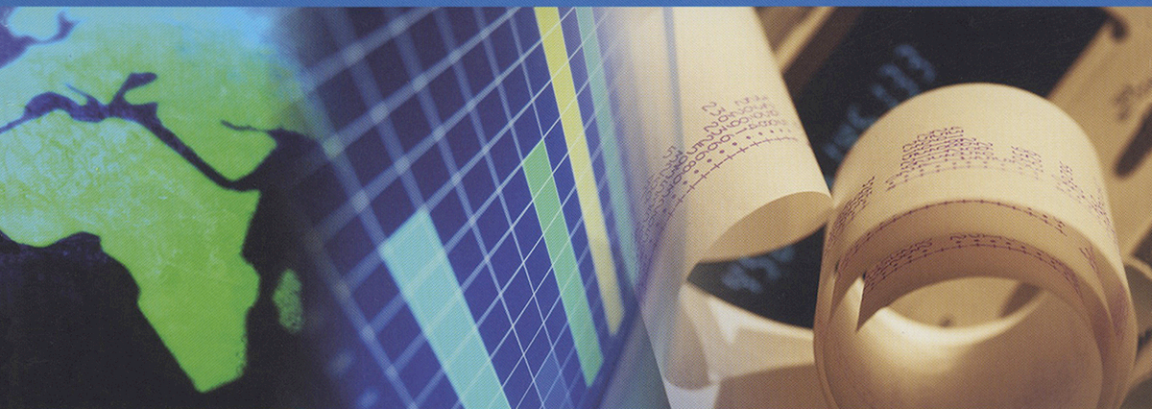




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## **Enron: An Accounting Analysis of How SPEs Were Used to Conceal Debt and Avoid Losses**

By Gordon Yale, CPA

## **Enron: An Accounting Analysis of How SPEs Were Used to Conceal Debt and Understate Losses**

### **Purpose**

At the heart of Enron's downfall was its treatment of special purpose entities (SPEs). In this special report, a forensic accounting expert examines Enron's use of SPEs and traces the short history of SPE misuse. His analysis, which looks at elements of the Powers Report, also focuses on controversial gain-on-sale accounting common to many securitizations.

### **Executive Summary**

We know now that Enron financially engineered a number of off-balance sheet transactions that vastly understated the company's debts and materially overstated the firm's earnings and net worth. While the final analysis may not be complete, Enron announced that it took a \$1 billion pre-tax charge largely relating to the unwinding of several SPEs that had served as the counter-party to some of Enron's largest hedge transactions and reversed transactions, which created \$1.2 billion of net worth.

In November 2001, Enron announced it was restating earnings for 1997 through 2000. The restatements resulted in added losses of roughly \$508 million (\$591 million per the Enron 8-K, dated November 8, 2001, for the period). They also reduced shareholders' equity by an additional \$754 million and increased reported debt by \$711 million in 1997, \$561 million in 1998, \$685 million in 1999 and \$628 million in 2000.

The earnings announcement and restatements set off a chain reaction that included the re-evaluation of Enron's investment grade debt rating by several ratings agencies. In turn, the re-evaluation of debt rating, together with Enron's loss of credibility in the marketplace, created a liquidity crisis and a free-fall in its stock price. Within a month of the November announcement, Enron filed for bankruptcy.

This report focuses on Enron transactions involving SPEs in which the company attempted to preserve massive gains in several of its investments by hedging the transactions with a counter-party that substantively was itself. One hedge was designed to protect Enron's massive gains in Rhythms NetConnections, a Colorado-based Internet corporation.

Enron's sizable position plus the volatility and illiquidity of Rhythms made some of Enron's holdings impossible to hedge commercially. These factors apparently were the catalysts behind Enron's attempt to hedge its Rhythms investment by creating a limited partnership SPE, capitalized primarily with Enron shares.

The Rhythms hedge was little more than a prototype to the substantially larger hedges that Enron attempted with four other SPEs known as the Raptors. The SPEs were largely capitalized by transfers of Enron common stock at a discount to market price in three of the four Raptor transactions. Thus, the very defects inherent in the transactions—the possibility of declining prices in both investments and Enron stock—precipitated Enron's collapse.

## Irony Not Appreciated

Andy Fastow the now disgraced chief financial officer of Enron, was anything but modest. In 1999 when he received the *CFO Magazine* Excellence Award for Capital Structure Management Fastow minced no words: "Our story is one of a kind," he said

To fund Enron's dramatic growth, Fastow contended "We couldn't just issue equity and dilute shareholders in the near term. On the other hand, we couldn't jeopardize our (debt) rating by issuing debt which would raise the cost of capital and hinder our trading operations."<sup>1</sup>

So instead, we now know Fastow and Enron are alleged to have financially engineered a number of off-balance sheet transactions that understated the company's debts and massively overstated its earnings and net worth. But before it all came crashing down with the October 2001 announcement that Enron was unwinding several partnerships at a pre-tax cost of about \$1 billion and that an additional \$1.2 billion of net worth had simply vaporized, the then 37-year-old Fastow was something of a Wall Street wunderkind

"Thanks to Andy Fastow Enron has been able to develop all these different businesses, which require huge amounts of capital, without diluting the stock price or deteriorating its credit quality—both of which have actually gone up. He has invented a groundbreaking strategy." Ted A. Izzett, a senior vice president of Lehman Brothers Inc., told *CFO Magazine*.<sup>2</sup>

Ground, however, wasn't all that Fastow's innovations appear to have broken. Some of Enron's transactions clearly departed from generally accepted accounting principles (GAAP) and there is growing evidence that many of them may well have been outright fraud. But to understand fully how Enron concealed its true financial condition from analysts, investors and regulators, one must first understand accounting standards concerning special purpose entities. And to comprehend the accounting, one must also understand their short but decidedly unhappy history.

The simple fact is that Enron is not the only corporation to abuse special purpose entities. SPEs have also figured prominently in controversial gain-on-sale transactions that resulted from securitizations of financial assets. Such gain-on-sale accounting has been the object of litigation at Greentree Financial and at Conseco Inc., the Indiana-based insurance company that purchased Greentree in 1998. It is also central to plaintiffs' class action litigation involving Creditrust, the Maryland public company that raised tens of millions of dollars of equity largely based upon gain-on-sale accounting. Sub-prime lenders, such as First Plus Financial Group Inc., Ugly Ducking Corp., Mercury Finance Co. and Delta Financial Corp. used gain-on-sale accounting to recognize profits up-front on transactions that were in substance little more than secured loans. Ultimately in some of these instances, such profits were either restated or reversed with the write-downs of assets that represented a company's overvalued residual interest in the transactions.

***The simple fact is that Enron is not the only corporation to abuse special purpose entities. SPEs have also figured prominently in controversial gain-on-sale transactions that resulted from securitizations of financial assets.***

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<sup>1</sup> *CFO Magazine*, dated October 1, 1999.

<sup>2</sup> *Ibid.*

## SEC Always Wary

SPEs first appeared in accounting literature in 1989 when the Securities & Exchange Commission (SEC representative told the Emerging Issues Task Force of the Financial Accounting Standards Board FASB that the SEC staff was becoming increasingly concerned about transactions involving special purpose entities. The Emerging Issues Task Force (EITF) was formed in 1984 to assist the FASB in the timely identification and resolution of financial accounting issues within the framework of existing literature. EITF consensus positions are considered GAAP and are given particular credence by the SEC because consensus positions represent "the best thinking on areas for which there are no specific standards."<sup>3</sup>

According to the EITF Topic No. D-14, SEC staff first dealt with SPEs in the context of leasing transactions. Special purpose entities became increasingly popular in the 1970s and 1980s, particularly with secured lenders. Placing assets pledged to secure loans in special purpose entities (with defined powers and limited in scope) provided secured lenders with a vehicle that made the foreclosure process both simpler and more certain. In that context, SPEs were designed to be bankruptcy-proof.

Initially, the SEC held that SPEs should, under most circumstances, be consolidated into the financial statements of their sponsors or transferors. More specifically:

*Generally, the SEC staff believes that for nonconsolidation 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 the nonconsolidation 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 debt of the SPE rest directly or indirectly with the sponsor or transferor.<sup>4</sup>*

A subsequent EITF consensus position, EITF 90-15, discussed the degree of investment necessary for the nonconsolidation of the SPE in leasing transactions. In part, EITF 90-15 stated:

*The SEC staff understands from discussions with the Working Group members that those members believe that 3% is the minimum acceptable investment. The SEC believes a greater investment may be necessary depending on the facts and circumstances, including credit risk associated with the lessee and the market risk factors associated with leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether equity greater than 3% is needed.*

Consolidation or nonconsolidation of SPEs was key to Enron and many other sponsors. If consolidation is required, the SPE is treated as a subsidiary whose assets and liabilities would be included on the sponsor's balance sheet and whose income would be consolidated into the sponsor's statement of operations. Transactions between the

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<sup>3</sup> AICPA Professional Standards, AU§411.10, Footnote 3.

<sup>4</sup> EITF Topic No. D-14, Transactions Involving Special-Purpose Entities.

sponsor and the SPE, however, would be eliminated. Such eliminated transactions would include inter-entity sales and the resulting receivables or payables. Thus, if the SPE did not meet the tests provided in the standards, what was off-balance sheet would become on-balance sheet and inter-entity sales—such as pools of assets in securitizations—would not be sales at all. For Enron, and many other entities, such a result meant or could mean, disaster.

On October 16, 2001, Enron announced a \$1 billion pre-tax charge largely relating to the unwinding of SPEs that had served as the counter-party to some of Enron's largest hedge transactions. In addition, the company announced that \$1.2 billion of net worth recorded in connection with sales of Enron's stock to its SPEs would be reversed. In one fell swoop, roughly 20% of Enron's capital simply disappeared. Moreover, the \$1 billion charge produced a third quarter loss of \$618 million, an amount that represented roughly 60% of earnings for all of 2000.

***.if the SPE did not meet the tests provided in the standards, what was off-balance sheet would become on-balance sheet and inter-entity sales—such as pools of assets in securitizations—would not be sales at all. For Enron, and many other entities, such a result meant, or could mean, disaster***

Less than one month later, Enron dropped the inevitable second shoe by restating earnings for the years 1997 through 2000. The restatements not only netted additional losses of approximately \$508 million (\$591 million according to the Enron 8-K, dated November 8, 2001) over the period, they also resulted in reducing shareholders' equity by an additional \$754 million and increasing reported debt by \$711 million in 1997, \$561 million in 1998, \$685 million in 1999 and \$628 million in 2000. Within a month of the announcement, Enron filed for bankruptcy.

### **Enron's Hedging Transactions**

The most interesting of the Enron transactions involving SPEs were the company's attempts to preserve massive gains in several of its investments by hedging the transactions with a counter-party that substantively was itself.

Financial hedges are something of a zero sum game where the winner's gains and loser's losses largely offset each other—less fees and commissions. Enron was extremely experienced in hedging commodity transactions, but hedging its considerable investments was quite another matter. The first Enron hedge was designed to protect Enron's large gains in Rhythms NetConnections. Rhythms, a Boulder, Colorado-based corporation, was one of the Internet shooting stars that wowed analysts and investors for a brief time before incinerating upon entry into the most forbidding atmosphere of all—financial reality.

Enron invested \$10 million in Rhythms in March 1998, roughly a year before the Internet service provider went public. With a cost basis of \$1.85 per share, Enron began to recognize massive profits with the initial public offering at \$21 per share. By the close of the first trading day, Rhythms rose to \$69 per share.

According to the *Report of Investigation issued by the Special Investigative Committee of the Board of Directors on Enron Corp.* (known widely as the Powers Report), Enron was prohibited from selling its Rhythms shares prior to the end of 1999 pursuant to a lock-up agreement. Enron accounted for the investment as part of its merchant portfolio; thus



Enron's income statement reflected some \$290 million of unrealized gains from Rhythms by the end of May 1999.<sup>5</sup>

The size of Enron's position together with the volatility and illiquidity of Rhythms made Enron's holdings impossible to hedge commercially according to the Powers Report. That same price volatility and illiquidity apparently were the catalysts behind Enron's attempt to hedge its Rhythms investment in a wholly unconventional way.

Enron's solution was to create a limited partnership SPE, capitalized primarily with appreciated Enron shares covered by forward contracts. Enron had entered into the forward contracts to purchase its own stock at a specified price initially to hedge the dilutive effects from the exercise of employee stock options at relatively low strike prices. By 1999, the forward contracts provided Enron the option to purchase its own shares at prices significantly below the shares' then current market value, making the contracts increasingly valuable.

The complex scheme, which was concluded in June 1999, contained three principal elements. Enron first restructured the forward contracts to release 3.4 million shares of Enron common stock that Enron then transferred to LJM1, one of the partnerships created and controlled by Fastow. At the date of closing, the Enron shares had a market value of \$276 million. Enron, however, placed a contractual restriction on the shares that prohibited their sale for four years and their hedging for one year. The value of the restricted shares was set at \$168 million, a discount of approximately 39%. In exchange for the shares, LJM1 gave Enron a note for \$64 million, due on March 1, 2000.

In turn, LJM1 capitalized a second SPE, Swap Sub, with 1.6 million of Enron shares (worth approximately \$80 million and \$3.75 million in cash). The second SPE granted a put option on 5.4 million shares of Rhythms to Enron. The put option gave Enron the right to sell its entire Rhythms position at \$56 per share in June 2004. The put option was valued at roughly \$104 million—the difference between the \$168 million value of Enron's restricted shares and the note payable by LJM1 to Enron to acquire the shares. The put option was carried on Swap Sub's books as a liability.

**By 1999, the forward contracts provided Enron the option to purchase its own shares at prices significantly below the shares' then current market value, making the contracts increasingly valuable.**

As described earlier, hedging is something of a zero sum game. In this instance, the Swap Sub—the second SPE—could only cover Enron's losses on Rhythms up to its cash of \$3.75 million. Beyond that, the second SPE held only 1.6 million of Enron shares that could not be hedged for a year or sold for four years. Thus, if Rhythms stock declined substantially, the Swap Sub's ability to make good on its put option was largely dependent on Enron shares holding or increasing their value.

In July 1999, Enron and the Swap Sub negotiated further refinements to the transaction. While the hedge worked to some extent, the continued volatility of Rhythms still had some impact on Enron's income. In March 2000, when the restrictions came off of the Rhythms stock, Enron unwound the transaction.

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<sup>5</sup> Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., William C. Powers, Jr., Chair. Page 77.

Aside from the problems of perfecting the hedge there was a fundamental accounting issue involving the SPE. According to the Powers Report Swap Sub could not demonstrate its 3% equity position to satisfy the nonconsolidation requirements put forward in the EITF consensus position. Instead, Enron investigators believe that Swap Sub had negative net worth from its beginning, which by definition, meant the test was never met. In Congressional testimony last December Arthur Andersen's CEO Joseph F. Berardino acknowledged that the decision not to consolidate was an "error."<sup>6</sup>

As we have seen, however, the 3% test was not a static requirement. The SEC's wariness over nonconsolidations of SPEs was clearly documented in the EITF consensus opinions and the 3% test was only a minimum. Had the Swap Sub SPE been consolidated, there would have been no hedge whatsoever. The Swap Sub hedging transaction resulted in the overstatement of Enron's net income in 1999 by \$95 million and net income in 2000 by an additional \$8 million.<sup>7</sup>

### **Raptor Transactions**

The Rhythms hedge was little more than a prototype to the substantially larger hedges Enron attempted with four other SPEs known as the Raptors. In each of the Raptor transactions, Enron tried to engineer hedges that protected—on a one-for-one basis—declines on certain of its merchant investments. As with the Rhythms hedge these transactions were not economic hedges, but depended solely on Enron's ability to deliver stock to SPEs in an amount sufficient to cover their losses. Thus, Enron was hedging its risks with itself.

***The Rhythms hedge was little more than a prototype to the substantially larger hedges Enron attempted with four other SPEs known as the Raptors.***

The SPEs were largely capitalized by transfers of Enron common stock at a discount to market price in three of the four Raptor transactions. As the market values of its merchant investments dropped and the price of Enron weakened, several of the Raptor entities required additional capital to shore up their ability to cover Enron's losses on its merchant investments. The very defects inherent in the transactions—the possibility of declining prices in both investments and Enron stock—precipitated Enron's collapse.

As a result in the third quarter of 2001 Enron reported some \$544 million in losses from the unwinding of the Raptor transactions and acknowledged that some \$1.2 billion of shareholders' equity would be written off. Enron's internal investigators are not certain that the massive charges were adequate.<sup>8</sup> According to the Powers Report it was Jeffrey Skilling, Enron's then President and future CEO, who directed Enron's professionals to devise mechanisms that hedged a portion of Enron's many investments.

The first Raptor transaction was created effective April 18, 2000 and involved an SPE called Talon LLC (Talon LMJ2, another of Fastow's partnerships, capitalized Talon with \$30 million in cash. Enron, through a wholly owned subsidiary contributed \$1,000 in cash, a \$50 million promissory note and Enron stock and stock contracts with a fair market value of \$537 million.

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<sup>6</sup> Ibid, Pages 83 and 84.

<sup>7</sup> Ibid, Page 84.

<sup>8</sup> Ibid, Page 98.

As with the Rhythms hedge the Talon SPE received restricted Enron shares that prevented their immediate hedge or sale. As a result the shares were discounted by approximately 35% from their then current market price. LJM2's initial \$30 million investment in cash was considered to be adequate for the purposes of the 3% test and by Enron's calculation, Talon could absorb losses up to \$217 million. The credit capacity consisted of the \$30 million in cash and \$187 million of discount to the market on the contributed Enron shares. In other words, if Enron's stock price remained stable Talon would realize \$187 million in price appreciation once the restrictions on its Enron common stock expired. It was that potential appreciation that was available to cover Enron hedges.

***The very defects inherent in the Raptor transactions—the possibility of declining prices in both investments and Enron stock—precipitated Enron's collapse.***

Other, apparently unwritten, provisions assured that LJM2 would recoup its investment plus a handsome return before Talon could enter into hedging transactions with Enron. Such provisions appear to depart directly from the EITF consensus position that required that the 3% outside investment be at risk for the entire term of the transaction. To circumvent that requirement Talon sold Enron a put on Enron stock for \$41 million. The effect of the transaction was to create income for Talon that could be paid out to LJM2, which, in fact it was. Enron's business purpose of in effect betting against itself was not explained.

Moreover, if LJM2 did not recoup its investment within six months, it could require Enron to purchase its interest in Talon at a value based upon the unrestricted price of Enron stock and stock contracts. Such a term would have resulted in a \$187 million windfall to LJM2. With Fastow and his LJM2 partnership enriched, Talon could begin the business for which it was apparently created—concealing Enron's losses on merchant investments.

Most of the Enron transactions with Talon involved total return swaps on Enron's merchant investments. These swaps provided that Talon would receive the amount of any future gain on those investments, but in turn, would have to pay Enron the amount of any future losses. The initial transactions, according to the Powers Report, were dated August 3, 2000, which coincided with the date Avici Systems, a public company in which Enron had a substantial stake, reached its all-time high of \$162.50 per share. Had the transaction been dated September 15, 2000, when the agreements were actually signed, Enron would have suffered substantial losses. As it was executed, Enron avoided recording a \$75 million loss on Avici for the third quarter in 2000 while Talon bit one very large bullet. Since LJM2 had already been paid \$41 million, substantially more than its investment of \$30 million, it had no incentive to drive a harder bargain on Talon's behalf.

The one-sided nature of these transactions, after the LJM2 recoveries, was apparently characteristic of the Enron's dealings with the Raptor vehicles. Enron North America attorney Stuart Zisman, wrote on September 1, 2000:

*Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). As it turns out we have discovered that a majority of the investments being introduced into the Raptor Structure are the bad ones. This is disconcerting (because . . . it might lead one to believe that the financial books at Enron are being "cooked" in order to*



*eliminate a drag on earnings that would otherwise occur under fair value accounting.*

Enron North America's two most senior attorneys received a copy of the memorandum, but apparently believed its primary assertion, that Raptor could be misused to hedge bad investments, was untrue.<sup>9</sup>

The continued decline in the value of Enron's merchant investments throughout the fall of 2000 became a primary concern at Enron. While the engineered accounting hedges provided seeming protection against these portfolio losses, there was fear that the losses would exceed Talon's total assets—which by then was the value of Enron stock and stock contracts. Once Talon's liability to Enron exceeded its assets, Enron would be compelled to record a charge against income for the difference.

To forestall the risk of a decline in the price of the Enron stock, Enron entered into a "costless collar" on the approximately 7.6 million shares of Enron held by Talon. The "collar" provided that if Enron stock fell below \$81 per share, Enron would pay Talon the amount of any loss. If the stock price increased above \$116 per share, Talon would pay Enron the amount of the gain. If the price remained between the floor and ceiling prices, neither party was obligated to the other.

Still, the very existence of the "collar" was motive enough for Enron to continue its schemes to prop up the hefty price/earnings multiple of its shares by concealing its losses. Moreover, the collar violated the restrictions Enron had placed on the stock when it was conveyed to Talon. Those restrictions, it should be recalled, were the primary basis for a valuation discount of roughly 35%. The potential stock appreciation as the restrictions expired was a primary source of capital, according to the Powers Report.

By November 2000, Enron had entered into derivative transactions with the Raptors valued at more than \$.5 billion. By December 2000, Enron's gains and the Raptors' collective losses on the transactions exceeded \$500 million, which created a credit capacity crisis. Both Talon and Raptor III had liabilities to Enron that exceeded their total assets. Under those circumstances, Enron was obligated to record some of the losses, but circumvented the write-down by cross pledging assets of Raptors II and IV, which were not yet under quite so much water.

### **Losing Control**

In the first quarter of 2001, both Enron's investments and its stock price continued to decline. By March 31, 2001, Enron had some \$504 million of losses it would have been compelled to record unless the Raptor transactions, including Talon, were restructured. Enron solved the problem by selling the Raptor entities an additional \$828 million of discounted Enron stock for Raptor entity promissory notes. It recorded the stock as shareholders' equity but erroneously recorded the notes receivable as assets. Enron had followed the same accounting treatment in some of the Talon transactions.

The problem with the accounting is that it was an obvious and flagrant departure from long-standing, generally accepted accounting principles that prevented corporations from self-funding their own stock sales to create additional net worth. Indeed, an early EITF consensus position—EITF 85-1—specifically concluded that reporting the note received for stock as an asset is "generally not appropriate except in very limited

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<sup>9</sup> Ibid, Page 109

circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time ”<sup>10</sup>

The EITF further referenced longer-standing SEC requirements that public companies report notes received in payment for an enterprise's stock as a deduction from shareholders' equity. Despite the clear guidance, Arthur Andersen initially blessed the transactions.

In August 2001, Andersen and Enron accountants realized the accounting for the share sales to the Raptor entities was clearly wrong. To correct the error, however, Enron would be required to write down both its assets and net worth by \$1 billion during a period when Enron was borrowing heavily. The potential impact on Enron's credit ratings was profound. In mid-August, after less than a year on his dream job, Jeffrey Skilling, Enron's new CEO, resigned for personal reasons. Within days, Sherron Watkins, the internal Enron whistleblower, wrote Kenneth Lay, Enron's chairman and CEO, her now infamous memo.

*We have recognized over \$550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly—Avici by 98%, from \$178 mm to \$5mm, The New Power Company by 70%, from \$20/share to \$6/share. The value in these swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.*

*I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an accounting hoax.”<sup>11</sup>*

With the September 30, 2001, quarter-end rapidly approaching, events were careening beyond Enron's control. While Andersen was not forcing a restatement of prior financial statements as a result of the improper recognition of sales of equity to the Raptors, the error would be reckoned in the third quarter 10-Q, Enron's required quarterly filing with the SEC. Moreover, because such announcements may well have driven down the price of Enron stock further, the Raptor hedges, largely dependent on Enron share values, would likely be in further jeopardy. On September 28, Lay, who resumed his CEO duties with Skilling's resignation, ordered the Raptor transactions unwound.

On October 16, 2001, Enron made its earnings announcement, disclosing the \$1 billion pre-tax loss. Excluded from the nine-page press release was any discussion of the \$1 billion write-off of equity as a result of the improper accounting for the notes receivable. The issue was mentioned in the conference call with analysts, but attributed to the unwinding of the Raptor partnerships which required an additional \$200 write-down of equity.<sup>12</sup>

During the next three weeks, Andersen began reversing its positions regarding the nonconsolidation of the SPEs. On November 8, Enron announced that its financial statements from 1997 forward would be restated, largely as a result of Enron's failure to consolidate its major SPEs.

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<sup>10</sup> EITF 85-1 Consensus Position

<sup>11</sup> Watkins Memo, Page 1

<sup>12</sup> *Enron Posts Surprise 3rd Quarter Loss After Investment Asset Write-Downs*, the Wall Street Journal, dated October 17, 2001.

## **Blame the Standards?**

In Enron's aftermath, some critics have argued that the standards vis-à-vis SPEs were too vague to provide adequate guidance while others contended that the standards took a narrow "cook book" approach—which resulted in engineering the form of the transactions to meet applicable criteria, but ignored their substance

The fact is that the EITF consensus opinions and other accounting and auditing standards made it clear that the consolidation of an SPEs was dependent not only on compliance with the so-called three percent rule but required careful, professional judgment concerning determinations of whether the sponsor controlled the entity was the primary beneficiary of the SPE's activities or was the party primarily at risk if the SPE's activities went awry

Moreover many of Enron's SPEs were related parties because of the involvement of Fastow and other Enron employees. Audit and fraud literature repeatedly warn auditors to pay particular attention to such transactions because they obviously cannot be easily negotiated at arm's length. Audit standards on related parties state specifically:

*In addition, the auditor should be aware that the substance of a particular transaction could be significantly different than its form and the financial statements should recognize the substance of particular transactions rather than merely their legal form.<sup>13</sup>*

In examining related party transactions, audit standards require that the auditor understand the business purpose of a transaction and caution that until an understanding of the "business sense" of the transaction is obtained, "he cannot complete his audit"<sup>14</sup> Like or not auditors are required to see the forest through the trees.

That Enron restated prior financial statements, together with the fact that Andersen is reportedly attempting to settle Enron claims for \$700 million to \$800 million more than double previous record amounts for audit negligence settlements<sup>15</sup>) suggests that these issues do not fall into gray areas that can be conscionably argued in good faith. Therein lies the rub.

No matter what systems are implemented, Enron is not likely to be the last or the largest case of financial reporting fraud. Accounting and reporting standards are generally written to fairly reflect the economic and financial substance of transactions often simple but sometimes complex. Whether couched in broad principle or written with excruciating specificity, accounting principles will govern only if thoughtful and competent professionals acting with integrity implement them

## **Blame the Interpreters?**

At the same time, legal and capital market innovations have created new and difficult transactions forcing standard setters to play an endless game of catch up. SPEs were initially established as a structure to benefit secured lenders, but quickly became a vehicle for off-balance sheet transactions and ultimately a pretext for misguided gain-

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<sup>13</sup> AICPA Professional Standards, AU§334.02.

<sup>14</sup> Ibid, AU§334.09 and Footnote 6.

<sup>15</sup> Andersen Makes Offer to Enron Creditors Panel, Wall Street Journal, February 21 2002.

on-sale accounting All of these transactions involve complex analysis and judgments about the substance of significant financial and economic events.

SPEs have not only been central to the Enron debacle but are fundamental to the gain-on-sale accounting permitted in FASB Statement No. 125, which was replaced by FASB Statement No. 140. The abuse of gain-on-sale accounting is the primary issue in the substantial class action litigations against Conseco Inc., and Creditrust the bankrupt Maryland Corporation, which purchased and securitized delinquent credit card receivables. Sub-prime lenders, such as First Plus Financial Group Inc., Ugly Duckling Corp., Mercury Finance Co and Delta Financial Corp., also used gain-on-sale accounting to recognize up-front profits on securitization transactions. Ultimately, in some instances, such profits were either restated or reversed with the write-downs of assets that represented a company's overvalued residual interest in the collateral

Because of these and other benefits, securitizations of financial assets have become increasingly popular in the last 30 years. In substance they can be little more than secured borrowings collateralized by financial assets, such as car loans, real estate mortgages or credit card receivables. In many instances, the *de facto* issuer pledges pools of receivables to secure borrowings, usually in the form of notes or bonds. The pools of receivables are often held in bankruptcy-proof SPEs at the insistence of purchasers. Typically note purchasers have the benefit of the pools of receivables only so long as principal and interest remains to be paid Thus, when the notes are paid, the residual collateral reverts to the original holder Often, the residual values are considerable because the notes were over collateralized or the interest receipts on the pools were at substantially higher rates than the interest payments on the notes.

***SPEs have not only been central to the Enron debacle but are fundamental to the gain-on-sale accounting permitted in FASB Statement No. 125, which was replaced by FASB Statement 140.***

FASB Statement No. 140 permits the transfer of the pools of receivables to special purpose entities to be treated as a sale as long as the residual value held by the so-called seller is reasonably estimable Such accounting permits the recognition of up-front gains on these pseudo-sales even before a dollar of the underlying security had been collected Invariably the amount of the gain on sale is determined by an estimate subject to human engineering

Just as disclosures at Enron have ultimately resulted in increased market skepticism of other corporations whose accounting is opaque or otherwise suspect Wall Street also punished Conseco Inc., the Indiana insurance company which employed gain-on-sale accounting only to ultimately announce material write-downs of its residual interests in its securitizations. Conseco abandoned gain-on-sale accounting in September 1999 because analysts became increasingly doubtful about its reported gains.<sup>16</sup> Creditrust collapsed after the insurer of several of its securitizations pulled the servicing of the receivables from the company after allegedly discovering substantial irregularities.

Because of the far-reaching impact of these and other corporate failures, like it or not accounting and audit standards have become serious public policy issues and should so be treated SPEs were and continue to be an important legal innovation that serve to

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<sup>16</sup> *Insurer Conseco Says Accounting Change Will Hurt 1999 Earnings*, Dow Jones Business News, September 8, 1999

protect secured lenders. As a matter of public policy however it would clearly have been best to simply have left them at that

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