 30, 2004.

134 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 27 (2005).

135 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 32 (2005).

purpose entities. The idea being, if the use was wide-spread and pervasive versus narrow and hardly used, that assessment would drive, to some extent, the necessary approach to enforce effectively the use of, accounting for, and disclosures of special purpose entities. The SEC did a number of empirical studies, collecting data through looking at a stratified sample of publicly held companies and then published the results of those empirical studies in a report (the "Report").[136]

It was hoped that the Report would uncover the types of off-balance Special Purpose Entities being structured by public issuers. In other words, the hope and expectation was that the Report would convey either "yes" there are a myriad of corporations that are using Special Purpose Entities in a fraudulent and abusive manner similar to Enron. Or "no" the abuse of the SPE structure is not wide-spread such that we need not be alarmed nor enact more legislation to address the problem. But the Report, not surprisingly, did not yield such clear results or conclusions.

Instead, the Report was broader in nature. Data on these issues were reported in a number of different ways from which different conclusions could be drawn. But before discussing and analyzing the data itself, it is important to point out that at the point in time that the study was done, FIN 46(R) was still in its fledgling stages. Therefore, a number of the studies' participants at the time they were picked as part of the sample may not have fully matriculated the mandates of FIN46(R) into their financial reporting. That notwithstanding, the Report itself gives us some interesting information.

One of the first empirical studies outlined in the Report was the "Anticipated Effects of Adoption of Interpretation No. 46(R) Present in Annual 10-K Filings."[137] The Report took a stratified sample of large and small issuers. Of the stratified sample comprised of 200 large and small issuers, the study revealed that 38 percent of those sampled reporting issuers reported that the effect of adopting FIN 46(R) was not material or not expected to be material.[138] The study also revealed that less than 4% of the 200 issuer sample reported that the impact of adopting Interpretation No. 46(R) was not material or not expected to be material.[139] An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that less than 1% of

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136 *See generally* SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 27 (2005).

137 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 93 (2005).

138 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 93 (2005).

139 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 93 (2005).

the issuers in the population would expect the effect of the Interpretation to be material.[140]

Statistical data can often be interpreted in a number of different ways. The data revealed in the report is no exception. As state earlier, roughly 38% of the 200 issuers sampled stated that the impact of FIN 46(R) was either not material or not expected to be material. Only 3.5% of the Sample reported that the impact of adopting FIN 46(R) was material or was expected to be material for any VIEs.[141]

Among other things, a few possible inferences can be drawn. First is the distinct possibility that improper corporate use of Special Purpose Entities is not pervasive; especially to the point where revamping the criteria under which consolidating such entities is required. Second, and perhaps the more plausible explanation, is the fact that FIN 46(R) will just be another accounting guideline around which corporations will structure their transactions to achieve their desired results. That being either consolidation or non-consolidation. The new accounting guidance related to consolidating VIEs is a continuation of the cycle that has brought us to this juncture in the first place. The SEC and the Financial Accounting Standards Board enacts accounting guidance and interpretations to shore up perceived weaknesses or shortfalls in financial reporting, and then corporations, in response, merely restructure their transactions to circumnavigate the matter. A better mousetrap is built, followed by a better mouse to avoid the "trap".

From such a pattern the inferential leap would not be so large to suggest that public companies' in response to FIN 46(R) will react the same way. Corroborating this assertion are sentiments the SEC expressed in its Report. The Report suggests that some of the low numbers related to corporate consolidations in response to FIN 46(R) is attributed to issuers being pre-emptive in their financial reporting and restructuring their off balance sheet or variable interest entity transactions to avoid reporting such entities on a consolidated basis.[142] Although the report does note that if issuers are changing the way their SPEs are structured such that they no longer control the SPE or are not the primary beneficiary of the expected returns or losses, interpretation 46(R) will have improved financial reporting even if there is not a significant increase in the frequency of consolidation of SPE consolidation.[143]

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140 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 93 (2005).

141 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 93 (2005).

142 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

143 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

These are just possible inferences that the data might suggest, not definitive conclusions. But what is certain, is that the Report did not reveal and purposely did not try to reveal the extent to which potential SPE abuse similar or akin to Enron was being practiced by other issuers. Understandably and arguably this would be hard information to ferret. Now, however such information should be much easier, given that we now know for what to look.

Bringing the analysis full circle, the question is begged – does such legislation move the ball any more down the field in addressing the type of SPE abuse similar to Enron? Though unclear, the answer is likely to be no. As stated earlier, what we saw with Enron was not a situation where accounting guidelines were written such that Enron could follow the letter of the law while breaking the spirit of the law. Enron made intentional efforts to circumnavigate the accounting rules then in existence with the specific intent of achieving accounting results while obfuscating the true underlying substance of those transactions. Accordingly, the main point to emphasize here is that in Enron's case, accounting guidance or lack thereof was not the problem. It is therefore counterintuitive to think that ADDITIONAL accounting guidance would then be the solution. Arguably, those persons set on breaking the prior rules will break any new legislation or guidance as well, if that is in fact their intent.

Of course the counter-argument would then be that revised accounting guidelines now make it more difficult to perpetrate the accounting fraud that Enron perpetrated because the criteria and circumstances under which consolidation is required is much broader, with higher thresholds for non-consolidation which means a lot less "wiggle-room". One may speculate how the use of SPEs under FIN 46(R) will work. More than likely, those corporations that are in the "grey-area" with respect to SPEs may error on the side of caution and decide either to comply with the rule, or not do the transaction at all. On the other hand, it is not a stretch to conclude that those corporations that are intent on committing financial fraud will do so, regardless of what the rules are. The thought here is that once the intent to circumnavigate the rule is there, the "how" is merely a formality.

VII. SEC INITIATIVES TO IMPROVE FINANCIAL REPORTING TRANSPARENCY- (A Critique) – *Better Mousetrap, Better Mouse* –

The difficulties in improving financial reporting related to SPEs not withstanding, merely because the task or problem at hand is formidable does not mean that attempts should not be made to fix them. Quite the contrary. In fact, in the later part of the Report, it cites a number of proposed and current initiatives aimed at improving accuracy and transparency in financial reporting. Whether or not such attempts will meet their desired objectives remains to be seen. But evidence suggests that while these efforts may enjoy success in the short run, the long-term prospects for success may be minimal if at all. This Section looks at some of the proposed initiatives and will critique their likelihood of success, pointing out some of the challenges that the proposed effort will face.

A. SEC Recommendation: Eliminate or at least reduce Accounting- Motivated Structured Transactions

The Report's first suggestion is to eliminate or reduce accounting-motivated structured transactions. Accounting-motivated structured transactions normally involve transactions that are structured in an attempt to achieve accounting results that do not mirror the underlying economics of the transaction .[144] The very glaring example being the accounting motivated transactions Enron structured to boost its earnings and cash-flow numbers but were quite different in economic substance. The Report discusses the need to eliminate or at least reduce the extent to which issuers are engaging in accounting-motivated transactions.

The goal of eliminating accounting motivated transactions in theory is a sound one. Recording accounting results that are contrary to their true economic substance threatens one of the foundational bricks upon which the capital markets are built. So, in theory the extent to which such practices could be reduced, if not eliminated altogether, is a step in the right direction. But in practice, eliminating or even reducing accounting motivated transactions is a difficult task in part due to the reasons discussed next.

Discordant Incentives – Management's Disincentives in Disclosing Adverse Financial Information – The Hurdle to Achieving Fairly Presented Financial Statements

One of the big obstacles to fair financial reporting that either seems to be underappreciated, merely accepted as a given, or perhaps not considered at all, are the discordant incentives between management that is tasked to report accurate financial information within material respects and the potentially adverse consequences that management may suffer personally or individually as a result of reporting such adverse financial information.

When we look at the compensation structure of upper level management at many large publicly held companies, we see some recurring themes. Most of these upper level managers receive a large part of their compensation in the form of bonuses based on the company's profitability or the performance of its stock.[145] The stock awarded may be incentive based, performance based, etc.[146] Also, bonuses and more importantly,

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[144] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 99 (2005).

[145] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 99 (2005).

[146] A look at the executive compensation of any publicly held company will likely have some incentive based form of compensation tied to the company's stock performance or earnings per share. *See, e.g.*, 2005 Home Depot Proxy Statement, *Executive Compensation* section, http://ir.homedepot.com/downloads/hd2005proxy.pdf (page 36) (last visited Feb. 24, 2006). Bonuses and additional payouts to executives were contingent on the company meeting certain specified levels of average diluted earnings per share.

continued employment can be tied to the earnings numbers their respective company's report.[147]

Given such a dynamic, we can see the competing tensions being put on the financial reporting process. The resulting situation is one in which you have management dealing with the difficult situation of disclosing adverse financial information that could have a direct adverse impact on their own personal situations. In an ideal world we would like to think that these officers, in adhering to their fiduciary duties of care and loyalty would not let such possible personal consequences compromise their professional integrity. But the reality of the situation is that it can and often does.[148] With this dynamic ever-present each and every reporting period, we see the inherent vulnerability in the reporting process which was likely integral to some of the incredibly large scale accounting scandals that have occurred to date.

It is these divergent incentives that create the competing tensions between standard setters looking for more transparency in financial reporting and management that is sensitive to how such transparent information, when such information is negative, will effect the company's share price in general and more specifically the impact that such negative information will have on their own personal financial situations as they relate to the corporations over which they preside as fiduciaries.

As long as these tensions exists, standard-setters will in large part be relying on management to "do the right thing" even in those instances where doing the right thing could have an adverse effect on them personally. Granted, we would like to think that one's commitment to one's fiduciary duties as an officer or director, one's personal and professional integrity, or even one's moral compass would place the requisite checks and balances on doing the right thing. But a cursory glance at the Wall Street Journal and the inundation of corporate scandals tells us otherwise.[149] Until this dynamic of divergent incentives is remedied, it is logical to conclude that accounting motivated transactions will continue.

B. SEC Recommendation: Improve Communication Focus in Financial Reporting

The SEC also calls for a paradigm shift in the whole idea behind communicating through financial reporting. As the Report notes, *"…An unfortunate effect of the large volume and complexity of financial reporting requirements is that many accountants,*

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147 2005 Home Depot Proxy Statement, *Executive Compensation* section, http://ir.homedepot.com/downloads/hd2005proxy.pdf (page 36) (last visited Feb. 24, 2006).

148 For example, the Houston Chronicle printed an article that summarized some of the more recent and high profile scandals. Listed among them were Adelphia Communications Corporation, WorldCom Inc., Tyco International Ltd., and HEALTHSOUTH Corp. *Enron Began a Wave of Scandals: Collapses changed the way that companies do business*, Hous. Chron., Jan. 27, 2006, *available at* www.chron.com/cs/cda/printstory.mpl/special/enron/3616142 (last visited Jan. 30, 2006).

149 *Enron Began a Wave of Scandals: Collapses changed the way that companies do business*, Hous. Chron., Jan. 27, 2006, *available at* www.chron.com/cs/cda/printstory.mpl/special/enron/3616142 (last visited Jan. 30, 2006).

lawyers, and others seem to view the goal of financial reporting as achieving technical compliance with the rules without regard to communicating effectively to investors."[150] The Report further notes that *"…if all participants in the process came at financial reporting with a view of complying with the objectives of the guidance and clearly and transparently communicating material information to investors, significant improvements would occur even if none of the other recommendations in this Report were to be adopted. Conversely, the focus on seeming technical compliance results in a tendency to only make improvements when new rules or standards required those improvements. This burdens the standard-setters with the responsibility for driving all improvements, and investors with the responsibility for deciphering reports that are not written clearly.*[151]

The Report also noted another recurring practice in its review of selected issuer's financial statements, and that was the practice of spreading relevant and connected pieces of information in several places with little explanation of how the various disclosures related to each other or to the amounts represented in the financial statements.[152]

Technical compliance versus clear, concise and meaningful communications: the crux of the matter when talking about improved communication in financial reporting. *Full and fair disclosure is one of the cornerstones of investor protection under the federal securities laws. If a prospectus fails to communicate information clearly, investors do not receive that protection…A major challenge facing the securities industry and its regulators is assuring that financial and business information reaches investors in a form they can read and understand."*[153] But again the dynamics involved make this proposition for financial reporting a difficult one. Take for instance the following example. Something of an adverse nature occurs within a corporation. Depending on the gravity of the event, a meeting is called, the CEO, the CFO, the Board of Directors if they are available, Corporate counsel, the company's outside counsel as well as their public accountants have assembled in the company's "war room" to discuss how such news should be handled. The securities laws mandate that material information related to the corporation must be disclosed. In any number of these meetings that occur across the country with publicly held companies, the discussion can be interesting. What goes on is a sort of verbal ballet, where the very smart lawyers, CEO's, etc., deliberate a way to "disclose" the information without really disclosing the information. The end result of these meetings and deliberations are tepidly worded phrases, buoyed by mitigating facts,

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150 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 103 (2005).

151 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 104 (2005).

152 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 104 (2005).

153 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 103–04 (2005).

white washed in superfluous verbiage. The goal of which is to meet the technical disclosure requirements while at the same time, burying the essence of such information in tersely worded phrases or dispersing the information throughout the filing such that while the information may technically be there, effective communication of what is actually occurring is not.

The Competing Dynamics

As alluded to earlier, the practice of obfuscation through lack of clarity stems from the competing dynamics. Management understands that they have to comply with the disclosure rules under the federal securities laws. But at the same time management is aware of the possible adverse affects such information may have on the corporation's stock price and the implications this may have on them personally once the news is disseminated. The competing incentives that create the tension that results in technical compliance versus real true meaningful communication.

Once again, this dynamic puts tension on the free-flow of material information. It is understood that there are disclosure laws in place, new legislation passed such as the Sarbanes Oxley Act, stiffens penalties for violators which is resulting in jail time for offenders.[154] Not to mention the fiduciary duties for directors and officers and finally, the mere moral and ethical obligations about simply doing the right thing. In theory, all these layers of legal protections, inhibitors and moral obligations should insulate financial reporting from the problems that have occurred. But more than likely, the problems that we are seeing with financial reporting are likely to continue as human decision making is not always based on the unyielding obligation to follow both the letter and the spirit of the law, but on a more deeply rooted desire for self-preservation. The emotional reaction to self preservation is akin to how we handled matters in our youth when we did something we weren't supposed to do. If we didn't tell our parents what we did then we wouldn't get in trouble.

But Just as our parents eventually became aware of the offending conduct then, such is the case now as adults. And just as the consequences were exacerbated then by our attempt at a cover up, so is the case as adults when the truth eventually comes to light. In hindsight almost inevitably up front disclosure likely would have been the better choice for self-preservation both as children and as adults. But again the emotional response of self-preservation is to "cover up" the truth and hope nobody (ever) finds out about it.

Sometimes, both as children and as adults, the truth stays buried indefinitely and the consequences are avoided. From a self-preservation stand-point the choice of "non-disclosure" makes most sense where the offense is non-recurring, i.e. a "one-time" instance. But where the offenses are recurring or ongoing (such as Enron's fraudulent reporting which occurred on both a quarterly and an annual basis), it would seem like the long-term goal of self-preservation would be to confess and accept the consequences which hopefully would be mitigated by the forth right behavior. All of this makes sense

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[154] White-Collar Crime Penalty Enhancement Act of 2002, 18 U.S.C.A § 1341 (part of the Sarbanes-Oxley Act).

from a hind-sight logical, unemotional perspective. But putting one's self in the shoes of an Enron executive, the pressure put upon them by their constituencies, the ramifications of reduced shareholder value, etc., the "gut" reaction prevailed and the obfuscation continued until it snowballed so large that discovery of their improprieties were inevitable.

The overall point to understand here is that as long as the current dynamic of leaving the responsibility of financial reporting in the hands of those who may be adversely affected personally, the competing tensions of discordant incentives will continue to put pressure on clear and meaningful financial reporting. And the issues of fraud, obfuscation, and omission of material financial information is likely to continue until this "mis-alignment" is somehow rectified.

C. SEC Agenda Item: Continue Work on Consolidation Policy

As was discussed earlier, the consolidation decision is typically based on whether or not control exists, with the determination of control generally based on legal ability to control the entity. However, it is possible to control effectively an entity without having legal control. An issuer that owns 49% of the voting shares of an entity whose shares are otherwise widely distributed would almost certainly be able to set policy for that other entity, but currently would not be deemed to control that other entity for accounting purposes."[155]

"While the FASB discontinued its broad project on effective control, Interpretation No. 46(R) is an attempt to deal with SPEs by creating a consolidation test for those entities that is meant to identify which entity has the majority of the exposure to variations in performance and in turn, effective control. However, because that test is so different from the test used to determine consolidation of other entities, a new series of structures that straddle the lines between consolidation approaches has sprung up, and various structures have been designed to work around the guidance in Interpretation No. 46(R). The Staff believes that more time should be taken to evaluate the results of Interpretation 46(R) and to allow the development of interpretive guidance that may assist in its application. Several projects currently being undertaken by the EITF and the FASB staff may provide such guidance.[156]

The current consolidation guidance is complicated, despite the consistent objective of requiring consolidation when an investor controls another entity. The SEC believes additional standard setting efforts related to consolidation should be focused on whether there are ways to achieve the objectives with less complex guidance. In addition, once the questions regarding Interpretation No.46(R) have been more fully addressed, the FASB may also wish to consider whether it should again explore the use

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[155] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 109 (2005).

[156] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 109 (2005).

of effective, rather than legal, control to guide all consolidation decisions. Finally additional work holds the promise of promoting further convergence between consolidation guidance in the US GAAP and the consolidation guidance in the International Accounting Standards Board's standards.[157]

It is without question that the more changes that the standard-setters make which causes issuers to account for their off-balance sheet transactions in such a way that the form of those transactions reflect the structure's economic substance, the better off theoretically we will be. Such efforts are to be applauded as they are well intentioned and could lead to better and more accurate financial reporting in the future.

But at the same time, we must not let such changes create a sense of false euphoria and lull us into thinking that those efforts will be the panacea to the issues related to SPE abuse. Within the depths of all of this empirical data, within the depths of the intellectual discussion surrounding the issues related to SPEs, what seems to get only minimal attention or discussion is the fact that the SPE abuse Enron perpetrated was simply fraud with the SPE being the entity of choice, in part due to its inherently complex nature. But in spite of their complexity, had the true economic substance and nature of these entities been disclosed properly and in accordance with GAAP, analysts, investors, and shareholders alike all would likely have seen that such transactions were problematic and investors could have reacted and altered their investment decisions accordingly. Again, lack of sufficient accounting guidance was not the problem.

VIII. SUGGESTIONS FOR AN ALTERNATIVE APPROACH –

How to prevent another Enron

How to prevent another Enron; literally the billion dollar question. Before a discourse even commences on this subject, we must first acknowledge that any efforts to prevent another Enron would be just that, an effort. When we weigh the resources of the Securities and Exchange Commission against the some 10,000 plus publicly held companies out there, abuses such as this and others will continue to happen.

One maxim that we as an investing public have had is the notion that we can legislate people into doing the right thing. When the fact of the matter is that is difficult if not impossible to do. No matter what type of law, regulation, or statute that is put in place, if an individual or a group of people are intent on breaking that law, they will. When we look at Enron and examine in detail what was going on with Enron and its use of SPEs, the problem had nothing to do with ambiguities in the accounting or statutory literature with respect to SPEs. The problem was with unethical, and criminal behavior. The problem was that you had people in positions of power and public trust who made deliberate decisions to abuse that power and violate that trust. At the time those people

157 SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 109 (2005).

knew quite well what the law was and what it was they needed to do to comply with that law. Lack of clarity in the law was not the problem.

If we take the above assessment and analysis as true, the natural inquiry then is what then should be done or what should we have done in response to the Enron's, Adelphia's and WorldCom's of the world? How then could they have been prevented? And how do we make sure that another Enron, WorldCom or Adelphia doesn't occur again? Well, that is the question that lawmakers have been contemplating for the better part of 4 ½ years as they carefully examine Sarbanes Oxley's effectives as the Act's provisions take a foot hold and matriculate themselves into corporate America's collective culture. Observations from high ranking officials involved with standard setting and regulation suggest that the Act's provisions have been effective in improving financial statement disclosure, corporate governance, and auditor independence.[158]

The response to this empirical data though is whether financial statement disclosure, corporate governance, and auditor independence improved because of Sarbanes Oxley or in spite of Sarbanes Oxley. The argument here could go either way. Some would say that the Act's provisions were instrumental in bringing about much needed reform in corporate governance, auditor independence, and financial statement disclosure. On the other hand, others contend that the improvement in these areas are merely due to the fact that issuers are now operating in the "post-Enron" environment of heightened scrutiny. The only real response to either school of thought is that time will tell.

It is at this juncture that we can acknowledge that the efforts that the standard-setters are making may prevent those issuers who may be tempted to straddle the "financial reporting fence" from actually doing so. The post-Enron climate in which we find ourselves where everyone for the most part seems to be minding their "P's" and "Q's". That alone may be enough to keep issuers from even coming close to the line. But eventually the bright lights of public scrutiny will dim. The memory of Enron will likely be there for some time, but the pain from its sting will eventually subside. And when the bright lights do dim and the climate again reverts back to one where issuers for the most part will be left to their own recognizance, what decisions will be made then? As we have seen, when smart people wish to circumnavigate the rules, they will find a way to do so. Money and power; opiates proven to succeed in clouding judgment, and eroding the core values and ethical judgement of otherwise law abiding people.

There is no set of accounting guidance and literature out there that will prevent this type of occurrence from happening. And this is the very type of accounting abuse that we do want to avoid and prevent. But as much as we want to convince ourselves otherwise, the making of better mousetraps likely will not do that. All better mousetraps will likely do is cause the evolution of better mice that will be genetically improved to avoid such traps. As the SEC has already noted, there is evidence that many issuers were

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[158] See generally – Testimony Concerning the Impact of the Sarbanes-Oxley Act – Before the House Committee on Financial Services – Remarks by William H. Donaldson, SEC Chairman on April 21, 2005, *available at* www.sec.gov/news/testimony/ts042105whd.htm (last visited March 3, 2006).

preemptive with respect to FIN 46(R) and already commenced to restructuring their off-balance sheet transactions to avoid consolidation under the new guidance[159]

What then is the Solution?

If there is any good that came from a situation like Enron, it's that collectively as an investing public, we are better versed on accounting fraud of this nature. The financial markets, the analysts, the Securities and Exchange Commission, and the public accountants have all by now absorbed many of the intricacies of SPE abuse. In short, we now know for what to look and efforts can be focused accordingly.

So how do we prevent another Enron from happening again? The standard-setters and the gatekeepers, in spite of all the accounting and disclosure reform, need to appreciate with what they are dealing. A deficiency or a perceived deficiency in the accounting rules is not the problem. The problem is persons that seek to obfuscate, omit, and fraudulently report financial information. Accordingly focus on ferreting out SPE abuse should be primarily placed on the abusers themselves, not the SPEs formed to perpetrate such abuse. Wide spread legislation and accounting reform merely casts a broad net with the hopes that the abusers will get snared along with the rest of the fish. But in the mean time those fish are burdened with the added cost of complex and complicated compliance when they weren't doing anything wrong under the old regime nor had problems complying under the old regime.

So what is the alternative? The forefront of the approach should be a narrow and isolated focus on SPE abusers. Although the matter has not been completely resolved, the evidence suggests that actual SPE abusers represent a small pool of companies relative to the total population of public companies. This could be achieved by the SEC and or other related gate-keepers taking a "risk-based" approach toward the problem. First, the gatekeepers should narrow its scope by first focusing on those companies or industries that lend themselves or could potentially lend themselves toward SPE abuse. Those industries that tend to deal heavily in derivatives, intangible assets such as the buying and selling of futures contracts, etc. would be good places to start. Additionally, those industries or companies that stand to come under earnings pressure, i.e. having trouble reaching financial forecasts or earnings targets, or seem to be engaging in creative ways at maintaining earnings and revenue growth.

The overarching idea is that since we have seen it before (ala Enron), that accumulated knowledge is taken and applied going forward. It could very well be possible that in terms of SPE abuse, the proprietary abuse that Enron perpetrated was a local and isolated event. The SEC Report, though useful in the information it contained, did little to address the question of whether or not there is widespread SPE and off-balance sheet abuse. The Report merely focused on SPE and off-balance sheet use, which is helpful but doesn't tell the whole story nor tell the most important part of the story.

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[159] SEC, REPORT AND RECOMMENDATIONS PURSUANT TO 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 92 (2005).

With all of this collective knowledge and insight as to the accounting fraud that Enron perpetrated, it is reasonable to conclude that the SEC could derive some sort of search criteria or "corporate profiling" of either industries or particular companies that show indicia for potential SPE abuse. Those companies could then be targeted and special attention and focus could be placed on those companies. Understand that the initial stages of such action would be non intrusive. The initial stages of the focus would merely involve a close and scrutinizing look at those companies' annual and periodic reports for evidence of SPE abuse or any other type of financial reporting irregularities. If such scrutiny raises red flags then the SEC could then perform an escalated inquiry into the matter.

If the escalated inquiry yields problematic accounting, then the next step would be for the SEC to initiate a more aggressive fact finding inquiry. If accounting irregularities are found, the indictment, prosecution and ultimate conviction should be a high profile event. Such would then send a clear and unequivocal message to other similarly situated offenders to make the proper adjustments in their financial reporting or face the same fate.

IX. CONCLUSION

The issues dealt with in this paper are complex and trying to resolve these issues pose an even greater challenge. But before real effective change can be achieved, we must first be able to target the root of the problem. Complex problems tend to involve complex solutions. The band-aid of legislation, more guidance, or "clearer" guidance if you will, will more than likely result in nothing more than the tug and pull between standard-setters and issuers to continue along this "move", "countermove" approach that has gotten us to where we are today. Until we are able to focus more narrowly on the problem and deal with it from that more directed approach, we'll probably be seeing more of the same. Better mousetrap, better mouse.

<u>Appendix A</u>