Fraud and Deception: An Enron Case Study

By
National Tax Institute, Inc.

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Objectives: The purpose of this course is to review the factors that led to the demise of Enron. This course also looks at the aftermath of Enron including changes that have been made to accounting, auditing and SEC rules as a direct result of those issues identified as existing in Enron. This course reviews the GAAP rules in effect at the time of the Enron abuses, at the Enron case with particular emphasis on the four special purpose entities that led to Enron's restatement of its financial statements and its ultimate bankruptcy filing. It also looks at the aftermath of Enron including the Sarbanes Oxley Act of 2002 and its rules affecting auditors and accountants, and the new consolidation rules related to variable interest entities (VIEs) which require that certain off-balance sheet entities be consolidated.

Upon completing Section I of this course, you will be able to:

- Outline the GAAP rules that existed at the time of Enron, as they relate to investments, special purpose entities (SPEs) and consolidations;
- Compare and contrast the three tiers of ownership of outstanding voting stock and their accounting treatment;
- Categorize the three types of securities and the accounting treatment within the categories under FASB No. 115;
- Identify when the equity method should be used;
- Name the general rule for consolidation under ARB 51;
- Explain the SEC's position on consolidation;
- List the factors that the registrant should consider in determining the most meaningful presentation in deciding upon consolidation policy;
- Provide examples of when to use combined financial statements;
- Delineate the basic rules that must be followed when presenting combined financial statements;
- Name the exceptions to the more than 50% ownership test of ARB No. 51;
- Define the term "special purpose entity";
- Trace the steps that were usually taken by an SPE;
- Name the advantages of using SPEs under the previous rules in effect during Enron;
- Describe the three general criteria for non-consolidation;

- Summarize the special rules for SPEs involved in leasing transactions;
- Explain the rules for SPEs when there was a transfer of financial assets and liabilities;
- Identify the rule for balance sheet classification of notes receivable in connection with the issuance of equity and paid-in capital; and
- Name the rule regarding companies recording income and gains on their own stock.

Upon completing Section II of this course, you will be able to:

- Trace the development of Enron's mishandling of SPEs;
- Explain the various way that Enron violated the three non-consolidation criteria for SPEs;
- Draw and outline the basic structures of Enron's SPEs;
- Delineate the events of each phase of the first Enron SPE, JEDI and Chewco Investments L.P.;
- Name the GAAP violations that occurred during each phase of JEDI-Chewco;
- Explain the outcomes of JEDI-Chewco and its GAAP violations;
- Recognize the other GAAP issues related to Chewco and JEDI;
- List the events of each phase of the LJM1 partnership;
- Recognize the GAAP violations that occurred during each phase of LJM1 and Swap Sub;
- Name the events of each phase of LJM2 and the Raptors;
- Identify the GAAP violations that occurred during each phase of LJM2 and the Raptors;
- Explain how the LJM partnerships mishandled other transactions;
- Delineate how several employees were personally enriched at the expense of Enron;
- Identify the restatements that Enron made in November 2001;
- Trace the demise of Enron following the announcement of the restatements;
- Illustrate Enron's disclosure deficiencies;
- Describe the existing GAAP requirements for related party transactions;
    - Delineate the general rules for disclosing related party transactions;
    - Name the SEC rules for related party transactions; and
- Discern whether or not Enron satisfied the GAAP and SEC disclosure requirements;

Upon completing Section III of this course, you will be able to:

- Summarize the background for boards of directors and audit committees;
    - State some obvious symptoms that existed in companies that committed fraud;

  - Describe the SEC's rules related to audit committees provided in *Audit Committee Disclosure*;
  - Identify the changes that were made to *Audit Committee Disclosure;*
- Determine whether Enron's board of directors was independent of management;
- Explain the breakdown in internal control;
- Identify the specific roles of Enron's board of directors;
- Delineate the specific roles of Enron's audit and compliance committee;
- List the specific roles of members of Enron's senior management; and
- Explain the specific roles of Arthur Anderson.

Upon completing Section IV of this course, you will be able to:

- Differentiate between the authority provided for fraud and illegal acts;
- Explain how Enron's audits identified some signs of fraud;
- Name the problems that were associated with independence and conflicts of interest between Anderson, Enron and the Big Five;
- Recognize what portion of the Big Five's revenue was derived from non-audit services;
- Discern whether there is any correlation between the receipt of large consulting fees and the quality of the audit;
- Trace the SEC's attempt to change the independence rules;
- Provide examples of the problems with conflicts of interest among the financial analysts community; and
- Outline the new rules that the Sarbanes-Oxley Act requires of analysts and investment bankers.

Upon completing Section V of this course, you will be able to:

- Categorize the major changes that have been made and will be made as a direct result of Enron;
- Outline the changes that Harvey Pitt made to Congress;
- Explain the general changes that the Sarbanes-Oxley Act of 2002 made;
- Provide details about the makeup of the Public Company Accounting Oversight Board (PCAOB);
- Identify how the Sarbanes-Oxley Act affects SEC auditors;
- Recognize how the Sarbanes-Oxley Act changes the conflicts of interest and auditor independence rules;
- Describe how the Sarbanes-Oxley Act affects boards of directors and audit committees;
- Illustrate how the Sarbanes-Oxley Act affects corporate officers;
- List the new corporate disclosures required by the Sarbanes-Oxley Act;

- Determine the punishments for various violations;
- Explain the revised rules for investment bankers and analysts;
- Recognize other provisions of the Sarbanes-Oxley Act;
- Illustrate the trickle down effect of the Sarbanes-Oxley Act;
- Identify results of the GAO's *Mandated Study on Consolidation and Competition in the Accounting Profession*;
- List the recommended changes for FASB;
- Explicate Enron's impact on a principles-based accounting system;
- Compare a rules-based system of accounting to a principles-based accounting system;
- List advantages and disadvantages of both a rules-based system and a principles-based system;
- Explain Enron's impact on the change in the SPE rules (i.e., FASB Interpretation No. 46R);
- Define a "variable interest entity";
- Categorize and describe off-balance sheet entities;
- Apply and explain the rules of FASB Interpretation No. 46R;
- Name the three basic rules for consolidation;
    - Determine whether there is a variable interest entity;
    - Establish whether an entity or individual has variable interests in the VIE;
    - Resolve the issue of the primary beneficiary;
- Define the term "variable interest";
- Provide examples of variable interests;
- Define the term "primary beneficiary:'
- Follow the rules to determine who the primary beneficiary of the VIE is;
- Outline the related-party rules for primary beneficiaries;
- Explain the operating lease issue;
- Follow the rules for initial testing and measuring of the VIE by the primary beneficiary;
- Recognize the effective date and transition requirements of Interpretation No. 46R for public entities and non-public entities;
- Describe the ongoing changes being made in Congress to pensions and 401(k) plans;
- List reasons why individuals would choose to not serve as a board member or on a company's audit committee;
- Illustrate the new post-Sarbanes environment for directors;
- Provide examples of possible claims against directors and officers;
- Explain the issue of D&O insurance;
- List the three areas of D&O insurance coverage;

- Recognize the effect of higher malpractice insurance rates and higher audit fees;
- Identify how the cost of section 404 of Sarbanes-Oxley compliance is exceeding estimates;
- Outline reasons why European companies are delisting from the U.S. exchanges and why smaller companies are going private; and
- Explain the effect that the Enron scandal has had on the accounting profession.

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While allegations of wrongdoing have been made in the financial press, the Powers Report, and other publications, as well as in Congressional Hearings, that are referenced in these materials, only certain employees and officers of Enron have been convicted of any crime. These materials are based on information the author has obtained from third parties who the author believes are reputable and who are referenced in the materials. However such information, by admission of the third parties, is not necessarily complete, and may contain errors or misleading information.

Fraud and Deception: An Enron Case Study

I. General

As the Enron trials against its key executives have finally come to an end, in hindsight, Enron has had one of the most pervasive impacts on the accounting profession and the investment community since the Depression. The largest bankruptcy in American history has called into question the effectiveness of auditors and the integrity of the accounting profession, as a whole. In the post-Enron era, dramatic reforms have been passed, several of which have impacted the ability of the accountants to continue as a self-regulated profession.

Other players in the Enron saga, including financial analysts and lawyers, have also felt the effects of Enron's demise, which has resulted in sweeping reforms in independence, conflict of interest rules and liability limits. More than 6 years later, changes continue to come.

In six short years, the Justice Department has charged 34 individuals and companies with crimes most of which have been prosecuted or settled.

Some of the more high-profile cases follow:

- Andrew Fastow, former Executive VP and CFO was found guilty and is serving a 6.5 year prison term
- Jeffrey Skilling, the former CEO was found guilty of 19 counts of fraud, conspiracy and insider trading and is serving a 24-year prison sentence, pending appeal.[1]
- Kenneth Lay was convicted of six counts of fraud and conspiracy. He subsequently died in prison while awaiting his appeal.[2]

The public has watched and demanded accountability for the billions lost by Enron shareholders, creditors and employees. Congress responded with the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes). Sarbanes has made dramatic changes to corporate governance, audit conflicts of interest, and makes officers of SEC companies more accountable for their financial statements. Sarbanes also introduced a Public Company Accounting Oversight Board (PCAOB) to oversee the accounting profession and to promulgate both accounting and auditing standards for SEC companies. Congress continues to propose and pass other laws affecting SEC companies, some of which are positive and constructive, while others are simply political window dressing. Oddly, some of the changes made by Congress have brought to the forefront Washington's hypocrisy. Many of the same Congressmen who demanded changes to the accounting rules in the wake of Enron, ultimately opposed those changes when proposed by the FASB several years later. One example was where several congressmen challenged the issuance of FASB No. 132R involving stock options, even though Enron executives reaped the benefits of sizable stock option programs.

The collapse of Enron also resulted in the end of Arthur Andersen. Who would have thought that a bankruptcy of any one publicly held company could bring down a multi-billion-dollar Big Five

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[1] Prosecutors also sought $182.8 million recovery from Skilling. The final judgment was for $45 million which is still pending in appeal.

[2] In October 2006, a federal judge reversed Kenneth Lay's case in light of his death. The $43.5 million damages claim against Law was also dropped.

accounting firm and its eighty-five thousand employees and members? Enron will also be one of the true tests of the "litigation-proofing" of a limited liability partnership (LLP) and the ability to pierce the LLP and seek personal liability from its members. Given the fact that LLC and LLP legislation is relatively new, the ability of the courts to attach personal liability to Andersen members would send a chilling message to members in other professional practices who believe they are insulated from the sins of their fellow members. One irony is that with the elimination of Andersen, the Justice Department may have created a monopoly with the remaining Big Four. Simply put, with only four multi-national accounting firms remaining, the Justice Department cannot afford to allow another one of them to be taken down. This fact was evident when the Justice Department agreed not to file criminal charges against KPMG for its promotion of tax shelters. A Big-Three environment would clearly create a monopoly within the auditing profession as it relates to audits of SEC companies.

The American Institute of Certified Public Accountants (AICPA) was also a big loser as a result of the Enron scandal. The fact that the AICPA did not aggressively pursue radical changes in conflicts of interest among the then Big Five accounting firms tainted the AICPA's reputation. Critics of the AICPA had further evidence to fuel their claim that the AICPA was a representative of the former Big Five accounting firms, and not concerned about the profession as a whole. The AICPA's role in the promulgation of auditing standards (via the Auditing Standards Board) has been reduced, with the PCAOB taking over the issuance of auditing standards for SEC companies. Ultimately, the author believes the PCAOB also will take over a portion, if not all, of the accounting standard setting, thereby making the FASB irrelevant to SEC companies. The public oversight board (PCAOB), which is discussed in the Sarbanes-Oxley Act section of this course, makes accountants and auditors much more accountable to an independent board.

The FASB's relevance in establishing accounting standards has also been challenged as a result of Enron. Congress and the investment community have criticize the FASB for issuing accounting pronouncements that have been inadequate and unintelligible. Critics continue to bring to the forefront the fact that all accountants have known for years; that is, accounting pronouncements are so complex and voluminous that even accountants don't understand them. For example, if an accountant cannot understand a pension footnote, why should one expect a non-accountant third party to understand it!

The FASB had also been criticized for having a conflict of interest in that Corporate America funds a large portion of the FASB's annual budget. This apparent conflict appears to have been neutralized by Sarbanes-Oxley's requirement of mandatory FASB funding by SEC companies thereby eliminating any discretionary funding by such companies. There is also concern that the FASB's rule-making process is slow, taking as long as several years from start to issuance of a final accounting statement.

What's in this section?

A discussion of Enron could follow several directions. A "soap-opera" approach, focusing on who knew what, where and when, will continue to be played out in the financial press and Hollywood movies for years to come. Such an approach, although fascinating, does not deal with the underlying diseases of the Enron case and how they can be avoided in the future.

Instead, the author uses a more technical approach to discussing Enron, focusing on answering the following questions. What were the rules? How were they applied? What were the violations and results of those violations? What are the changes that have occurred in light of Enron?

The Enron case is a very public one. Although the Enron era has slowly come to an end, not too long ago it has been impossible to read the *Wall Street Journal* or *New York Times* without finding several articles related to Enron. In the archives at www.congress.gov, there are transcripts of previous Enron hearings as twelve committees and subcommittees previously dissected the case. Numerous bills have been proposed in Congress, most dealing with the accounting profession, auditing, pension reform, and financial statement disclosures. Some of those bills have passed, while others have been combined or withdrawn. Much of the information presented to the public is more dramatic than technical in nature, as the public generally is not interested in the myriad of details of accounting and auditing rules that apply to this case. In preparing this chapter, the author conducted his research from the following sources:

- FASB Pronouncements including FASB statements
  Emerging Issues Task Force Opinions
- The Powers Report[3]
- *Wall Street Journal* Articles
- *New York Times* Articles
- Interviews with FASB and SEC staff
- Congressional Record
- AICPA Related Party Toolkit.

The author's discussions in this chapter are based primarily on second-hand information. In reading this chapter, one will observe many references to the ***Powers Report***, or more formally entitled *Report on Investigation,* by the Special Investigative Committee of the Board of Directors of Enron Corp. In October 2001, William Powers, Dean of the University of Texas School of Law, and two other individuals were named to a Special Investigative Committee of Enron's Board of Directors to conduct an investigation into the related-party transactions of Enron. In February 2002, the investigation culminated with the issuance of the Report on Investigation (the "Powers Report"), which was submitted to Congress and used as the basis of Congressional Hearings on Enron. To date, the Powers Report represents one of the most thorough and complete investigative analyses of the Enron partnerships and other related-party transactions to date.

The author has also relied on the numerous articles written by the *Wall Street Journal, New York Times* and other professional periodicals, all of which have done exhaustive coverage to feed the public's appetite for Enron. Because most of the information presented was obtained second hand, there is the risk that ultimately the facts presented may be deemed false or exaggerated, and those parties implicated may be vindicated.

The Enron section of this chapter is segregated into the following sections:

1. Accounting Issues
2. Enron and GAAP violations
3. Enron's Board of Directors and Audit Committee
4. Auditing, Independence and Conflicts of Interest

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[3] Report on Investigation, by the Special Investigative Committee of the Board of Directors of Enron Corp. (February 1, 2002), authors: Williams C. Powers, Jr., Raymond S. Troubh, and Herbert S. Winokur, Jr. (herein referred to as The Powers Report).

5. Changes after Enron
6. Is the Image of the Accounting Profession Rebounding After Enron?

II. Accounting Issues

The Enron collapse is as much a debate on misapplication of generally accepted accounting principles (GAAP) as it is an assessment of the quality and adequacy of the GAAP rules themselves. Although regulators have mandated changes to the accounting rules for special purpose entities (SPEs) and consolidations, the real question is whether Enron would have failed anyway had it properly applied the existing GAAP rules? That is, was the real problem in the fact that Enron did not follow the GAAP rules, or were the existing GAAP rules for SPEs inadequate in the first place? The answer to that question remains to be seen.

In this section, we review the GAAP rules that existed at the time of Enron, as they relate to investments, special purpose entities (SPEs) and consolidations. Some of the rules have since been changed such as those related to off-balance sheet entities. Although the GAAP scope could certainly be expanded to discuss other issues including use of derivatives, the author has limited his discussion specifically to those GAAP trouble areas that are purported to have resulted in Enron's collapse.

In general, it has been reported that Enron used a strategy to take advantage of existing GAAP rules to achieve a few objectives as follows:

1. Used SPEs to remove selected assets and related debt from its balance sheet

2. Sold selected assets to SPEs to generate gains on sales and revenues

3. Manipulated the timing and percentages of ownership of other entities to avoid consolidation with those entities.

1. Overview of GAAP Rules for Investments, Consolidations and SPEs

The accounting for investments has generally been based on the percentage ownership that one entity has held in another entity's voting stock. The ownership percentages are segregated into a multi-tiered system, summarized as follows:

Ownership of Outstanding Voting Stock	Accounting Treatment
TIER 1: Less than 20% ownership	
a. Non-securities- closely held investments	ARB No. 43- Investments recorded at amortized cost. A writedown is made to lower of cost or fair value if a loss is permanent.
b. Securities- debt or equity- placed into 3 categories	FASB No. 115- Securities are recorded at fair value or cost based on three investment categories:
1. Held to maturity- Recorded at amortized cost 2. Trading securities- Recorded at fair value- gain/loss on income statement 3. Available-for-sale -Recorded fair value- gain/loss in stockholders' equity	
TIER 2: 20-50% or significant influence	APB No. 18: Use the equity method
TIER 3: Consolidation or Combined Financial Statements	
a. Consolidation based on ownership of more than 50% ownership in voting stock	ARB No. 51 and FASB No. 94: Consolidate unless control is temporary, or does not rest with the majority owner.
b. Exceptions where consolidation is based on control, but not necessarily more than 50% ownership.	Three exceptions to the more than 50% consolidation rules- Consolidate based on different rules: 1. Physician Practice Management Entities 2. Real Estate Entities 3. Special Purpose Entities (SPEs)
c. Combined financial statements	Option to combine financial statements of two or more entities when it is more meaningful to do so.

TIER 1: Investments with less than 20% ownership in the voting stock

The accounting for investments in less than 20% of the outstanding voting shares is addressed by two sets of rules:

Investments in non-securities: If the investments are non-securities, such as closely held stock, convertible debt or redeemable preferred stock, the investments are recorded at cost in accordance with ARB No. 43, Chapter 3, *Working Capital.* Subsequently, the investments are adjusted to the lower of cost or market value only if there is a significant loss and that loss is other than temporary.

Investments in securities: If the investments are securities (e.g., traded on a public exchange), the rules of FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities* apply. FASB No. 115 places investments in securities into *three categories* and has separate rules for each category.

The **three (3) categories** are as follows:

1. Debt securities held-to-maturity- Debt securities that management plans to hold until maturity.

2. Trading securities- Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).

3. Available for sale securities- Both debt and equity securities that are not categorized as either held-to-maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

The category in which a security is placed is determined at the time of purchase based on **management's positive intent and ability.** Once a security is placed in a particular category, it generally can be changed only where there are significant unforeseeable circumstances.

The following table summarizes the accounting treatment for the securities within the three categories under FASB No. 115.

	Debt securities held-to-maturity	**Trading securities**	**Available-for-sale securities**
Type	Debt	Debt and equity	Debt and equity
Intent	Hold to maturity	Sell in the near term	Undecided
Record at	Cost	Fair value	Fair value
Unrealized gains or losses	Not applicable	Presented on income statement	Presented in stockholders' equity, net of the tax effect
Balance sheet	Based on maturity date	Current even if sale is expected beyond one year	Based on management's intent at year end

Special rules for investments in energy contracts and broker-dealers/traders

Investments in energy contracts are accounted for using market-to-market accounting in accordance with EITF Issue No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities.* Energy contracts refer to contracts entered into for the purchase or sale of electricity, natural gas, natural gas liquids, crude oil, refined products, coal, and other hydrocarbons, collectively referred to as energy. The gain or loss on the contract is recorded on the income statement. Generally, brokers-dealers and traders of financial contracts use mark-to-market accounting.

Tier 2: Investments accounted for using the equity method

If an investor has the ability to exercise *significant influence* over the operating and financial policies of the investee, the investment must be accounted for using the equity method in accordance with APB No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Absent information to the contrary, significant influence is presumed to exist with an *investment (direct or indirect) of 20-50% of the outstanding voting stock of the investee*. Generally, investments of less than 20% follow the rules of FASB No. 115 for securities, or ARB No. 43 for non-securities, discussed in the previous section. In some cases, an entity may own less than 20% of an entity and be required to use the equity method because that entity exerts significant influence at less than 20% ownership.

Using the equity method, the investor recognizes its share of the earnings or losses of the investee through the investment account. Dividends received reduce the carrying amount of the investment.

The entries look like this:

Example:
Company X owns 25% of Company Y. Y's net income for 20X1 is $1,000,000 of which $250,000 is X's share. X receives a dividend in the amount of $100,000.

Entries on X:

Entry 1: Record X's share of Y's income:		
Investment in Y	250,000	
Equity income		250,000

Entry 2: Record Y's dividend received by X:		
Cash	100,000	
Investment in Y		100,000

The determination of whether an entity has significant influence over another is based on facts and circumstances. Examples given by APB No. 18 of evidence supporting significant influence include:

- Having representation on the board of directors,
- Participation in policymaking processes,
- Material intercompany transactions,
- Interchange of managerial personnel, or
- Technological dependency.

An important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings. However, substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor.

Does the equity method apply to partnerships and unincorporated entities?

Under present GAAP, APB Opinion No. 18 applies to investments in common stock and does not specifically apply to investments in partnerships and other unincorporated entities. However, it has been widely held that the equity method should be similarly applied to investments in unincorporated entities. Specifically, AICPA Staff Interpretation No. 2 of APB No. 18 states that many of the provisions of APB No. 18 are appropriate in accounting for investments in unincorporated entities. Although the Interpretation appears to endorse use of the equity method for unincorporated entities, it falls short of specifically requiring its use in such circumstances.

In 1979, the AICPA's Accounting Standards Executive Committee (AcSEC) provided non-authoritative guidance in its issues paper entitled *Joint Venture Accounting*. In that Paper, the AcSEC recommends that the equity method should be required for joint ventures.

Further support for using the equity method for unincorporated investments is found in AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures. SOP 78-9* deals with the accounting treatment for real estate ventures, including those organized as a general or limited partnership or undivided interest. Although this SOP is limited to real estate ventures, it is generally accepted that its guidance can, but is not required to, parallel other non-real estate joint ventures and unincorporated investments. The SOP states that investments *in noncontrolled real estate general partnerships* should be accounted for and reported under the equity method.

Tier 3: Consolidations and Combined Statements

The rules for consolidations are found in Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.*

ARB No. 51 states:

> *"There is a presumption that consolidated statements are more meaningful than separate statements…"*

In general, ARB No. 51 and FASB No. 94 require the consolidation of all majority-owned *(more than 50%)* subsidiaries. There are two exceptions whereby an entity is not required to consolidate even though ownership exceeds 50%:

- Control is temporary, or
- Control does not rest with the majority owner, such as where an entity is in bankruptcy and a trustee controls the entity.

Observation: Although an entity may own more than 50% of the voting shares of stock of an entity, FASB No. 94 provides that consolidation is not required if control does not rest with the majority (more than 50%) owner. EITF Issue No. 96-16, "*Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*," provides guidance as to a situation in which the majority owner does not have control because the *minority owner has certain rights*. Specifically, substantive rights (whether granted by contract or by law) that allow the minority owner to effectively participate in significant decisions that would be expected to be made "in the ordinary course of business" overcome the presumption that the investor with a majority voting interest should consolidate its investee. Such rights, resting in the minority owner, result in the majority owner not having control and, thus, not consolidating even though the owner holds more than 50% of the voting shares.

However, there are certain rights given to minority shareholders that may be only "protective" of the minority shareholder's investment. Such rights do not overcome the presumption that the majority owner should consolidate. EITF Issue No. 96-16 also provides guidance on determining whether minority rights are substantive participating rights giving control, or protective rights not giving control. Further, certain minority rights that allow the minority shareholder to block certain corporate actions are considered protective rights that do not result in the majority owner losing control and not consolidating. Examples of such protective rights include:

- Amendments to the articles of incorporation of the investee,
- Pricing on transactions between the owner of the majority interest and the investee and related self-dealing transactions,
- Liquidation of the investee or a decision to cause the investee to enter bankruptcy or other receivership,
- Acquisitions and dispositions of assets greater than 20% of the fair value of the investee's total assets, and
- Issuance or repurchase of equity interests.

The SEC's Position on Consolidation:

The SEC has generally followed the authority of ARB No. 51 and FASB No. 94 in establishing the 50% majority ownership threshold over which to require consolidation.

SEC Regulation S-X, Rule3A-02 states:

> In deciding upon consolidation policy, the registrant must consider what financial presentation is most meaningful in the circumstances and should follow in the consolidated financial statements principles of inclusion or exclusion which will

clearly exhibit the financial position and results of operations of the registrant. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation *when one entity directly or indirectly has a controlling financial interest in another entity*. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation. In any case, the disclosures required by § 210.3A-03 should clearly explain the accounting policies followed by the registrant in this area, including the circumstances involved in any departure from the normal practice of consolidating majority owned subsidiaries and not consolidating entities that are less than majority owned. Among the factors that the registrant should consider in determining the most meaningful presentation are the following:

- *Majority ownership*: Generally, registrants shall consolidate entities that are *majority owned and shall not consolidate entities that are not majority owned.* The determination of "majority ownership" requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy, or when control is likely to be temporary). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than that of voting stock.

- *Different fiscal periods*: Generally, registrants shall not consolidate any entity whose financial statements are as of a date for periods substantially different from those of the registrant. Rather, the earnings or losses of such entities should be reflected in the registrant's financial statements on the equity method of accounting. However a difference in fiscal periods does not of itself justify the exclusion of an entity from consolidation. It ordinarily is feasible for such an entity to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal year of the registrant. Where the difference is *not more than 93 days, it is usually acceptable to use*, for consolidation purposes, such entity's statements for its fiscal period. Such a difference, when it exists, should be disclosed as follows: the closing date of the entity should be expressly indicated, and the necessity for the use of different closing dates should be briefly explained. Furthermore, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

- *Foreign subsidiaries*: Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries that are operated under political, economic or currency restrictions. If consolidated, disclosure should be made as to the effect, insofar as this can reasonably be

> determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

Observation: Since the early 1990s, the FASB has attempted to change the consolidation rules. The goal has been to replace the existing more-than-50% ownership rule with a more subjective measurement based on control, rather than ownership. After several years of deliberating, the FASB decided not to move forward with a new consolidations statement. In light of Enron, the FASB has announced that it plans to revisit the consolidation rules.

Combined Financial Statements

In some instances, the issuance of combined financial statements is an alternative to consolidated financial statements. ARB 51 provides guidance on the preparation of combined financial statements where a controlling financial interest does not rest directly or indirectly with one of the companies included in the consolidation. Combined financial statements are never required, but may be useful in certain cases. Also, although combined financial statements are similar to consolidated statements, they are different in several ways noted below.

ARB 51 states:

> *"There are instances, however, where combined financial statements (as distinguished from consolidated financial statements) of commonly controlled companies are likely to be more meaningful than their separate statements."*

Examples of where combined financial statements may be useful include:

1. A group of unconsolidated subsidiaries.

2. One individual owns a controlling interest in several corporations which are related in their operations, markets or industries.

3. One individual owns a controlling interest in an operating company who is the sole lessee of a real estate trust or partnership, but consolidation is not required by Interpretation No. 46 (discussed in Section 3).

   Example 1: Harry owns 100% of Company A and B, yet there is no direct ownership between A and B. A sells 25% of its product to B but there is no indication of control or ownership between A and B.

   Example 2: Harry owns 100% of Company A. Company A rents the real estate used in its operations from Company B, which is an LLC. Harry is the sole member of the LLC.

If combined financial statements are presented, there are some basic rules that must be followed:

1. Combining is treated essentially in the **same manner** as a consolidation with all intercompany transactions eliminated.

2. Stockholders' equity is combined, not eliminated, because there is no investment to eliminate.

3. The report must be altered to reflect two combined entities.

Example: Assume that Company X and Y, both corporations, are combined with Company Z, a real estate LLC. The combined equity would look like this:

Combined equity		
Common stock:	X Corporation	$xx
	Y Corporation	xx
		xx
Retained Equity:		
	X Corporation	xx
	Y Corporation	xx
	Z Company LLC	xx
		xx
Total combined equity		xx

The report language looks like this:

Example of Report Language- Compilation Report:

> We have compiled the combined financial statements of ***X Corporation, Y Corporation and Z Company, LLC*** as of December 31, 20XX…….

Exceptions to the more than 50% ownership test- consolidations

Since 1980, the FASB has made several attempts to change the basic rule of consolidation found in the 1959 (yes 1959) pronouncement, ARB No. 51. Yet with each attempt, the FASB was unable to reach a consensus on a better alternative to ARB No. 51. Thus, the general rule that consolidation occurs when there is control by owning more than 50% of the voting shares of stock, still prevails. For tax purposes, consolidation is required at an 80% or more ownership threshold.

Although the more-than-50% ownership requirement is the minimum standard for consolidations, there are three situations in which consolidation may occur even though the more-than-50% majority rule of ARB No. 51 is not satisfied:

1. Physician Practice Management Entities
2. Real Estate Entities
3. Special Purpose Entities (SPEs) (replaced with the variable interest entity (VIE) rules found in Interpretation No. 46)

Note that exception 3 (the special purpose entities (SPEs) has since been revised by the issuance of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*. The FASB has revamped the off-balance sheet entity rules which are discussed in Section 3 of this course.

Each of the three exceptions that existed during Enron, is discussed below.

Exception 1: Physician Practice Management Entities- EITF Issue No. 97-2:

EITF Issue No. 97-2, *"Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*," provides an exception to the more-than-50% ownership test in determining control of another entity. Specifically, there are situations in which physician practice management entities (PPME) establish a controlling financial interest in a physician practice through a contractual management agreement without having ownership of a majority of the outstanding voting equity instruments of the physician practice. In such circumstances, the PPME should consolidate with the physician's practice.

EITF Issue 97-2 makes reference to the fact that there may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in EITF Issue 97-2. The use of the guidance in EITF Issue 97-2 should be considered when the circumstances are similar.

Observation: The EITF references that the guidance of EITF Issue 97-2 can be used in other similar circumstances. This would suggest that in other circumstances in which control is determined by a contract other than ownership, entities may consolidate. However, the author believes that the EITF should not be taken out of context. Because the EITF gives no examples where circumstances would be considered "similar," the author believes that it would not be prudent to apply a control standard that is not measured on majority ownership.

Exception 2: Real Estate Entities- SOP 78-9

Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures,* provides a second deviation from the general consolidation requirement that control must be based on ownership of more than 50% of the voting shares of an entity.

SOP 78-9 states the following:

<u>Investments in general partnerships:</u>

- Investments *<u>in noncontrolled real estate general partnerships</u>* should be accounted for and reported under the *<u>equity method</u>*.

- An investor that *<u>controls, directly or indirectly</u>*, a general partnership is treated as a subsidiary of the investor and should be consolidated.

    a. Control is not necessarily based on more-than-50% ownership.

- If partnership control is not clear, ownership of a majority (more than 50 percent) of the financial interests in profit or losses is considered control.

- Control may exist at 50% or less ownership, if control is given by contract, lease, agreement with other partners, or by court decree.

- Control may not exist at more than 50% ownership if major decisions such as acquisition, sale or refinancing of principal partnership assets must be approved by one or more other parties.

Investments in limited partnerships:

- A general partner (an entity) *should consolidate* with a limited partnership if it *controls the limited partnership*.

  a. Control is not based on ownership.

  b. Control is based on the rights given to the general partner within the partnership and other agreements.

  c. Control does not rest with the general partner if the limited partners have important rights that restrict the general partner's control such as:

     - Right to replace the general partner

     - Approve the sale or refinancing of principal assets

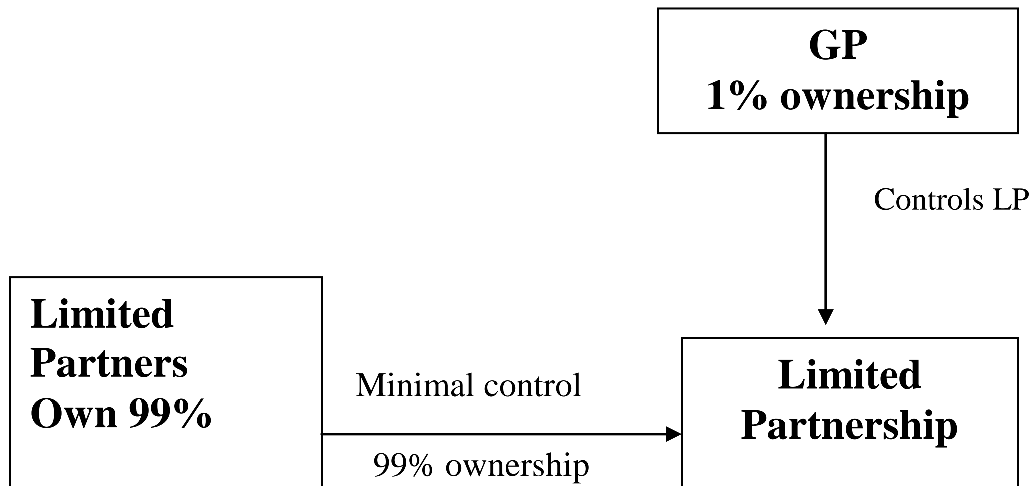
     - Approve the acquisition of principal partnership assets

What the SOP states is that a general partner in real estate should consolidate the limited partnership if the *general partner controls*, but does not necessarily own, the limited partnership. This means that a general partner may consolidate with a limited partnership in which it has *no percentage ownership*. However, control can be mitigated by placing restrictions on the general partner. For example, if a general partner must obtain approval from limited partners to make decisions regarding acquisition, sale or refinancing of the partnership assets, then the general partner is not deemed to have control and should not consolidate with the limited partner. Further, if the limited partners have the right to remove the general partner for any reason, that too would be a restriction that mitigates the general partner's control.

The rules under SOP 78-9 are limited to real estate and do not apply to other businesses or entities. Thus, other entities must still follow the rules of ARB No. 51 which requires consolidation based on more-than-50% ownership.

Example: Assume that a general partner (an entity) controls a real estate limited partnership, yet owns only 1% of the limited partnership. The remaining 99% is owned by the limited partners who have minimal control over the limited partnership. Further, there are no restrictions on the general partner and the limited partners do not have the right to remove the general partner unless there is proven fraud.

The ownership looks like this:



Conclusion: The GP should consolidate with the limited partnership even though there is only 1% ownership. This conclusion is based on the fact that the general partner controls the partnership with minimal restrictions on that control.

Change the facts: The partnership agreement restricts certain rights of the general partner by giving those rights to the limited partners. Those rights include the right to replace the general partner by a super majority vote, or approval required for the sale, refinancing or acquisition of principal assets.

Conclusion: Because the general partner's control is restricted by additional rights given to the limited partners, the general partner should not consolidate with the limited partnership.

Exception 3: Special Purpose Entities (SPEs)

This section addresses the SPE rules that were in existence during the time Enron used off-balance sheet entities, primarily the period 1997 to 2001. Reference to the SPE rules is made in the past tense because, effective in 2004 (2005 for nonpublic entities), they were superseded by FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities.*

Never before has so much been written about something that is so widely used as special purpose entities (SPEs) that are at the forefront of the Enron failure. Congress and the media have challenged their application and the liberal rules under which they were used to eliminate selected assets and debt from an entity's balance sheet.

If the old SPE rules had been followed properly, SPEs offered an entity the opportunity to operate a portion of its business "off-balance sheet," thereby segregating unwanted assets and liabilities from its balance sheet. By doing so, a "cleaner" balance sheet was certainly more attractive to its investors and other third parties. Usually, an SPE could borrow or obtain capital easier and at a lower cost than the sponsor company primarily because the SPE assets were isolated from the rest of the sponsor's assets.

The primary issue regarding an SPE was whether it should have been consolidated with its sponsor company. Since, in most cases, there was no direct ownership between the sponsor company and the SPE, the general rules for consolidation (more-than-50% ownership of the voting interest) did not apply. Yet, because the SPE represented a "carved out" portion of the sponsor company's balance sheet, it was usually more meaningful to consolidate the sponsor company and the SPE. The rules for consolidating SPEs did not follow those found in ARB No. 51, and are addressed below.

What is an SPE?

Accounting literature has not specifically defined an SPE, although there have been several references to them within the accounting standards. SPEs were typically "independent" entities created by a company (the sponsor) to conduct a particular function. They were commonly used by an entity to conduct off-balance sheet arrangements such as financing, leasing and other business activities. The legal form of an SPE was usually a corporation, partnership, limited liability company (LLC) or a trust. Common uses of SPEs included:

- Leasing arrangements, including sales with leasebacks (referred to as synthetic leases)
- Financing arrangements with third party financial institutions to fund acquisitions of certain assets or businesses
- Management of certain receivables or investments
- Research and development and other project development activities
- Hedge activities to manage risk

Depending on whether they satisfied a series of rules, SPEs could have been consolidated with their sponsor company, or unconsolidated. The old consolidation rules for SPEs that were in effect during Enron are discussed further on in this section.

The steps that were usually taken by an SPE follow:

1. The SPE was set up in the form of a partnership, LLC or trust, to perform a specific function such as leasing, management, etc.

2. An independent administrative trustee or partner was assigned to perform the functions for the SPE. Generally, the trustee or partner could not be affiliated with the sponsor company.

3. The SPE obtained capital in the form of outside debt and/or equity from third party lenders and investors.

The typical allocation of capital from outsiders was as follows:

- 3% equity[4]

- 97% debt in the form of asset-backed securities such as collateralized bonds, debt, loan obligations, trade receivables,

[4] 3% equity is the minimum percentage that must be received by an independent third party.

commercial paper conduits

4. The SPE usually was involved in one of the following functions:

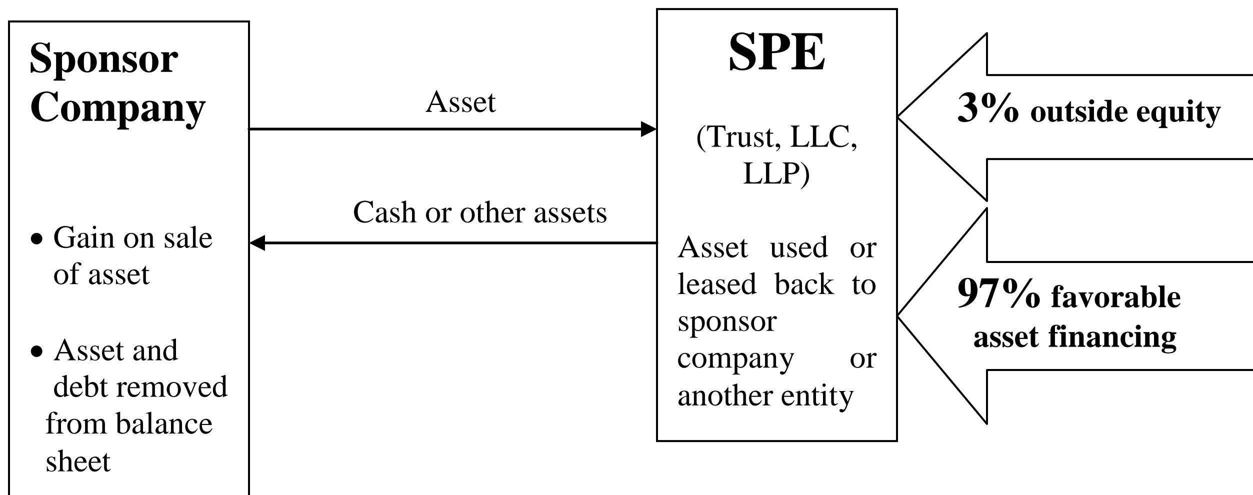
   a. It purchases company (sponsor) assets and may have leased back those assets to the company.

      Examples: Power plants or production facilities

   b. It sold assets that qualified as installment sales where the gain was deferred for tax purposes.

   c. It purchased an asset and leases that asset to another entity.

Typical Legitimate SPE Structure
Rules in Effect During Enron



There were several advantages to using SPEs under the previous rules in effect during Enron:

1. Lower-cost financing: By isolating the assets from the sponsor company and limiting its business purpose, an SPE was able to attract *lower-cost financing* since the lender had a better security interest in the specific assets financed.

2. Tax-advantages: Using a pass-through entity such as a partnership, LLC or trust, an SPE could provide more attractive tax advantages than if the transaction were structured inside the sponsor company. Examples of tax-advantages include:

   - Losses passed through to the investors

- Distributions avoided double taxation

3. Removal of assets and liabilities: If the SPE was structured properly, debt and selected assets were removed, and not consolidated with the sponsor company.

4. Creation of gains: Gains on sales of assets to the SPE could be generated by the sponsor company.

Observation: Today, one of the most popular off-balance-sheet entities used by closely held businesses continues to be the segregation of real estate into a separate trust, partnership or LLC which leases the real estate to the operating business. Although most companies and their accountants have not referred to these entities as SPEs, they have achieved the same result that SEC companies have sought in setting up their SPEs; that is, selected assets and liabilities have been segregated from the operating entity. For closely held businesses, the primary purpose of using the real estate entity is tax advantages from losses passing to its shareholders and placing the real estate into a more tax-flexible pass-through entity. Further, mortgage financing is easier to obtain when the real estate is segregated into a separate entity.

GAAP Authority for SPEs

During the Enron years, SPEs followed the general guidance of all other investments previously discussed in this chapter in determining whether to use the equity method or to consolidate the SPE with the sponsor company. However, because there generally was no direct ownership between an SPE and its sponsor company, the traditional rules of consolidation (ownership of more than 50% of the voting shares) did not apply.

Ultimately, because of more aggressive and widespread use of SPEs, the FASB's Emerging Issues Task Force (EITF) issued several consensus opinions which became the rules for deciding whether an SPE should be consolidated with its sponsor company.

EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions"

EITF Topic D-14, Transactions Involving Special-Purpose Entities

EITF Issue No. 96-20: Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities

EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities"

EITF Issue 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those Involving Special-Purpose Entities" provide further guidance on related issues

FASB No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.

The above mentioned documents represented the GAAP that was in effect during Enron some of which has since been superseded.

Although the requirements for consolidation of SPEs varied depending on whether the SPE was involved in leasing transactions or not, a sponsor company was required to consolidate any SPE unless the SPE could demonstrate that it was *independent and self-sustaining* apart from the sponsor company.

The sponsor company was not required to consolidate with the SPE if the following *three general criteria* were met in which case the SPE was considered to be independent and self-sustaining, apart from the sponsor company.

The majority owner(s) of the SPE must have been an independent third party who:

1. Had made a *substantive investment in the SPE,*

    a. Substantive investment was defined as *at least 3%* of the SPEs total debt and equity, or total assets.

    b. An independent third party generally could not have included an employee or officer of the sponsor company.

    c. The initial 3% investment had to be retained in the SPE throughout its life. If a lease was involved, the 3% investment must have been in place throughout the lease term.

2. Had *control of the SPE*, and

    a. Control was not defined by GAAP.

3. Had *substantive risks and rewards of ownership* of the SPE's assets (including residuals).

    a. The 3% investment had to be at risk by the third party.

    b. The owner's investment was not at risk if it was guaranteed by another party.

Observations:

The SEC initiated the discussion of SPEs in 1989, which resulted in the issuance of EITF Topic No. 14. At that time, in the SEC Observer, the SEC announced that:

> "the SEC staff is becoming increasingly concerned about certain receivables, leasing, and other transactions involving special-purpose entities (SPEs). Certain characteristics of those transactions raise questions about whether SPEs should be consolidated (notwithstanding the lack of majority ownership) and whether transfers of assets to the SPE should be recognized as sales. 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 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 the debt of the SPE rest directly or indirectly with the sponsor or transferor."

The three criteria for not consolidating an SPE were not necessarily clear and easy to follow. The second criterion required that the majority owner of the SPE must control the SPE. Yet, accounting literature did not define the term "control." as it related to SPEs. Since, by definition, a majority owner already owned more than 50% of the entity, the "control" requirement was most likely based on other factors. The author believes that guidance offered by other pronouncements related to "control" in consolidations might have been helpful in shedding light on what "control" meant in the context of SPEs. For example, a parallel could be drawn between SOP 78-9's definition of control as it relates to whether a general partner had effective control over a limited partnership. SOP 78-9 looks at who has the power to approve the sale, or refinancing or acquisition of principal assets as a primary control factor. The author believes that guidance of SOP 78-9 could have been similarly used in the context of whether a majority owner controlled an SPE.

Special Rules for SPEs Involved in Leasing Transactions

Although the general rules for consolidation of SPEs (the three criteria) that were in effect during Enron are addressed above, EITF Issue No. 90-15 provided a special set of rules when an SPE was established to conduct leasing transactions with the sponsor company.

> **Example**: Sponsor Company sells equipment to an SPE. The SPE then leases the equipment back to the Sponsor Company. Should Sponsor Company have consolidated with the SPE?

In EITF No. 90-15, a lessee (sponsor company) was *required to consolidate* a special-purpose entity (SPE) lessor when *all of the following conditions* existed:

1. Substantially all of the activities of the SPE involved assets that were to be leased to a *single lessee.*

2. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE *resided directly or indirectly with the lessee* through such means as:
    - The lease agreement
    - A residual value guaranteed through, for example, the assumption of first dollar of loss provisions
    - A guarantee of the SPE's debt
    - An option that granted the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor's sales proceeds in excess of a stipulated amount.

3. The owner(s) of record of the SPE had not made an initial *substantive residual equity capital investment (at least 3%)* that was at risk during the entire term of the lease.

Observation: The above three criteria for leasing transactions overlapped with the general requirements to consolidate an SPE. Criteria 2 and 3 that required the risks and rewards of ownership and the 3% investment be made, were also in the three general SPE consolidation criteria. However, the control requirement, which was found in the general criteria was not required for leases. Further, condition one relating to a single lessee applied only to SPE leasing transactions and was not one of the general criteria.

The 3% Rule

EITF 90-15 addressed several issues related to the 3% equity investment as it applied to leases. However, these rules paralleled other non-lessor SPEs.

Q&A- EITF Issue 90-15:

EITF Issue 90-15 provided a Q&A as follows:

Question : What amount qualifies as a substantive residual equity capital investment?

Response: The SEC staff understands from discussions with Working Group members that those members believe that *3 percent is the minimum acceptable investment*. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances.

Question: If the initial substantive residual equity capital (minimum 3%) is reduced below the minimum amount required because of losses recorded by the SPE in accordance with GAAP, is the investor required to make an additional capital investment?

Response: No.

Question: May the investor withdraw its initial minimum required equity investment (3%) prior to the expiration of the lease term?

Response: There may be circumstances in which an investor makes an investment in excess of the minimum required equity investment. In those circumstances, the investor may withdraw its initial investment in excess of the minimum required equity. However, the EITF included in condition (3) of the consensus, a requirement that the initial minimum equity investment be at risk during the term of the lease. Accordingly, that minimum amount could not be withdrawn either directly or indirectly.

Question: If an SPE contained a building whose value increased such that the equity of the SPE increased on an appraised fair value basis, could the investor withdraw its initial capital to the extent of the increase in the fair value of the property?

Response: No. Condition (3) requires the initial investment to be at risk during the entire term of the lease.

Question: Would an equity investment (3%) that is financed with nonrecourse debt qualify as an initial substantive residual equity capital investment? Would an equity investment that is financed with recourse debt qualify?

Response: If the source of funds used to make the initial minimum (3%) equity investment is financed through nonrecourse debt that is collateralized by a pledge of the investment, the investment would not meet the at-risk requirement… If the initial minimum equity investment is financed with recourse debt from a party not related to the lessee, the owners (borrowers) must have other assets at risk to support the borrowing…. Thus, if the loans were full recourse loans and if the fair value of the residual equity investment serves as collateral for the debt, the lessor-owner would be considered at risk to the extent that the owners of record are liable for any decline in the fair value of the residual interest, and have, and are expected to continue to have during the term of the lease, other significant assets, in addition to and of a value that exceeds their equity investment, that are at risk.

What happens if the equity investment dropped below 3% because the value of total debt and equity increases?

Response: Once the 3% investment had been made, it had to remain in the SPE throughout the lease but did not have to be updated if the percentage dropped below 3%. For example, if more than 3% was initially invested, the investor was permitted to take out all of the investment except the original 3%. Further, the 3% test was performed at the inception of the transaction and did not have to be updated thereafter.

Rules for SPEs When There Is a Transfer of Financial Assets and Liabilities

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, was issued in 2000 and superseded FASB No. 125.

FASB No. 140 provided guidance for determining whether transfers of financial assets (including financing lease receivables) qualify as sales to the extent that consideration other than beneficial interests in the transferred assets is received in the exchange. The transferor surrenders control over the transferred assets when all of the following conditions are met:

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

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

3. The transferor does not maintain effective control over the transferred assets through either an agreement that entitles and obligates the transferor to repurchase or redeem them before maturity, or the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, prohibited the consolidation of *qualifying* SPEs (QSPEs) and establishes conditions that an SPE must meet to be a qualifying SPE. The description of qualifying SPEs in Statement No. 140 is narrow, and the accounting for qualifying SPEs and transfers of financial assets to them should not be extended to any entity that does not currently satisfy all of the conditions in the Statement.

In 2009, FASB No. 140 was amended by FASB No. 166: *Accounting for Transfers of Financial Assets an Amendment of FASB Statement No. 140. FASB No. 166* is effective as beginnning after November 15, 2009.

FASB No. 166 makes numerous changes to FASB No. 140, a key one of which is the elimination of the QSPE concept and exemption from consolidations for QSPEs.

2. Other GAAP Issues

Because this chapter addresses the issues related to Enron, it is important to review two additional rules that are discussed further on in this chapter.

a. Classification of Notes Receivable Received for Capital Stock:

EITF Issue 85-1, *Classifying Notes Receivable Received for Capital Stock,* provides the rule for balance sheet classification of notes receivable in connection with the issuance of equity and paid-in capital. In such circumstances, it is common for the entity to record the note receivable in the asset section on the balance sheet. However, EITF Issue 85-1 reaches a different conclusion:

Specifically, EITF Issue 85-1 reaches a consensus that:

1. Reporting the note as an asset is generally not appropriate, except in very limited circumstances where there is substantial evidence of ability and intent to pay within a reasonably short period of time.

2. Instead, that note should be presented as a *reduction in stockholder's equity.*

The SEC reaffirms the EITF's conclusion in Regulation S-X, Rule 5-02.30 whereby it states that public companies must report notes received in payment for the enterprise's stock as a *deduction from shareholders' equity*. An example of a presentation looks like this:

LIABILITIES AND EQUITY	
Current liabilities:	
Accounts payable	$xx
Accrued expenses	xx
Current portion of debt	xx
Total current liabilities	xx
Long-term debt	xx

Stockholders' equity	
Common stock	1,000,000
Less amounts due from stockholders related to shares issued	***(400,000)***
Retained earnings	*xxx*
Total stockholders' equity	$xxx

b. Recording Gains and Income on Your Own Stock

GAAP generally precludes a company from recording income and gains on its own stock, whether directly or indirectly through use of another entity, such as an SPE. The authority for this conclusion is found in APB No. 9, *Reporting Results of Operations*, which states:

Paragraph 28 of APB No. 9 states:

> "…the following should be excluded from the determination of net income or the results of operations under *all circumstances*: (a*) adjustments or charges or credits resulting from transactions in the company's own capital stock*……"

The intent of APB No. 9 is to encompass all transactions involving an entity's own stock. Thus, using SPEs to record gains and income from a company's own stock is acceptable provided the gain or income from the stock is not recorded, directly or indirectly, on the company's income statement.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What securities are recorded at amortized cost?
   a. available-for-sale securities
   b. closely held investments
   c. held to maturity securities
   d. trading securities

2. To what investments do the rules of FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, apply?
   a. security investments of less than 20% of the outstanding voting shares
   b. non-securities investments of less than 20% of the outstanding voting shares
   c. investments of 20 to 50% of the outstanding voting shares or significant influence
   d. investments of more than 50% ownership in voting stock

3. According to SOP 78-9, how should investments in a noncontrolled real estate general partnership be reported?
   a. at amortized cost
   b. at fair value
   c. under the equity method
   d. using consolidated financial statements

4. What is a basic rule of combined financial statements?
   a. all intercompany transactions are eliminated
   b. stockholders’ equity is eliminated
   c. the report must present one unified entity
   d. they are the same as consolidated financial statements

5. Under SOP 78-9, in a real estate general partnership, control:
   a. lies with those who directly own financial interests if partnership control is unclear
   b. may not exist at 50% or more ownership if another party must approve major decisions
   c. may not exist at less-than-50% ownership
   d. must be based on ownership levels of 50% or more

6. What is a characteristic of a special purpose entity (SPE)?
   a. dependent
   b. had to be consolidated
   c. typically a sole proprietorship
   d. used to conduct off-balance sheet arrangements

7. In a typical legitimate structure of an SPE:
   a. an independent administrative trustee or partner performed SPE functions
   b. the SPE did not have to report assets or debt on the balance sheet
   c. the sponsor company leased an asset to the SPE
   d. the sponsor company took on 97% debt and 3% equity

8. Under what circumstance might a company have been considered an independent SPE?
   a. an employee of the sponsor had made a substantive investment in the SPE
   b. an independent third party made an initial 3% investment in the SPE, which was later transferred to an officer of the sponsor
   c. the majority owners were at risk for their investment
   d. the sponsor had control of the SPE

9. Per EITF Issue No. 90-15, if all other conditions were met, when would a sponsor be required to consolidate an SPE?
   a. assets were leased to several companies
   b. SPE owners had substantive risk in the investments
   c. SPE owners had not made an initial substantive investment
   d. the SPE received all of the substantive rewards in the leased asset

10. Of the general SPE consolidation criteria, what was not required of SPEs performing leasing transactions under EITF Issue No. 90-15?
    a. the control requirement
    b. the requirement relating to a single client
    c. the substantive investment requirement
    d. the substantive risk and rewards requirement

11. Of the special rules for SPEs involved in leasing transactions under EITF Issue No. 90-15, what was not required by the general SPE consolidation criteria?
    a. the control requirement
    b. the requirement relating to a single client
    c. the substantive investment requirement
    d. the substantive risk and rewards requirement

12. Under EITF Issue No. 90-15, the initial substantive residual capital investment for SPEs involved in leasing transactions:
    a. may have been withdrawn in excess of the minimum required amount in certain instances
    b. may have been withdrawn to the extent of the increase in the property's fair value
    c. that was reduced below the minimum amount, had to be restored with additional investments
    d. was 5%, at a minimum

13. Under FASB No. 140 previously in effect, when was control over transferred assets surrendered?
    a. the assets had been separated from the transferee
    b. the transferee could pledge or exchange assets received
    c. an agreement entitled and obligated the transferor to repurchase assets
    d. the transferor's creditors could claim the assets

14. Under what authority is (was) the consolidation of qualifying SPEs disallowed?
    a. APB No. 9
    b. EITF Issue 85-1
    c. FASB No. 125
    d. FASB No. 140

15. What is the intent of APB No. 9, *Reporting Results of Operations*?
    a. to clarify how to report notes receivable received for capital stock
    b. to cover all of an entity's transactions that involve its own stock
    c. to prohibit companies from using SPEs to record gains and income
    d. to prohibit the consolidation of qualifying SPEs

SUGGESTED SOLUTIONS

1. What securities are recorded at amortized cost?
   a. Incorrect. Available-for-sale securities are recorded at fair value. Gain or loss is presented in stockholders' equity, net of taxes.
   b. Incorrect. Closely held investments are non-securities that are recorded at amortized cost.
   c. Correct. Held to maturity securities are recorded at amortized cost.
   d. Incorrect. Trading securities are recorded at fair value. Gain or loss is presented on the income statement.

2. To what investments do the rules of FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, apply?
   a. Correct. The rules of FASB No. 115 apply to security investments of less than 20% of the outstanding voting shares.
   b. Incorrect. The rules of ARB No. 43 apply to non-securities investments of less than 20% of the outstanding voting shares.
   c. Incorrect. The rules of APB No. 18 apply to investments of 20 to 50% of the outstanding voting shares or significant influence.
   d. Incorrect. The rules of ARB No. 51 and FASB No. 94 apply to investments of more than 50% ownership in voting stock.

3. According to SOP 78-9, how should investments in a noncontrolled real estate general partnership be reported?
   a. Incorrect. When there is less than 20% ownership, non-securities and held-to-maturity securities should be recorded at amortized cost.
   b. Incorrect. When there is less than 20% ownership, available-for-sale securities and trading securities should be recorded at fair value.
   c. Correct. According to SOP 78-9, the equity method should be applied to investments in a noncontrolled real estate general partnership.
   d. Incorrect. When there is 50% or more ownership, the entities generally should use consolidated financial statements.

4. What is a basic rule of combined financial statements?
   a. Correct. When combined financial statements are prepared, all intercompany transactions are eliminated. This treatment is basically the same as when presenting consolidated financial statements.
   b. Incorrect. When preparing combined financial statements, the stockholders' equity must be combined since no investment is eliminated.
   c. Incorrect. When preparing combined financial statements, the report must present two combined entities, rather than one unified entity.
   d. Incorrect. Combined financial statements are not the same as consolidated financial statements. They have similarities and differences.

5. Under SOP 78-9, in a real estate general partnership, control:
   a. Incorrect. Under SOP 78-9, in a general partnership, when partnership control is unclear, control lies with more-than-50% ownership of the financial interests in profit or losses.
   b. Correct. Under SOP 78-9, in a general partnership, control may not exist at 50% or more ownership if another party must approve major decisions (e.g., acquisition, sale or refinancing of principal assets).
   c. Incorrect. Under SOP 78-9, in a general partnership, control may exist at less-than-50% ownership. For example, control will lie with the less-than-50% ownership if dictated by a contract, lease, agreement among partners, or court decree.
   d. Incorrect. Under SOP 78-9, in a general partnership, control does not have to be based on ownership levels of 50% or more. There are instances where control lies with the less-than-50% ownership.

6. What is a characteristic of a special purpose entity (SPE)?
   a. Incorrect. Generally, SPEs were "independent" entities that a company (i.e., sponsor) would create to conduct a particular function.
   b. Incorrect. SPEs could consolidate their financial statements with the sponsor company, if certain rules were satisfied.
   c. Incorrect. SPEs typically took the form of a corporation, partnership, LLC, or trust, not a sole proprietorship.
   d. Correct. SPEs were often created by a company (i.e., sponsor) to conduct off-balance sheet arrangements (e.g., financing and leasing).

7. In a typical legitimate structure of an SPE:
   a. **Correct. In a typical legitimate structure of an SPE, the sponsor would assign an independent administrative trustee or partner to perform SPE functions.**
   b. Incorrect. The sponsor company did not have to report assets or debt on the balance sheet because the SPE would purchase the assets.
   c. Incorrect. The SPE would lease an asset, which had been purchased from the sponsor, back to the sponsor.
   d. Incorrect. Typically, from third party lenders and investors, the SPE took on 97% debt and 3% equity, which would be used to purchase assets from the sponsor company.

8. Under what circumstance might a company have been considered an independent SPE?
   a. Incorrect. A company might have been considered an independent SPE if an independent third party had made a substantive investment in the SPE. In general, the independent third party could not be an employee of the sponsor.
   b. Incorrect. A company might have been considered an independent SPE if an independent third party made an initial 3% investment in the SPE that was retained throughout the life of the SPE and not transferred to an officer of the sponsor. In general, the independent third party could not be an officer of the sponsor.
   c. Correct. A company might have been considered an independent SPE if the majority owners were at risk for their investment. The majority owners had to be independent third parties, and they had to make a substantive investment in the SPE of at least 3% of the SPE's total debt and equity, or total assets. In addition, the (vague) control criterion had to be met.
   d. Incorrect. A company might have been considered an independent SPE if the independent third party, not the sponsor, had control of the SPE.

9. Per EITF Issue No. 90-15, if all other conditions were met, when would a sponsor be required to consolidate an SPE?
   a. Incorrect. Per EITF Issue No. 90-15, if all other conditions were met, a sponsor would be required to consolidate an SPE if all of the SPE's assets, which were involved in most of the SPE's activities, were leased to only one company.
   b. Incorrect. Per EITF Issue No. 90-15, if all other conditions were met, a sponsor would be required to consolidate an SPE if the SPE owners did not have substantive risk in the investments.
   c. Correct. Per EITF Issue No. 90-15, if all other conditions were met, a sponsor would be required to consolidate an SPE if the SPE owners had not made an initial substantive investment that was at risk throughout the life of the investment.
   d. Incorrect. Per EITF Issue No. 90-15, if all other conditions were met, a sponsor would be required to consolidate an SPE if the lessee, not the SPE, received all of the substantive rewards in the leased asset and was responsible, either directly or indirectly, the debt obligation.

10. Of the general SPE consolidation criteria, what was not required of SPEs performing leasing transactions under EITF Issue No. 90-15?
    a. Correct. The control requirement in the general SPE consolidation criteria was not required for leasing transactions under EITF Issue No. 90-15.
    b. Incorrect. The general SPE consolidation criteria does not require that the SPE have more than one client, whereas EITF Issue No. 90-15 requires an SPE to consolidate if most of its activities involved assets that were leased to only one lessee.
    c. Incorrect. The substantive investment requirement of the general SPE consolidation criteria is also mentioned in the third requirement of EITF Issue No. 90-15 that requires the SPE to consolidate if its owners had not made an initial substantive investment of at least 3%.
    d. Incorrect. The substantive risk and rewards requirement of the general SPE consolidation criteria is also mentioned in both the second and third requirements of EITF Issue No. 90-15. The second requirement states that the SPE must consolidate if the risks and rewards of the asset and the debt obligation lie with the lessee, and the third requirement states that the SPE must consolidate if the SPE owners had not made an initial investment that was at risk during the life of the lease.

11. Of the special rules for SPEs involved in leasing transactions under EITF Issue No. 90-15, what was not required by the general SPE consolidation criteria?
    a. Incorrect. The control requirement in the general SPE consolidation criteria was not required for leasing transactions under EITF Issue No. 90-15.
    b. Correct. The general SPE consolidation criteria does not require that the SPE have more than one client, whereas EITF Issue No. 90-15 requires an SPE to consolidate if most of its activities involved assets that were leased to only one lessee.
    c. Incorrect. The substantive investment requirement of the general SPE consolidation criteria is also mentioned in the third requirement in EITF Issue No. 90-15 that requires the SPE to consolidate (if all other conditions are met) if its owners had not made an initial substantive investment of at least 3%.
    d. Incorrect. The substantive risk and rewards requirement of the general SPE consolidation criteria is also mentioned in both the second and third requirements in EITF Issue No. 90-15. The second requirement states that the SPE must consolidate (if all other conditions are

met) if the risks and rewards of the asset and the debt obligation lie with the lessee, and the third requirement states that the SPE must consolidate (if all other conditions are met) if the SPE owners had not made an initial investment that was at risk during the life of the lease.

12. Under EITF Issue No. 90-15, the initial substantive residual capital investment for SPEs involved in leasing transactions:
    - **a. Correct. For SPEs involved in leasing transactions, in certain instances when an investor invested more than the minimum initial substantive residual capital investment, the investor may have withdrawn in excess of the minimum required amount.**
    - b. Incorrect. For SPEs involved in leasing transactions, the initial substantive residual capital investment may not have been withdrawn to the extent of the increase in the property's fair value.
    - c. Incorrect. If the initial substantive residual capital investment for SPEs involved in leasing transactions was reduced below the minimum amount, the investor did not have to make an additional investment.
    - d. Incorrect. The initial substantive residual capital investment for SPEs involved in leasing transactions was 5%, at a minimum.

13. Under FASB No. 140 previously in effect, when was control over transferred assets surrendered?
    - a. Incorrect. Under FASB No. 140, control over transferred assets was surrendered when the assets were separated from the transferor, not the transferee. The transferee gained control of the assets that become attached to the transferee.
    - **b. Correct. Under FASB No. 140, control over transferred assets was surrendered when the transferee pledged or exchanged assets or beneficial interests received. Furthermore, the transferee had no constraints in employing its right to pledge or exchange the assets.**
    - c. Incorrect. Under FASB No. 140, control over transferred assets was surrendered when there is no agreement requiring that the transferor repurchase or redeem the transferred assets before maturity.
    - d. Incorrect. Under FASB No. 140, control over transferred assets was surrendered when the transferor's creditors could not claim the assets. When the assets had been surrendered, the assets could be a target of the transferee's creditors.

14. Under what authority is (was) the consolidation of qualifying SPEs disallowed?
    - a. Incorrect. APB No. 9 intended to cover all of an entity's transactions that involve its own stock. However, under this authority, companies were permitted to use SPEs to record gains and income from their own stock if the gains and income were not recorded on the company's own income statement.
    - b. Incorrect. EITF Issue 85-1, *Classifying Notes Receivable Received for Capital Stock*, clarified how to report notes receivable received for capital stock.
    - **c. Correct. FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, prohibited the consolidation of qualifying SPEs.**
    - d. Incorrect. FASB No. 125 preceded FASB No. 140.

15. What is the intent of APB No. 9, *Reporting Results of Operations*?

a. Incorrect. EITF Issue 85-1, *Classifying Notes Receivable Received for Capital Stock*, clarified how to report notes receivable received for capital stock.
b. Correct. APB No. 9 intended to cover all of an entity's transactions that involve its own stock.
c. Incorrect. Under APB No. 9, companies were permitted to use SPEs to record gains and income from their own stock if the gains and income were not recorded on the company's own income statement.
d. Incorrect. FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, prohibited the consolidation of qualifying SPEs.

III. Enron and GAAP Violations

In the previous section, we reviewed the GAAP rules for SPEs and other transactions that were in effect during the Enron years. This section focuses on two specific GAAP issues as they related to Enron:

a. Enron's Use of SPEs- Where Did They Violate the GAAP Rules?
b. Enron's Disclosures- Did Enron Violate the Disclosure Rules for Related Parties?

a. Enron's Use of SPEs-Where Did They Violate the GAAP Rules

A full discussion of Enron's use of SPEs would take far longer than is needed to stress the key points regarding what should or should not have been done with the SPEs. Instead of dealing with all of Enron's SPEs, the author focuses on a few key transactions, which appear to have been pivotal to Enron's demise.

The players in the Enron episode which are discussed throughout this section were as follows:

Name	Title/Relationship
Kenneth Lay	Chairman and CEO
Jeffrey Skilling	President and COO
Andrew S. Fastow	Executive VP and CFO
Michael J. Kopper	Enron Global Finance officer (not an "executive officer")
William D. Dodson	Not an Enron employee- friend of Kopper
Ben Glisan	Officer
Jeffrey McMahon	Treasurer
Kristina Mordaunt	In-house lawyer for Enron
Anne Yaeger Patel	Employee in finance department
Rick Causey	Chief Accounting Officer
Rick Buy	Chief Risk Officer

First a refresher. We said that under the SPE rules in effect during Enron, in order for a sponsor company to avoid having to consolidate an SPE, *three criteria* had to be met which were:

The majority owner(s) of the SPE had to be an *independent third party* who:

1. Had made a *substantive investment in the SPE of at least 3%* of the SPEs total debt and equity, or total assets,

2. Had *control of the SPE*, and

3. Had *substantive risks and rewards of ownership* of the SPE's assets-

   a. 3% investment had to be at risk.
   b. The owner's 3% investment was not at risk if it was guaranteed by another party.

Now let's look at Enron

According to Congressional hearings and the Powers Report, Enron had more than 3,000 SPEs. Although many, if not most of these SPEs, were initially established with a valid business purpose, (such as obtaining a lower cost of capital), several ultimately resulted in the payout of sizeable gains to certain employees and officers of Enron. The justification for these payouts shall be determined by Congress and the courts.

From a review of the Powers Report, it appears that much of Enron's growth involved large initial capital investments that were not expected to generate significant earnings or cash flows in the short term. As a result, Enron had a substantial debt load. Funding new investments by issuing additional debt was not attractive because cash flows in early years would not be sufficient to service the additional debt service and would put pressure on Enron's credit ratings at investment grade. Moreover, funding investments by issuing additional equity would have diluted earnings per share.

The use of SPEs appeared to be a perfect solution under which Enron would find outside investors willing to enter into arrangements to shift certain activities, assets and related debt off Enron's financial statements. Although the reasons for using SPEs may have been valid, Enron's downfall was that it did not follow the SPE rules with the discipline needed to avoid consolidation of certain SPEs.

In October and November 2001, Enron announced that it had mishandled the accounting treatment of three SPEs, and was taking sizeable charges against earnings related to transactions with these three SPE partnerships, the names of which were:

1. JEDI
2. Chewco
3. LJM1

All three partnerships should have been consolidated with Enron for years going back as far as 1997. Financial statements for 1997 to 2000 were restated, resulting in a $586 million reduction in net income, a $2.6 billion debt increase, and a $1.2 billion reduction in stockholders' equity. Moreover, Enron announced that Andrew Fastow, its VP and CFO, had received more than $30 million from his involvement in LJM1 and LJM2 partnerships, as well as the involvement of other employees, notably Michael Kopper, in transactions, which reaped significant personal financial gains.

A sizeable amount of the reduction in stockholders' equity was a result of Enron's misclassification of certain notes receivable related to the issuance of Enron stock in the Raptor partnerships. These notes were classified as assets when they should have been presented as reductions in stockholders' equity. Ultimately, this misclassification resulted in a restatement and reduction of $1.2 billion of stockholders' equity in 2001.

At the end of 2001, once an announcement was made regarding the restated financial statements coupled with the financial press's questions about Fastow's conflict of interest charges, there was a decline in investor confidence in Enron. Enron's stock, which had already seen some declines, began spiraling downward. Because Enron stock was used as collateral for outstanding debt and

guarantees, several lenders demanded repayment of outstanding debt or an increase in the number of shares given as collateral. This endless spiral of dropping stock price and demand for debt payment resulted in Enron filing for bankruptcy in December 2001.

It is fair to say that the single most pervasive violation of accounting principles was Enron's failure to consolidate its SPEs which clearly had not satisfied the three criteria for non-consolidation, as previously discussed in this chapter.

Enron and the three SPE criteria for non-consolidation

The three non-consolidation criteria for SPEs were violated by Enron in several ways.

Criterion 1: An *independent third party* made a *substantive investment of at least 3%:*

- In several SPEs, Enron was unable to attract outside investors to make the 3% substantive investment. Instead, that 3% was funded directly by Enron, which violates Criterion 1. Enron was not an independent third party.

- On other occasions, outside investors did make investments. However, those investments were either less than 3% or ultimately dropped below the 3% threshold.

- In several SPEs, Enron used, through other entities, employees of Enron as trustees and/or general partners/members to control the SPEs. It is difficult to argue that an officer or employee of Enron is an independent third party. An independent third party generally should not include an employee or officer of the sponsor company.

Criterion 2: The majority owner (independent third party) had to *control the SPE:*

- With the LJM partnerships, there was evidence that Enron had control over the SPE because its employees, Andrew Fastow (CFO and VP) and Kopper (Enron officer) controlled the SPEs.

Criterion 3: The majority owner (independent third party) had to have *substantive risks and rewards of ownership* of the SPE's assets (including residuals):

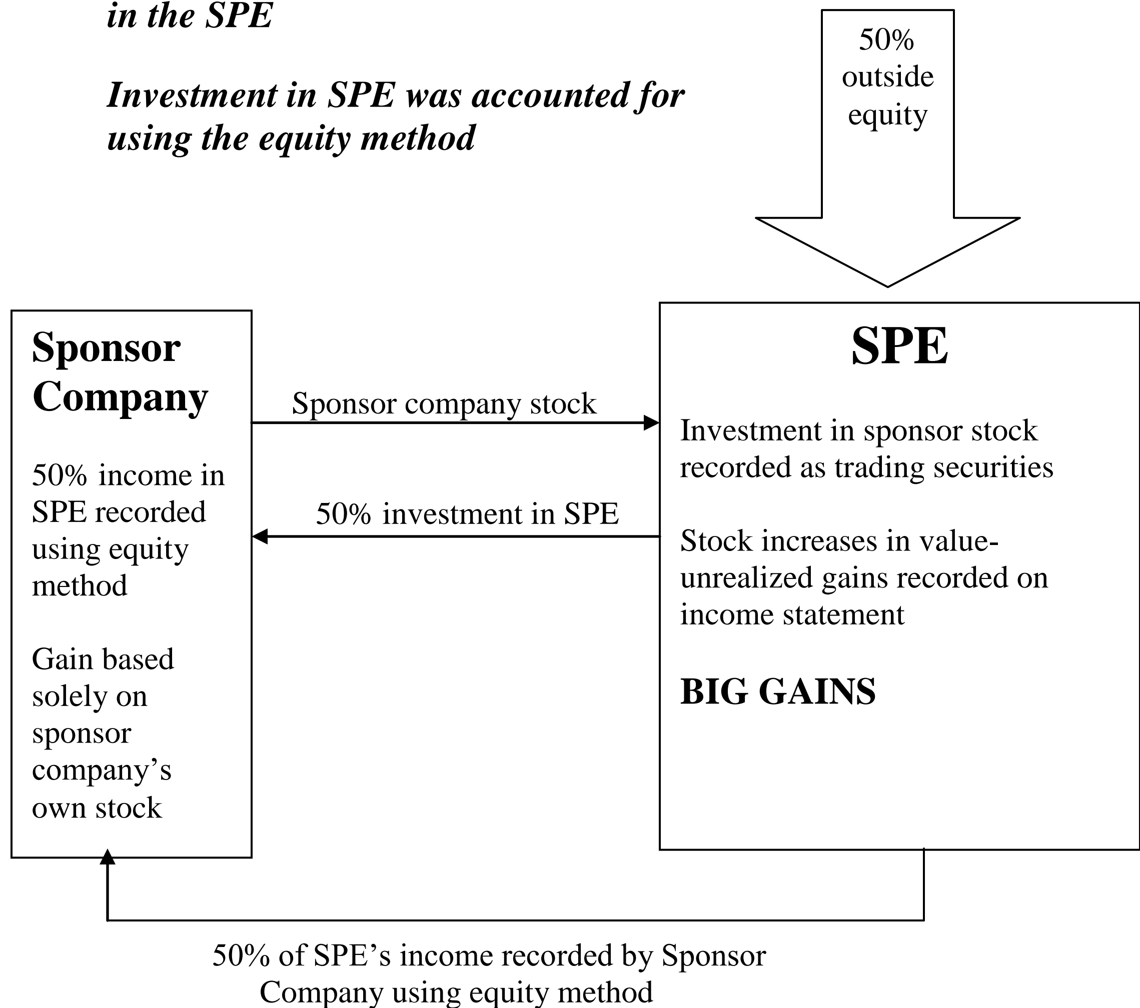
- In several instances, Enron guaranteed the initial investment made by the LJM partnerships, which mentioned the investment was not at risk.

- In another situation, the 3% investment was not at risk because it was collateralized by a cash escrow account.

The basic structures of Enron's SPEs

Before we look at the specific GAAP issues related to Enron, let's look at a few SPE structures that were used by Enron.

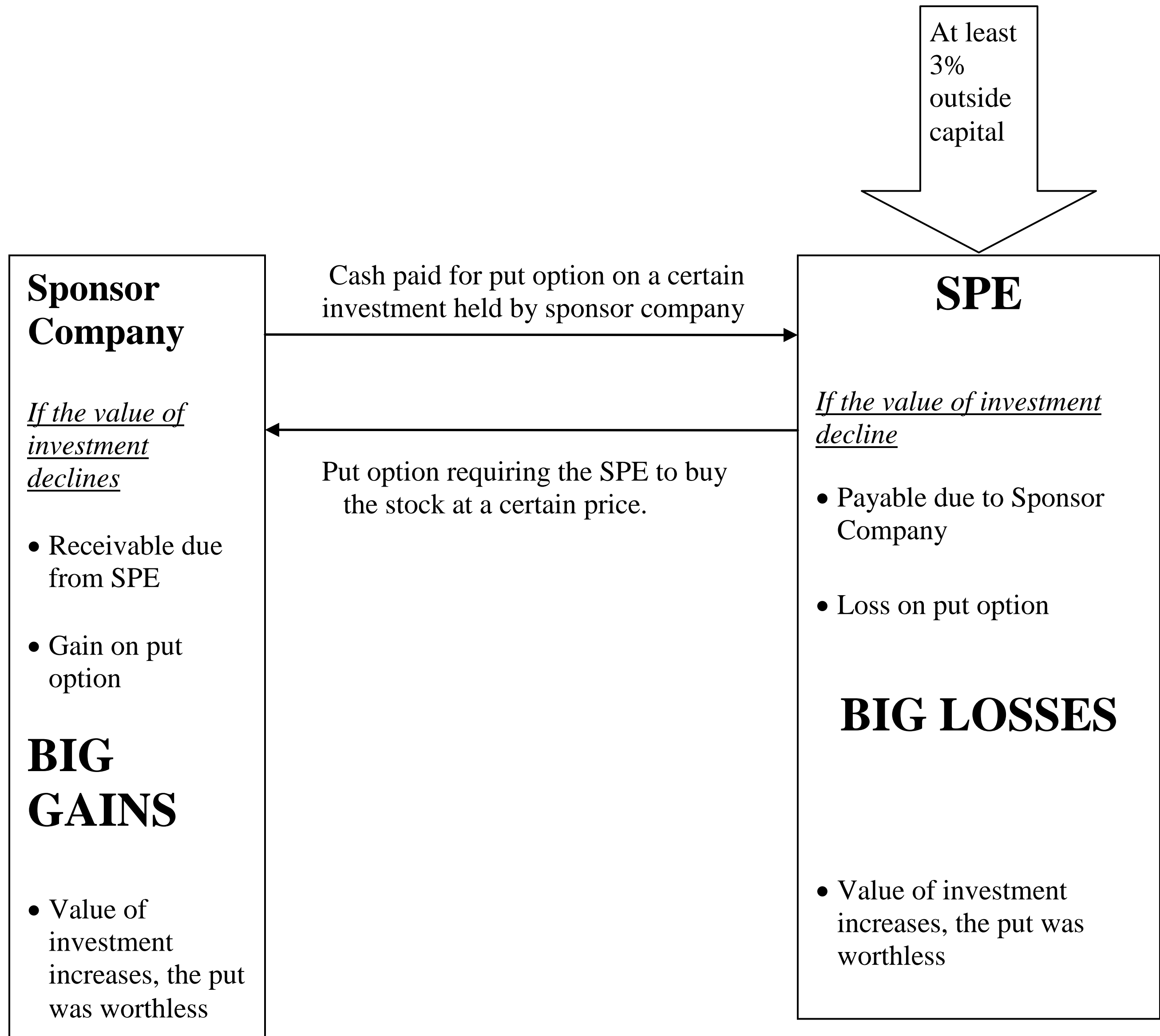
SPE Structure 1- Recording Gains on Your Own Stock



Result: Sponsor Company recorded income on the increase in the value of its own stock, which was in violation of GAAP. A company was not permitted to record income on its own stock.

SPE Structure 2- Using the SPE for Hedge Transactions

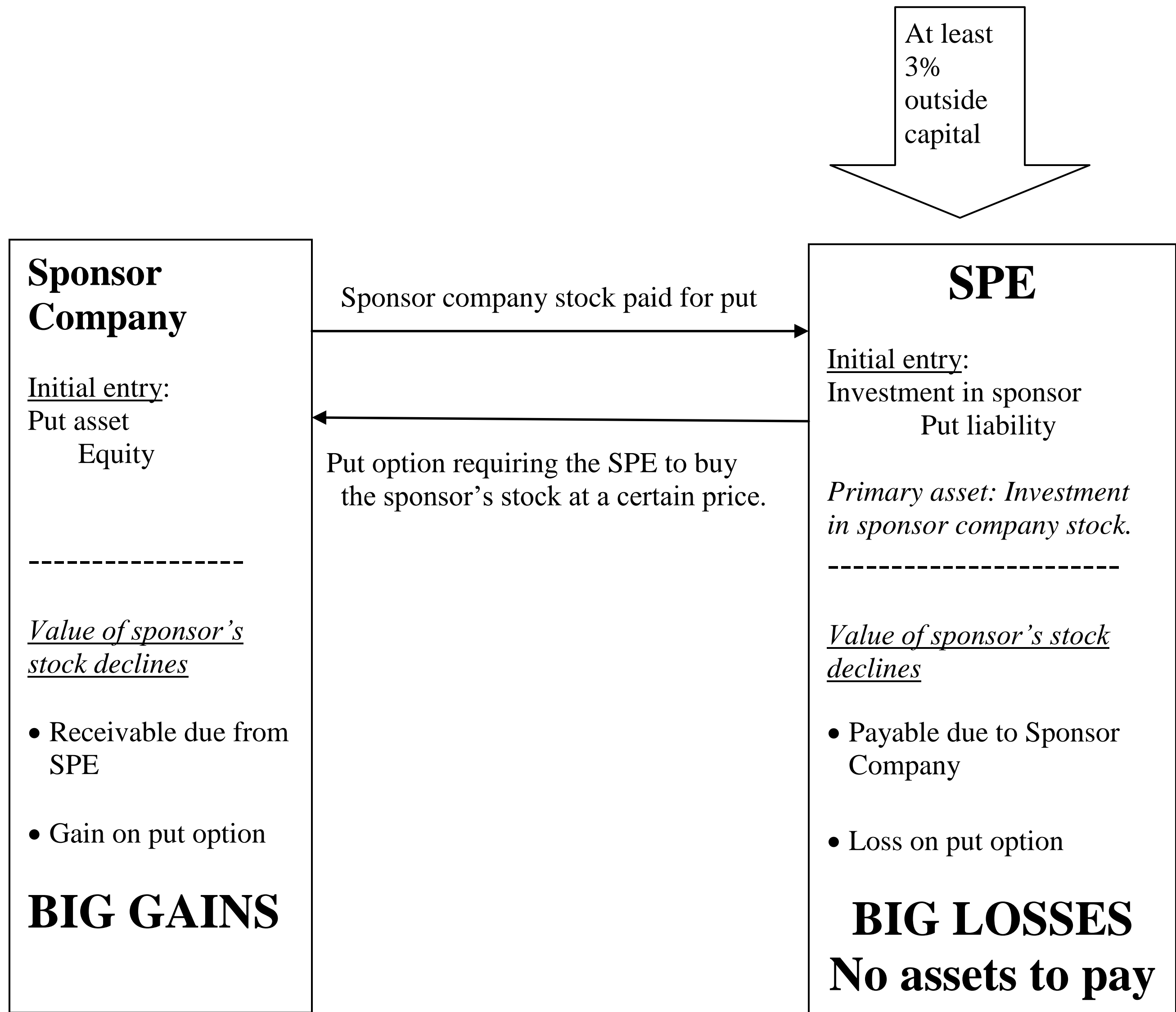
Sponsor Company purchased a put option from an SPE requiring the SPE to purchase shares of Sponsor Company investments at a certain price.



Result: This structure was legitimate as long as the SPE was truly independent and solvent with outside capital. The structure broke down if the SPE did not have adequate outside capital and could not fund the put option liability.

SPE Structure 3-Using the SPE for Hedge Transactions on Sponsor's Own Stock

Sponsor Company purchased a put option from an SPE on its own stock. Put option was paid for by giving the SPE shares of the sponsor Company's Stock.



Result: This structure *violated GAAP* since Sponsor Company recorded put option gains on its own stock. Further, because the SPE was capitalized with the Sponsor Company's stock, as the put liability increases, the value of the SPE's asset investment in sponsor company declined. The SPE was left with a large liability due to the Sponsor Company with no assets to repay it. The Sponsor Company was left with a receivable due from the SPE that may not have been collectible and required a written down.

The First Enron SPE-
JEDI and Chewco Investments L.P.
Phase 1: 1993-1997

Facts:

- In 1993, Enron and the California Public Employees' Retirement System (CalPERS) entered into a joint venture investment partnership called JEDI.

- Enron, as general partner, contributed $250 million of its own stock. CalPERS, as limited partner, contributed $250 million cash.

- Under the partnership agreement, both entities had joint (50%) control of the partnership.

- From 1993 until 2000, Enron recorded the investment on the equity method since it did not have majority control.

- JEDI used mark-to-market accounting to record its investments (merchant accounts) and recorded the increases in the Enron and other stocks within the partnership.

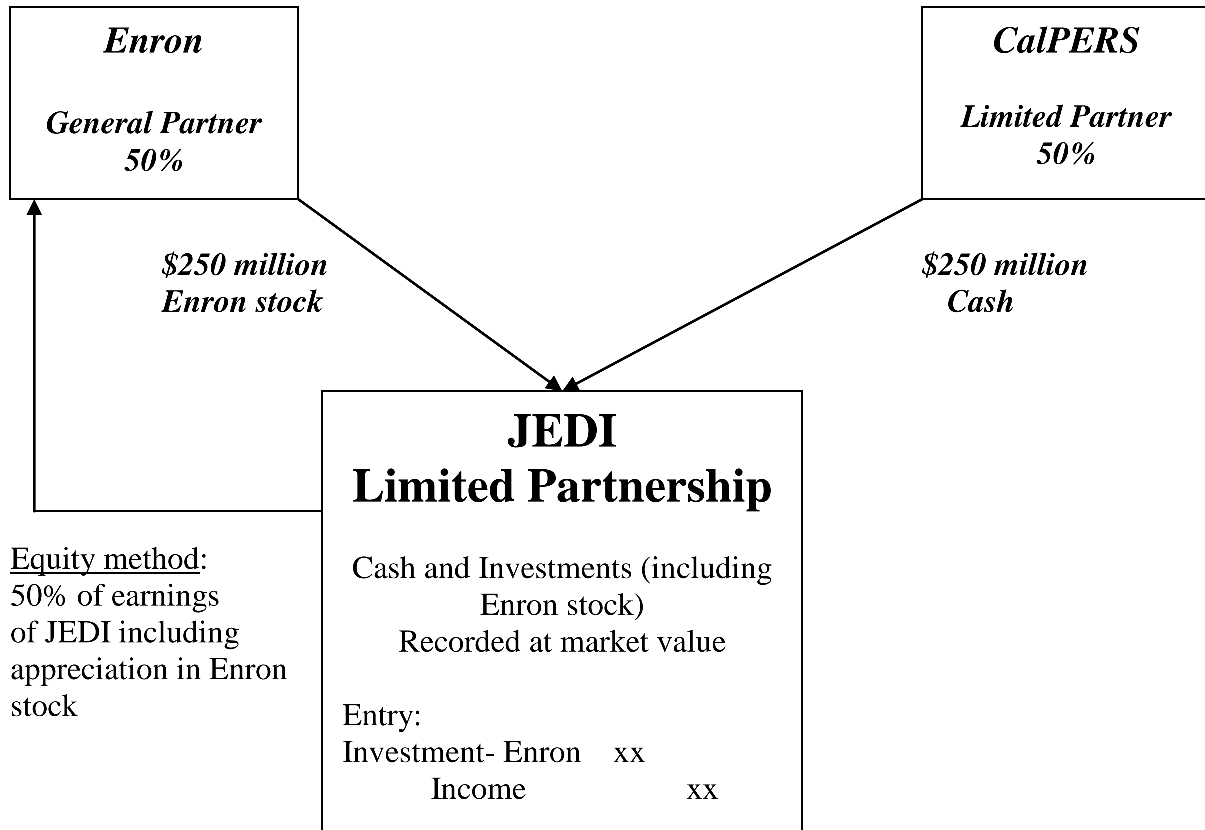
  Annual entries within JEDI to record mark-to-market (fair value) accounting:

Investment in Enron and other stocks	*xx*	
Investment income		*xx*

  Note: There has been no discussion as to why JEDI used mark-to-market (fair value) accounting. Either they considered the investment portfolio "trading securities" accounted for at fair value under FASB No. 115, or they considered themselves a broker-dealer, which used mark-to-market accounting.

- Using the equity method, Enron recorded 50% of the JEDI profits fueled from the increase in the value of its own stock within the partnership.

The first phase of the JEDI-Chewco arrangement looked like this:



Comments: From 1993 until the first quarter 2000, using the equity method, Enron recorded 50% of JEDI net income. JEDI's net income including its recording of unrealized gains on appreciation on Enron stock, based on mark-to-market (fair value) accounting. The result is that a portion of the equity income booked by Enron on its investment in JEDI consisted of *gain on its own stock*, which is generally a violation of GAAP.

In a simplistic form, the entries recorded by JEDI and Enron were as follows:

Assume that JEDI has an investment in Enron common stock that appreciates by $1,000. The income tax effects are ignored in the example.

JEDI would make the following entry on its books:

ENTRY ON JEDI'S BOOKS:

Investment in Enron stock	1,000	
Gain on appreciation		1,000

Assume further, that JEDI's total income for the year was:

JEDI'S BOOKS

Net income exclusive of the Enron stock gain	$11,000
Unrealized gain on Enron stock investment (entry above)	***1,000***
Net income- JEDI	$12,000
Enron's 50% portion of the JEDI net income	$6,000

On Enron's books, it would have made an entry to record its 50% share in the net income of JEDI, based on the equity method.

ENTRY ON ENRON'S BOOKS

Investment in JEDI	6,000	
Equity method income		6,000

The result of these two transactions is that Enron has just recorded income on its own stock. The $6,000 share of its JEDI income includes $500 ($1,000 x 50%) appreciation on its own stock.

GAAP Violations: A company was precluded from recording gains or income on its own stock, whether done directly or indirectly. In this case, JEDI was a vehicle for Enron recording unrealized gains on its own stock, which violates GAAP.

Phase 2: JEDI-Chewco- November 1997

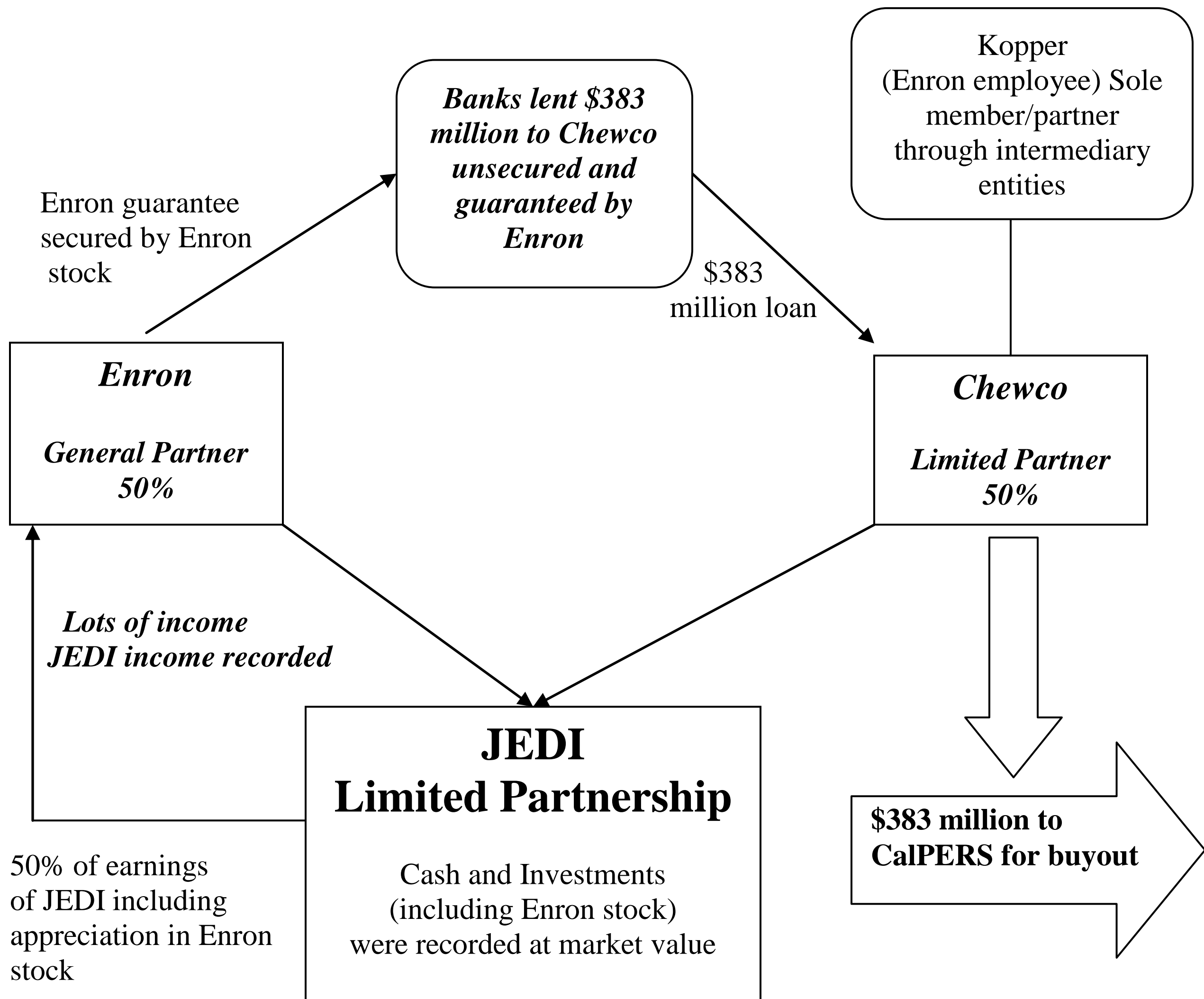
Facts:

- In 1997, CalPERS wanted to be bought out of its 50% investment for a price of $383 million.
- To avoid having to consolidate JEDI with Enron, Enron needed to find another limited partner to replace CalPERS.
- Chewco Investments L. P. (named after the Star Wars character, Chewbacca) was formed as a Delaware LLC in 1997 with the purpose of purchasing CalPERS's 50% investment in JEDI for $383 million.
- November 1997, Enron arranged bridge financing for $383 million for Chewco from two banks, on an unsecured basis, guaranteed by Enron.
- Players involved:

Name	Title/Relationship	Function performed
Andrew S. Fastow	Executive VP and CFO	Structured the transaction
Michael J. Kopper	Enron Global Finance officer (not an "executive officer")	Managed and controlled the Chewco LP- used instead of Fastow to avoid proxy statement disclosure rules
William D. Dodson	Not an Enron employee- best friend of Kopper	Acted as a straw to avoid the SPE consolidation rules

Observation: It was clearly noted in the Powers Report that Kopper was intentionally used to manage and control Chewco, LP. Because Kopper was an officer, but not an "executive officer," under SEC rules, his involvement would not have to be disclosed in Enron's proxy statement. However, it would have to be disclosed in the financial statements under FASB No. 57.

JEDI-Chewco November 1997



Comments: After the buyout of CalPERS in November 1997, Chewco owned the 50% limited partnership interest and Enron owned the 50% general partnership interest in JEDI.

GAAP Violations: Enron had several significant violations of the SPE rules that, if not corrected by December 31, 1997, would have resulted in Chewco being a consolidated SPE. If Chewco were consolidated, the $383 million of debt would be consolidated on Enron's balance sheet. Moreover, by consolidating Chewco, Enron would be deemed to be a majority (100%) owner of JEDI LP, and it too would be consolidated with Enron. If JEDI were to be consolidated, the unrealized gains from market-to-market (fair value) accounting would be eliminated in consolidation.

Chewco violated the SPE non-consolidation rules for several reasons.

1. Missing the 3% minimum investment requirement: It had 100% debt outstanding and did not have the minimum required 3% equity received from independent third-party investors.
2. Lacked control by an independent third party: Chewco was not in control by an independent third party since an Enron employee, Kopper controlled Chewco through a general partnership.

Phase 3: JEDI-Chewco- December 1997- 2001

Facts:

- In November 1997, Chewco's capital structure was changed to force it to satisfy the 3% minimum investment requirement and the lack of independent control before December 31, 1997. If these two issues were not corrected by December 31, 1997, Enron would be required to consolidate with Chewco and JEDI as of December 31, 1997.

The control issue:

- A limited partnership and general partnership were established for Chewco.

- The partnership agreement was revised to provide limits on the general partner's ability to manage the partnership's affairs without limited partnership approval. Kopper remained as the sole managing member of SONR LLC, the GP.

- Kopper, an Enron employee and officer (not a senior officer), transferred his ownership and management in the LP to his friend, William D. Dodson. Dodson was not an employee of Enron and had no involvement in any of the other transactions.

- After the adjustments, the ownership structure of Chewco looked like this:

  SONR LLC- GP- Kopper was the sole managing member of the GP with limited ability to manage the partnership affairs without limited partners approval.

  Big River Funding LLC- Chewco's sole limited partner with Little River Funding LLC as its sole member.

- The new structure plan of $383.5 million was established to pay off the $383 million of interim financing.

$240 million	Unsecured subordinate loan from Barclays Bank, guaranteed by Enron
$132 million	Advance (loan) from JEDI to Chewco under a revolving credit agreement
$11.5 million[5]	Outside equity (3% of $383.5 million total capital) to be received from Chewco general and limited partners.
$383.5 million	**TOTAL REVISED CAPITAL STRUCTURE**

- Chewco was unable to obtain the 3% ($11.5 million) capital from independent third-parties. An alternative plan was developed to *disguise the 3% investment* as follows:

$125,000	Kopper equity investment through Chewco general and limited partnerships.
11.4 million[6]	Borrowed "equity loans" from Barclay's Bank by Chewco's limited partnership, Big River.
$11.525 million	Total Reported Equity Investment

- The Barclays note of $11.4 million was collateralized by $6.6 million of cash reserve accounts that Chewco received from a JEDI distribution.

Revenue recognition and other fees:
From 1997 to 2000, the following fees and revenue were recorded in the various entities.

- Kopper received $2 million

- Chewco received a $400,000 restructuring fee from Enron

- 1997: Enron received a $10 million fee for guaranteeing the $240 million loan which was recognized all in 1997 instead of being amortized over the life of the guarantee.

- 1998: Enron amended its JEDI partnership agreement to require that annual management fees were a "required payment" for services to be rendered from 1998 to 2003. Enron recognized

[5] The $11.5 million was the minimum 3% of outside equity investment (3% of $383.5 million) that was required to satisfy the non-consolidation rules for SPEs.

[6] According to the Powers Report, it appears that Barclays Bank assisted Enron in disguising loan as an equity instrument. The Barclays' loans to Big River were reflected in documents that resembled promissory notes and loan agreements, but were labeled "certificates" and "funding agreements" that required Big River to pay a "yield" at a specified percentage rate, instead of interest. This structure allowed Barclays to treat the advances as loans on its books, while allowing Chewco to treat them as equity contributions for accounting purposes.

the entire fee on a present value basis in the amount of $25.7 million in 1998, prior to the management services being rendered.

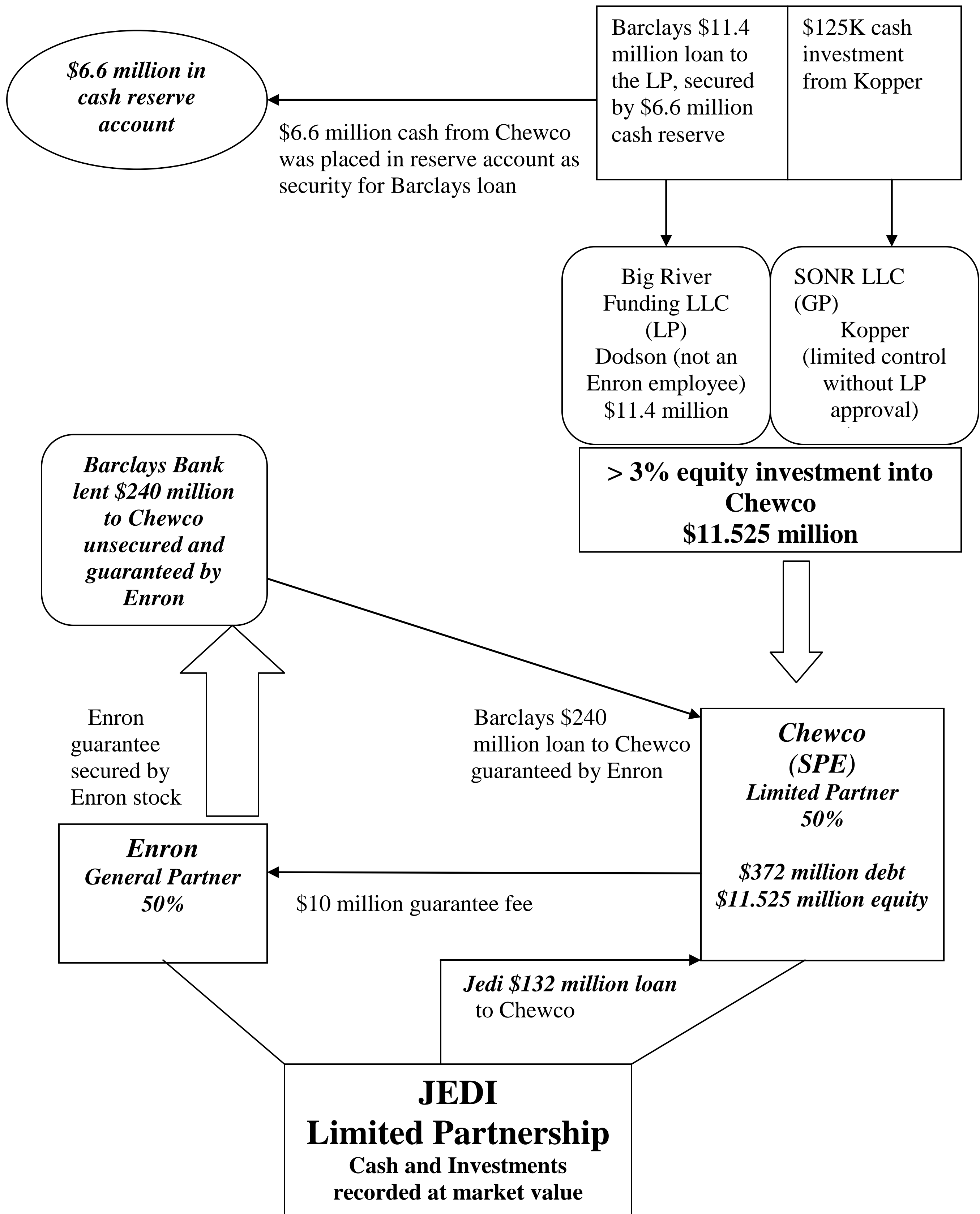
Final sale and liquidation of Chewco.

- In March 2001, Enron repurchased Chewco's 50% limited partnership interest in JEDI for $35 million and consolidated JEDI into its consolidated financial statements. With the proceeds, Chewco paid off the remainder of its debt.
- Final results: Kopper and Dodson received a total of $10.5 million from Chewco, based on an investment of $125,000.

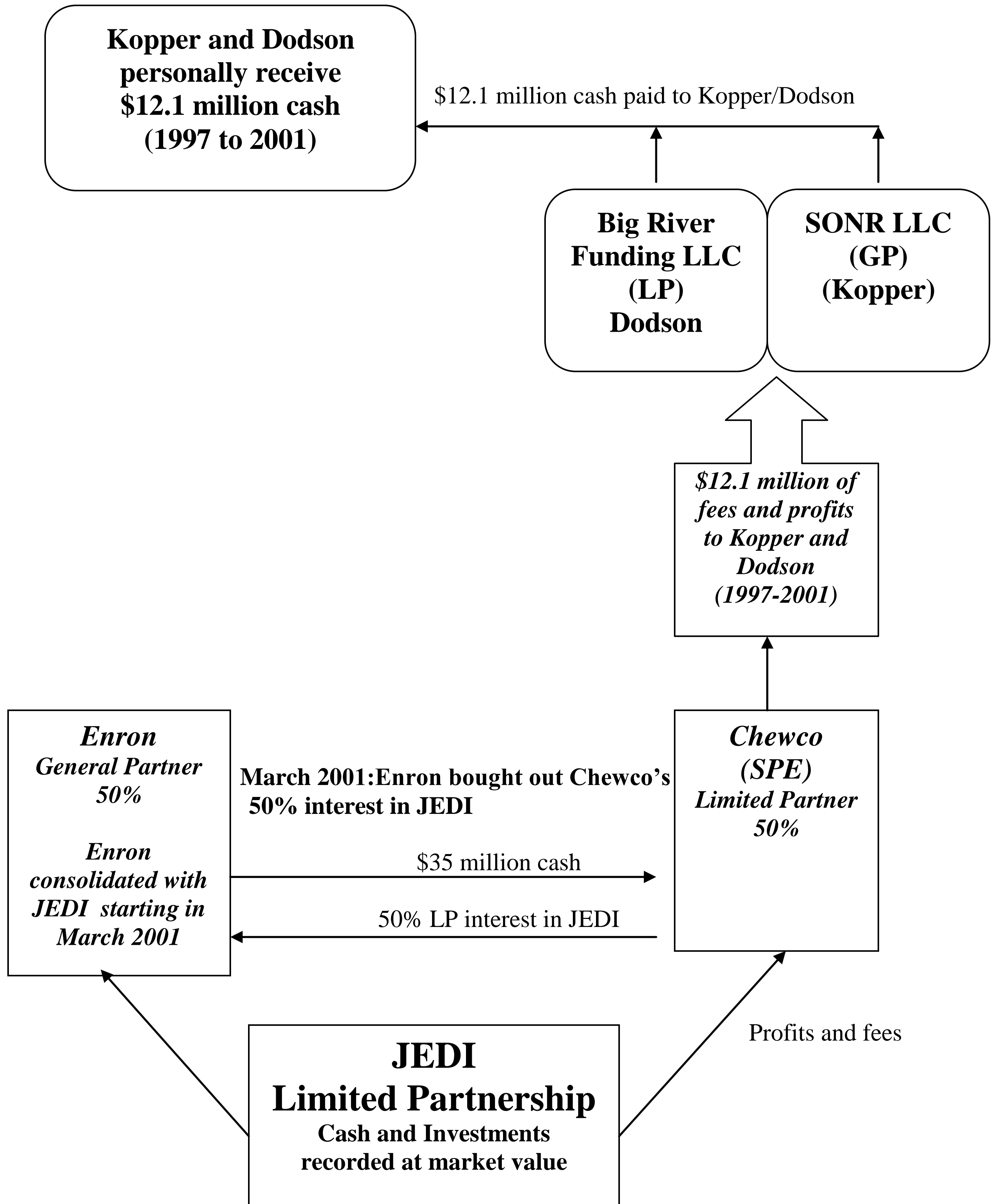
Profit to Kopper and Dodson:

Investment return from 1997 to 2000	$7.5 million
Additional return from 2001 buyout of Chewco	3.0 million
Total	10.5 million
Additional management fees received	1.6 million
Total received (1997 to 2001)	12.1 million
Investment made	125,000
Rate of return	*2400%*

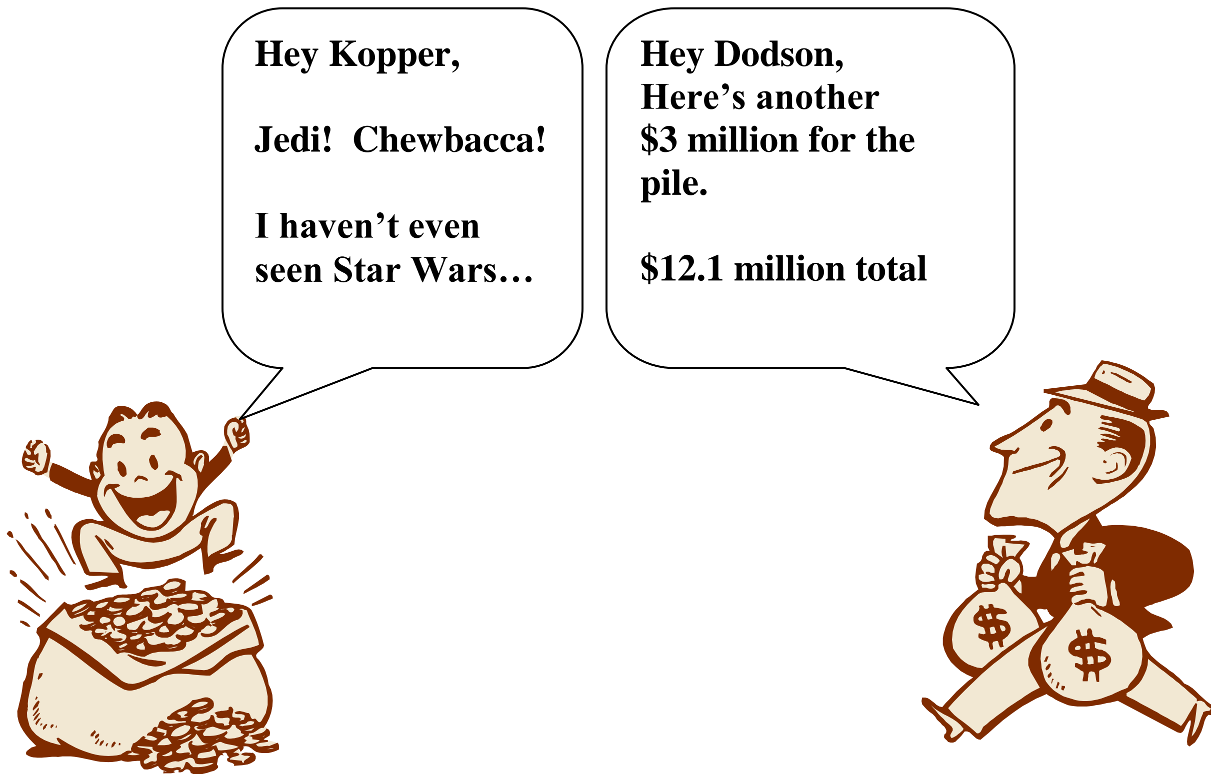
JEDI-Chewco- Final Structure- December 31, 1997



JEDI-Chewco- 1997 to March 2001 including Enron Buyout $12.1 Million Score for Kopper and Dodson



The Star Wars Epic
Easy Money for Kopper and Dodson



Comments: After the final restructuring of Chewco, Chewco had a capital structure consisting of 97% debt ($372 million) and 3% equity ($11.525 million). However, there were several GAAP violations.

GAAP Violations: Although Enron believed they had rectified the non-consolidation criteria for the Chewco SPE, it actually had not. In fact, Chewco violated two of the three SPE criteria required for non-consolidation, discussed as follows:

1. 3% minimum investment requirement- VIOLATION: Although Chewco thought it had satisfied the 3% minimum equity requirement by infusing $11.525 million (greater than 3% of the total capital of $383.5 million), it actually had not. The rule stated that the 3% investment had to be from an independent third party. Out of the $11.525 million equity investment, $125,000 was infused by Kopper, who was not independent because he was an employee of Enron. The remaining $11.4 million of "equity" was received from Big River Funding LLC, Chewco's limited partner. In form (not substance), this equity qualified as being received from an independent third party since Big River's control and ownership was held by Dodson, who had no employment or other ties to Enron or its affiliates. In substance, Dodson could have been considered merely a straw for Kopper which, if proven, would have also eliminated the $11.4 million of equity from an independent third party.

Assuming for this analysis that the $11.4 million of equity made by Dodson was valid independent third-party equity, Chewco still violated the 3% minimum equity rule with a percentage of 2.97% calculated as follows:

Equity received from independent third party	$11.4 million
Total capital	$383.5 million
% equity to total capital	2.97%

2. *Control by an independent third party:- NO VIOLATION*: Chewco changed the terms and structure of its partnership agreement in order to ensure that it satisfied the control requirement. First, it transferred total control over the limited partnership to Dodson, who had no affiliation with Enron, although a close friend of Kopper. Second, it rewrote the agreement to restrict the authority of the general partner, SONR LLC, which was managed by Kopper. The result was that one could argue that the general partner *did not control* Chewco, because the general partner had to receive approval from the limited partner to manage Chewco. If Kopper (through the general partner SONR) did not control Chewco, then there was no string to Enron controlling Chewco. What is not clear is whether Dodson was merely a straw for Kopper, thus resulting in Kopper controlling the limited partner, Big River, and Chewco. If Kopper controlled Chewco, then Enron was deemed to control Chewco.

3. *Substantive risks and rewards of ownership of the 3% SPE investment: VIOLATION:* The third requirement to satisfy the non-consolidation of the Chewco SPE was that the majority owner had to have substantive risks and rewards of ownership with respect to the 3% equity investment. The risk and rewards did not passed to the majority owner if there was a *guarantee of any or all of its equity* investment. Here is where Chewco violated the SPE rules. By having a portion of the $11.4 million loan secured by the $6.6 cash reserve fund, $6.6 million of equity was not at risk by the investor (Big River Financing LLC), thereby not satisfying the third criterion for non-consolidation of the Chewco SPE.

The overall result is that Chewco violated at least two of the three criteria (Criterion 1 and 3) for not consolidating an SPE. Consequently, Chewco should have been consolidated with Enron beginning in 1997 through 2000. Further, because Chewco and Enron should have been consolidated, Enron was deemed to own 100 percent of the JEDI partnership, which, in turn, should have been consolidated with Enron from 1997 to 2000.

Other GAAP issues related to Chewco and JEDI

Although not proven to date, there appears to be several issues with respect to revenue recognition timing of fees received from Chewco. In 1997, Enron received a $10 million fee for guaranteeing the $240 million loan. All of the fee was recognized as revenue in 1997 instead of being amortized over the life of the guarantee, from 1997 to 2000.

In 1998, Enron amended its JEDI partnership agreement to require that annual management fees were a "*required payment*" for services to be rendered from 1998 to 2003. Enron recognized the entire fee on a present value basis in the amount of $25.7 million in 1998, prior to the management services being rendered. There is no reference as to what discount rate was used to compute the present value amount.

These facts suggest that revenue earned in 1999 and 2000 was accelerated into 1997 and 1998.

Restatement of financial statements from the Chewco-JEDI transactions:

In November 2001, both Enron and Arthur Andersen concluded that Chewco did not satisfy the SPE non-consolidation requirements and, should have been consolidated into Enron's financial statements. Because Chewco should have been consolidated, that meant that JEDI also should have been consolidated.

In November 2001, Enron announced that it would restate its prior period financial statements from 1997 to 2000 and reported quarters for 2001, with a retroactive consolidation having a significant effect on Enron's restated financial statements as follows:

Year	Originally reported net income	Decrease in net income due to Chewco/JEDI	Debt increase
1997	$105 million	$(28 million)	$711 million
1998	$703 million	$(133 million)	561 million
1999	$893 million	$(153 million)	685 million
2000	$979 million	$(91 million)	628 million

The Second SPEs- the LJM Partnerships

Facts:

From 1999 to 2000, Enron entered into 24 transactions with two LJM partnerships. Taken together, these transactions resulted in significant recognition of income for Enron, and the avoidance of substantial losses. These relationships consisted of several types of transactions including:

1. Sales of assets between Enron and the LJM partnerships

2. Purchases of debt or equity interests by LJM partnerships or in Enron-sponsored SPEs and affiliates

3. Purchases of equity investments by LJM partnerships in SPEs designed to mitigate market risk in Enron's investments, including its own stock

4. Sales of call and put options by LJM partnerships on assets

5. Significant gains and fees being paid to Andrew Fastow, through the general and limited partnerships to LJM

LJM 1:

Facts:

In 1999, LJM 1 (referred to as LJM Cayman, LP) was established to permit Enron to hedge its investment in Rhythms NetConnections, Inc. (Rhythms) and possibly to purchase other assets from Enron's investment portfolio.

Andrew Fastow, VP and CFO, was the sole and managing member of LJM Partners, LLC, which was the sole general partner of LJM Partners, LP, the sole general partner of LJM1.

The limited partners of LJM1 (ERNB and Campsie) were unrelated to Enron.

Mr. Fastow arranged for certain employees of Enron to also work on the LJM partnerships.

In June 2000, the LJM1 partnership agreement was changed to limit the control of the general partner, Fastow. Specifically, the agreement:

- Limited the general partner's investment authority and required approval of certain investment decisions by the limited partners.

- The LJM1 agreement *did not provide* for removal of the general partner, without cause, which was a general partner limitation included in the revised agreement of LJM2 (see below).

Initial capital for LJM1 was as follows:

$1 million	From Andrew Fastow
15 million	From two limited partners, ERNB and Campsie, Ltd.

LJM1 entered into three transactions with Enron:

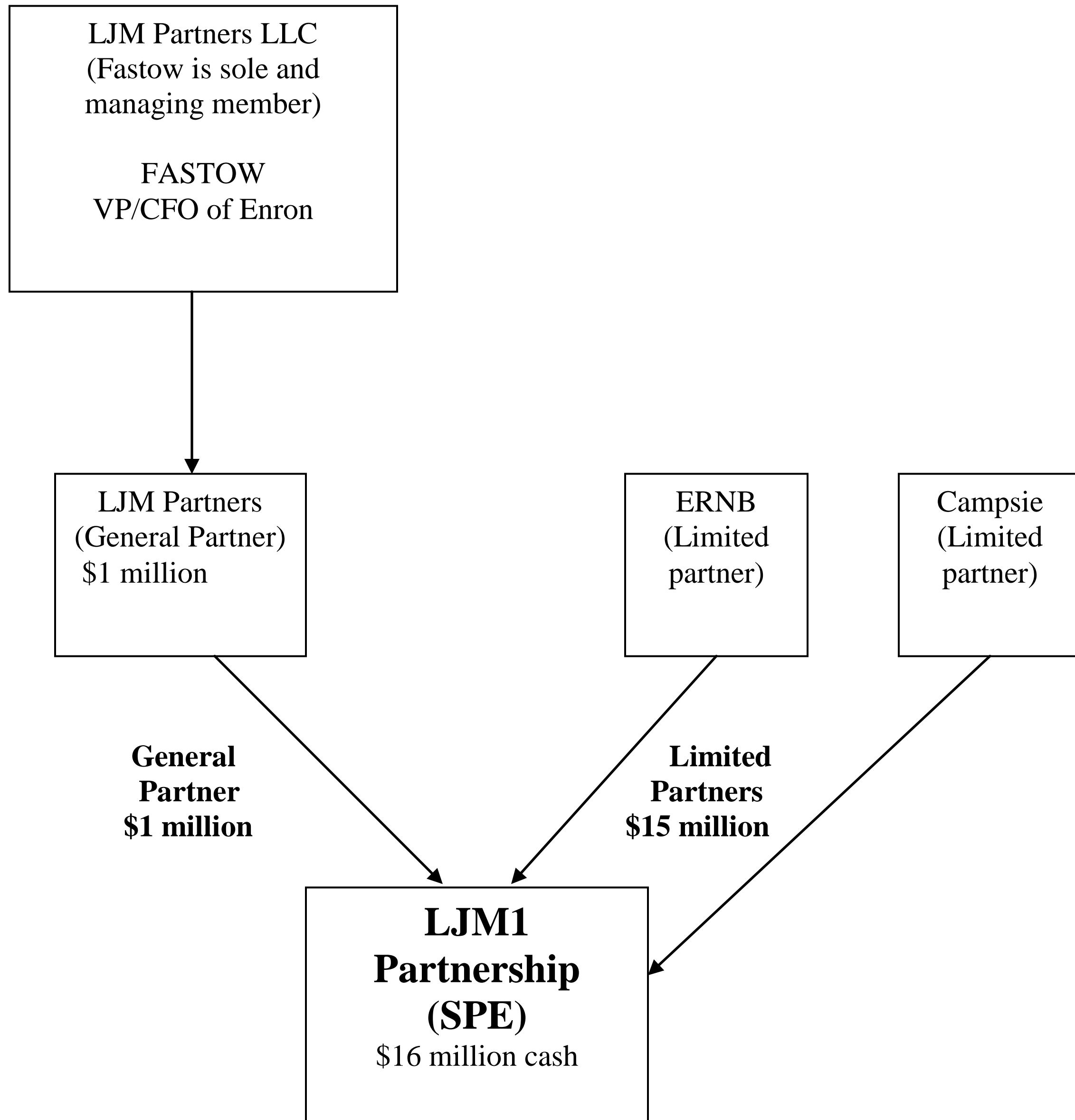
1. Purchased a portion of Enron's interest in a Brazilian power project (Cuiaba)

2. Purchased certificates of an SPE called Osprey Trust.

3. Hedged Enron's investment in Rhythms NetConnections stock.

The initial structure looked like this:

Initial Structure- LJM1 Partnership



Comments:

Andrew Fastow, VP and CFO of Enron, through intermediaries, was the sole general partner of LJM1. At its inception, did LJM1 qualify as a non-consolidated SPE by satisfying the three criteria?

It looks like, at its inception, there was at least 3% of investment from independent third parties. Although Fastow's $1 million did not qualify as part of the 3%, the $15 million from the independent limited partners did qualify. Also, there is indication that the $15 million was at risk, which satisfied criterion 3.

The open issue is whether criterion 2 (control) was satisfied. Did the limited partners (the majority owners) control the partnership or did Fastow, through his general partnership? If Fastow controlled LJM1 through his general partnership, then criterion 2 would have been violated because Fastow was not an independent third party. The LJM1 partnership agreement included several restrictions of the general partner so as to argue that Fastow had no control over LJM1, and, instead, the limited partners controlled the partnership. However, the restrictions were rather meek as compared with those placed in LJM2 (discussed further on) For example, a key restriction that was not included in the LJM1 partnership agreement was the limited partners' ability to remove the general partner. Although not conclusive, it appears that LJM1 violated the control requirement by having Fastow managing the general partner of LJM1.

LJM1 and the Rhythms Hedge

Facts:

- In 1999, LJM1 set up an SPE called Swap Sub to hedge Enron's investment in the common stock of Rhythms, held by Enron.

- LJM 1 was the limited partner of Swap Sub, while the general partner of Swap Sub was an entity controlled by Andrew Fastow.

- LJM1 capitalized Swap Sub with $3.75 million cash and 1.6 million shares of Enron stock. After the capitalization, Swap Sub's primary assets were the shares of Enron stock and $3.75 million cash.

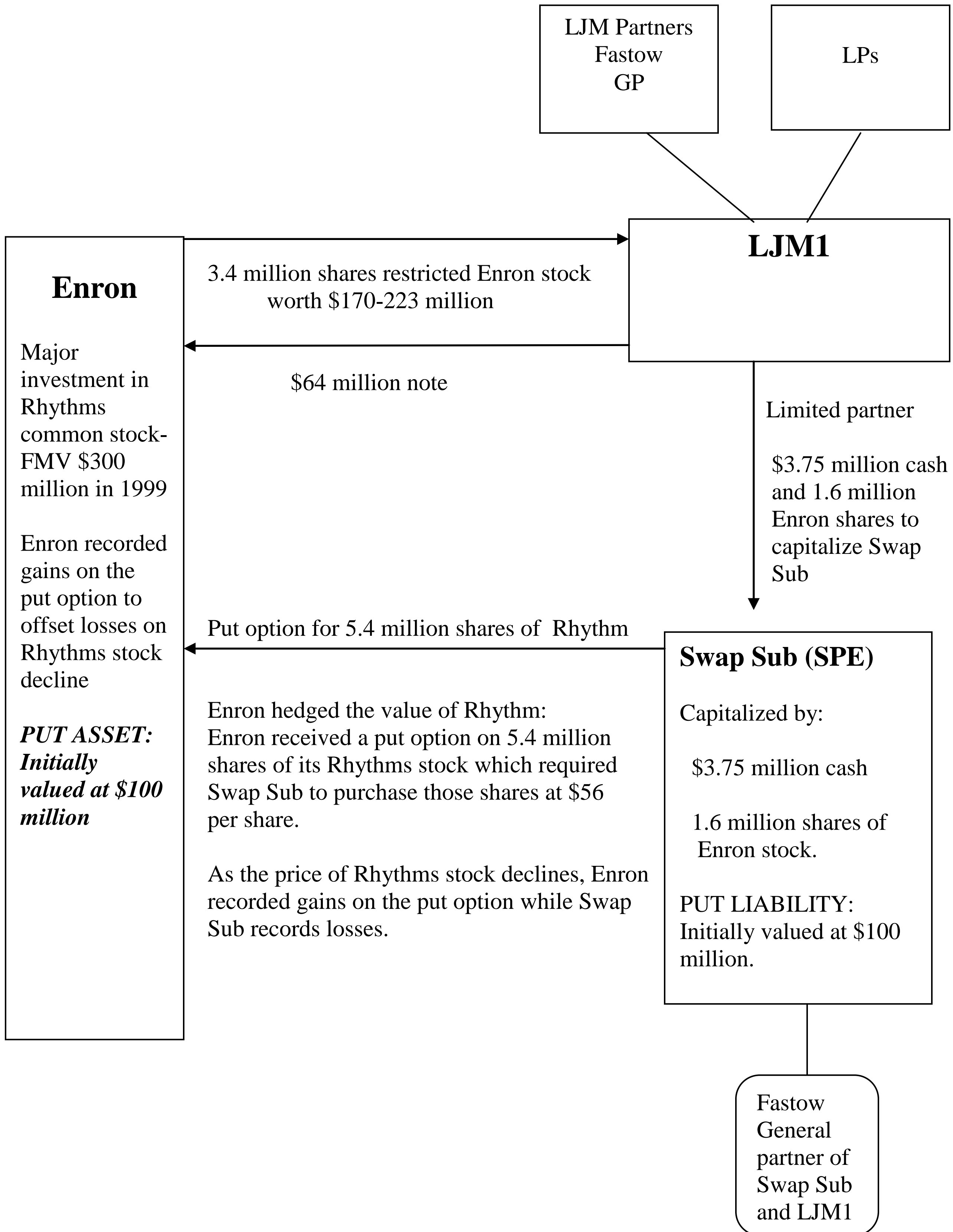
- In June 1999, Enron sold 3.4 million shares of common stock to LJM1 in exchange for a $64 million note receivable and a put option from Swap Sub on 5.4 million shares of Rhythms common stock.

- Enron presented the $64 million note as a note receivable in the asset section of its balance sheet, and not as a contra-account in stockholders' equity.

- The put option provided that Enron could require Swap Sub to purchase 5.4 million shares of Rhythms common stock from Enron at a price of $56 per share.

  Note: If the Rhythms stock value declined, Enron would have exercised the put option on Swap Sub, requiring it to purchase the Rhythm shares at $56 per share. However, Swap Sub's primary asset that would be used to fund the put liability due to Enron was the 1.6 million Enron shares. If Enron's shares declined in value, Swap Sub would not have the capital to purchase the Rhythms shares for $56 per share under the put option. Further, from period to period, as Rhythms' stock price declined, Enron recorded losses on that decline, with a corresponding gain recorded for the increase in the value of the put option due from Swap Sub.

Phase I of LJM1 and The Rhythms Hedge- 1999



End of 1999 to March 2000:

- End of 1999: The value of Rhythms stock declined, resulting in Swap Sub having to record a liability due to Enron for the decline in value. Enron recorded corresponding gains on the Swap Sub put option and a receivable due from Swap Sub.

- On Swap Sub's books, the put liability exceeded the value of the Enron stock investment.

- Enron loaned $10 million to Swap Sub.

- Swap Sub and Enron consummated an agreement for Enron to "unwind" (liquidate) Swap Sub. The transaction called for 1) Swap Sub giving Enron back 3.1 million (post-split) Enron shares, 2) Enron paying $16.7 million to Swap Sub) termination of the Rhythms put options, and 4) the $10 loan was netted in the $16.7 million.

- Enron reversed off the receivable due from Swap Sub with the offset being the receipt of Enron shares received.

- Residual assets retained in Swap Sub and LJM1 after unwinding- Fastow primary beneficiary of these assets.

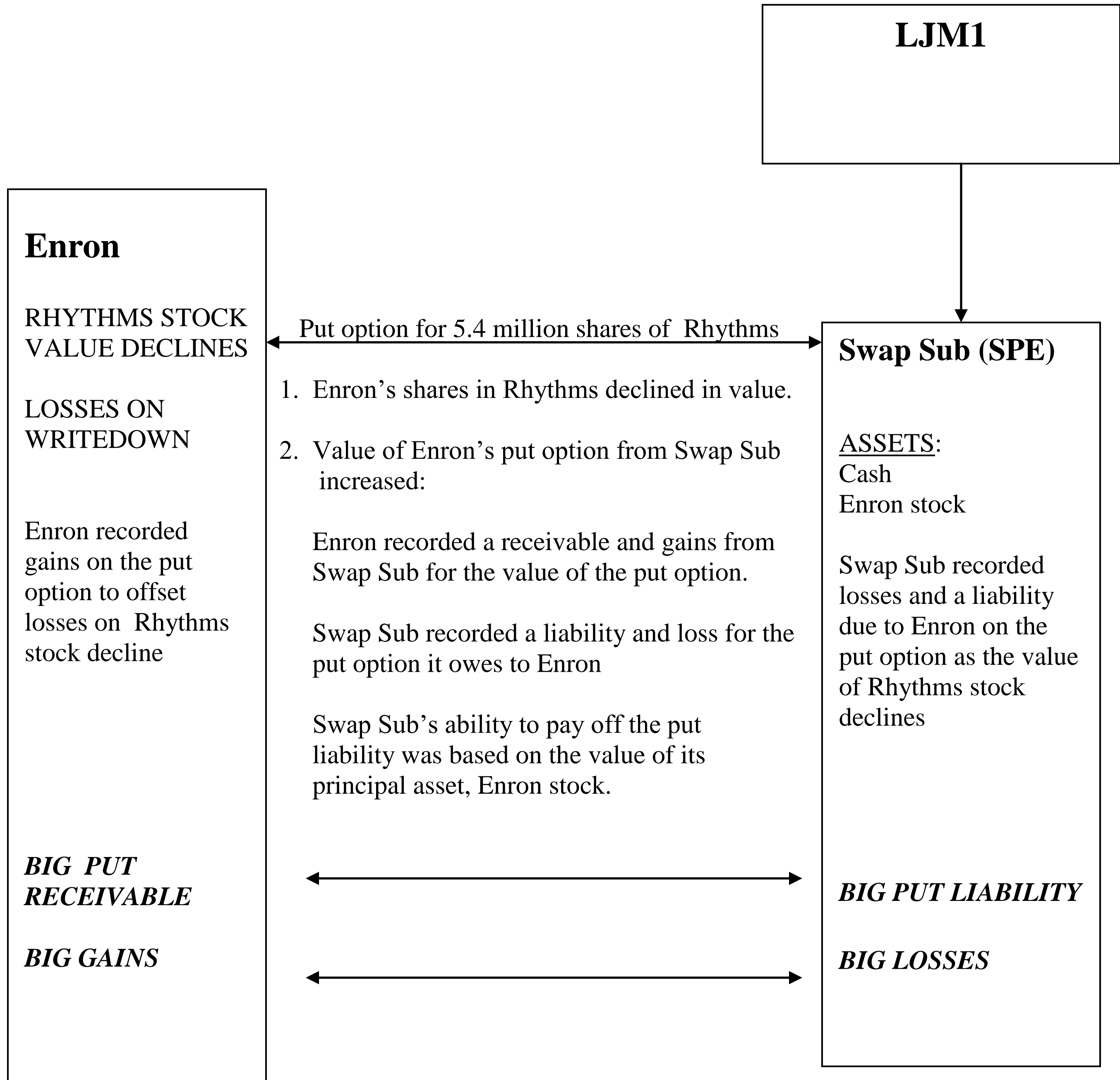
Excess cash	$3.75 million
Final payment	16.7 million
3.6 million shares of shares of Enron stock	251 million[7]
Estimated cut to Andrew Fastow	$30 million[8]

- Note: A fairness opinion *was not obtained* on the transaction.

[7] The Powers Report estimates the value of the residual shares at $251 million on an undiscounted basis, since the shares were still restricted. There is no evidence as to the timing of when these shares were sold which could affect the value.

[8] It is not clear as to the exact amount of profit that Fastow received from the LJM1 and Swap Sub transactions. What is known is that there was a significant amount of residual assets remaining in the partnerships after the unwind with Enron and that Fastow, through the general partnership, was the primary beneficiary of the partnerships. Further, the Powers Report notes that, through review of the partnership K-1s, Fastow's capital increased by $31 million from 1999 to 2000. Thus, it estimated that his take on the transactions was at least $30 million.

Phase II: LJM1 - The Rhythms Hedge
Big Gains- Big Losses



Phase III- LJM1 - The Rhythms Hedge
The Sweetheart Bailout

LJM Partners
Fastow
GP

LPs- including several Enron employees

LJM1

Enron

Receivable due from Swap Sub was reversed off against the value of the 3.1 million Enron shares received
Entry:
Equity xx
Receivable xx

THE FINAL DEAL

Swap Sub (SPE)

$30 million cash after transaction

Put liability was removed:
Entry:
Liability xx
Investment-Enron xx

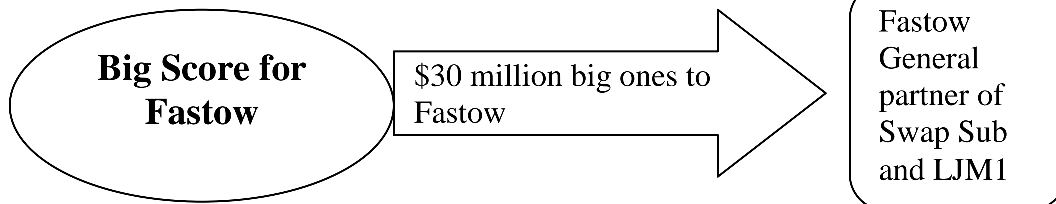
3.1 million Enron shares

$10 million cash loan

$16.7 million cash

$30 million

March 2000: Enron buyout of Swap Sub transaction: Shares of Enron were swapped for options and cash. $30 million windfall to Fastow in the transaction



Hey Andy Fastow- what are you going to do with your $30 million?

Comments regarding LJM1:

Enron's goal was to hedge its large position in Rhythms stock. It set up Swap Sub as an SPE that entered into a put option with Enron.

There is a question as to whether this was a true economic hedge in which a market price is paid to a creditworthy counterparty who is willing to take on the risk of loss. In essence, because of the affiliation with Swap Sub (through LJM1) Enron really did not transfer the economic risk of a decline in the value of Rhythms.

Enron would have exercised the put option on Swap Sub, requiring it to purchase the Rhythm shares at $56 per share. However, Swap Sub's primary asset was the 1.6 million Enron shares. If Enron's shares declined in value, Swap Sub would not have had the capital to purchase the Rhythms' shares for $56 per share under the put option. Further, from period to period, as Rhythms stock price declined and losses were recorded on that decline, a corresponding gain was recorded for the increase in the value of the put option from Swap Sub.

GAAP Violations- LJM1 and Swap Sub:

1. Presentation of the note receivable for $64 million: GAAP requires that a note receivable in connection with the issuance of equity should be presented as a contra-stockholders' equity account, not as an asset. Yet, Enron presented the note as an asset, in clear violation of GAAP.

2. Invalid put option: Because Swap Sub lacked overall economic substance, there is the question as to whether the put option was valid and, therefore, whether the gains recorded on the put option should have been recorded. Absent those gains, the losses on the decline of the Rhythms stock would have been recorded by Enron, without a corresponding gain from the increase in the put option value.

3. 3% minimum equity investment: The 3% minimum equity investment was not satisfied for Swap Sub. All contributed capital to Swap Sub came from LJM1, its limited partner that did not qualify as an independent third party because it was controlled by Fastow. As a result, Swap Sub was an SPE that should have been consolidated with Enron. Consolidation would have had a significant effect on Enron for several reasons. First, the put option gains recorded on the Rhythms stock would have been eliminated by the losses recorded by Swap Sub. Second, the additional equity from Swap Sub's investment in Enron would have been eliminated, thereby affecting Enron's total shareholders' equity and overall financial position.

4. Control: Both LJM1 and Swap Sub violated the control requirement because Fastow controlled the general partner in both entities.

The final result is that both Swap Sub and LJM 1 should have been consolidated with Enron retroactive to the inception of each entity.

LJM2:

The LJM2 limited partnership was established in October 1999 with Andrew Fastow acting as the sole general partner through its intermediaries. LJM2 obtained outside investment of about $394 million from approximately 50 limited partners and the general partner (including Fastow). The amount of investment from Fastow and other Enron employees was not disclosed, but, presumably was not a significant amount of the $394 million.

In the LJM2 prospectus, Fastow was identified as a manager of the partnership and that his dual role with Enron would be valuable to the partnership.

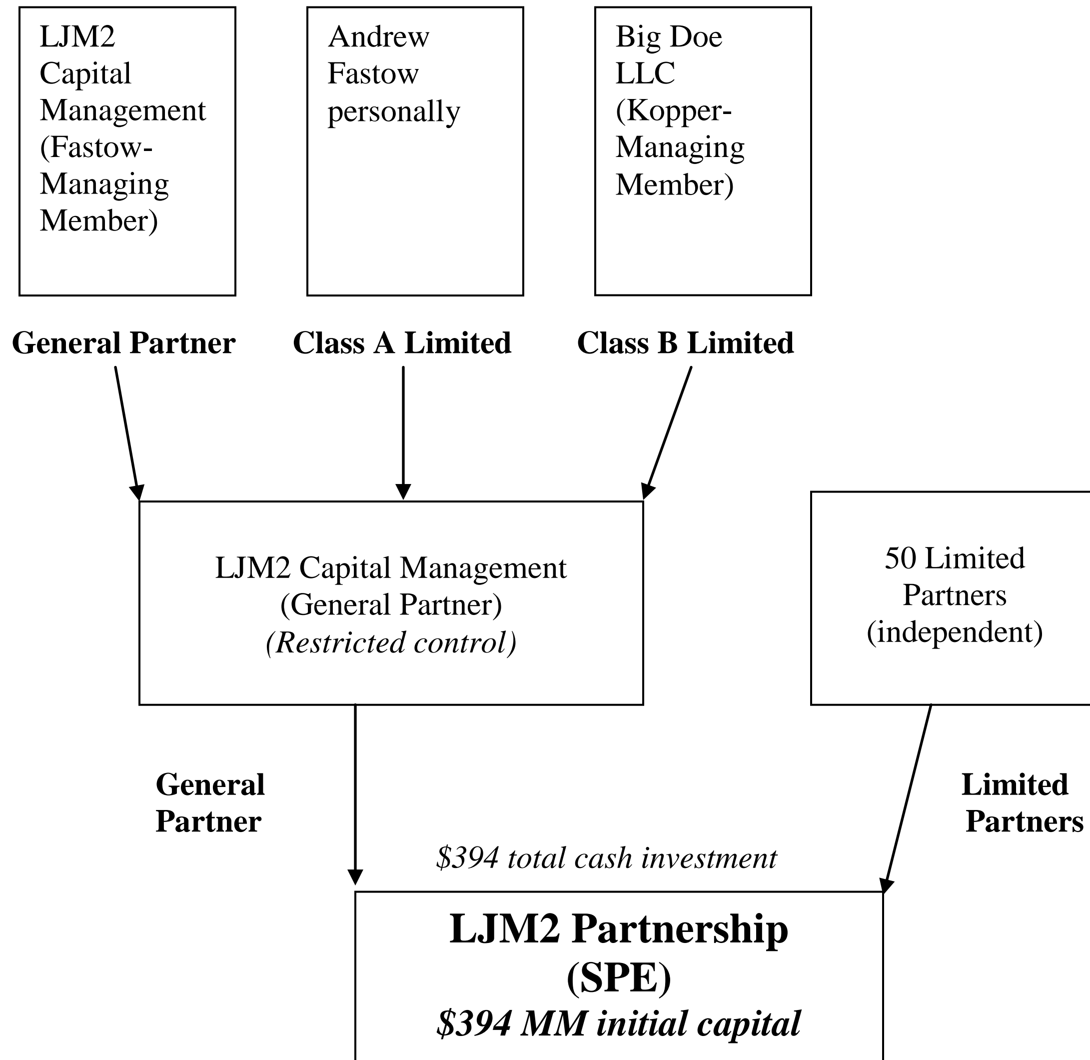
In June 2000, the LJM2 partnership agreement was changed to *limit the control* of the general partner, Fastow. Specifically, the agreement:

- Limited the general partner's investment authority and required approval of certain investment decisions by the limited partners.

- Provided for *removal of the general partner*, without cause, by a recommendation of an Advisory Committee and a vote of at least two-thirds of the limited partners.

LJM1 agreement also had included similar general partner restrictive language except that it *did not* provide the second right, which was the right to remove the general partner.

Initial Structure- LJM2 Partnership



Comments:

As with LJM1, Andrew Fastow, VP and CFO of Enron, through intermediaries, was the sole general partner of LJM2. Further, Kopper, an Enron employee, was a limited partner in the general partnership, LJM2 Capital Management. These facts brought to issue *whether LJM2 was actually controlled by Enron*, and not an independent third party. If so, LJM2 would have to be an SPE consolidated with Enron. As a way to mitigate the control issue with the general partnership, *extensive restrictions* were placed in the partnership agreement, including the ability of limited partners to remove the general partner without cause. Thus, it could be argued that the limited partners, not the general partner, controlled LJM2 and that Fastow did not control LJM2.

The other requirements for non-consolidation also appear to have been met, at least initially. There was more than the required 3% initial investment from independent third parties and, their investment was at risk.

LJM2 and the Raptors- Phase I

Facts:

- Similar to LJM1 and Swap Sub, LJM2 set up four SPEs, known as the Raptors to consummate hedge transactions on Enron's stock and other investments. These Raptor transactions were consummated through SPEs called Talon, Timberwolf, Bobcat and Porcupine.

- Although there were some variations to the four Raptor transactions, the chart that follows below depicts the typical Raptor structure, using Talon as an example. Overall, Enron entered into more than $1.5 billion of derivative transactions with the four Raptors.

- For purposes of this discussion and analysis of the four Raptors, the author has selected Raptor I (Talon LLC) as an example of all the Raptor transactions.

Raptor I:

LJM2

- Raptor I (Talon LLC) was initially capitalized with $30 million of cash received from LJM2.

- Enron paid $41 million to Talon for a put option on 7.2 million shares of Enron common stock. The option gave Enron the right to require Talon to purchase 7.2 million shares of Enron common stock on or before October 18, 2000 at a price of $57.50 per share. At the time the put option agreement was consummated, Enron's stock price was $68 per share. The restrictive terms of the option suggest that the option price of $41 million was far too generous and in excess of the true fair value of the option.

  As part of the transaction, Enron received a small interest in Talon LLC, a $400 million note, in exchange for issuing Enron shares to Talon. Talon also received a $50 million note due from Enron.

- Subsequently, the price of Enron stock increased and the put option was deemed worthless. Talon reversed its liability into income.

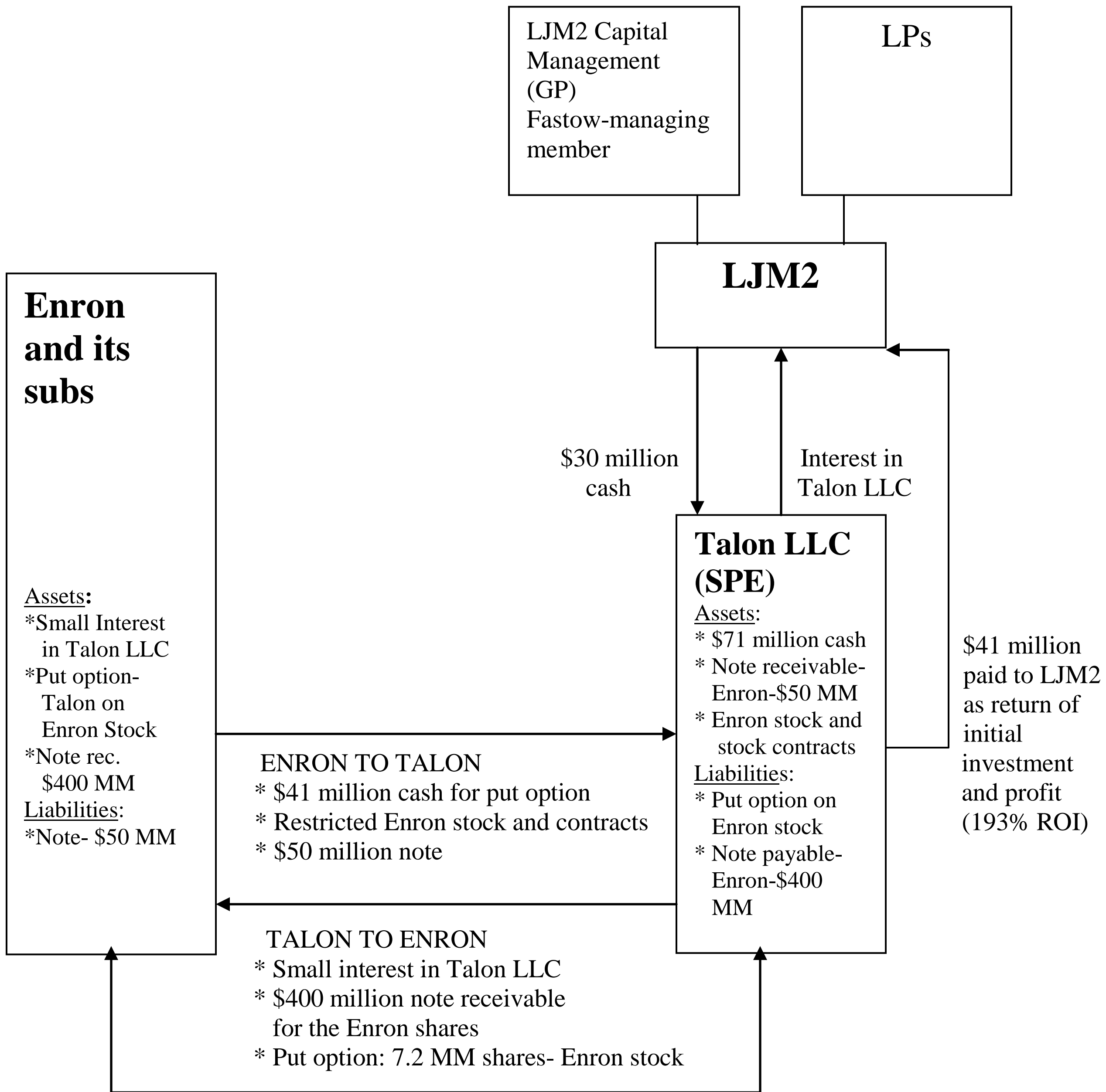
- Upon receiving the $41 million cash from Enron, Talon paid $41 million to LJM2 as a repayment of its $30 million initial investment, plus a $11 million profit-- a 193% return on investment. For accounting purposes, the company considered the entire $41 million as a return <u>on</u> investment, instead of a return <u>*of*</u> investment. By doing so, the $30 million initial investment was not considered repaid, thereby keeping the initial 3% investment in Talon.

  Note: In order to avoid consolidation, it was critical that Talon retain the initial 3% investment of $30 million. That amount could not be repaid to LJM2. Because the company's put option was considered worthless, Talon was able to reverse the liability into income. This gave Talon enough equity from which to pay the $41 million to LJM2 without paying back any of the initial $30 million investment. However, all documentation indicates that the initial $30 million was returned and there was no $30 million still at risk.

- Talon entered into derivative contracts with Enron on its investments, including Enron common stock, under which Talon received future gains on the value of those investments, while Talon would have to pay Enron the amount of future losses. The total notional value of the derivatives was $734 million.

- The general structure of Raptor I at its inception looked like this.

LJM2 and the Raptors- Phase I (April 2000)



Derivative contracts: Enron and Talon entered into derivative contracts on several of Enron's investments totaling $734 million. Talon was required to pay all future losses from declines in those investments while they received all future gains.

LJM2 and the Raptors- Phase II-Trouble in Paradise (End of 2000)

Facts:

- In the fall of 2000, Enron's investments, including its own stock, had declined in value, resulting in Talon owing Enron for the decline in value. As Talon's liability to Enron increased, coupled with a decline in Enron's common stock investment held by Talon, there was a concern about the solvency and credit worthiness of Talon. A decline in Talon's credit rating would result in Enron having to write down its receivable due from Talon.

- To protect Talon against a possible decline in its primary asset, Enron's common stock, and thereby retaining its credit capacity, in October 2000, Enron entered into a "costless collar" on 7.6 million Enron shares and stock contracts held by Talon. The "collar" provided that, if Enron stock increased above $116 per share, Talon would pay Enron the amount of any gain. Conversely, if the stock price fell below $81, Enron would pay Talon the amount of the loss. A stock price in between $81 and $116 per share resulted in no obligation between the parties.

- Enron continued to recognize a receivable and related income due from Talon as a result of the decline in the investments covered under the derivative contracts.

  The financial position of the four Raptors was as follows:

Raptor I:	Negative financial position
Raptor II:	Positive financial position
Raptor III:	Negative financial position
Raptor IV:	Positive financial position

- Total gains recognized by Enron from all four Raptor transactions totaled about $500 million for 2000.

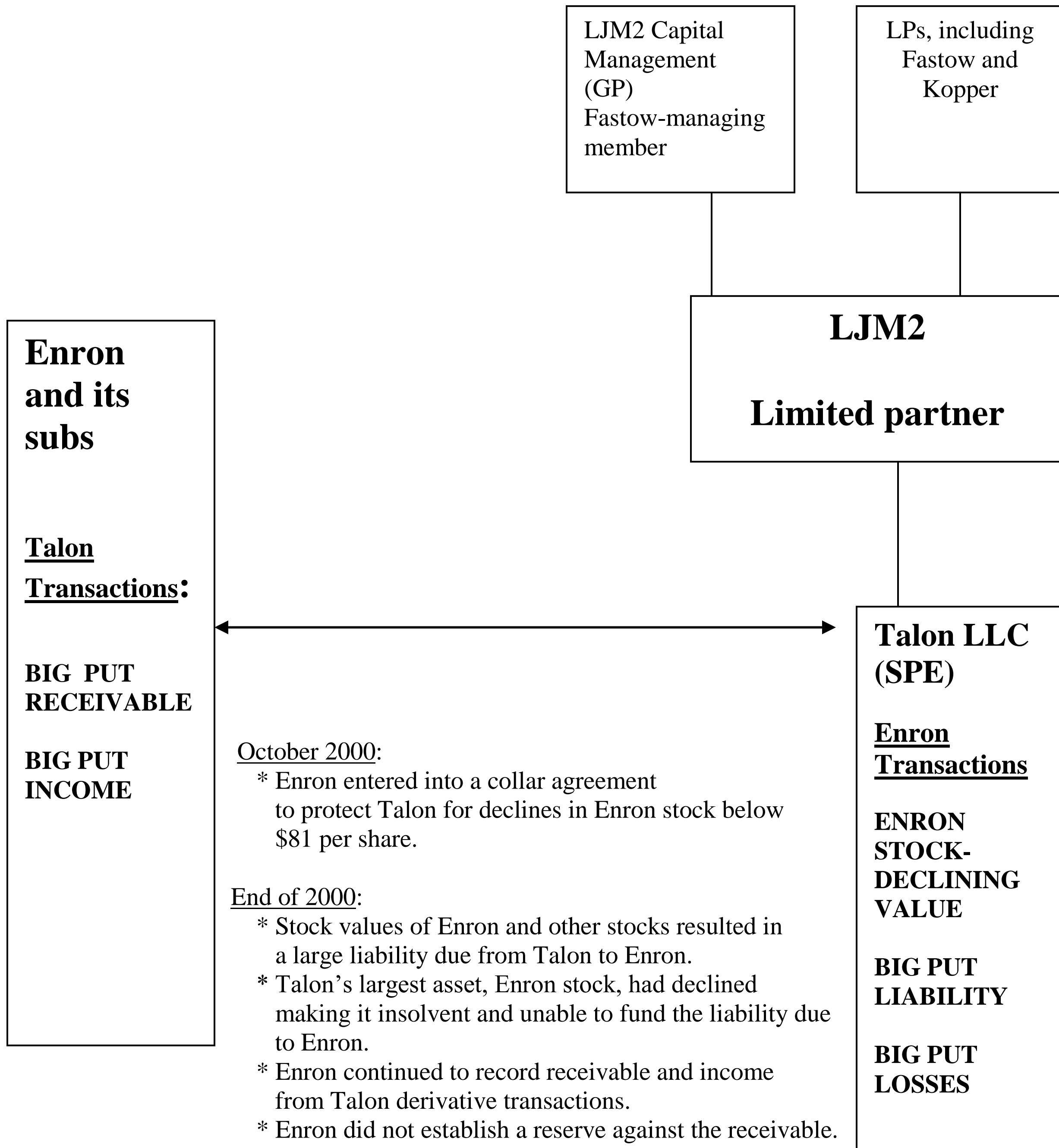
- No allowance was established against the Raptor receivables even though two of the Raptors (Raptor I and III) were essentially insolvent with a negative credit capacity (e.g., liabilities exceeded assets).

- <u>December 2000</u>: In order to avoid having to reserve for the receivable due from Raptors I and III, on December 22, 2000, a 45-day cross-guarantee agreement was signed with the four Raptors under which the credit capacity of the four entities was combined. Thus, the positive financial position of Raptors II and IV was used to offset the negative financial position of Raptors I and III.

  Note: According to the Powers Report, Andersen's Chicago office did not believe that the cross-guarantee agreement was valid to avoid recording the reserve and credit loss.

- In the first quarter 2001, the credit capacity of Raptors I and III continued to decline as the stock values of both Enron and other derivative based investments fell. It was estimated that the credit shortfall of the Raptors on a combined basis was about $500 million at the end of the first quarter of 2001.

LJM2 and the Raptors- Phase II-Trouble in Paradise (End of 2000)



October 2000:
* Enron entered into a collar agreement to protect Talon for declines in Enron stock below $81 per share.

End of 2000:
* Stock values of Enron and other stocks resulted in a large liability due from Talon to Enron.
* Talon's largest asset, Enron stock, had declined making it insolvent and unable to fund the liability due to Enron.
* Enron continued to record receivable and income from Talon derivative transactions.
* Enron did not establish a reserve against the receivable.

December 2000:
* Enron and Andersen avoid a writedown of the Talon receivable by writing a 45-day cross collateral agreement among the four Raptors. The solvent Raptors II and IV offsetted the insolvency of Raptors I and III.

LJM2 and the Raptors:

Facts- continued

March 2001: Enron restructured the Raptor contracts to ensure that only about a $36 million reserve would have to be recorded against the Raptor receivables, instead of the $500 million estimated without a restructuring. The restructuring had the following parts to it:

1. There was a permanent cross-collateralization of all the Raptors along with concessions from Enron as to its rights to receive certain distributions upon the termination of any Raptor.

2. Enron agreed to deliver up to 18 million additional Enron shares to the two solvent Raptors (II and IV) to shore up their collateral and to assist Raptors I and III in their insolvency. In exchange for the 18 million shares, Enron received notes from Raptors II and IV in the amount of $260 million.

3. Additionally, in exchange for $568 million of notes, Enron sold 12 million shares of restricted Enron stock to Raptors II and IV at a 23% discounted price of $47 per share.

4. For the first quarter 2001 financial statements, Enron recorded a $37 million reserve and related loss on the Raptor receivables. The $37 million was less than the $500 million that was computed had a restructuring not been done.

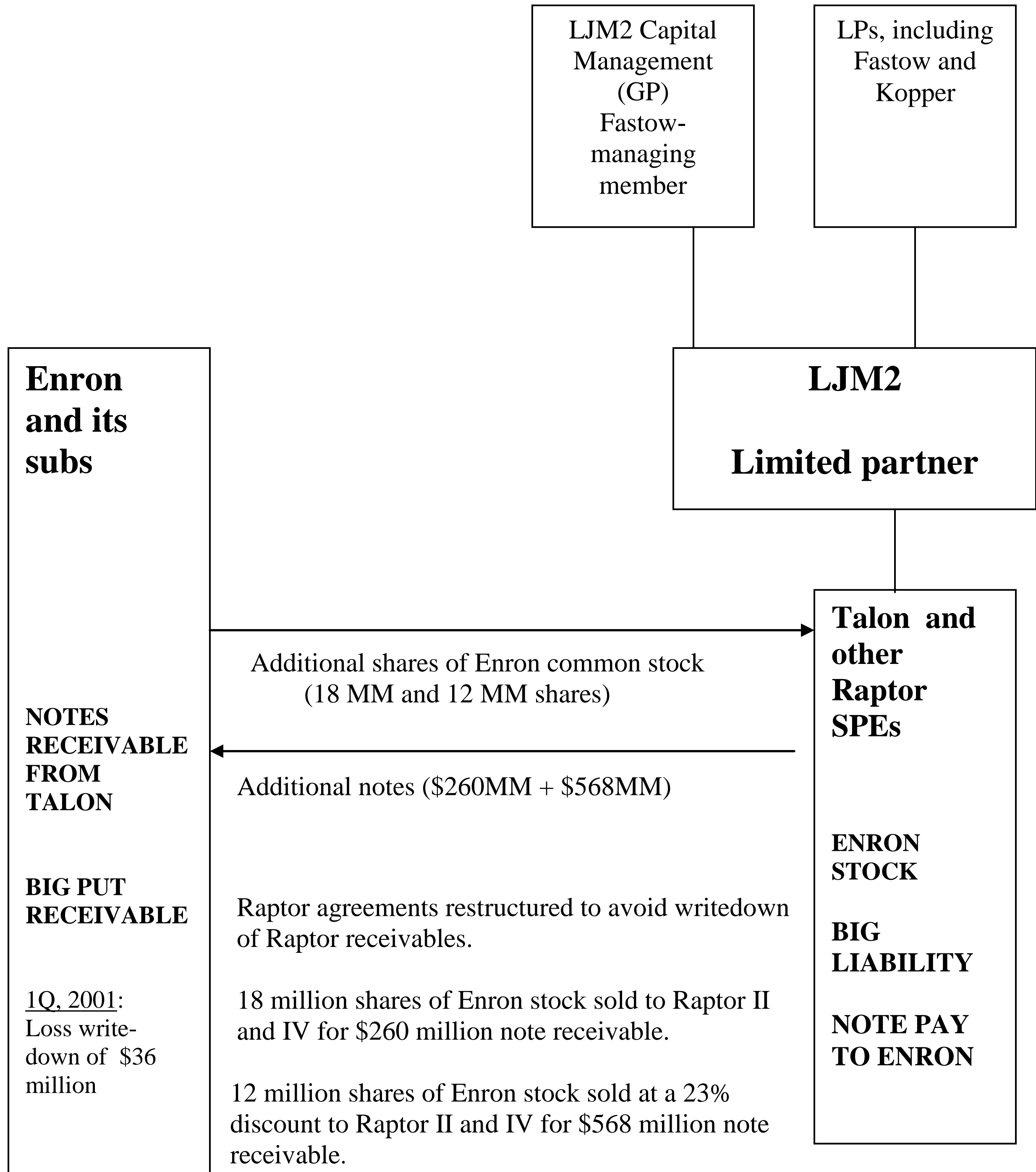
September 2001:

- Enron purchased LJM2's interest in the Raptors for $61 million. LJM2 received extremely generous returns on investments in the four Raptors in the amount of 193%, 278%, 2500% and 125%, respectively.

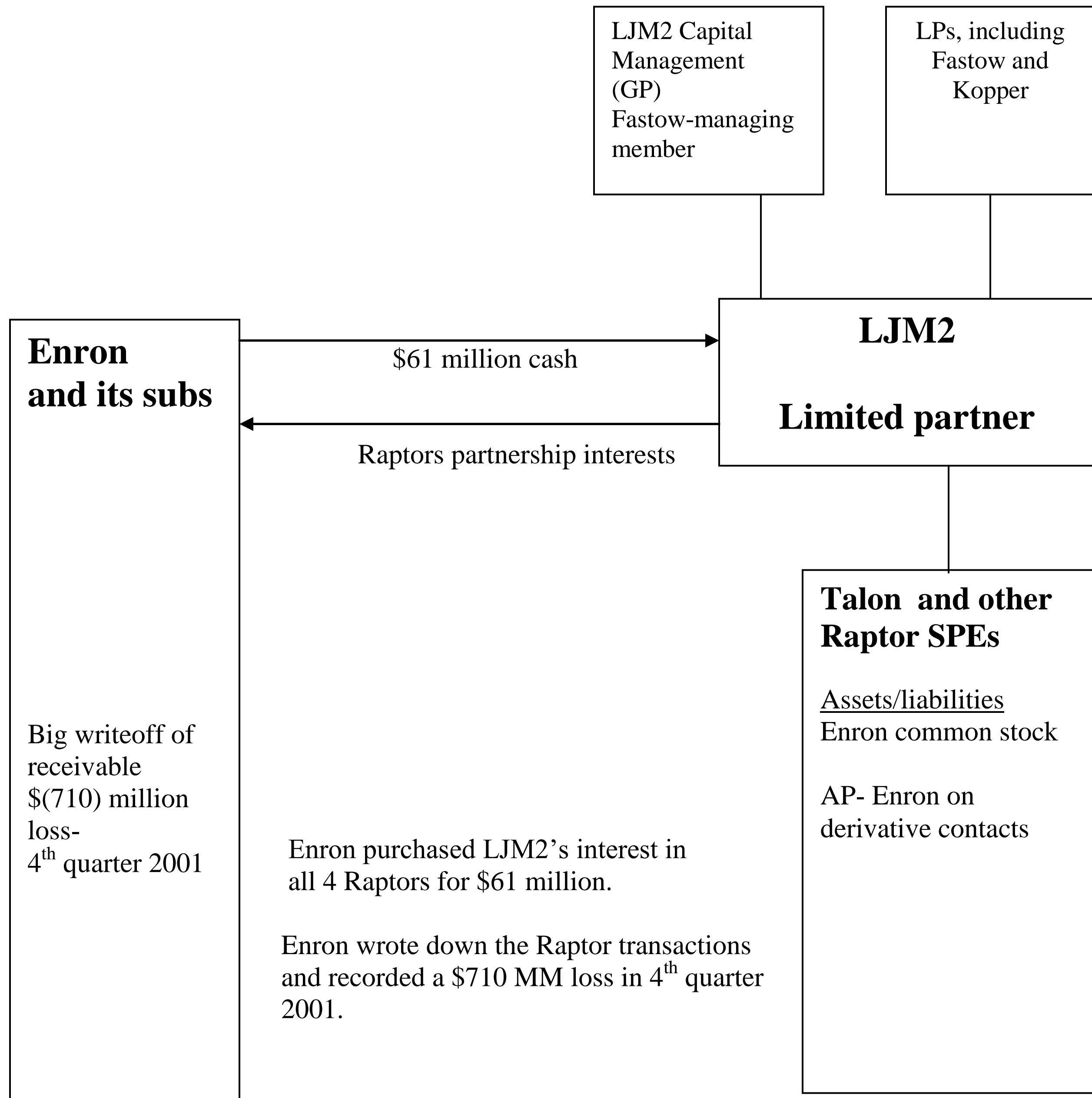
December 2001:

- Enron wrote down the Raptor transactions and recorded a loss of $710 million in the fourth quarter 2001.

LJM2 and the Raptors- Phase III-
Restructuring of Raptors- 1st quarter 2001



LJM2 and the Raptors- Phase IV
The End of Paradise (End of 2001)



Comments on LJM2 and the Raptors:

Once again, Enron pushed the limits in trying to hedge its stock and other investments using entities that were not creditworthy counterparties. The Raptor transactions illustrated Enron's attempt to record the change in the value of its own stock through use of an SPE. Because the primary asset of the Raptor SPEs was Enron's own stock, Enron essentially recognized gains on put options on its own stock.

GAAP Violations:

1. Recording gains on Enron stock: Through the Raptors, Enron was able to *record gains on the hedge of its own stock, which violated GAAP.*

2. Consolidation criteria- LJM2 and Talon:

   LJM2: It appears that LJM2 satisfied all three of the SPE non-consolidation rules as follows:
   The $394 million initial investment exceeded the 3% of independent third-party investment. Second, an argument could have been made that because of the restrictions on the general partner (Fastow) in the partnership agreement, the limited partners, not the general partner, controlled LJM2 partnership. Third, the 3% initial investment was at risk. Therefore, it appears that Enron's decision not to consolidate LJM2 partnership was appropriate.

   Talon SPE: There is strong evidence to suggest that Talon violated the 3% minimum investment rule. Since Talon was capitalized with $30 million and no other debt or equity, the 3% initial capital requirement was satisfied. However, all evidence points to the fact that the $30 million initial investment (3%) was returned to LJM2, resulting in a violation of the non-consolidation rules.

   The other three Raptors had a similar result in which the $30 million initial investment was returned to LJM2.

   Talon was controlled by LJM2 which, in turn, was controlled by the limited partners. As noted above for LJM2, the LJM2 partnership agreement had been drafted to place several restrictions on the ability of the general partner (Fastow) to control LJM2. Thus, it would appear that Fastow, in form, did not control LJM2 and, thus, neither did Enron.

3. Use of the equity method: Even if the Raptors had satisfied the rules for non-consolidation of an SPE, there is certain evidence that suggests that, at a minimum, Enron should have accounted for its small limited investment in Raptors using the equity method. It appears that Enron clearly had significant influence over the affairs of the Raptor operations.

4. Receivable writedown: In late 2000, and 2001, there was clear evidence that a reserve should have been established to write down the Raptor receivables by as much as $500 million. Enron, with the assistance of Andersen, established a cross-collateral arrangement to secure the credit of the two weakest Raptors with the credit of the two strongest ones. It is not clear whether the cross-collateral arrangement among the four Raptors was adequate enough to eliminate the need to reserve for the receivable writedowns that was estimated to be about $500 million.

5. Presentation of notes receivable related to stock issuance: Enron presented notes receivable from the Raptors, related to the issuance of its stock, as an asset. GAAP requires that such receivables be presented as a contra-equity account, and not as an asset.

Nowa Sarzyna Power Plant

The author believes that the Nowa Sarzyna power plant transaction, consummated through LJM2, was representative of how Enron sold undesirable assets to an SPE (in this case LJM2) at a gain, and removed the asset and related debt, if any, from its balance sheet.

Facts:
In December 1999, Enron sold to LJM2 a 75% interest in a company that owned a power plant under construction in Poland. The 75% interest was important because, with 25% remaining, Enron was not required to consolidate with the power plant company.

LJM2 paid $30 million in the form of a loan and equity.

Enron recorded a $16 million gain on the sale.

As we have already seen, LJM2 was controlled by Fastow.

In March 2000, Enron and another SPE bought out LJM2's interest in the power plant company, repaid the loan, providing LJM2 with a 25% return on investment.

Other Transactions- LJM Partnerships

LJM1 and Southampton- Sharing the Wealth with the Other Employees

In March 2000, several employees of Enron set up a limited partnership called Southampton Place, L.P. for the purpose of acquiring a portion of the interest held in the existing limited partner of LJM1.

Southampton's general partner was Big Doe, LLC with Kopper being the managing member.

Limited partners were the Fastow Family Foundation (Fastow was director), Glisan, Mordaunt Lynn, Yaeger Patel, and Michael Hinds. Each limited partner contributed between $5,800 to $25,000.

From the Powers Report, there was no evidence that these investments were approved by the Board of Directors. The employees ultimately received the following returns within two weeks of their investments.

Investor in Southampton	Initial investment	Return received
Fastow Family Foundation	$25,000	$4.5 million
Ben Glisan	5,800	1.0 million
Mordaunt	5,800	1.0 million
Other investors	Not available	Unknown

There were many other SPEs that were established to consummate transactions with Enron. Like the ones mentioned in this chapter, these SPEs had several common elements including:

1. Removed certain assets and debt from Enron's balance sheet

2. Allowed Enron to accelerate income for which losses were captured within the SPEs

3. Circumvented the consolidation rules for certain operations of Enron.

There was no specifics information as to the amount of personal enrichment received from the other partnerships.

Results of the SPEs

In the end, Enron mishandled at least three SPEs that should have been consolidated. Further, several employees were personally enriched at the expense of their employer, Enron, as follows:

Fastow and his Family Foundation	$34.5 million
Kopper and his friend	10 million
Glisan	1 million
Mordaunt	1 million
Several others	Unknown

Restatement of Financial Statements:

In November 2001, Enron announced that it had discovered additional information about various related-party and off-balance sheet transactions in which the company was involved. Specifically, Enron made the following restatements:

Restatement 1: Chewco Investments, LP, and its JEDI should have been consolidated beginning in November 1997 to reflect that they did not qualify as an unconsolidated SPE.[9]

Restatement 2: LJM1's subsidiary, Swap Sub, should have been consolidated beginning in 1999 to reflect that it did not qualify as an unconsolidated SPE due to inadequate capitalization (less than 3% minimum outside equity).

Restatement 3: Notes receivable related to the issuance of stock in the Raptor transactions should have been presented as a reduction in stockholders' equity, not as an asset. The result was a restatement of $1.2 billion of stockholders' equity to reflect the reclassification.

Restatement 4: There were several audit adjustments that Arthur Andersen did not record in previous years. These adjustments were recorded in the restated financial statements.

[9] Enron's SEC filing does not indicate which of the three criteria for consolidating SPEs were not met. The author's analysis presented earlier in this chapter concludes that Chewco violated two of the three criteria: the 3% minimum outside equity, and the control criteria.

The transactions of LJM2 and the Raptors were not considered to be in violation of the SPE consolidation rules and not consolidated.

The total cumulative effect of the restatements from 1997 through the third quarter 2001 were as follows:

Net income decrease	$(586) million
Debt increase	2,585 million
Stockholders' equity decrease	(272) million

The details of the restatements are summarized in the following tables:[10]

Net Income (in millions)				
Year	**Net income Originally stated**	**Impact of SPEs**	**Proposed audit adjustments not made**	**Restated**
1997	$105	$(45)	(51)	$9
1998	703	(107)	(6)	590
1999	893	(248)	(2)	643
2000	979	(99)	(33)	847
2001- 1st	425	0	17	442
2001- 2nd	404	0	5	409
2001- 3rd	(618)	0	(17)	(635)
Totals	$2,891	$(499)	$(87)	$2,305
	Total NI impact (1997-2001)		***$(586)***	

Debt (in millions)				
Year	**Debt as originally stated**	**Impact of SPEs**	**Proposed audit adjustments not made**	**Restated**
1997	$6,254	$711	$0	$6,965
1998	7,357	561	0	7,918
1999	8,152	685	0	8,837
2000	10,229	628	0	10,857
2001- 1st	11,922	0	0	11,922
2001- 2nd	12,812	0	0	12,812
2001- 3rd	12,978	0	0	12,978
Totals	$69,704	$2,585	$0	$72,289

[10] Source: Enron press release dated November 8, 2001 and accompanying restatement calculations.

Stockholders' Equity (in millions)					
Year	**Equity as originally stated**	**Impact of SPEs**	**Raptor receivable reclassification**	**Proposed audit adjustments not made**	**Restated**
1997	$5,618	$(262)	$0	$(51)	$5,305
1998	7,048	(391)	0	(57)	6,600
1999	9,570	(706)	0	(128)	8,736
2000	11,470	(750)	(172)	(242)	10,306
2001- 1st	11,727	60	(1,000)	(286)	10,501
2001- 2nd	11,740	60	(1,000)	11	10,811
2001- 3rd	9,491	0	0	0	9,491
Totals	$66,664	$(1,989)	$(2,172)	$(753)	$61,750

Observation: Notice that the financial statements were not restated to reflect the effect of consolidating the Raptors. Instead, the only restatement related to the Raptors was the reclassification of the notes receivable from assets to a reduction in stockholders' equity. Yet, there is still an issue as to whether the Raptors should have been consolidated with Enron. Based on the analysis given by the author earlier on in this chapter, there is strong evidence to suggest that the 3% minimum outside equity was not maintained by the Raptors throughout its period of operation. Further, on a less likely scale, there is the issue as to whether LJM2 also should be consolidated due to Fastow's control over LJM2's general partnership. Further, there is the issue of whether, at a minimum, the Raptors should have been accounted for under the equity method.

In the third quarter 2001, Enron recorded a charge in the amount of $710 million ($544 million after taxes) related to the recording and writedown of the Raptor investments. No restatement was made for the impact of this writedown on prior periods.

After the restatement announcement, Enron had a financial position that would not generally have warranted filing bankruptcy. It's third quarter balance sheet looked like this:

Total assets	$22,469,000,000
Total debt	-12,978,000.000
Stockholders' equity	$9,491,000.000

After announcing its restatements, Enron's stock and credit rating plummeted. Wall Street lost confidence in the reliability of Enron's financial information and its management in light of the announcements of Fastow's involvement in the special purpose entities. Moody's lowered Enron's bond ratings. Dynegy, who had been talking to Enron about an $8 billion merger, walked from its proposed deal with Enron. Enron's stock declined. Enron's lenders started demanding repayment of loans. Ultimately, it was not the financial statement restatements that resulted in Enron's demise. Rather, it was Wall Street's reaction to the amount of the restatements and the self-dealing charges by senior management, that resulted in lost confidence by Wall Street and other third parties, thereby forcing Enron into bankruptcy.

b. Enron's Disclosures

Introduction

In the first section, it is clear that Enron violated the rules for SPE accounting with respect to at least three SPEs. Enron's related party disclosures illustrate several deficiencies with respect to the LJM and Chewco-JEDI partnerships. In particular, there was a *clear intent to avoid disclosure of the amount of interest and compensation received by Fastow and others* from their SPE dealings. Other disclosure deficiencies are not as extreme and could be defended on the basis of stylistic variances and ambiguities in GAAP interpretations. What is clear is that there is no way that investors, analysts and other third parties could have sorted out the particulars of the partnership transactions by reading the Enron related party footnote. A larger question to consider is whether Enron's disclosures were ambiguous in order to hide vital information, or whether the rules for GAAP resulted in disclosures that were too difficult for any third party to understand, including accountants!

Existing GAAP Requirements for Related Party Transactions

The guidance for disclosing related party transactions is limited. Although FASB No. 57, *Related Party Disclosures*, is the primary GAAP document for related party transactions, since its issuance in 1982, there has been little further guidance. As a result, accountants and auditors have had to grapple with when and how to deal with the disclosure rules in unusual cases.

For SEC companies, the SEC's Regulation S-K provides requirements for disclosing related-party transactions in both financial and non-financial statement portions of SEC filings.

In the post-Enron era, there have been two documents issued on related party transactions.

In December 2001, the AICPA issued a non-authoritative document to assist accountants and auditors with related party transactions, entitled *Accounting and Auditing for Related Parties and Related Party Transactions- A Toolkit for Accountants and Auditors*. This Toolkit is nothing more than an accumulation of the GAAP and auditing standards that presently exist on related party transactions.

In January 2002, the SEC issued a statement urging companies to consider describing the elements of the transactions that are necessary for an understanding of the transactions:

- Business purpose
- Economic substance
- Effects on the financial statements
- Special risks or contingencies arising from the transactions

According to the SEC, their statement related to current disclosure requirements was not meant to create new legal disclosure requirements.

Therefore, the authoritative disclosure requirements for related party transactions remains unchanged since the issuance of FASB No. 57.

General rules for disclosing related-party transactions

All companies are required to disclose related party transactions in accordance with FASB No. 57, *Related Party Disclosures.*

FASB Statement No. 57, *Related Party Disclosures*, provides guidance on the disclosure of transactions with related parties. Examples of related parties transactions include transactions between:

- A parent company and its subsidiaries;
- Subsidiaries of a common parent;
- An enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management;
- An enterprise and its principal owners, management, or members of their immediate families; and
- Affiliates.

FASB Statement No. 57 defines related parties as the following:

- Affiliates of the enterprise. An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise. *Control* for purpose of FASB Statement No. 57 means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.
- Entities for which investments are accounted for by the equity method by the enterprise.
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- Principal owners of the enterprise. Principal owners are owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.
- Management of the enterprise. Management includes persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.
- Members of the immediate families of principal owners of the enterprise and its management. Immediate family includes family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Related party disclosures must be made for _material related party transactions_, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. Further, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.[11]

FASB No. 57 requires disclosures to include:

a. The nature of the relationship(s) involved.
b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, _may not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless those representations can be substantiated._

If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship must be disclosed even though there are no transactions between the enterprises.

The SEC rules for related party transactions

The SEC has rules for disclosing related party transactions. SEC regulation S-X, rules 4-08(k)(1) and (2) provide additional disclosure requirements from those required by FASB No. 57:

1. Related party transactions should be identified and the amounts stated on the _face of the balance sheet, income statement, or statement of cash flows._

2. In cases where separate financial statements are presented for the registrant, certain investees, or subsidiaries, separate disclosure shall be made in such statements of the amounts in the related consolidated financial statements which are (i) eliminated and (ii) not eliminated. Also, any intercompany profits or losses resulting from transactions with related parties and not eliminated and the effects thereof shall be disclosed.

[11] The requirements of FASB Statement No. 57 are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

The SEC also requires disclosure of related party information outside the financial statements. Specifically, SEC Regulation S-K requires disclosure of certain relationships and related transactions in the nonfinancial-statement portions of SEC filings, including proxy statements and annual reports on Form 10-K, and any other documents required to be filed under the 1934 Securities Act, as follows:

1. *Transactions with management and others*. Any transaction, or series of similar transactions, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, or series of similar transactions, to which the registrant or any of its subsidiaries was or is to be a party, in which the *amount involved exceeds $60,000* and in which any of the following persons had, or will have, a direct or indirect material interest, naming such person and indicating the person's relationship to the registrant, the nature of such person's interest in the transaction(s), the amount of such transaction(s) and, *where practicable, the amount of such person's interest in the transaction(s):*
   - Any director or *executive officer* of the registrant;
   - Any nominee for election as a director;
   - Any security holder who is known to the registrant to own of record beneficially more than five percent of any class of the registrant's voting securities; and
   - Any member of the immediate family of any of the foregoing persons.

Observation: Notice that the amount of the transaction is required only where it is "practicable," a term that is not defined. Second, the disclosure relates to any director or "executive officer," not a regular officer. Thus, transactions with a CFO, CEO or executive vice president would have to be disclosed; but those with a regular vice president might not have to be disclosed. Both of these issues will be further discussed in the Enron case below.

2. *Certain business relationships*. Any relationships regarding directors or nominees for director that exist, or have existed during the registrant's last fiscal year, indicating the identity of the entity with which the registrant has such a relationship, the name of the nominee or director affiliated with such entity and the nature of such nominee's or director's affiliation, the relationship between such entity and the registrant and the amount of the business done between the registrant and the entity during the registrant's last full fiscal year or proposed to be done during the registrant's current fiscal year.

3. *Indebtedness of management*. Any of the following persons has been indebted to the registrant or its subsidiaries at any time since the beginning of the registrant's last fiscal year in an amount *in excess of $60,000*, indicate the name of such person, the nature of the person's relationship by reason of which such person's indebtedness is required to be described, the largest aggregate amount of indebtedness outstanding at any time during such period, the nature of the indebtedness and of the transaction in which it was incurred, the amount thereof outstanding as of the latest practicable date and the rate of interest paid or charged thereon:
   - Any director or *executive officer* of the registrant;
   - Any nominee for election as a director;
   - Any member of the immediate family of the persons;
   - Any corporation or organization (other than the registrant or a majority-owned subsidiary of the registrant) of which any of the persons is an

executive officer or partner or is, directly or indirectly, the beneficial owner of ten percent or more of any class of equity securities; and
- Any trust or other estate in which any of the persons has a substantial beneficial interest or as to which such person serves as a trustee or in a similar capacity.

4. *Transactions with promoters*. Registrants that have been organized within the past five years and that are filing a registration statement on Form S-1 under the Securities Act or on Form 10 and Form 10-SE under the Exchange Act shall:
   - State the names of the promoters, the nature and amount of anything of value (including money, property, contracts, options or rights of any kind) received or to be received by each promoter, directly or indirectly, from the registrant and the nature and amount of any assets, services or other consideration therefore received or to be received by the registrant; and
   - As to any assets acquired or to be acquired by the registrant from a promoter, state the amount at which the assets were acquired or are to be acquired and the principle followed or to be followed in determining such amount and identify the persons making the determination and their relationship, if any, with the registrant or any promoter. If the assets were acquired by the promoter within two years prior to their transfer to the registrant, also state the cost thereof to the promoter.

Did Enron satisfy the GAAP and SEC disclosure requirements?

The Power's Report makes the following assessments:

> *"They did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of the financial statements to understand what was going on."*

The author has reviewed the Enron year-end 1999 and 2000 financial statement disclosures and believes that they are missing selected information. However, the author does not take the complete view that the disclosures failed to disclose the "essence of the transactions." The fact is that the transactions were extremely complex. Consequently, it would be difficult for any third party to fully understand the "essence" of the transactions merely by reading the footnotes.

Specifically, the following is the author's assessment of Enron's disclosures based on his review of its 1999 and 2000 financial statements.

1. The Company did disclose the fact that there were large transactions with LJM and a senior officer of Enron (Fastow).

2. The Company *did not disclose* important information about the amounts of financial interests and compensation of Fastow and other Enron employees.

3. The disclosures regarding the LJM partnerships were not complete and truthful.

Example: The disclosure stated that the transactions with LJM were "arm's-length" and that Fastow was not involved in the negotiations of the transactions. Evidence supports that Fastow was actively involved in all aspects of the LJM partnerships, including the negotiations.

Let's look at the Related Party Transactions footnote from Enron's 2000 and 1999 financial statements:

Source: Enron's 2000 and 1999 Annual Financial Statements

RELATED PARTY TRANSACTIONS- 1999

In June 1999, Enron entered into a series of transactions involving a third party and LJM Cayman, L.P. (LJM). LJM is a private investment company which engages in acquiring or investing in primarily energy-related investments. ***A senior officer of Enron is the managing member of LJM's general partner***. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) LJM received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, ***LJM agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares (5).*** LJM repaid the note receivable in December 1999.

LJM2 Co-Investment, L.P. (LJM2) was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses. In the fourth quarter of 1999, ***LJM2, which has the same general partner as LJM (4),*** acquired, directly or indirectly, approximately $360 million of merchant assets and investments from Enron, on which Enron recognized pre-tax gains of approximately $16 million. In December 1999, LJM2 entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million. Additionally, LJM acquired other assets from Enron for $11 million.

At December 31, 1999, JEDI held approximately 12 million shares of Enron Corp. common stock. The value of the Enron Corp. common stock has been hedged. *In addition, an officer of Enron has invested in the limited partner of JEDI and from time to time acts as agent on behalf of the limited partner's management.* ***(3)***

In 1999, Whitewing acquired approximately $192 million of merchant assets from Enron. Enron recognized no gains or losses in connection with these transactions.

Management believes that the terms of the transactions with related parties are representative of terms that would be negotiated with unrelated third parties.[12]***(1)***

[12] The 10Q report for the second and third quarters of 1999 inserted the words "reasonable and no less favorable" instead of "representative."

RELATED PARTY TRANSACTIONS (2000 Annual Report)

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) ***whose general partner's managing member is a senior officer of Enron***. ***The limited partners of the Related Party are unrelated to Enron***.

Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties. *(1)*

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities. In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a

strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to the Related Party.

In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for $30 million cash and a $70 million note receivable that was subsequently repaid. Enron recognized a gross margin of $67 million on the sale.

In 2000, the Related Party acquired, through securitizations, approximately $35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed $17.5 million in cash. Subsequently, Enron sold a portion of its interest in the partnership through securitizations. See Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a $36 million loss to Enron.

In 1999, the Related Party acquired approximately $371 million of merchant assets and investment and other assets from Enron. Enron recognized pre-tax gains of approximately $16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million.

Comments regarding the Enron disclosures:

The following specific comments are made regarding the above-presented 1999 and 2000 related party footnotes. The comment number is shown in parentheses next to the related footnote.

1. The language found in the last paragraph "management believes that the terms …. are representative of terms that would be negotiated with unrelated third parties" violates paragraph 3 of FASB No. 57 which states:

   "Representations about transactions with related parties, if made, *may not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless those representations can be substantiated*."

   The Powers Report asserts that there was *no evidence* that Enron or its law firm or Andersen took any steps to substantiate the arms-length nature of the partnership transactions. Thus, the above paragraph should not have been included in the footnote and was misleading.

2. The footnote makes *no reference* to the amount of Fastow's interest and compensation in the LJM partnerships.

   - The amount of Fastow and others' financial interests in the SPEs
   - The actual or likely economic benefits and compensation that Fastow and others would receive or the formulas used to measure that compensation
   - The specific economic purpose behind the SPE transactions

- The financial statement effects of the SPE arrangements

Note: From the Powers Report, it appears that the drafting of related party disclosures was a joint effort encompassing the assistance of Enron's senior management, employees in the legal and accounting departments, business units, and both Arthur Andersen and its law firm, Vinson & Elkins.

Note: Regulation S-K also requires that a disclosure of the description of any related-party transactions in which the amount of the transaction *exceeds $60,000* and an executive has a material interest. All of the LJM transactions exceeded the $60,000 threshold.

The Powers Report makes note of the fact that Enron's management structured many transactions to avoid disclosure and, had a goal of disclosure minimization. In fact, based on Andrew Fastow's input, the Company *"spent considerable time and effort working to say as little as possible about the LJM transactions in the disclosure document. Fastow made it clear that he did not want his compensation from the LJM partnerships to be disclosed…"*

Based on Enron memoranda, Enron and its representatives intentionally chose not to disclose the amount of Fastow's compensation. In doing so, they were relying on their interpretation of language found in SEC Regulation S-K, Item 404, which states that *"where practicable, the amount of such person's interest in the transaction(s)."* They argued that it was not "practicable" to disclose the amount of Fastow's interest. However, the "where practicable" language relates to the amount of the related-party's "interest (ownership)," not the amount of compensation. Therefore, failing not to disclose the amount of Fastow's compensation from the partnerships based on it not being practicable to do so, was not appropriate.

Moreover, the Powers Report notes that the direction and ultimate decisions as to the adequacy of disclosures, was made by the employees of Enron Global Finance, rather than by Senior Management, in-house and outside counsel, and the Audit and Compliance Committee. The Report references the fact that, through memoranda, both Enron and Vinson & Elkins agreed not to disclose the amount of Fastow's compensation from the partnerships, in particular the large amount he received from the sale of the Rhythms transaction in 2000.

3. The disclosures related to JEDI-Chewco were inadequate and were presented only in 1999. In 1999, the footnote refers to Kopper's involvement in Chewco as follows:

> *"an officer of Enron has invested in the limited partner (Chewco) of JEDI and from time to time acts as agent on behalf of the limited partner's management."*

However, there is no reference to the amount of Kopper's interest or compensation received from Chewco.

In 2000, there was no disclosure related to JEDI or Chewco even though the transaction with Kopper was ongoing until 2001.

4. In 1999, the footnote indicates that:

   "In the fourth quarter 1999, LJM2, which has the same general partner as LJM…"

   The statement is not correct because LJM1 had a different general partner than LJM2. LJM's general partner was LJM Partners while LJM2's general partner was LJM Capital Management. Both general partners were controlled by Fastow, but each had different partnership terms and conditions.

5. In the 1999 footnote, the following language is included:

   "LJM agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares."

   Not only did Fastow violate this provision, but, by its inclusion in the footnote, it suggests that Fastow followed this requirement. In fact, Fastow did have a pecuniary interest in Enron common shares through Swap Sub, of which Fastow was the sole general partner. Further, in 2000, this footnote language was removed.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. In Phase 1 (1993 to 1997), how did Chewco violate GAAP?
   a. 3% minimum investment requirement was missing
   b. lacked control by an independent third party
   c. recorded gains or income on its own stock
   d. substantive risks and rewards of ownership of the 3% SPE investment did not pass to the majority owner

2. Why was Michael J. Kopper's involvement in JEDI-Chewco questioned?
   a. he structured the transaction
   b. he was an officer of Enron
   c. he was an executive officer of Enron
   d. his involvement enabled Enron to avoid the SPE consolidation rules

3. During Phase 3, from 1997 to 2000, what was recorded by Enron and its SPEs?
   a. each year Enron recognized a $4.3 million management fee
   b. Chewco received a $400,000 restructuring fee from Enron
   c. Enron received as $2 million guarantee fee in 1997
   d. Kopper received $10 million

4. What GAAP issue or SPE non-consolidation requirement was in question at the inception of the LJM1 partnership?
   a. 3% investment from independent third parties
   b. control
   c. 3% investment at risk
   d. valid put option

5. What was involved in the restructuring of the Raptor contracts?
   a. Enron received notes from Raptors I and III in exchange for 12 million shares
   b. Enron recorded a loss of $500 million in the fourth quarter of 2001
   c. Enron sold shares to Raptors II and IV at a 23% discounted price
   d. LJM2 bought Enron's interest in the Raptors for $61 million

6. What was the return on investment that the Fastow Family Foundation received within two weeks of its investment?
   a. $5,800
   b. $25,000
   c. $1 million
   d. $4.5 million

7. What ultimately resulted in Enron's ruin?
   a. financial statement restatements
   b. lenders' demands for repayment on loans
   c. reclassification of the Raptors' notes receivable
   d. Wall Street's reaction

8. An affiliate of an enterprise:
   a. controls, is controlled by, or is under common control with an entity
   b. is an immediate family member
   c. is not a related party
   d. includes principal owners

SUGGESTED SOLUTIONS

1. In Phase 1 (1993 to 1997), how did Chewco violate GAAP?
   a. Incorrect. In Phases 2, November of 1997, and 3, December 1997 to 2001, Chewco violated the SPE non-consolidation rule that 3% minimum investment was required. Instead, in Phase 2 Chewco had 100% debt outstanding. In Phase 3 Chewco satisfied the requirement in form, but not in substance. Chewco had 3% equity; however, the equity was held by Kopper and Big River Funding LLC, Chewco's limited partner. Kopper, as an Enron employee, was not independent, and Dodson, who controlled and owned Big River, could have been shown to be a straw for Kopper, making him not independent as well.
   b. Incorrect. In Phase 2, November of 1997, Enron employee Michael J. Kopper controlled Chewco through a general partnership. Therefore, Chewco violated the SPE non-consolidation rule that required control by an independent third party.
   c. **Correct. During Phase 1 and into Phase 2, from 1993 until the first quarter of 2000, Enron recorded gains on its own stock. This was done by recording 50% of JEDI's net income, which included its recording of unrealized gains on appreciation of Enron stock.**
   d. Incorrect. In Phase 3, from December 1997 to 2001, Chewco had a portion of a $11.4 million loan secured by the $6.6 cash reserve fund. Thus, Big River Financing LLC was not at risk for the $6.6 million of equity. As a result, Chewco violated the third criterion for non-consolidation of the Chewco SPE: in substantive risks and rewards of ownership of the 3% SPE investment did not pass to the majority owner.

2. Why was Michael J. Kopper's involvement in JEDI-Chewco questioned?
   a. Incorrect. Andrew Fastow, the Executive VP and CFO, structured the transaction.
   b. **Correct. Michael J. Kopper was Enron's Global Finance Officer. He was responsible for managing and controlling Chewco. Under FASB No. 57, disclosure in the financial statements of his relationship to Enron was required.**
   c. Incorrect. Michael J. Kopper was not an executive officer of Enron. Therefore, under SEC rules, his involvement was not required to be disclosed in the proxy statement.
   d. Incorrect. Michael J. Kopper's involvement helped Enron avoid having to disclose in Enron's proxy statement his relationship with the company, whereas William D. Dodson's involvement enabled Enron to avoid the SPE consolidation rules.

3. During Phase 3, from 1997 to 2000, what was recorded by Enron and its SPEs?
   a. Incorrect. In 1998, Enron recognized a total of $25.7 million for annual management fees from 1998 to 2003 on a present value basis. However, the management services had not been rendered.
   b. **Correct. During Phase 3, Chewco received a $400,000 restructuring fee from Enron.**
   c. Incorrect. In 1997, Enron received a $10 million guarantee fee for the $240 million loan, which was recognized in its entirety in 1997, rather than being amortized over the life of the guarantee.
   d. Incorrect. Kopper received $2 million, not $10 million.

4. What GAAP issue or SPE non-consolidation requirement was in question at the inception of the LJM1 partnership?
   a. Incorrect. It appears as though the requirement for 3% investment from independent third parties was met, since $15 million from independent limited partners qualified.
   b. **Correct. The requirement in question at LJM1's inception is control. It seems as though Fastow, the general partner, was in control. The partnership agreement had only minor limitations placed on the general partner.**
   c. Incorrect. The 3% investment at risk requirement was probably met, since the $15 million from the independent limited partners appears to have been at risk.
   d. Incorrect. LJM1 was the limited partner of Swap Sub. The validity of Swap Sub's, not LJM1's, put option was questionable since it lacked overall economic substance.

5. What was involved in the restructuring of the Raptor contracts?
   a. Incorrect. In March 2001, Enron received notes in the amount of $260 million from Raptors II and IV, not I and III, in exchange for 18 million shares. The purpose of this exchange was to support their collateral and assist I and III in their insolvency.
   b. Incorrect. Enron recorded a loss of $710 million in the fourth quarter of 2001.
   c. **Correct. Enron sold 12 million shares of restricted Enron stock to Raptors II and IV for $568 million of notes, at a 23% discounted price of $47 per share.**
   d. Incorrect. In September 2001, Enron bought LJM2's interest in the Raptors for $61 million. The returns on investments in the Raptors were in the amounts of 193%, 278%, 2500%, and 125%, respectively.

6. What was the return on investment that the Fastow Family Foundation received within two weeks of its investment in Southampton Place, L.P.?
   a. Incorrect. Initially, Ben Glisan and Mordaunt each invested $5,800 in Southampton Place, L.P.
   b. Incorrect. Fastow Family Foundation's initial investment in Southampton Place, L.P. was $25,000.
   c. Incorrect. The return on investment that Ben Glisan and Mordaunt received within two weeks of their investment in Southampton Place, L.P. was $1 million each.
   d. **`Correct. The return on investment that the Fastow Family Foundation received within two weeks of its investment in Southampton Place, L.P.was $4.5 million.**

7. What ultimately brought about Enron's ruin?
   a. Incorrect. Following the announcement, Enron's third quarter balance sheet did not indicate inevitable bankruptcy. The company reported: $22,469,000,000 in total assets; $12,978,000,000 in total debt; and $9,491,000,000 in stockholders' equity.
   b. Incorrect. After Enron's stock declined, lenders began to demand that Enron repay its loans.
   c. Incorrect. The only restatement regarding the Raptors was the reclassification of the notes receivable from assets to a reduction in stockholders' equity. This was only one of Enron's several restatements. Had Enron had just a single restatement, the investors would not have reacted as they did.
   d. Correct. As a result of the restatement announcement, Wall Street's reaction drove the stock prices down. Investors questioned the reliability of management and the financial statements. Enron's bond ratings were lowered, and Dynegy backed out of a proposal deal. Enron was forced to file bankruptcy.

8. An affiliate of an enterprise:
   a. Correct. An affiliate of an enterprise controls, is controlled by, or is under common control with an entity.
   b. Incorrect. A principal owner or a member of management might control or influence an immediate family member. On the other hand, a member of the immediate family might control or influence a principal owner or a member of management.
   c. Incorrect. Related parties include affiliates of the enterprise.
   d. Incorrect. Principal owners own 10 percent or more of the voting interests of the enterprise.

IV. Enron's Board of Directors and Audit Committee

Background:

The manner of selecting members for boards of directors and audit committees has come under scrutiny. Charges that not enough members are independent and that Boards do not challenge management have expanded as more cases of fraud have been publicized in the financial press.

In March 1999, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Fraudulent Financial Reporting: 1987-1997, An Analysis of U S. Public Companies.* The COSO is dedicated to the prevention of fraudulent financial reporting, and is an alliance of five professional organizations: AICPA, AAA, FEI, IIA and the IMA.

The COSO study analyzed 200 randomly selected cases of alleged financial fraud investigated by the SEC. In total, the SEC investigated approximately 300 cases during the period of the study.

The results of the COSO fraud report illustrated some obvious symptoms that existed in companies that committed fraud.

Specifically,

1. In 83% of the cases, either the CEO, CFO or both were involved.

2. In 65%, the audit committees lacked knowledge in accounting or finance.

3. In most cases, the board lacked independence:
   - 60% of directors were insiders with little experience serving on the board.
   - Directors and officers owned nearly 33% of the companies' stock.
   - The CEO/President personally owned about 17%.
   - 40% of the boards had no outside directors.
   - In more than 50% of the cases, the original CEO/President was still in place.

In 2000 the SEC issued rules related to audit committees, entitled *Audit Committee Disclosure.* The rules were written based on recommendations made by the *Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,* which suggested drastic changes to the rules for audit committees. Among the suggested changes was to require greater independence of audit committee members and to ensure greater communication between the auditor and the committee.

The rules did the following:

1. Required that companies' auditors review the financial information included in the companies' Quarterly Reports on Form 10-Q or 10-QSB.

2. Required that companies include reports of their audit committees in their proxy statements. The report must state whether the audit committee has a) reviewed and

discussed the audited financial statements with management, b) discussed with the independent auditors the matters required to be discussed by SAS No. 61, and c) received from the auditors disclosures regarding the auditors' independence.

3. Required companies to disclose in their proxy statements a) whether the audit committee members are independent and disclose information for any member who is not independent, and, b) whether the Board of Directors has adopted a written charter at least once every three years.

4. Provided safe harbors for the new proxy disclosures to protect companies and their directors from certain liabilities under the federal securities act.

Through June 2001, the SEC made further changes to the rules regarding independence of audit committee members.

- At least three members must sit on the committee and each must be independent.

- Members cannot have any former ties to the company, can't be related, and cannot be affiliated with any firm who does any work for the company. Nor can they have a controlling financial interest in the stock of the company on which it serves.

- Members cannot receive any money from the company for nonboard services and must be "financially literate." Financially literate means that they must have knowledge of financial reporting.

- At least one of the three members of the audit committee must be a professional or someone with extensive experience, either as a CPA, attorney, or a former CFO.

Enron's Board and Audit Committee

Although it is not yet clear whether Enron's board experienced any of the same problems as noted in the above noted study, it is obvious that the Board did not oversee the actions of management in making them accountable for representations made to the Board. Moreover, many if not all of the Board members, either directly or indirectly, received some financial benefit in dealings with Enron, exclusive of their compensation as Board members.

Was the Enron Board of Director's independent of management?

Although Enron audit committee members were identified as being independent, several members received direct or indirect fees and donations from Enron.

- Wendy Gramm (wife of Senator Phil Gramm), a teacher at George Mason University, received a $50,000 fee. George Mason received a donation from Enron.

- Richard Jaedicke, a teacher at Stanford University: Stanford received a donation from Enron.

- Robert Belfer, a board member: His oil and gas business received $30 million of business from Enron.

- A board member was affiliated with the University of Texas Cancer Center, which received a $600,000 donation from Enron.

Because donations to the universities were not personal donations, they were not disclosed in the company's filings.

Although there is evidence that Enron's Board and Audit Committee may have lacked some independence, it is not clear whether their decisions and oversight were clouded by the financial consideration that they received from Enron. Further, it is not known the extent to which Board and Audit Committee oversight failures were a function of misrepresentations made to the board by Fastow and others, or simply poor follow-through. From the Powers Report, it appears that the truth lies somewhere in the middle.

The Powers Report cites that oversight of the partnership and related-party transactions by Enron's Board of Directors and Senior Management failed for numerous reasons.

The Report notes the following deficiencies in internal control were the backdrop for the breakdown in the Enron system:

1. Poor segregation of duties between Enron and LJM partnership employees- as employees of Enron also were involved in the partnerships.

2. The Board of Directors approved transactions between Enron and the partnerships that, on the face, demonstrated a clear conflict of interest with Fastow.

3. The Board attempted to mitigate the effects of Fastow's conflict of interest by establishing strict oversight and control procedures to ensure that all transactions between Enron and the partnerships were arms-length.

4. Those parties required by the Board to oversee the transactions, including the Audit and Compliance Board and Senior Management did not fulfill their requirements.

5. The Board and Audit Committee relied heavily on the fact that Arthur Andersen had specifically been paid to review the partnerships and had structured them to be in compliance with GAAP.

6. Andersen did not have enough direct contact with the Audit and Compliance Board or the Board of Directors, and, instead, dealt strictly with management.

Specific issues are noted as follows:

1. The breakdown in internal control:

a. There was no clear separation of duties between Enron employees and the partnerships.

- Despite being forbidden by the Board, Enron employees involved in the partnerships exerted significant influence over Enron employees in negotiations between Enron and the partnerships. This resulted in transactions being completed at other than arms length.

- Several employees who negotiated on behalf of Enron reported directly or indirectly to Fastow, who was involved in the partnerships.

- Fastow used his influence from his Enron position to benefit LJM by pressuring investment banks and others that did business with Enron to do business with or invest in LJM2.

- Fastow was involved in determining bonuses for Enron employees who worked in LJM. For example, Kopper, who worked in Chewco and LJM, was accused of receiving a larger-than-usual bonus from Enron.[13]

b. The internal control structure was decentralized with each business unit being autonomous and in full control of transactions within its unit.

c. There was no accountability as to the economic substance of transactions and their true value.

- The fair values at which transactions between Enron and the partnerships were, in certain cases, not verified.

- Fairness opinions were not always obtained in each transaction.

d. There was no oversight of the process by senior management.
- It is not clear the extent of the roles of Skilling and Lay in overseeing the partnership transactions.

e. Warnings from a senior employee, Watkins, about the LJM-Raptor transactions in August 2001 were not addressed by independent outside counsel.

- Kenneth Lay, CEO, selected Andersen and Enron's law firm, Vinson & Elkins to investigate Watkins's letter, instead of using an outside law firm.

2. The specific roles of the players:

a. Board of directors:

- The Board agreed to the establishment of the LJM partnerships based on purported economic reasons, despite the known conflicts of interest with

[13] Per memorandum from Jeff McMahon, Enron employee, as noted in the Powers Report.

Fastow. The Board did not focus on Fastow's dual roles and conflict of interest until the problem was discovered in October 2001.

- The approval of the partnerships was predicated on the establishment of significant controls to monitor the transactions between Enron and the partnerships including:

  1. Oversight and approval of all LJM2 transactions by two other Enron officers, other than Fastow, and

  2. An annual review of the transactions by Enron's Audit and Compliance Committee.

- There is no indication that the Board of Directors inquired as to Fastow's compensation under LJM1.

- Ongoing information presented to the Board was not complete and truthful including the involvement of employees other than Fastow in the ownership and management of the partnerships.

  1. There was no evidence that the Board of Directors was aware of the fact that an Enron employee, Kopper, was an investor in or manager of Chewco.

  2. The Board was not aware that Fastow was interfering in the negotiations for sales of assets between Enron and the partnerships.

- Ultimately, the Board did not insist on receiving evidence as to follow-through of the partnership transactions by the Audit Committee and Senior management

- The Board was informed about the Raptor transactions and the fact that Enron was hedging its own stock; yet, the Board relied solely on the Involvement of Andersen to validate the partnership transactions and others because Andersen was paid specifically to review Enron's disclosures and review the structuring of the partnerships. The Board assumed that Andersen would raise questions about Enron's internal control or other transactions.

b. Audit/compliance committee

- The Committee was responsible for overseeing the transactions between Enron, LJM partnerships and Fastow.

- The Committee relied heavily on the involvement of Andersen in uncovering GAAP violations and weaknesses in internal control.

- The Committee relied on the opinion of its inside and outside legal counsel as to the adequacy of disclosures and the validity of the partnership transactions.

- The Committee purports that they received incomplete information from Fastow regarding the partnerships.

- The Committee did not require evidence as to the amount of Fastow's compensation and profit from the partnerships. Information about LJM and the Raptors was not presented to the Audit and Compliance Committee, in order for them to perform their annual review of the LJM partnerships.

  1. Information about the number of transactions and internal rates of return was not correct.

  2. Information about the credit capacity of Raptor I and III, owing $175 million, was not disclosed to the Committee.

  3. The Committee was not informed about the cumulative deficit in the credit capacity of the four Raptors, which was $500 million.

  4. The Committee was not informed about the restructuring of the Raptors and the issuance of about $800 million of additional Enron stock.

  5. There is little indication that Andersen addressed any of its concerns about the partnerships with the Committee even though such discussions were conducted with Enron management.

c. Members of senior management:

- Senior management, including Skilling, in accordance with the Board approval, were required to oversee and approve the dealings between the partnerships and Enron.

- Senior management did not actively review the transactions and Fastow's compensation, as required by the Board of Directors.

d. Andersen

- Andersen did not report GAAP and internal control violations to the Audit Committee.

- Andersen was paid specifically to review Enron's disclosures and review the structuring of the partnerships.

How the Enron System Broke Down

Board of Directors

Approved partnership transactions and accepted Fastow's conflict of interest, subject to:

1. Strong controls being in place and being monitored as follows:
   - Annual oversight by the Auditing and Compliance Committee, and
   - Two senior officers and Skilling approving all transactions with the LJM partnerships.
2. LJM management, particularly Fastow, cannot negotiate on behalf of Enron.
3. An approval sheet must be approved by senior management.
4. Periodic review of Fastow's compensation by the Compensation Committee.

Board indicated that the reliance on Andersen's involvement in the structuring and accounting for the transactions was a key factor in their approval of the transactions.

Audit/Compliance Committee

Did not follow up on the requirements of the Board.

Relied on the involvement of Andersen to uncover non-compliance and weaknesses in internal control.

Received incomplete information about the LJM transactions from Fastow.

Did not perform a review of Fastow's compensation as required by the Board, until 2001.

Senior Officers, Skilling and Lay

Did not oversee LJM and Fastow as required by the Board.

Did not adequately approve and oversee LJM transactions with Enron nor of Fastow's compensation.

Skilling did not sign Approval Sheets.

Andersen

Communicated with management and not the Board or its committees.

Did not disclose internal control deficiencies until 2001.

Assisted in the structuring of the partnership transactions.

Erred in determining if partnerships qualified under the SPE rules.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

.To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. In June 2001, what change was made to the SEC rules for independence of audit committee members?
   a. all members of the committee must be professionals
   b. at least five members who are independent must sit on the committee
   c. members may not have any previous connections to the company
   d. members may only receive money from the company for nonboard services

2. What information was not presented to the Audit and Compliance Committee so that they could perform their annual review of LJM partnerships?
   a. the credit capacity of Raptors I and III
   b. the existence of the Raptors
   c. the issuance of $18 million in Enron stock
   d. the number of transactions and internal rates of return

3. What factor was a condition of the board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest?
   a. Andersen must sign an approval sheet
   b. Fastow cannot negotiate on behalf of LJM
   c. senior management must periodically review Fastow's compensation
   d. strong controls must be in place and be monitored

SUGGESTED SOLUTIONS

1. In June 2001, what change was made to the SEC rules for independence of audit committee members?
   a. Incorrect. Only one of the audit committee members must be a professional or have extensive experience as one of the following: CPA, attorney, or CFO.
   b. Incorrect. There must be at least three members to sit on the committee, and each of them must be independent.
   c. **Correct. Members may not have any previous connections to the company. They may not be related, nor may they be affiliated with any entity that provides goods or services for the company in question. Also, members may not have a controlling financial interest in the company's stock.**
   d. Incorrect. Members may not receive money from the company for nonboard services. Further, they must be familiar with financial reporting.

2. What information was not presented to the Audit and Compliance Committee so that they could perform their annual review of LJM partnerships?
   a. **Correct. The Audit and Compliance Committee was not informed of the credit capacity of Raptors I and III, owing $175 million.**
   b. Incorrect. The Audit and Compliance Committee was aware of the Raptors' existence. However, they were unaware of the credit capacity of all four Raptors—a cumulative deficit of $500 million.
   c. Incorrect. The Audit and Compliance Committee was uninformed about Enron's issuance of $800 million of their stock to the Raptors. They were also unaware of the restructuring.
   d. Incorrect. The Audit and Compliance Committee failed to require proof of the number of transactions and internal rates of return. Had they done so, they would have found that the figures provided were incorrect.

3. What factor was a condition of the board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest?
   a. Incorrect. The board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest was dependent on four factors. One factor was that senior management must sign an approval sheet.
   b. Incorrect. The board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest was dependent on four factors. One factor was that neither LJM management nor Fastow can negotiate on behalf of Enron.
   c. Incorrect. The board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest was dependent on four factors. One factor was that the Compensation Committee must periodically review Fastow's compensation.
   d. **Correct. The board's approval of LJM partnership transactions and acceptance of Fastow's conflict of interest was dependent on four factors. One factor was that strong controls must be in place and be monitored.**

V. Auditing, Independence and Conflicts of Interest

In this section, the author addresses some of the audit and independence issues that were at the forefront of the Enron-Andersen debate.

Background

Under present auditing standards, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, requires an auditor to consider fraud risk in planning and designing auditing procedures to perform a financial statement audit. Fraud risk is the risk that financial statements are materially misstated due to fraud, either through misappropriation of assets (theft) or fraudulent financial reporting. At the time of Enron, SAS No. 99's predecessor, SAS No. 82, was in effect. Like SAS No. 99, SAS No. 82 required an auditor to consider fraud risk.

Although an auditor is not required to discover fraud, he or she is required to document his or her consideration of fraud risk factors in designing his or her audit procedures. More of the audit focus should be in those areas that have a high degree of fraud risk. For example, in auditing a jewelry store, an auditor would likely enhance his or her auditing procedures related to inventory, since there is a high degree of fraud risk associated with portable, highly valuable jewelry inventory. Conversely, less emphasis would be placed on auditing prepaid insurance where fraud risk is lower.

SAS No. 54, *Illegal Acts by Clients*, requires an auditor to communicate potential illegal acts to the Audit Committee, as well as consider the effect of the act on the financial statements and disclosures.

Enron and the Audit

When there is a fraud conducted, there are typically early warning signals related to that fraud. With Enron, for a period of four years (1997 to 2001) neither the audit committee, nor the auditors took action related to an ongoing purported fraud. Specifically, Fastow was conducting partnership operations beyond the scope approved by the board of directors and with personal enrichment that was not disclosed.

With respect to Arthur Andersen, they did ultimately notify Enron's Audit and Compliance Committee in 2001, but failed to identify the GAAP violations and the conflicts of interest prior to that time.

In the end, two damaging pieces of evidence against Andersen were, first, the fact that they were specifically hired to structure and review the SPEs and second, the shredding of documents.

Independence and Conflicts of Interest- Andersen, Enron and the Big Five

The entire accounting profession (primarily the Big Five, at that time) has been on trial with Enron. Congress, the SEC and the financial press all challenged the profession's objectivity in light of the fact that all of the Big Five at one time or another generated a large portion of their revenue from non-auditing services. Many of those services were performed for those same clients

that the Big Five audited, suggesting that independence had been replaced by advocacy. That is, how could a CPA firm that received large consulting fees from an audit client be truly independent?

According to the Powers Report and Congressional testimony by Andersen employees, for 2000, Andersen received approximately $27 million in non-audit consulting fees, and $25 million for the audit fee, for a total of $52 million in revenue from Enron.

Enron's law firm, Vinson & Elkins received more than $30 million per year in legal fees in connection with services provided to Enron.

Consulting services performed related to the structuring of the SPEs was a significant factor in mitigating Andersen's argument that they were not aware of the SPE violations by Enron. Beyond work performed on the SPEs, Andersen was paid to perform certain internal auditing functions. Performing both internal and external audit work on the same company has caused real concern among third parties who suggest such dual services are essentially the same as auditing one's own work.

According to the Powers Report, Andersen received significant fees for advice given on the structuring and ultimate termination of the Chewco-JEDI, LJM and Raptor partnership transactions as follows:[14]

Consulting in connection with the Chewco and LJM partnerships	$5.7 million
Creation, maintenance, advice and termination of all Raptor transactions	1.3 million
Total from Chewco, LJM and Raptor Partnerships	$7 million

Specific fees, by categories for other consulting services were not available.

What portion of the Big Five's revenue was derived from non-audit services?

According to the Bowman Accounting Report, as published by CFO Magazine in March 2002, four of the five Big Five firm's received more than 50% of their revenue from non-audit services for 2001, the year of Enron's demise, as noted in the following chart.

[14] Fees were identified throughout the Powers Report.

Big Five Revenue By Category- 2001				
Firm	**Audit**	**Taxes**	**Management consulting**	**Total**
Andersen	42%	32%	26%	100%
Deloitte & Touche	33%	22%	45%	100%
Ernst & Young	57%	38%	5%	100%
KPMG	44%	38%	18%	100%
Price Waterhouse Coopers	35%	20%	45%	100%
Source: Bowman Report (published in CFO Magazine, March 2002)				

Is there any correlation between the receipt of large consulting fees and the quality of the audit?

At its peak in 2001, fees for non-audit services had risen in the past decade as the Big Five had attempted to expand their more lucrative consulting services.

In many cases, the fees for non-audit services had exceeded the audit fees.

The following table presents some of the publicly disclosed audit and non-audit fees for SEC companies for 2000:[15]

Company	**Auditor**	**Audit fees**	**Non-audit fees**
Motorola	KPMG	$3.9	$62.3
Sprint	Ernst & Young	2.5	63.8
AT&T	Price Coopers	7.9	48.4
Waste Management	Andersen	7.5	18.0

What both analyses revealed was that during the years of Enron (pre 2002) auditing services made up a smaller percentage of total revenues for the Big Five, with taxes and management consulting consisting of more than 50% of total revenues of four of the five firms.

The SEC's attempt to change the independence rules

In 1999, Arthur Levitt, then chairman of the SEC proposed drastic changes to the independence rules for auditors of SEC companies. Specifically, Levitt proposed a restriction under which auditors of SEC companies would be precluded from performing most consulting services including lucrative information technology consulting and internal auditing functions.

[15] Sources: *Wall Street Journal* Articles.

Subsequently, the AICPA and three of the Big Five firms challenged the SEC's proposal and, through a strong lobbying effort, convinced Congress that changes to the profession were not needed. Finally, in November 2000, the SEC issued Final Rule S7-13-00, Revision of the Commission's Auditor Independence Requirements, a watered-down version of its original proposal. The new ruling, which is presently in effect, defines independence within the categories of conflicts of interest with an audit client, audits of the auditor's own work, functioning as management or an employee of an audit client, and acting as an advocate for an audit client. In general, the new rules offer very few limitations on the Big Five's ability to perform lucrative consulting services for audit clients, but does require the disclosure of non-audit services fees of audit clients in their proxy statements.

The issue of whether auditors who perform consulting services for their audit clients are any less independent in spirit than those who do not, is one that cannot be concluded on with a broad statement.

The best and most recent attempt at trying to address the issue of fees for non-audit services is presented in a recently issued Stanford University research study report entitled, *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality,*[16] issued in January 2002.

In this research study, the authors selected data collected from proxy statements of SEC companies to test a hypothesis.

> *Is there a correlation between the amount of non-audit services fees disclosed in SEC proxy statements, and a company's earnings quality as perceived by investors?*

Because companies were required to disclose in their proxy statements, the amount of fees paid to auditors for non-audit services, the question is whether such disclosures had a negative or positive impact on stock price. That is, did investors assume that higher non-audit fees translated into poorer quality of earnings, which, in turn, was reflected in a lower stock price?

The Stanford study tests two points of view:

> **View 1:** Higher non-audit services fees have an *adverse effect on stock price* because the investment community reflects the potential risk from weakened auditor independence from having performed non-audit services for an audit client. That is, an auditor who performs non-audit services develops an "economic bond" with a client, which increases the auditor's *"incentive to acquiesce to client pressure."*

> **View 2:** The performance of non-audit services to audit clients-*increases the quality of financial reporting* by providing the auditor with information about the client's business that is useful in performing the audit.

The study was based on the collection of audit and non-audit fee data from 3,074 proxy statements filed with the SEC between February 5 and June 15, 2001. The study provided evidence of the

[16] Authors: Karen K. Nelson, Marilyn F. Johnson, and Richard M. Frankel.- January 2002.

association between non-audit fees and earnings management, as well as evidence on the stock market reaction to the announcement of non-audit fees.

Conclusions of the study:

1. *There was a high correlation between fees paid for non-audit services and management's ability to manage earnings*:

    a. Companies purchasing more non-audit services from their auditors were more likely to just meet or beat analyst earnings expectations and to report larger absolute *discretionary accruals*.

    b. Companies that just meet or beat analyst expectations were saving excess earnings for future periods using "rainy day funds."

    c. Additional discretionary accruals allowed companies to reserve excess income for future periods.

2. *There is a high correlation between stock price volatility and the amount a company pays for non-audit fees*.

    a. Investors associated non-audit fees with lower quality audits and, by implication, lower quality earnings.

    b. The highest correlation of data was with companies that just met analyst forecasts and those that had high discretionary accruals available to manage earnings.

Other conflicts of interest- The analysts are on the hot seat

During the Enron hearings, there was extensive finger pointing made toward Arthur Andersen and their purported conflict of interest from providing consulting services to Enron. The assumption was that Andersen, with full knowledge of GAAP violations in years 1997 to 2000, did nothing about disclosing those violations in fear that it would jeopardize its lucrative consulting fees received from Enron.

What was not actively discussed were the conflicts of interest that existed with the financial analysts on Wall Street who did not disclose Enron's shortfalls from 1997 to 2000. The signs of problems were there yet, no research firm challenged Enron's financial solvency and the viability of its SPEs until 2001.

Prior to Enron, there was debate within Wall Street and the SEC as to the severe conflicts of interest that existed with most investment analysts and research firms. This bias was based on the fact that investment research was done and recommendations made by those same firms that offered investment banking and other services to those companies being researched. Entities such as Goldman Sachs, J. P. Morgan, Citibank and Merrill Lynch used investment research services as a loss leader to the more profitable investment banking and brokerage services. Investment research companies were reluctant to challenge companies such as Enron, in fear that those companies would not purchase other more lucrative services from them. Those same analysts

continued to recommend that investors buy Enron stock even as the scandal was unraveling in 2001.

In his testimony in front of the U. S. House of Representatives, Subcommittee on Capital Markets (June 14, 2001)[17], Scott Cleland, CEO of the Precursor® Group, noted several troubling problems with conflicts of interest among the financial analysts community. Cleland refers to the conflict as the "Chinese wall" in which multiple hats are worn within the same Wall Street firm which performs investment research, investment banking and brokerage services for the same company.

Specifically, Cleland observed that:

1. There were significant conflicts of interest among the financial analysts community.

2. Investment banking and proprietary trading had largely co-opted the brokerage research function as an arms length extension of the company represented.

3. Specific data includes:

   - Less than 1% of analyst recommendations were sells.
   - Brokerage firms made their money buying, not selling.
   - Analysts lost their jobs for authoring negative research about a company.
   - So many institutional investors had so heavily beefed up their in-house research staffs
   - The system produced <u>consensus earnings</u> expectations which so eerily mirrored company "guidance" and independent or divergent expectations routinely got purged from the "consensus" system.

Former SEC Chairman, Arthur Levitt, made similar remarks in saying:

> *"I see… a web of dysfunctional relationships….The analyst attempts to walk the tightrope of fairly assessing a company's performance without upsetting his firm's investment banking relationships."*[18]

Congress has started addressing the abuses and conflicts of interest that existed on Wall Street. The first action was to adopt new rules as part of the Sarbanes-Oxley Act. Specifically, the Act calls for stricter rules to be drafted on analysts and investment bankers to mitigate some of the conflicts of interests that exist on Wall Street. Such rules include:

- Limitations on supervision and compensatory evaluation of analysts to officers and employees who are not engaged in investment banking;

- Restrictions on the prepublication clearance or approval of research reports by individuals who work in investment banking or those not directly responsible for research, exclusive of legal or compliance staff; and

[17] "Who's Looking Out for Investors?", presented before the House of Representatives Financial Services Committee Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 14, 2001.
[18] April 6, 2000, Remarks at the Economic Club of Washington, published in "Quotes from the Industry & Academics", The Precursor® Group, May 2001.

- A requirement that each analyst disclose in public appearances, and each broker-dealers disclose in each research report, any conflicts of interest that he or she knows or should know.

In addition, several Wall Street firms, including Merrill Lynch, have made significant financial settlements with the SEC for various securities law violations.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

.To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. With what authority did the auditors of Enron not have to comply?
   a. SAS No. 52
   b. SAS No. 82
   c. SAS No. 99
   d. the Financial Fraud Detection Disclosure Act of 1996

2. In 2001, what percent of Andersen's revenue was from audit services?
   a. 26%
   b. 32%
   c. 42%
   d. 57%

3. What data provided by Scott Cleland illustrate the conflicts of interest among financial analysts community?
   a. analysts often recommended selling
   b. brokerage firms mostly made money selling
   c. no analysts had lost their jobs for publishing their research
   d. in-house research staffs had been expanded

SUGGESTED SOLUTIONS

1. With what authority did the auditors of Enron not have to comply?
   a. Incorrect. The auditors of Enron had to comply with SAS No. 52, *Illegal Acts by Clients*. Under this statement, auditors must communicate potential illegal acts to the audit committee. They must also consider the effect of the acts on financial statements and disclosures.
   b. Incorrect. The auditors of Enron had to comply with SAS No. 82, the predecessor of SAS No. 99. Under SAS No. 82, auditors had to consider fraud risk, not detect it.
   c. **Correct. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, was not in existence during Enron. It follows SAS No. 82, and requires that auditors consider fraud risk, but not detect it.**
   d. Incorrect. Enron's auditors had to comply with the Financial Fraud Detection Disclosure Act of 1996. In general, compliance with this Act is required of SEC companies.

2. In 2001, what percent of Andersen's revenue was from audit services?
   a. Incorrect. In 2001, 26% of Andersen's revenue was from management consulting services.
   b. Incorrect. In 2001, 32% of Andersen's revenue was from tax services.
   c. Correct. In 2001, 42% of Andersen's revenue was from audit services.
   d. Incorrect. In 2001, 57% of Ernst & Young's revenue was from audit services.

3. What data provided by Scott Cleland illustrates the conflicts of interest among financial analysts community?
   a. Incorrect. Scott Cleland provided data that showed that analysts rarely (less than 1%) recommended selling.
   b. Incorrect. Scott Cleland provided data that showed that brokerage firms mostly made money buying.
   c. Incorrect. Scott Cleland provided data that showed that analysts had lost their jobs for writing negative research about companies.
   d. **Correct. Scott Cleland provided data that showed that in-house research staffs had been expanded.**

VI. Changes After Enron

Introduction:

The changes from Enron have been and continue to be far-sweeping and, in some cases, extreme. Some changes that were slated to be made anyway, such as investments in SPEs, and a new fraud auditing standard, have occurred.

Since 2002 numerous changes have been made as a direct result of Enron and other corporate scandals:

1. In July 2002, Congress passed the Sarbanes-Oxley Act of 2002, dealing with corporate and auditing accountability.

2. In late 2002, the Auditing Standards Board issued SAS No. 99 dealing with stricter, more comprehensive fraud standards.

3. In late 2002 under public pressure, Harvey Pitt resigned as Chairman of the SEC.

4. In January 2003, the FASB issued Interpretation No. 46 of ARB No. 51 dealing with changes to the SPE rules. In that interpretation, the term special purpose entity (SPE) has been replaced with the term "variable interest entity (VIE)". In December 2003 and in 2009, the Interpretation was further revised with the issuance of Interpretation 46R and FASB No. 167.

5. In 2003, the Public Company Accounting Oversight Board (PCAOB) announced that it was assuming responsibility for issuing all new auditing standards, taking that responsibility away from the self-regulated AICPA's Auditing Standards Board. To date, the PCAOB has issued several auditing standards.

6. In December 2004, the FASB issued FASB No. 123R, *Share Based Payments*, to change the accounting for stock options.

7. In 2006, the FASB moved toward standards that result in greater transparency and the recording of previous off-balance-sheet items with the issuance of FASB No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans,* and the addition of a project on lease accounting to its agenda.

8. In August 2006, Congress passed the Pension Protection Act of 2006 which revamps the ERISA funding requirements for certain pension plans.

On the other side, the AICPA and the Big Four continue to salvage the current system of self-regulation within the accounting profession.

A. Specific Changes After Enron

More than six years after the impact of Enron was disclosed to the public, many changes have been made through the regulatory and political process. The following are some of those major changes that have been made or are in the process of being made, noted by category:

Post-Enron Change 1: SEC Changes:

Prior to his resignation in late 2002, Harvey Pitt, then Chairman of the SEC made several recommendations to Congress regarding changes that needed to be made to both accounting and auditing standards, as well as independence and oversight of the accounting and auditing profession.

On March 21, 2002, Pitt testified as to the SEC's recommended courses of action many of which have been implemented by the SEC.

a. Changes in disclosures of public companies must be truly informative and timely:

    1. Improve MD&A information, including trend information.

    2. Critical accounting policies, that is, those that are most important to the presentation of financial position, financial results, and that require the most subjective complex accounting estimates.

    3. SPEs and related-party transactions.

b. Clarity and accountability:

    1. Improve the quality and utility of the corporate disclosure system by increasing the CEO's individual accountability for his or her company's disclosure.

    2. Produce clear and concise financial statements including giving companies the flexibility of disclosing information in layers ranging from "big picture" focus to those that encompass minute details.

c. More timely disclosure and reporting including:

    1. Accelerate annual report filings from 90 to 60 days and quarterly filings from 45 to 30 days.
    2. More accessible filings on web sites with the same information presented as in the SEC filings.
    3. Accelerate disclosure of corporate insiders' trading activities.
    4. More current disclosures including:

        - Changes in rating agency decisions about a company
        - Defaults and other events that could accelerate direct or

contingent obligations
- Transactions that result in material direct or contingent obligations not included in SEC filings
- Offerings of equity securities not included in a prospectus
- Waivers of corporate ethics and conduct rules for officers, directors, and other key employees

- Material modifications to rights of security holders
- Departure of a company's CEO, CFO, COO or president
- Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use its report in a SEC filing
- Definitive agreements that are material to the company
- Losses or gains of material customers or contracts
- Material write-offs, restructurings or impairments
- Movement or de-listing of a company's securities from an exchange or quotation system
- Any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans

5. Require all public companies to maintain corporate websites, and to post corporate disclosures and other documents on those sites.

d. Oversight of accounts and the accounting profession must be strengthened and accounting principles that underlie financial disclosure must be made more relevant.

e. Corporate governance needs to improve including crafting guidance for directors and senior officers to follow.

f. Improvements under the Private Litigation Act of 1995 for ease in litigation.

Post-Enron Change 2: The Sarbanes-Oxley Act of 2002:

In August 2002, Congress passed legislation that has had a monumental impact on the accounting profession and federal securities laws. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) was a joint effort of both Houses of Congress and resulted in changes that affect not only accountants, but also lawyers, corporate officers and board members.

In essence, Sarbanes does the following:

1. Places new restrictions on SEC auditors, including providing a list of prohibited activities that an SEC auditor cannot perform for his or her SEC audit client, other restrictions including a mandatory audit partner rotation.

2. Introduces a new Public Company Accounting Oversight Board (PCAOB) to oversee the audits of SEC companies.

3. Places the authority for establishing GAAP and GAAS with the PCAOB.

4. Requires CEOs and CFOs to certify the fair presentation of their company's quarterly and annual financial statements.

5. Enhances required disclosures of off-balance sheet and certain related party transactions.

6. Places further responsibility on audit committees and the corporate governance process.

7. Establishes new requirements for attorneys to report material violations of securities law by their corporate clients.

8. Creates criminal penalties of up to 25 years for certain types of securities fraud.

Many accountants believe that Sarbanes affects only auditors of SEC companies. Yet, Sarbanes continues to impact the entire profession with its trickle-down effect to even the smallest closely held business. Specifically, more than 25 states have modified or are in the process of modifying their accountancy acts to incorporate many of the Sarbanes changes in them. Unfortunately, the changes are not being limited to auditors of SEC companies. Instead, they are applying the changes to all auditors, those of SEC and non-SEC companies, alike. Additionally, certain governmental agencies are applying the Sarbanes provision of mandatory partner rotation. Some are even expanding beyond Sarbanes by requiring mandatory audit firm rotation, a requirement that the final Sarbanes did not include. The author believes it is vital that all accountants and auditors understand what Sarbanes does and what their local state legislatures are considering for adopting certain provisions of Sarbanes.

In the section, the author discusses sections of the Act.

1. Sarbanes and The Public Company Accounting Oversight Board (PCAOB)

The Act established an oversight board called the *Public Company Accounting Oversight Board (the Board)* to oversee the audit process of SEC companies.

The purpose of the Board was to replace the self-regulatory process that existed in the accounting profession. Prior to the passage of Sarbanes-Oxley, auditing standards for all companies were centralized in the Auditing Standards Board (AICPA), while GAAP rules were issued by the FASB and the AICPA's Executive Committee (AcSEC). With the introduction of the PCAOB, the self-regulation process was changed thereby limiting the profession's ability to continue to promulgate auditing and accounting standards.

Specifics about the current PCAOB follow:

1. The Board is not an agent of the United States government. Its powers are subject to oversight by the SEC with Board rules requiring SEC approval.

2. The Board is funded through required fees that must be paid from SEC issuer (based on market capitalization) and all registered accounting firms.

3. The Board's responsibilities are to:

    - Register public accounting firms that prepare audit reports for issuers (e.g., auditors of SEC companies).

    - Establish or adopt auditing, quality control, ethics, independence and other Standards relating to auditors of SEC companies.

    - Conduct inspections of registered public accounting firms, as well as perform investigations and disciplinary proceedings concerning registered public accounting firms, including, if necessary, imposing sanctions against those firms.

    - Enforce compliance with the Act, the Board's rules, professional standards, and securities laws related to the preparation of audit reports by registered accounting firms and associated persons.

    - Perform other duties or functions as the Board of the SEC commissioner determines are necessary.

4. The Board has *five (5) full-time members* appointed by the SEC in consultation with the Secretary of the Treasury and the Chairman of the Federal Reserve.

    a. Members are selected from among prominent individuals of integrity and reputation who have demonstrated commitment to investors and the public, understand the responsibilities and nature of financial disclosures, and understand the obligations of accountants in the issuance of audit reports.

    b. A maximum of two (2) members must be or have been CPAs. If one of the two CPAs is the chairperson, he or she must not have practiced in a public accounting format within five years from his or her appointment to the Board.

    c. A Board member may not serve for more than two, five-year terms, regardless of whether those terms are consecutive.

5. Board members may not receive any payments from a public accounting firm except those that are fixed continuing payments (e.g., retirement plan payments).

    a. Board members may not engage in any other professional or business activity during his or her term.

    b. The five member terms shall be scattered so that no term expires at the same time as another term. Each member's term shall expire in annual increments.

6. The Board is required to conduct inspections of each registered public accounting firm:

a. The inspection must be done annually for firms that provide more than 100 annual audit reports on issuers,

b. The inspection must be done every three years for firms that issue 100 or fewer annual reports.

7. The Board may refer an investigation to the SEC, Federal regulator, Attorney General of the state or United States, or other authorities.

8. Annually, the Board must submit a report, including audited financial statements to the SEC with a copy to the Senate's Committee on Banking, Housing, and Urban Affairs, and the Financial Services Committee of the House.

2. Sarbanes Changes Affecting SEC Auditors

The Act added significant responsibilities and restrictions to auditors of SEC companies (referred to as registered accounting firms).

1. Registration with the Board: In order for auditors of SEC companies to prepare, issue, or participate in the preparation or issuance of an audit report on an issuer, that firm *must register with the Board* and provide specific information.

2. Registration fees: Registered firms *must pay registration fees* to the Board in an amount that is sufficient to cover the costs of processing and reviewing applications and annual reports.

3. New standards that registered firms must adopt: Registered accounting firms must adopt new standards in their quality control system and reporting standards:

   a. *A seven-year workpaper retention policy*: The firm must maintain audit workpapers and other information related to any audit report, in sufficient detail to support the conclusions reached in the audit report.

   b. *A concurring or second partner review*: On each audit, the firm must provide a concurring or second partner review and approval of each audit report. The second review must be performed by a qualified person associated with the firm, other than the person in charge of the audit, or by an independent reviewer.

   c. *Report on internal control*: In each audit report, the auditor must disclose the scope of auditor's testing of the internal control structure and the procedures of the issuer and present it as part of the audit report or in a separate report.

   d. *Quality control standards for registered accounting firms:* Firms must establish new quality control standards.

e. *Mandatory partner rotation rules*: A firm may not perform audit services that the lead or review partner has performed audit services for the issuer client for five (5) consecutive fiscal years.

f. *Auditors must report directly to the audit committee*: The Act requires that there be direct communication between the auditor and audit committee throughout the audit.

g. *Partner compensation limitations:* An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with the audit client to provide any products or services other than the audit, review or attest services. Small firms with ten or fewer partners and five or fewer audit clients, are exempt from the partner compensation limitations.

3. Sarbanes- Conflicts of interest and Auditor Independence Rules

a. One-year cooling off period: A firm is precluded from auditing an issuer if the issuer's CEO, controller, CFO, CAO, or any person serving in an *equivalent position for the issuer*, was employed by the firm and participated in any capacity in the audit of that issuer during *the one-year period* preceding the date of the initiation of the audit. The cooling-off provision applies only to those officers that served on the audit in the preceding year. If, instead, the officer served elsewhere in the firm, such as in the tax or consulting department, the preclusion would not apply.

b. Prohibited activities by accounting firms: A registered public accounting firm may not perform for an issuer any of the following *non-audit services* contemporaneously with the audit:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Legal services unrelated to the audit

- Expert services[19]

- Any other service that the Board determines, by regulation, is impermissible.

Note: A firm may perform any non-audit service (including tax services) not on the above list for an audit client only if the activity is approved in advance by the audit committee of the issuer. Such approval must be disclosed in the issuer's reports.

Note further that the Board has the authority to exempt any firm, on a case-by-case basis, from a prohibited transaction noted on the above list.

4. Sarbanes Changes Affecting Boards and Audit Committees

The Act made significant changes to the responsibilities of corporate boards and audit committees including effecting better communication between the audit committee and the audit and making the committee directly responsible for the selection of the audit firm. Further, the Act improved the competence of the audit committee by ensuring that its members are financially savvy.

1. Audit committee make up: Each member of the audit committee must also be a member of the board of directors and may not accept any consulting, advisory, or other compensatory fee from the issuer, or be an affiliated person of the issuer or any subsidiary thereof.

2. Audit committee responsibility for the auditor: The audit committee of an issuer is *directly responsible* for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer, (including the resolution of any disagreements between management and the auditor regarding financial reporting) for the purpose of preparing and issuing an audit report.

    a. All auditing services and non-audit services (other than those services prohibited) must be *preapproved by the audit committee* of the issuer.

    b. De minimis exception: Preapproval by the committee is waived with respect to non-audit services if certain conditions are met.

    c. The registered accounting firm must report *directly* to the audit committee.

3. Handling complaints: The audit committee must establish procedures for handling the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal control, or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting and auditing matters.

4. Audit committee financial expert: The issuer *must disclose in its reports* whether at least one member of the audit committee is a "*financial expert*." Who understands GAAP, has experience in the preparation or auditing of financial statements, and experience with internal controls, and understands audit committee functions.

[19] In the Act, the list included nine non-audit services with expert services being part of legal services. In its final rule, the SEC segregated the "expert services" into a tenth category.

5. Sarbanes Changes Affecting Corporate Officers:

The Act placed responsibility on corporate officers for the fair presentation of financial statements by requiring them to sign off on financial statements issued. Additionally, the Act severely restricts the ability of corporate officers to reap receiving financial benefits such as bonuses when financial statements are misstated. Specific requirements of the Act related to corporate officers include:

1. CFO/CEO Certification: The principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, must certify in the annual or quarterly report filed with the SEC in that the report *does not contain any untrue statement* of a material fact or omit a material fact, the financial statements, and other financial *information included in the report, are* fairly presented, in all material respects, and that the officers are responsible for establishing and maintaining internal controls, among other certifications.

2. Officer forfeiture of bonuses and profits: If an issuer's financial statements are restated due to a material noncompliance as a result of misconduct with any financial reporting requirement under the securities law, the CEO and CFO must reimburse the issuer for any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever comes first) of the financial document that includes the financial reporting requirement, and any profits realized from the sale of securities of the issuer during that 12-month period.

3. Prohibited trading provision: The Act prohibits any director or executive officer of the issuer directly or indirectly, to purchase, sell, acquire or transfer any equity security of the issuer during any *blackout period* if such director or officer acquires the equity security in connection with his or her service or employment as a director or executive officer.

4. Prohibited personal loans: The Act prohibits any issuer directly or indirectly (including through an affiliate) from extending or maintaining credit, arranging for the extension of credit, or renewing credit, in the form of a personal loan to or for any executive officer or director, or the equivalent thereof, of the issuer.

    a. Loans in effect at the date of enactment *are not subject to the prohibition* provided there are no material modifications to any term of the loan or renewal of the loan on or after the enactment date.

    b. Loans *not prohibited* include home improvement and manufactured home loans, an extension of credit under an open end credit plan, credit cards, and certain extensions of credit by a broker or dealer to an employee of that broker or dealer to buy, trade, or carry securities.

6. Sarbanes- New Corporate Disclosures

The Act enhanced the required disclosures that an issuer must include in each financial report.

1. Reflection of material correcting adjustments: Each financial report that contains financial statements prepared in accordance with GAAP *must reflect all material correcting adjustments* that have been identified by the accounting firm in accordance with GAAP and SEC rules.

2. Off-balance sheet transactions: An issuer's financial statements must *disclose all material off-balance sheet transactions*, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons, that may have a material, current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.

3. Real time disclosure of financial information: Each issuer shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations in plain English, which may include trend and qualitative information and graphic presentations.

4. Disclosure of non-audit service fees approved by the audit committee: Each issuer must disclose *approval by an audit committee of a non-audit service* to be performed by the auditor of the issuer. The disclosure should be made in the periodic reports under *four captions*: audit fees, audit-related fees, tax fees, and all other fees.

5. The issuer must disclose in its periodic reports whether or not the issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions. An additional disclosure is required if there is *a change to, or a waiver from*, a company's code of ethics for its senior financial officers.

7. Sarbanes and the Penalties and Criminal Fraud Provisions

The Act dramatically increased the penalties for violations of securities laws including enhanced criminal penalties as follows:

Violation	**Punishment**
Securities fraud in violation of the SEC Act of 1934 and other SEC violations	25 years imprisonment and up to $25 million fine
Destruction, alteration, or falsification of records in Federal investigations and bankruptcy, or commits securities, mail or wire fraud	Up to 20 years imprisonment
Destruction of corporate records	Up to 10 years imprisonment
Knowingly or willfully violating certain SEC rules	Up to 10 years imprisonment
False certification by CFO or CEO	$1-5 million fine plus 10-20 years imprisonment

Retaliation against whistleblowers	Up to 10 years imprisonment
Failure to maintain audit and review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded.	Fined and imprisoned up to 10 years.
Statute of limitations for discovering fraud	Extended from two to five years

8. Sarbanes- Rules for Investment Bankers and Analysts

The Act called for stricter rules on analysts and investment bankers to mitigate some of the conflicts of interest that exist on Wall Street. Such rules:

a. Limit the supervision and compensatory evaluation of analysts to officers and employees who are not engaged in investment banking.

b. Restrict the prepublication clearance or approval of research reports by individuals who work in investment banking or those not directly responsible for research, exclusive of legal or compliance staff.

c. Require that each analyst disclose in public appearances, and each broker-dealer disclose in each research report, any conflicts of interest that he or she knows or should know.

9. Sarbanes- Other Provisions of the Act

The Act provided various incidental provisions, some of which are noted as follows:

a. Whistleblower Protection: The Act provided protection to whistleblowers by creating a new civil action for employees of public companies who believe they have been discharged due to their disclosing violations of federal securities laws.

b. Improper influence on conduct of audits: The Act made it unlawful for any officer, director of the issuer, or any other person acting under their direction, to take any action to fraudulently influence, coerce, manipulate, or mislead any accountant in the performance of an audit of the issuer's financial statements in order to make the financial statements misleading.

c. Rules of professional responsibility for attorneys: Attorneys are required to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof. The report should be made to the chief legal counsel or the CEO of the company.

d. Debts not discharged in bankruptcy: The Act amended Title 11 of the Bankruptcy Code to provide that an individual who files for bankruptcy is not discharged from any debt that is as a result of a violation of any federal or state securities laws, regulations or any common law fraud, related to the purchase or sale of any security, judgment, order, decree, or any settlement agreements, including any damages, penalties, fines, or attorneys fees related thereto.

10. The Trickle Down Effect of Sarbanes

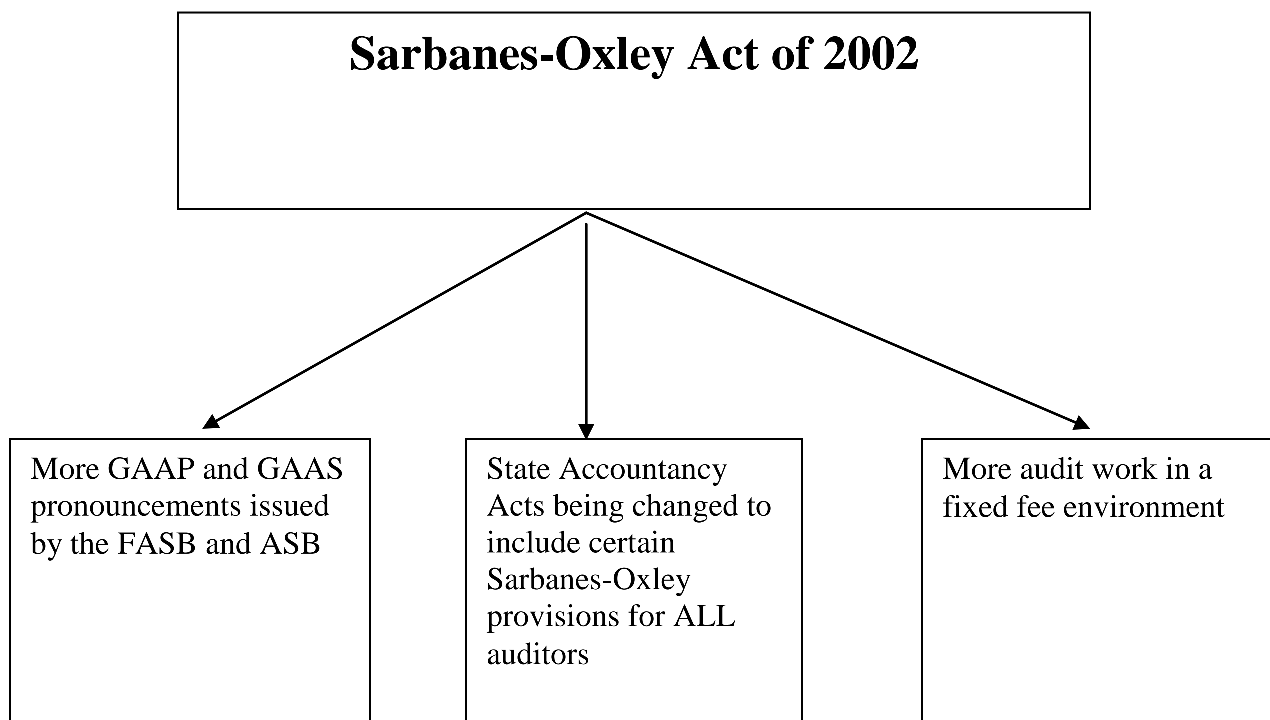
As expected, the repercussions of the Act continue to ripple through the accounting profession as accountants and auditors at all levels are impacted for several reasons:

1. There has been a major increase in the number of GAAP and GAAS statements being issued that apply to all entities, public and nonpublic, alike.

2. Many states have adopted portions of the Sarbanes-Oxley Act in their accountancy acts and have those provisions apply to all auditors, including those that audit nonpublic entities.

3. With the increase in audit and accounting rules, auditors are required to perform more audit work, the time for which may be difficult to pass on to clients in fixed-fee engagements.

The Trickle Down Effect of Sarbanes-Oxley to Auditors of Non-Public Companies



At the state level, more than twenty states have introduced or are about to introduce legislation bills that will adopt significant portions of the Sarbanes-Oxley Act into their state accountancy acts. Although the Sarbanes-Oxley Act affects SEC auditors only, many states are applying its provisions across the board to all auditors, including those who audit nonpublic entities.

11. Results of the GAO's Mandated Study on Consolidation and Competition in the Accounting Profession

With the loss of Andersen, questions arose as to whether, in putting Andersen out of business, the Justice Department had created an anti-competition environment as it related to audits of multi-national companies.

Section 701 of the Act required the GAO to conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems discovered.

In July 2003, the GAO issued its final report entitled, *Public Accounting Firms: Mandated Study on Consolidation and Competition* (herein referred to as the Report or the GAO Report).

The Report's analyses and conclusions are summarized below:

1. The Big Four currently audit more than 78 percent of all U. S. public companies and 99 percent of public company annual sales.

2. Internationally, the Big 4 dominate the market for audit services.

3. The GAO found *no empirical evidence that consolidation of accounting firms has impacted:*
    - Competition in the audit services market
    - The quality of audits
    - Audit fees
    - The capital markets

4. There *has been an impact* of consolidation on the limited number of auditor alternatives for larger national and multinational companies that require firms with extensive staff resources, industry-specific and technical expertise, geographic coverage, and international reputation.

5. Most public companies believe they have limited choices if they were to switch auditors:

    - 88% of large multinationals said they would not consider using a non-Big 4 audit firm.

    - 94% of public companies said that they had three or fewer alternatives were they to switch audit firms.

    - 100% of audit chairpersons surveyed said they had three or fewer alternatives if they were to switch audit firms.

    - 42% of companies surveyed said they did not have enough options for audit and attest services.

    - 76% said they would not be willing to expand choices if it meant letting market forces operate without government intervention.

- 80% of respondents said that industry specialization or expertise would be of great or very great importance to them if they had to choose a new auditor.

- 91 percent said they would not consider a non-Big 4 firm because of lack of technical skills or knowledge of their industry.

6. Sarbanes-Oxley has further limited the competition among audit firms:

- The new independence rules which limit the nonaudit services firms can provide to their audit clients, limits the choices available for audit firms.

  Example: Assume a company uses one Big 4 firm for its audit and attest services and another Big-4 firm for its outsourced internal audit function. If it wishes to switch auditors, it cannot use one of those two Big-4 firms. Consequently, it only has the two remaining Big-4 firms to consider as its replacement auditor. Assume further that one of the remaining Big-4 firms is not interested in bidding on the new business because the industry does not fall within its target markets. That would leave only one remaining Big-4 firm to be the replacement firm and no alternative viable choices.

- In specialized industries, most companies have only two choices in selecting an audit firm.

7. Smaller riskier public companies have been impacted by both Sarbanes and the consolidation of the national firms:

- As the Big 4 have increased their focus on larger public companies, smaller companies and those that are not profitable are losing access to the Big 4 as they shed some of their clients that represent unacceptable risks to their firms.

- There are fewer audit firms willing to audit smaller, higher-risk, and less-profitable SEC companies in the wake of Sarbanes-Oxley.

- Because of the higher risk of being audited, the cost of capital for smaller public entities is expected to continue to increase.

8. There are concerns about the impact of further consolidation and lack of viable alternatives in certain industries.

9. Because of the barriers to entry, market forces are not likely to result in the expansion of the current Big 4. Smaller accounting firms face significant barriers to entry into the audit market for large multinational public companies for several reasons including:

- Smaller firms generally lack the staff, technical expertise, and global reach to audit large and complex national and multinational public companies.

- The Big 4 had almost three times as many partners and over five times as many staff as the average for the next three largest firms.

- Even through merger of the next tier of non-Big 4 firms, any new firm would still lack the resources needed to compete, to any significant degree, with the Big 4 for larger clients.

  Note: Under a best-case scenario, the GAO projected that a merger of the five largest non-Big-4 firms would result in a firm with a 11.2 percent market share, compared with an 8.6 percent market share for the five non-Big-4 firms if they were not consolidated. Thus, there would be only a 2.6 percent increase in market share by consolidating those five firms.

- The capital markets are familiar with the Big 4 and are hesitant to recommend that companies use firms with whom they are not familiar.

  Note: Many investment bankers and institutional investors often stated that they preferred that public companies use a Big 4 firm for their audits.

- 83% of non-Big 4 firms surveyed indicated that the litigation risks and insurance costs associated with auditing a large public company made growth into the large public company market less attractive than other growth opportunities.

  Note: Many non-Big 4 firms also noted that changes in accounting principles and standards, the complexity of audits, and the price of talent and training to be factors that placed an upward influence on costs that would make growth into the large public company market less attractive.

- Raising the amount of capital to build the infrastructure necessary to audit large multinational companies is difficult, in part because the partnership structure of accounting firms limits these firms' ability to raise outside capital.

- Certain state laws make it difficult for firms to expand nationally. For example, firms face the burden and additional expense of obtaining state licenses for staff across the country.

10. The GAO provided no recommendations as what, if anything, can be done to address the lack of competition issue among the Big 4.

Largest U. S. Accounting Firms (Global Operations)				
Big 4	Actual market share (percent)*	Revenue ($$ per thousands)	Partners	Professional staff (non-partner)
Pricewaterhouse Coopers	18.98	$13,782	7,020	97,109
Deloitte & Touche	14.94	12,500	6,714	73,810
KPMG	14.38	10,720	6,600	69,100
Ernst & Young	19.73	10,124	6,131	60,713
Next tier				
BDO Seidman	3.13	2,395	2,182	16,078
Grant Thornton	4.21	1,840	2,256	14,019
McGladrey & Pullen	.82	1,829	2,245	12,775

Source: Tables 4 and 5 published in the GAO Report.
* Market share is based on the log of total company assets.

Largest U. S. Accounting Firms (US Operations)				
Big 4	Revenue ($$ per millions)	Audit and attest revenue ($$ in millions)	Partners	Professional staff (nonpartner)
Deloitte & Touche	$5,900	$2,124	2,618	22,453
Ernst & Young	4,515	2,664	2,118	17,196
PricewaterhouseCoopers	4,256	2,596	2,027	18,801
KPMG	3,200	2,016	1,535	12,502
Next 5 firms- non Big 4:				
Grant Thornton	400	200	312	2,380
BDO Seidman	353	145	281	1,510
BKD	211	93	193	1,165
Crowe, Chizek and Co.	205	45	101	1,037
McGladrey & Pullen	203	187	475	2,369
Total- next 5 non-Big 4	***1,372***	***670***	***1,362***	***8,461***

Source: Table 1 of the GAO Report, as modified by the Author.

Who Audits the Former Andersen Clients?

In 2001, Arthur Andersen LLP (Andersen) was the fourth-largest public accounting firm in the United States, with global net revenues of more than $9 billion.

On March 7, 2002, Andersen was indicted by a federal grand jury and charged with obstructing justice for destroying evidence relevant to investigations into the 2001 financial collapse of Enron.

At the time of its demise, Andersen performed audit and attest services for approximately 2,400 public companies in the United States, including many of the largest public companies in the

world. In addition, Andersen served private companies and provided additional professional services such as tax and consulting services.

The GAO report published information on who absorbed the Andersen clients after that firm's demise.

1. Of the former Andersen clients, only 13 percent switched to non-Big 4 firms.

2. The switch of Andersen clients to the Big 4 firms was more pronounced within specialized industries that had little choice of firms that had expertise within their specific industry.

3. In the post Andersen environment, many of the Big 4 firms have more than a 25 percent market share in selected industries as follows:

First Hired by Former Andersen Clients – As of Date of Indictment			
Accounting firm	Number of former Andersen clients	% of total Andersen clients	Average assets (millions)
Big 4	938	87%	$2,508
Grant Thornton	45	4	644
BDO Seidman	23	2	54
Other	79	7	193
	1,085	**100%**	**2,210**
Source: Table 10 of GAO Report			

Concentration of Industries Among the Big 4				
	Firms with 25% or more of the Industry			
Industry	Deloitte & Touche	Ernst & Young	KPMG	Pricewaterhouse Coopers
Oil and gas extraction				X
General building contractors		X		
Paper and allied products	X			
Food stores	X			X
Apparel and accessory stores	X			
Health services		X	X	
Hotels and lodging	X	X		
Communications		X		X
Source: Table 14 of the GAO Report				

Observation: Based on the above table, it would appear that firms with 25-percent or more industry market share would dominate the particular industry. Consequently, it is assumed that companies in those industries would have few choices of audit firms and limited options in switching audit firms.

Post-Enron Change 3: FASB's Rapid-Fire Accounting Changes

General

Unlike auditing standards which have been taken over by the PCAOB with respect to audits of SEC companies, for now, accounting principles for SEC companies will continue to be issued by the FASB. The SEC has indicated that the existing FASB structure should stay in tact subject to the following changes that the SEC recommends be made:

- FASB standards must ensure illumination and not obfuscation in financial reporting.
- The SEC will play a more active role in overseeing accounting standards.
- FASB funding should be mandatory, not optional in order to assure FASB's independence.
- FASB must speed up its standard setting process and focus on more important areas such as revenue recognition, consolidations, SPEs, etc.
- New accounting pronouncements should be principle-based instead of rule driven, to make them more flexible for a changing marketplace.
- Standards should be general and principle-based instead of encyclopedic and rule-based.

Nevertheless, the FASB is feeling pressure to justify its existence with the fear that the PCAOB will take over the FASB's role if it is not responsible to the needs for accounting reform.

As a direct result of Enron and other recent controversies on Wall Street, since the demise of Enron, the FASB has taken rapid action as follows:

1. It has announced that it is headed toward a principles-based accounting system to replace the existing United States rules-based system.
2. It has issued several very controversial statements in direct response to demands by the SEC to do so.

Specifically, the FASB has issued the following statements:

FASB Interpretation No. 46R- *Consolidation of Variable Interest Entities (as amended by FASB No. 167)*	Changes to consolidation rules for off-balance sheet entities (previously referred to as SPEs) and now requires many off-balance sheet entities to be consolidated.
FASB No. 150: *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*	Reclassifies many hybrid financial instruments from the equity to the liability section of the balance sheet.
FASB No. 132 (revised): *Employers' Disclosures About Pensions and Other Postretirement Benefits*	Expands disclosures for defined benefit plans to improve transparency of investment type, and the investment strategies, among other changes.
FASB No. 123R: *Share-Based Payments*	Changes the accounting for stock options by requiring all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees. measured based on an *observable value*, then *using an option model* (such as the Black Scholes Model).
FASB Interpretation No. 48 of FASB No. 109: *Accounting for Uncertainty in Income Taxes*	Changes the accounting for uncertain tax positions by requiring all entities to review their tax positions. If it is not more likely than not (less than 51%) that the tax benefit of the tax position will be realized assuming there is an audit, an entity must record a liability for the unrecognized tax benefit of that position.

Enron's Impact on a Principles-Based Accounting System

Clearly, Enron has had a significant effect on the FASB's move toward a principles-based system to replace the existing rules-based one.

In his speech to the Financial Executives International (FEI), Robert Herz, the FASB chairman recalled a line from the movie *A Few Good Men*, in which Jack Nicholson has a famous one-liner.

"You want the truth, you can't handle the truth."

Continuing with his speech, Herz asks whether the United States can handle the truth about accounting- whether it is ready to apply a more principles-based approach to accounting.

The accounting profession is at a crossroad at which it must decide the means by which it is going to establish accounting standards. At the heart of a recent debate is whether a principles-based accounting system should replace the more concrete, yet inflexible, rules-based approach. For years, the accounting profession has been criticized for its "black and white" approach to setting rules. In some instances, quantitative thresholds and rules have replaced logic. The result is that in recent instances, companies have "technically" satisfied GAAP's rules even though the substance of the transaction was contrary to the rules-based form.

A most relevant example took place with Enron and its application of the special-purpose entity (SPE) rules for deciding whether certain off-balance sheet entities should have been consolidated by Enron. Under the SPE rules, (which subsequently have been replaced by the new variable interest entity (VIE) rules), a company like Enron was not required to consolidate certain off-balance sheet entities as long as it satisfied a 3% outside equity threshold. With its eye on the 3% rule, Enron structured agreements to ensure that the 3 percent was satisfied. Andersen, if they even audited these SPEs, would presumably have tested the 3 percent rule. At 3.1% Enron would not have to consolidate certain off-balance sheet entities, but at 2.97%, it would. In fact, the author recalls one particular Enron off-balance sheet entity in which the percentage was actually 2.97%. Can you imagine making a decision to consolidate whereby at 2.97% the answer is “yes”, consolidate, while at 3%, the answer is “no?” The 3% SPE threshold is an excellent example of the “black and white,” “yes or no” rules-based system in which accounting rules are applied.

Now, let’s change the facts. Originally, the FASB established the 3% rule for SPEs to define the minimum threshold at which an entity could obtain financing by itself without outside assistance. Assume that instead of the 3% rules-based threshold, a more qualitative principle-based concept was used. That concept looks like this: “An entity must consolidate an off-balance sheet entity if that entity is not self-sustaining regardless of what the percentage threshold is.” In essence, the 3% “rule” is replaced with a “principle” that is used to determine when to consolidate an off-balance sheet entity. Would a principles-based GAAP work and could it be applied in practice? Another example is capital leases which are based on a set of rules found in FASB No. 13. Specifically, FASB No. 13 provides the “rules” for capitalizing a lease if four criteria are met.

Perhaps the best parallel of a rules-based versus principles-based system is the Internal Revenue Code. Tax law consists of the principles, while the rules are found in the regulations, rulings, etc. Imagine operating under the Internal Revenue Code relying solely on the law (code) without the rules (e.g., regulations, rulings, etc.). The system would be impossible to interpret and, interpretations of the law would be quite subjective and difficult to apply.

The following table compares a rules versus principles-based system for selected GAAP.

Comparison of Selected GAAP Under A Rules-Based Versus a Principles-Based System		
Accounting Area	**Rules-Based System**	**Principles-Based System**
Off-balance sheet entities-consolidation	Consolidate if the amount of outside capital is 3% or more of total equity[20]	Consolidate if the entity is not self-supportive
Capital leases	FASB No. 13 requires that a lease be capitalized if it meets four criteria: 1) present value of minimum lease payments equaling 90% or more of the fair value of the asset; 2) Lease term equals or exceeds 75% of the remaining lease term; 3) The lease has a bargain purchase, and, 4) there is a transfer of ownership at the end of the lease.	Lease is capitalized if, in substance, it has more attributes of ownership than of a lease.
Revenue recognition	General rule- SAB 101: Revenue is recognized if: • Persuasive evidence of an arrangement exists. • Delivery has occurred. • The seller's price to the buyer is fixed and determinable. • Collectibility is reasonably assured.	Revenue should be recognized when a) there has been a transfer of goods or services in exchange for consideration and b) the risks and rewards of ownership pass from the seller to the buyer.
Goodwill impairment	FASB No. 144: A long-lived asset should be considered impaired if 1) the carrying amount is not recoverable through future cash flow, and, 2) the fair value of the asset(s) is less than the carrying amount.	A long-lived asset should be considered impaired if, based on facts and circumstances, it will not provide an adequate economic benefit to the entity throughout the remainder of its useful life.

A principles-based accounting system continues to be under serious consideration by the FASB, SEC and even Congress. Surely, a system based on the economic substance of a transaction (principle) rather than its form (rule) makes sense. But can it be applied and enforced?

In 2002, Congress passed the Sarbanes-Oxley Act. In this Act, the SEC is required to conduct a study on the adoption of a principles-based accounting system by United States SEC companies.

[20] The 3% SPE rules have been superseded by FASB Interpretation No. 46 of ARB No. 51, issued in January 2003.

Subsequently, the SEC announced on several occasions that it supports a principles-based system. In May 2002, SEC Chief Accountant Robert Herdman told the Capital Markets Subcommittee of the House Financial Services Committee that the FASB should move toward a "principles-based" method of developing standards under which accountants use judgment to determine the appropriate accounting for transactions.

Former SEC Chairman Harvey Pitt stated:

> *"The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives."*

In December 2002, the FASB issued a proposal entitled, Principles-Based Approach to U. S. Standard Setting. In its proposal, the FASB states:

> *"The main difference between accounting standards developed under a principles-based approach and existing accounting standards are (1) the principles would apply more broadly than under existing standards, thereby providing few, if any, exceptions to the principles and (2) there would be less interpretive and implementation guidance.... for applying the standards."*

Can a principles-based system work?

The author believes it is doubtful that a pure principles system will work. A principles-based system is noble in concept, but would fail in practice. Accounting without a rules-based system is gray, not black and white. A system based on gray, nebulous rules is subject to dispute, confusion, and ambiguity. It also lacks consistency. Consider two companies in the same industry. Using principles-based accounting, one company interprets the timing of revenue recognition in one manner, while the other interprets it in another. Both entities reached their conclusions correctly based on valid assumptions. Yet, the system results in two entities within the same industry, with the same information reaching different conclusions about how to recognize revenue. The result is a lack of consistency within the same industry.

Let's also consider the impact of a principles-based system on auditors and accountants in litigation. It is difficult enough trying to defend and define the complex accounting rules under which accountants and auditors now practice. Can one imagine what would happen without accounting rules and how one could explain to a lay audience, conclusions reached using a principles-based approach?

Finally, the only way a principles-based system could ever work is if it operates within a universally ethical foundation. Although most accountants and their clients do follow an ethical compass, there are simply too many external forces and pressures that would persuade companies, and even their auditors and accountants, to interpret principles in one direction versus another. Such a result would mitigate the benefits expected to be derived from a principles-based system.

The rules-based system is not perfect, but it is the only one in which we can apply accounting on a consistent basis across industries.

Argument For and Against Principles –Based Accounting System	
Rules-Based System	**Principles-Based System**
Advantages	**Disadvantages**
• Objective- easier to defend in litigation.	• Subjectivity and judgment without rules to define thresholds places greater litigation risk on accountants and auditors.
• Can be applied with reasonable level of ethics and professional judgment. Requires less skills of judgment from staff.	• Requires high degree of ethics and exercise of professional judgment.
• Easier to enforce	• More difficult to enforce
Disadvantages	**Advantages**
• Much more complex and detailed.	• Less onerous, detailed and complex than the present "rules-based" "check-the-box" system.
• More difficult for accountants and auditors to stay current with rules-based system.	• Easier for accountants and auditors to stay current with a principles-based system.
• Fosters form over substance mentality for accounting.	• Fosters substance over form mentality for accounting.
• More difficult for U. S. system to converge with international standards under a rules-based system.	• Easier for the U. S. rules to converge with less rules based international standards.

Enron's Impact on a Change in the SPE Rules – FASB Interpretation No. 46R-Consolidation of Variable Interest Entities

A. General

For years the FASB had attempted to change the consolidation rules for off-balance sheet entities, previously referred to as special-purpose entities (SPEs). Each time the FASB could not muster the number of votes needed to pass a new standard or interpretation.

Then Enron came along, and the abuses of using off-balance sheet entities was well publicized. The result was a mandate from Congress and the SEC for the FASB to either clean up the off-balance sheet rules or Congress and the SEC would do it for them.

With the passage of the Sarbanes-Oxley Act of 2002, pressure grew for radical change to ensure that more SPEs were consolidated and for greater transparency to be given to shareholders and other third-party users about company transactions involving SPEs. Sarbanes introduced a new requirement to adopt rules for greater disclosure of off-balance sheet transactions.

In the summer of 2002, the FASB issued an exposure draft on "variable interest entities (VIEs)." The term "VIE" was used to replace the term "SPE." A VIE is an off-balance-sheet entity that is not self-supportive and that relies on another entity or individual for its financial support.

After deliberating on the exposure draft, the FASB issued Interpretation No. 46 in January 2003.

Upon the issuance of the Interpretation, public criticism of the document was rampant, as critics claimed the document was ambiguous and that the FASB Staff was not supporting its document by assisting in its interpretation. In fact, the document was so controversial, that the FASB staff issued or proposed to issue eleven FASB Staff Bulletins (FSBs) to clarify the language found in the Interpretation.

In December 2003, the Board issued a revised Interpretation No. 46 (unofficially referred to as Interpretation No. 46R). Two of the seven FASB Board Members dissented based on their conclusion that the revised Interpretation still lacked clarity in offering guidance as to how to implement the new rules.

Subsequently, the FASB issued FASB No. 167, *Amendments to FASB Interpretation No. 46R: Consolidation of Variable Interest Entities- An Interpretation of ARB No. 51*(FASB ASC Topic 810), to make further changes to FIN 46R but added little additional guidance on how to implement it except that it expanded the number of examples within its appendix.

In its final and revised form, Interpretation No. 46R makes dramatic changes to the landscape for consolidating variable interest entities (VIEs).

As a result, many entities may be required to consolidate VIEs that they supported even though they have no equity ownership in them. Even non-public entities will be impacted by the new rules under which many operating companies will be required to consolidate with related-party entities with which they are engaged in leasing transactions, shared operating expense arrangements, cross-guarantees of bank loans, and subordinated inter-company debt.

What is a VIE?

Interpretation No. 46R is built around the premise that, if certain criteria are met, an off-balance sheet entity (referred to as a VIE) should be consolidated with the entity that provides the majority of its financial support.

A VIE is <u>not self-supportive</u> in that it cannot finance its activities without additional financial support from another entity or individual such as through loans, guarantees, above-market leases, etc.

> **Example:** A company is not able to obtain bank financing without an affiliate guaranteeing its bank loan. Interpretation No. 46 states that because the company must receive additional financial support from others (e.g., in this example, in the form of another entity guaranteeing its loan), it is not self-supportive. Thus, it is a VIE. If certain other criteria are met, the VIE must be consolidated with the entity that gives it the majority of its financial support.

Not all off-balance sheet entities are VIEs, and those that are not, should not be consolidated under the Interpretation. In fact, many off-balance-sheet entities are not VIEs because they are self-supportive and can easily finance their activities without additional financial support from another entity or individual. A non-VIE is never consolidated under Interpretation No. 46R and is only consolidated if another entity owns more than 50% of its voting stock, as required by ARB No. 51. The following chart summarizes the way in which the reader should look at the term VIE as used throughout the remainder of this chapter:

Off-Balance Sheet Entities		
Type of off-balance sheet Entity	**General description**	**Rules –Interpretation No. 46R**
Variable interest entity (VIE)	Is not self-supportive- cannot finance its activities without additional subordinated financial support from others (e.g., guarantees, subordinated loans, etc.)	*May* have to be consolidated under Interpretation No. 46 if certain other criteria are met.
Non-variable interest entity (Non-VIE)	Self-supportive- can finance its activities without additional subordinated financial support from others.	*Not* required to be consolidated under Interpretation No. 46. Consolidated only based on the traditional consolidation rules (more than 50% ownership in voting equity.)

B. General Rules of Interpretation No. 46R

I. Application of the Interpretation:

Interpretation No. 46 supersedes all of the SPE rules for consolidation that existed before the Interpretation's issuance. Thus, the 3% rule and the special rules for consolidating leasing companies no longer exist, and instead, are replaced with the new Interpretation 46 rules as follows:

1. The term special-purpose entity (SPE) is superseded by the term "*variable interest entity (VIE).*" Typically, VIEs are involved in:
   - Leasing arrangements, including sales with leasebacks (referred to as synthetic leases)
   - Financing arrangements with third party financial institutions to fund acquisitions of certain assets or businesses
   - Management of certain receivables or investments
   - Research and development and other project development activities
   - Hedge activities to manage risk
   - Management services
   - Distribution services

2. The new rules apply to *all entities* and include any type of entity that is a legal structure used to conduct activities or to hold assets such as corporations, partnerships, limited liability companies, grantor and other types of trusts.

II. Rules of the Interpretation:

Interpretation 46 requires that one entity (the primary beneficiary) consolidate another entity (the variable interest entity (VIE)) if the primary beneficiary provides the majority of financial support for the VIE. Thus, the Interpretation expands the consolidation rules found in ARB No. 51 (based on more-than-50% ownership) to require consolidation based on *financial support*.

Interpretation No. 46R is built on the premise that an entity (the primary beneficiary) that provides the *majority of financial support* to another entity (the VIE) is acting as a "*defacto owner*" even if that primary beneficiary has no ownership in the VIE. Therefore, in substance, the entity providing the majority of financial support should consolidate the VIE as if it were the majority owner of the VIE's equity.

1. Basic Rules for Consolidation- 3 Requirements

In order for one entity to consolidate an off-balance sheet entity under Interpretation No. 46, there are *three requirements* that must be met:

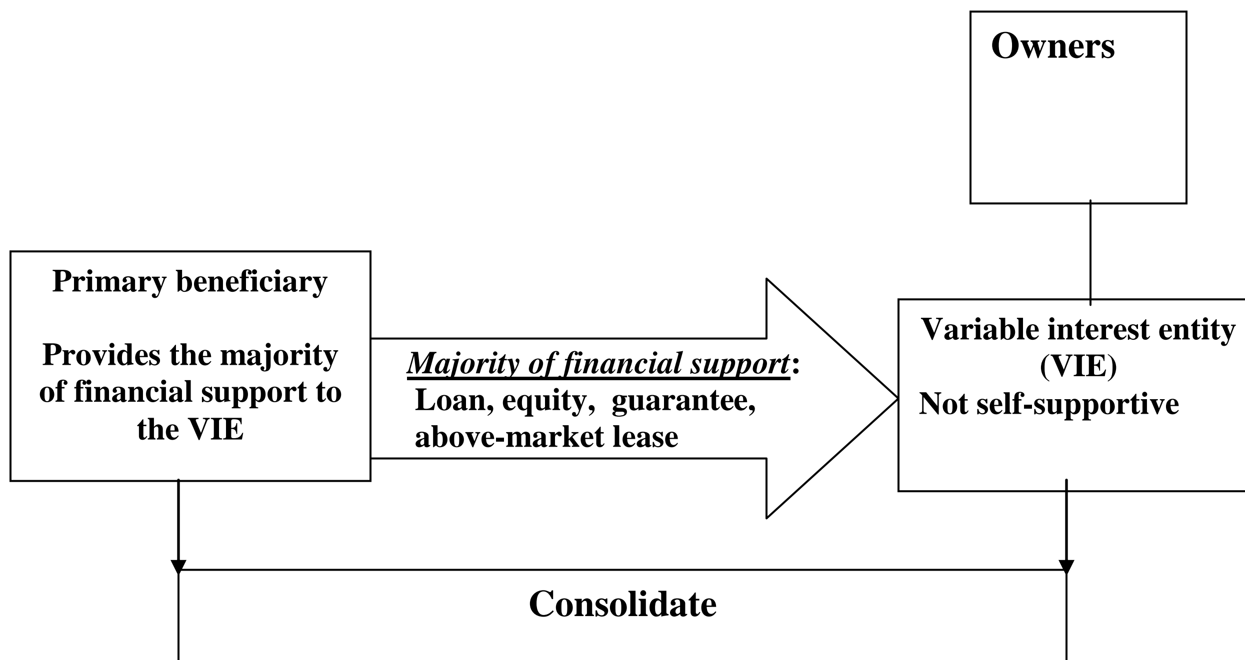
Requirement 1: There must be a *variable interest entity (VIE)* *(off-balance sheet entity that is not self-supportive)*

Requirement 2: Reporting entities and/or individuals must have *variable interests* in the VIE (e.g., provide subordinated financial support to the VIE through equity, loans, guarantees, etc.)

Requirement 3: A reporting enterprise must be the *primary beneficiary* of the VIE by having a controlling financial interest in that VIE through other than majority ownership.

If all *three requirements are met* and if an entity is the primary beneficiary, it *must consolidate the VIE*.

- If an individual (rather than an entity) is the primary beneficiary, there is no consolidation required of the VIE.
- If all three requirements are not satisfied, no consolidation of the VIE is required.
- If an entity has a variable interest in another entity, but the entity is not the primary beneficiary, consolidation is not required but certain disclosures must be made. A discussion of disclosures is made later on in this chapter.



Example: Company V is a variable interest entity (VIE) in that it is not self supportive. Company P has given a loan to V to help support it. The loan is a variable interest in V in that it is a form of financial support. Through its loan to V, P provides the majority (more than 50%) of the financial support for V.

Conclusion: Even though P has no equity investment in V, P must consolidate V because:

- V is a VIE in that it is not self-supportive.
- P has a variable interest in V in that it gives V some additional financial support through a loan to V.
- P is the primary beneficiary of V in that it gives V the majority of V's financial support.

Requirement 1: **There must be a *variable interest entity (VIE)***

1. Definition of a VIE:

The Interpretation provides a formal definition of a VIE.

An entity is considered a VIE if either:

a. *Its total equity (at fair value) is not sufficient* to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.

   1) Examples in which an entity's total equity is not sufficient include:

- The entity does not have enough equity to fund its expected losses without additional financial support such as loans, guarantees, etc.

- The entity is unable to obtain outside non-recourse financing from an independent third party (such as a bank or other lender), without additional financial support from other parties.

  Additional subordinated financial support (referred to as variable interests) may come in the form of any of the following:
  - Guarantees of the entity's loans from lenders
  - Management fees
  - Above-market lease payments
  - Subordinated (intercompany) loans
  - Distribution of the entity's products by contract or other agreement
  - Management or other services

2) Equity includes any investment that is *classified in the stockholder's equity* section of the balance sheet, including both common and preferred stock.

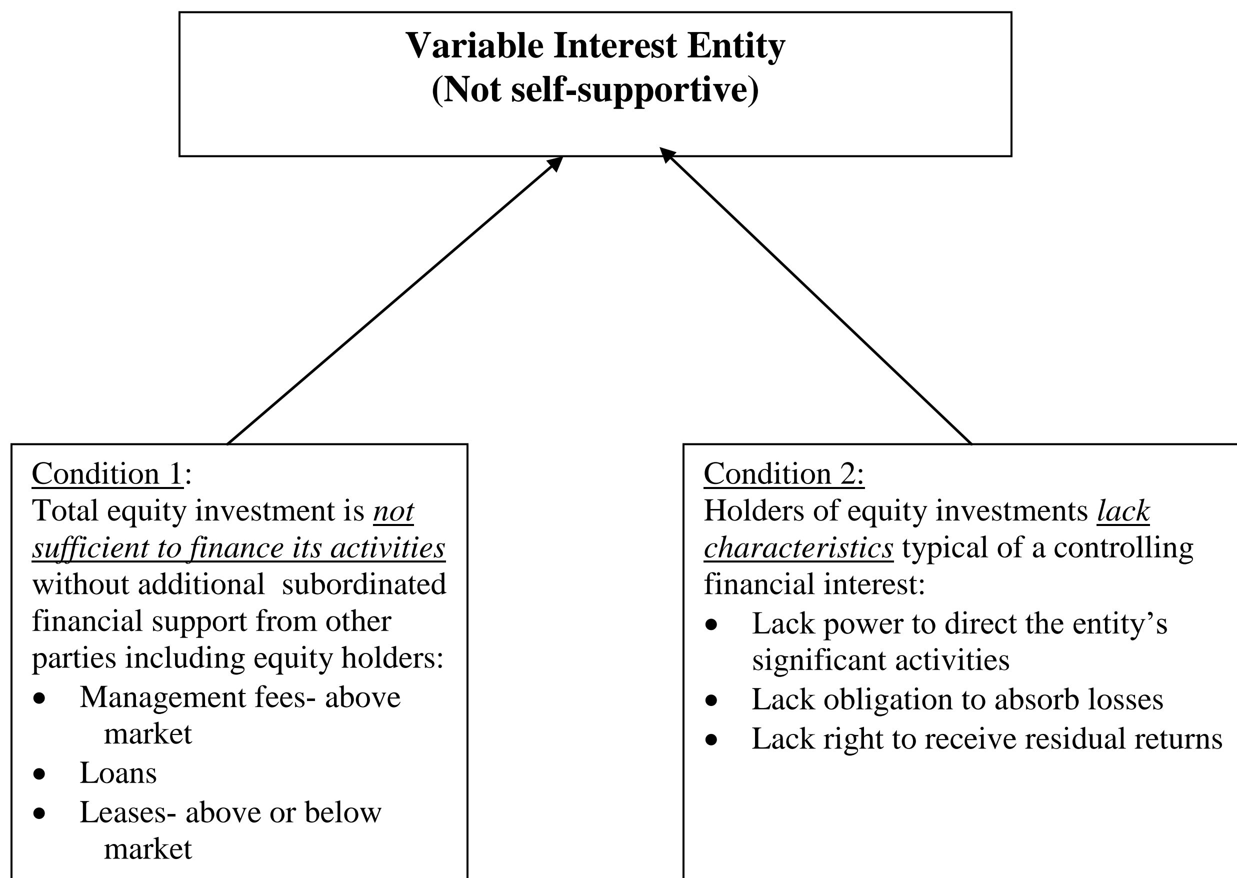
b. As a group, the holders of the entity's equity outstanding lack the typical risks and rewards of majority ownership.

1) They lack any one of the following *three characteristics* that are typical of a controlling financial interest:

a) Lack the *power* through voting rights or similar rights to *direct* the entity's activities that most significantly impact the entity's economic performance.

b) Lack the *obligation to absorb the expected losses* of the entity.

c) Lack the *right to receive* *expected residual returns* of the entity.



Example: In order to receive a bank loan, an entity must obtain a guarantee of its loan from its shareholder or an affiliate.

Conclusion: The entity's equity is not sufficient because it must obtain additional financial support (e.g., guarantees) in order to obtain the outside bank financing. Thus, the entity may be a VIE.

Example: An entity's equity is not sufficient to absorb its expected losses.

Conclusion: Because the entity's equity cannot absorb any expected losses, it is not sufficient to finance its activities. Therefore, the entity may be a VIE.

The Interpretation provides several methods by which any entity can demonstrate it has sufficient equity to finance its own activities without additional financial support. There is also 10-percent presumption rule which is discussed below.

What if an entity is not a variable interest entity (VIE)? Is consolidation ever required?

No. If an entity is not a VIE, there is no consolidation required of the off-balance sheet entity under Interpretation No. 46. By not being a VIE, the entity has demonstrated that it is self-supportive. Therefore, if an entity is not a VIE, it is not consolidated under Interpretation No. 46.

The only way it would be consolidated is under the existing consolidation rules; that is, if another entity owns more than 50% of the entity's voting stock.

Requirement 2 for Consolidation: Entities and/or Individuals Must Have Variable Interests in the VIE

If an entity is not a VIE, there is no need to continue with any additional effort because the entity shall not be consolidated under the Interpretation. Instead, the only way it will be consolidated is based on majority ownership (more than 50% ownership) under ARB No. 51 and FASB No. 94.

Assume, instead, that in Requirement 1, the entity is deemed to be a VIE in that either it does not have sufficient equity or its owners do not have the typical risks or rewards of ownership. If so, Requirement 2 is to identify those parties that hold variable interests in the VIE (variable interest holders); that is, the entities or individuals that provide financial support to the VIE. Only a variable interest holder can consolidate with a VIE.

1. **Definition of a variable interest**:

   a. A *variable interest* is defined as a contractual, ownership, or other pecuniary interest in a VIE that changes with changes in the fair value of the VIE's net assets, exclusive of variable interests.

   b. A variable interest is a means through which *one entity (or individual) provides financial support to a VIE* that could result in the providing entity (or individual):

      1. Absorbing a portion of the VIE's expected losses, or

      2. Receiving a portion of the VIE's expected residual returns.

   c. Examples of variable interests *include*:

      - Equity investments in a VIE are variable interests to the extent that they are at risk

      - Guarantees

      - Debt of all kinds including subordinated and senior debt, including bank loans

      - Certain service and management contracts that are above-market value

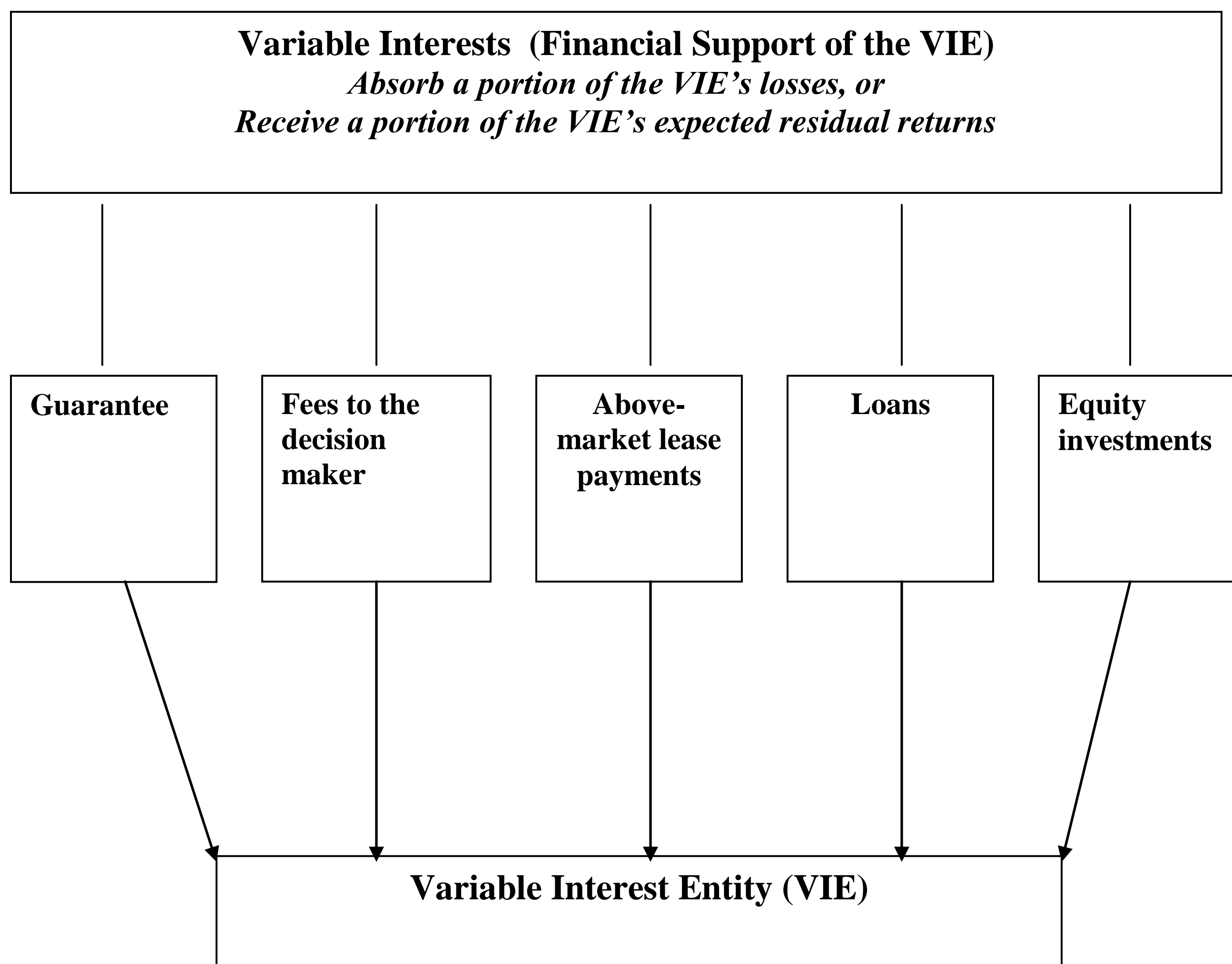
      - Leases that are above-market value, and/or have a residual value guarantee, or an option to acquire leased assets at the end of the lease term

      - Distribution contracts that are above or below-market

d. A <u>*variable interest*</u> excludes:

- Equity investments in a VIE that are not at risk or do not absorb or receive some of the entity's variability
- Market-value leases that have no residual value guarantee or option to purchase the leased property
- Trade receivables and payables in the normal course of business
- Casual purchases and sales at market value

Types of Variable Interests in a VIE



Requirement 3 for Consolidation: Determine the Primary Beneficiary of the VIE:

The third and final requirement to consolidating a VIE is to identify the enterprise that will consolidate the VIE.

a. The general rule is that a reporting enterprise shall consolidate a VIE when that reporting enterprise has a variable interest (or a combination of variable interests) that provides the reporting enterprise with a *controlling financial interest* in the VIE.

b. The reporting enterprise that holds the controlling financial interest in a VIE is called a *primary beneficiary*.

Essentially, the primary beneficiary is the entity or individual that has a controlling financial interest in the VIE. and, therefore, consolidates that VIE. If the primary beneficiary is an entity, it consolidates the VIE into its financial statements. If the primary beneficiary is an individual, no consolidation of the VIE is required.

In many instances, an individual is the primary beneficiary. In such a case, the VIE will not be consolidated because an individual does not consolidate even if it issues personal financial statements. In reality, an individual is not going to perform a test to determine whether it is the primary beneficiary because, the result has no impact on the individual; that is, the individual does not consolidate the VIE in any case. Instead, only a variable interest holder that is an enterprise will test the VIE to determine if the enterprise is the primary beneficiary that should consolidate the VIE.

1. Definition of a primary beneficiary:

FIN 46R defines a *primary beneficiary* as the following:

> An enterprise or individual is considered *the primary beneficiary* of the VIE if it has a variable interest (or a combination of variable interests) in a VIE and has a *controlling financial interest* in that VIE.

An entity has a controlling financial interest in a VIE if it has *both* of the following criteria:

a. The *power* to direct the activities of a VIE that most significantly impact the entity's economic performance (the power criterion), and

b. *The obligation* to absorb losses of the VIE or the *right* to receive benefits from the VIE that could potentially be significant to the VIE (the loss/benefits criterion).

Although many variable interest holders may have to test to determine whether they are primary beneficiaries, *only one enterprise or individual* can ultimately be deemed the primary beneficiary.

Note: There may be many variable interest holders that may have an obligation to absorb some of the losses of the VIE or have the right to receive some of the benefits from the VIE (loss/benefits criterion in (2) above), there is only enterprise or individual, if any, that has the power to direct the activities of a VIE that most significantly impact the entity's economic performance (power criterion in (1) above).

2. Rules for determining the primary beneficiary:

Each variable interest holder must perform its own assessment of whether that reporting enterprise has a controlling financial interest in the VIE and thus is the primary beneficiary.

a. A *controlling financial interest* is achieved if the holder has:

   1) The power to direct the activities of a VIE that most significantly impact the entity's economic performance (power criterion), and

   2) The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (losses/benefits criterion).

b. The assessment should be performed first at the time when a reporting enterprise obtains a variable interest (or combination of variable interests) in a VIE, and should continued on an ongoing basis while the entity is a variable interest holder.

c. The assessment of whether the holder has a controlling financial interest includes a review of several factors:

   - the characteristics of the reporting enterprise's variable interest(s) in the VIE
   - involvement of the reporting enterprise's related parties and de facto agents, and other variable interest holders in the VIE
   - the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders.
   - ***the extent to which the reporting enterprise was involved in the initial design of the VIE including preparing the governing documents.***
   - which activities most significantly impact the entity's economic performance and determine whether is has the power to direct those activities.

   Observation: In assessing whether it is the primary beneficiary that has a controlling financial interest in a VIE, a variable interest holder is required to review several factors noted above. One key factor is the extent to which the reporting enterprise (variable interest holder) was involved in the initial design of the VIE including whether that reporting enterprise prepared the governing documents.

   In its comments, the FASB observed that if the reporting enterprise is involved in designing the VIE, the reporting enterprise may be able to establish a design that provides power for the reporting enterprise to direct the significant activities of the VIE. Moreover, that reporting enterprise may have an explicit or implicit financial responsibility to ensure that the VIE operates as designed including an implicit agreement to fund the VIE's losses to protect the reporting enterprise's reputation.

   Further, if that same reporting enterprise is involved in establishing the VIE's governing documents, the reporting enterprise may have power through its ability to establish decision making authority inside those governing documents.

In the end, the FASB stated that a reporting enterprise's involvement in the design of the VIE and/or establishment of the governing documents are not determinative in identifying the reporting enterprise as the primary beneficiary. Instead, in such situations there should be increased scrutiny of whether that reporting enterprise has power over a VIE as a result of its explicit or implicit financial responsibility to ensure that the VIE operates as designed.

d. A reporting enterprise is also required to perform a test to determine whether an entity in which it has a variable interest is actually a VIE.

Note: Recall that in performing an assessment, each variable interest holder, in addition to performing a test to determine whether it is the primary beneficiary of the VIE, must also perform a test to determine whether the entity is a VIE. If it is not a VIE, the test as to whether the variable interest holder is a primary beneficiary is moot. Therefore, if there are several variable interest holders, each would perform a separate test of the VIE and, presumably, each could arrive at a different conclusion as to whether the entity is a VIE and whether the holder is the primary beneficiary that should consolidate that VIE.

e. There can be *only one primary beneficiary* of a VIE.

Observation: Inherent in the application of FIN 46R is the risk that two variable interests holders, with the same facts, could each reach the same conclusion that it is the primary beneficiary of the same VIE. The result is that the same VIE could be consolidated with two different variable interest holders.

Note further that in some instances, there will be no primary beneficiary that consolidates a VIE. Examples include:

- An individual is considered the primary beneficiary and does not consolidate the VIE.
- One variable interest holder meets the "power" criterion, while another satisfies the second criterion, obligation to absorb losses or right to receive benefits, but no party satisfies both criteria.
- A party meets the power criterion but holds no variable interest in the VIE and does not satisfy the second criterion.
- Power is shared among various parties.

f. Reconsideration of primary beneficiary status:

1) A variable interest holder is required to continually reconsider whether it is the primary beneficiary of a VIE.

Note: FASB No. 167 requires that a variable interest holder reconsider whether it is a primary beneficiary on a continued basis. This is a departure from the originally issued FIN 46R which requires that reconsideration be done when certain triggering events occur such as a change in the governing documents or if the primary beneficiary sells all or a part of its variable interest.

FASB No. 167 does not address how often a variable interest holder must reconsider whether it is the primary beneficiary. Presumably, a new assessment should be done at least once per year and at a time that gives the reporting enterprise time make any necessary adjustment (consolidation or deconsolidation) in time to issue its annual financial statements.

3. Tie-breaker rule for related parties

FIN 46R provides a tie-breaker rule as a method to determine the primary beneficiary among several related parties.

The tie-breaker rule applies only if there are several related parties, and no party within the group satisfies both criteria to being a primary beneficiary (the power criterion and losses/benefits criterion), but as a group, both criteria are met. Thus, collectively the related parties satisfy the two criteria for being a primary beneficiary but individually, no one party within the group meets both criteria.

The tie-breaker rule works like this:

1. If a reporting enterprise concludes that neither it nor any other of its related parties individually satisfies the two criteria to be a primary beneficiary, but, as a group, the enterprise and its related parties (including de facto agents) do satisfy the two criteria, the tie-breaker rule shall be used to determine which party within the related party group is the primary beneficiary that consolidates the VIE.

2. Under the tie-breaker rule, the related party that is designated to be the primary beneficiary is the party within the related party group, that is *most closely associated with the VIE*.

3. The determination of which party within the related party group is most closely associated with the VIE requires judgment and should be based on an analysis of all relevant facts and circumstances including:

   a. The existence of a principal-agency relationship between parties within the related party group.

   b. The relationship and significance of the activities of the VIE to the various parties within the related party group.

   c. A related party's exposure to the variability associated with the anticipated economic performance of the VIE.

   d. The design of the VIE, such as the purpose for which the entity was created.

Observation: The FASB's inclusion of the "most closely associated" provision within the tie-breaker rule is ambiguous and gives a group of related parties tremendous latitude in designating a primary beneficiary to consolidate a VIE. In the first Interpretation, the determination was based on "activities most closely associated with the VIE." In the revised Interpretation, the concept of activities was eliminated and replaced with "the related party most closely associated with the VIE." What does this mean? FIN 46R gives little guidance on how to select the finalist as the primary beneficiary among a group of related parties. Factors it does include are:

a. The existence of a principal-agency relationship between parties within the related party group.

b. The relationship and significance of the activities of the VIE to the various parties within the related party group.

c. A related party's exposure to the variability associated with the anticipated economic performance of the VIE.

d. The design of the VIE, such as the purpose for which the entity was created.

After the initial Interpretation was issued, the FASB Staff reviewed a series of case studies submitted to them in which conclusions were reached as to which entity had activities most closely associated with those of the VIE. In many instances, the FASB Staff determined that the conclusions reached were not consistent with the intent of the FASB. That is, in many instances, the wrong entity or individual was selected as having activities most closely associated with the VIE, and thus, the wrong entity or individual was deemed the primary beneficiary.

In the revised Interpretation, the FASB decided to make the "most closely associated" criteria vague. By doing so, entities have greater flexibility to determine which entity or individual is most closely associated with the VIE and would be able to evaluate all facts and circumstances in making that decision.

The author takes a different view and believes the four criteria noted above are ambiguous and will lead to varied selections of an entity or individual as a primary beneficiary. Because the conclusion as to which entity or individual is most closely associated with the VIE has a pervasive effect of consolidating or not consolidating a VIE, the author believes that the FASB should have provided more definitive criteria.

An important factor considered in determining whether one enterprise or individual is most closely associated with a VIE, is the design of the VIE (the fourth factor): that is, the reason why the VIE was created in the first place and the purpose for which it serves. For example, if a real estate LLC is created for the sole purpose of leasing real estate to a single related-party tenant, that one factor suggests that the operating entity may be most-closely associated with the real estate LLC. Of course, all factors must be considered in total.

Although the tie breaker rule has been provided by the FASB to assist in the selection of which party within a related party group is the primary beneficiary, its use will be limited. The reason is because in order for the tie breaker to work, one related party must satisfy the "power" criterion, who another related party satisfies the "losses/benefits" criterion. In most cases, you will find that one related party satisfies both criteria thereby having no need to break a tie.

4. The Lease Issue-Implicit Variable Interests

Perhaps one of the most confusing elements of the 46R rules is determining whether a lessee is required to consolidate a lessor who is a VIE. FIN 46R provides limited guidance on dealing with

lease-related transactions, and certainly does not specifically address the numerous permutations that exist in such lease structures

For example,

How should a lessee deal with a lease that includes a residual value guarantee, option to purchase, or renewal options?

Should the accounting for a lease be different if the lease is above- or below-market value as compared with market value?

In this section, the author reviews various lease situations, separating them into those leases involving unrelated parties versus related parties. Because there is limited authority, many of the conclusions reached by the author in this section are non-authoritative and based on discussions the author has had with FASB staff members and others. Further, some of the conclusions reached may differ from those opinions given by other authors and commentators. Remember that FIN 46R was written under the umbrella of principle-based accounting under which no hard and fast rules are supposed to apply and the user is required to look at the economic substance of the transaction instead of its form.

Operating lease- unrelated parties:

If the lessor and lessee are not related parties, the general rules follow, from the lessee's perspective. Assume that the lessor is a VIE.

1. If the lease is at a market rate and terms for a similar property in the same general geographic location, and there is no residual guarantee, no option to purchase at a fixed or predetermined price, or no lease renewal option at a fixed or predetermined lease amount, then the lease is not a variable interest, and the lessee is not the primary beneficiary that consolidates the lessor VIE.

2. If the lease terms are above- or below-market value, the lease is a variable interest.

3. If the lease (regardless of whether the lease is at market value or not) has any of the following, the lease is a variable interest and the lessee could be the primary beneficiary that consolidates the lessor VIE:

   - Residual value guarantee
   - Option to purchase the property at a fixed or predetermined price, or
   - Lease renewal option at a fixed or predetermined lease amount for a term that is beyond the lease term.

Thus, a straight market-value lease with no variability through a residual value guarantee, no option to purchase at a fixed or predetermined price, or lease renewal option at a fixed or predetermined rate, is not a variable interest.

If, instead the lease deviates from market value (e.g., above- or below-market value terms), and/or has a residual value guarantee, an option to purchase at a fixed or predetermined price, or a lease

renewal option at a fixed or predetermined lease amount for a term beyond the lease term,, that lease is a variable interest. If the lease is a variable interest, the lessee could be the primary beneficiary.

Operating lease- related parties:

Not all related party leases result in the lessee consolidating the lessor VIE. Nevertheless, the rules are slightly different than those for unrelated party leases and more related-party lessees will consolidate the related party lessor VIE if certain conditions are met. In many instances, leases among related parties may have a result that is different than leases among unrelated parties..

Before looking at the rules for operating leases involving related parties, let's review the *implicit variable interest rules* that the author addressed earlier in the course and that may impact the determination as to whether a related-party lessee consolidates its lessor VIE.

The general concepts of an implicit variable interest follow:

1. If an enterprise has an *implicit variable interest* in a VIE, the enterprise (e.g., operating entity) may be required to absorb the variability of the VIE or potential VIE.

   Example: Through its relationship with a common owner guarantor, an operating company may be called upon to satisfy the owner's guarantee of a VIE's debt.

2. An implicit variable interest (e.g., indirect guarantee) acts the same as an explicit variable interest (direct guarantee) except that an implicit variable interest involves absorbing and/or receiving the variability indirectly from the VIE, rather than directly from the VIE.

3. If an enterprise has an implicit variable interest in a VIE, the enterprise could be considered the primary beneficiary of the VIE.

The following fact pattern is used to deal with the related-party leasing rules:

Assume:
- Company X (an LLC) is a lessor and a VIE.
- Company Y (an LLC) is a related party lessee of the real estate held by X.
- John, is the 100% individual owner of both X and Y.

Rules for related party leases from the perspective of the lessee (Company Y).

1. If the lease has a market value rate and terms, with no residual value guarantee, no option to purchase at a fixed or predetermined price, and no lease renewal option at a fixed or predetermined lease amount, the following rules apply:

   a. If there are no guarantees of X's debt by John or Y (lessee), then Y is not the primary beneficiary of X and does not consolidate X.

   b. If there is a guarantee of X's debt by Y, then Y is the primary beneficiary and consolidates X.

c. If there is a guarantee of X's debt by John only:

- Y has an implicit guarantee of X's debt and is the primary beneficiary that consolidates X if it is likely that John will have to call upon Y to satisfy John's guarantee if that guarantee is called by the lender.

- Y does not have an implicit guarantee of X's debt and is not the primary beneficiary that consolidates X if it is not likely that John will have to call upon Y to satisfy John's guarantee if that guarantee is called by the lender.

2. If the lease has any of the following elements (regardless of the other terms of the lease), the Y (lessee) is the primary beneficiary and consolidates X regardless of whether X's loan is guaranteed by John and/or Y.

   a. The lease is above or below market value.
   b. The lease has a residual value guarantee.
   c. The lease has an option to purchase at a fixed or predetermined price, or
   d. The lease has a renewal option(s) at a fixed or predetermined lease amount for a lease period beyond the base lease term.

Observation: In general, if there is a related-party lease (market rate lease with no option, no residual value guarantee or renewal option), the lease is not a variable interest and the lessee does not consolidate X, as long as John (the owner) and/or the lessor are not guaranteeing X's debt.

If, instead, John is guaranteeing the debt and it is likely that John may have to call upon Y to satisfy its guarantee obligation if the lender calls that guarantee, that guarantee is assigned to Y (the lessee) as an implicit guarantee of X's debt. Once Y has an implicit guarantee of X's debt, Y is the primary beneficiary and consolidates X.

Initial test and measurement of the VIE by the primary beneficiary:

The rules for initial testing and measuring the VIE by the primary beneficiary vary depending on whether the VIE is under common control or not.

a. *First step: Determining whether an entity is a VIE, and whether a variable interest holder is the primary beneficiary:*

The test to determine whether an entity is a VIE, and whether a variable interest holder is the primary beneficiary is performed at the time the variable interest holder becomes *involved* with the VIE.

1. The term "*involved*" is not defined in the Interpretation, but presumably means the time at which an entity first develops a variable interest in the VIE that requires testing to determine whether the variable interest holder is the primary beneficiary of the VIE.

2. The initial test is done based on *the fair value* of the VIE's assets and equity.

b. <u>*Second step: Initial measurement (consolidation) of the VIE by the primary beneficiary:*</u>

Once an entity determines that it is the primary beneficiary of a VIE (step 1 above), the next step is that it must consolidate the VIE into its financial statements. Note, that if the primary beneficiary is an individual, no action is required because an individual does not consolidate a VIE in the individual's personal financial statements.

The initial measurement (consolidation) of the VIE's financial statements into the primary beneficiary's financial statements depends on whether the primary beneficiary is under <u>*common control*</u> with the VIE, or not.

1. <u>*Entities not under common control*</u>*:*

If the primary beneficiary and VIE are not under common control, the primary beneficiary of a VIE shall initially measure the assets, liabilities, and noncontrolling interests of a newly consolidated VIE at their <u>*fair values at the date the entity first becomes the primary beneficiary*</u>.

- <u>*Excess gain*</u>: If there is any excess of the fair values of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the VIE, over the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, the resulting gain must be allocated and reported as a pro rata adjustment of the amounts that would have been assigned to all of the newly consolidated assets as if the initial consolidation had resulted from a business combination.

  The allocation of the excess gain should be based on the rules found in paragraphs 44 and 45 of FASB No. 141, *Business Combinations.*

- <u>*Excess loss*</u>: If there is any excess of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, over the fair value of newly consolidated identifiable assets and the reported amount of identifiable assets transferred by the primary beneficiary to the VIE, the resulting loss must be reported in the period in which the entity becomes the primary beneficiary as:

  - Goodwill, if the VIE is a business[21]
  - An extraordinary loss, if the VIE is not a business.

  Fair value of the VIE is determined exclusive of goodwill and assigned to VIE assets and liabilities of the VIE, except for goodwill.

2. <u>*Entities under common control*</u>*:*

[21] The definition of a business was discussed earlier on in this course.

If the primary beneficiary and the VIE *are under common control* (e.g., same majority shareholder or owners), the primary beneficiary must initially consolidate the VIE's assets, liabilities and noncontrolling interests at their *carrying value* in the financial statements of the entity that controls the VIE- assuming that entity's financial statements were prepared on a GAAP basis.

- Assuming no other entity has been consolidating the VIE prior to the time the primary beneficiary must consolidate the VIE, the primary beneficiary consolidates the *VIE's carrying value (e.g., book value.)*

- Similarly, assets and liabilities transferred from the primary beneficiary to that VIE are transferred (at, after, or shortly before the date that the entity becomes the primary beneficiary) at the same value at which they were carried by the primary beneficiary. No gain or loss is recognized by the transfer even if the entity was not the primary beneficiary until shortly after the transfer occurred.

c. The principles of consolidation apply to the primary beneficiary's accounting for the consolidated VIE.

- After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE are accounted for in the consolidated financial statements as if the entity were consolidated based on voting interests.

- Specialized accounting requirements related to the type of business in which the VIE operates should be applied as they would be applied to a consolidated subsidiary.

- Intercompany balances, transactions, income and expenses should be eliminated, and rules for consolidations found in ARB No. 51 should be followed.

- Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE, and the resulting effect of that elimination on the net income or expense of the VIE *shall be attributed to the primary beneficiary* (and not the noncontrolling interests) in the consolidated financial statements.

  - The VIE's stockholders' (or other) equity should be presented as a *minority interest* in the stockholders' equity section of consolidated balance sheet.[22]

  - **Note:** Using the parent entity method, the minority interest is presented *outside stockholders' equity between debt and equity*.

  - Intercompany eliminations are assigned to the primary beneficiary and not the VIE.

[22] The Interpretation does not state where the VIE's stockholders' equity should be presented in the consolidated balance sheet. Because there is no elimination of the equity against an investment account, the only logical place in which to present the VIE's stockholders' equity is to present it as part of a minority interest. The author has verified with the FASB Staff that they believe the VIE should be treated as a minority interest.

Observation: The Interpretation deviates from ARB No. 51 with respect to the elimination of intercompany profit and loss. ARB No. 51 states that the elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests. Yet, Interpretation No. 46 follows a different tact by requiring the effect of any elimination to be eliminated fully against the primary beneficiary. Thus, the minority interest remains untouched.

Post-Enron Change 4: Various Changes From Enron

The impact of Enron, continues to be felt even several years after the filing of its bankruptcy. Some of the post-Enron changes that have and continue to occur include the following:

1. Pension and 401(k) changes
2. More accountability for boards and audit committees
3. Higher malpractice insurance rates
4. Higher audit fees
5. Testing the bulletproofing of the LLP
6. The cost of section 404 compliance is exceeding estimates
7. Some European companies are delisting from the U. S. exchanges
8. Smaller companies are fed up and going private

1. Pension and 401(k) changes:

There are ongoing changes being made in Congress to pensions and 401(k) plans. Common changes pending include:

1. Give employees more flexibility with their investments
2. Require companies to give employees adequate notice before there is a freeze on a withdrawal.
3. Allow employees to obtain investment advisors
4. Modifying the so-called "black out periods" within which employees are restricted from selling their company stock investments.

To deal with some of the pension plan changes, in August 2006, Congress passed and the President signed into law the Pension Protection Act of 2006 (PPA). The PPA revamps the ERISA funding requirements for single employer defined benefit pension plans, and is generally effective for plan years beginning in 2008. PPA does the following:

1. Expands funding requirements so that the minimum required contribution made by an employer is based on a formula that generally is equal to 100 percent of the present value of all benefit liabilities accrued as of the beginning of the current plan year.

2. Eliminates the practice of being able to smooth fluctuations in the market value of plan assets using a five-year average market value.

On the GAAP side, the FASB has made several changes to the accounting and disclosure requirements for pension plans. In December 2003, the FASB issued a revision of FASB No. 132,

Employers' Disclosures About Pensions and Other Postretirement Benefits. The revised FASB No. 132 (FASB No.132R) expands the disclosures required by defined benefit and post-retirement benefit plans to make information more transparent to retirees.

Specifically, FASB No. 132R expands the disclosures to include information about:

- The plan's assets, including major investment categories, and the percentage held in each category
- Description of the investment strategies and policies
- Basis used to determine the expected long-term rate of return on assumption, and other information.

The FASB made further changes to the accounting rules for defined benefit plans with the issuance of FASB No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. Specifically, FASB No. 158 requires an entity to record the funding status of a defined benefit plan; that is the difference between the accumulated (or projected) benefit obligation and the fair value of plan assets. The offset is to other comprehensive income.

2. Audit committees and Board Members:

If you were asked to become a member of the Board of Directors of an SEC company, would you? Would you accept a position on that company's audit committee?

Many existing board and audit committee members ask this question in light of the changes made by the Sarbanes-Oxley Act. In the post-Act environment, serving as a board member or on a company's audit committee may not be worth it for several reasons:

1. Under the Act, in the wake of the recent scandals, board and audit committee members are *required to spend much more time* in their capacity focusing on the new corporate governance rules and examining more data. Board members are *finding it difficult to find adequate time to serve on multiple boards* at the same time.

2. The Act *precludes* board and audit committee members from receiving *any personal benefit* from the company that it serves. The days of receiving consulting fees or contracts from the company that is served are gone.

3. *Liability claims* against board and audit committee members have risen.

4. Additional travel requirements play a toll on board and committee members.

For some board and audit committee members, the additional effort and risk relative to the compensation is simply not worth it. Consequently, many companies continue to have trouble attracting the best and brightest to serve on their boards. In a Wall Street Journal article, one board member noted that he will spend an additional 100 to 200 hours per year (total of 300 hours) serving as a board member as compared with prior years.[23]

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[23] *Meetings, Meetings, Meetings* (Wall Street Journal)

WorldCom directors settle claims

Perhaps the most shocking example of how directors can be held personally liable for their actions or lack thereof, was evident in the WorldCom settlement. Eleven former board members of WorldCom settled a claim against them that resulted in their paying $20.2 million out of their own pockets.

The WorldCom agreement represented the latest of several settlements that were made in a WorldCom class-action case brought in New York State against not only directors, but also underwriters, and Arthur Andersen. Other third parties, including more than a dozen banks agreed to settlements aggregating $6 billion in total.

What is so unusual about the WorldCom case as it relates to directors is this:

a. It is unusual for board members to have to pay personally to settle claims.

b. It is rare that claims about board members exceed the amount of D&O insurance in place. The D&O insurance company paid $35 million in addition to the $20 million paid by the directors.

What every director needs to know about the new post-Sarbanes environment

The landscape for directors has changed in the post-Sarbanes environment. Not only are directors having to invest more time into their duties, but they also face the unknown of having to be responsible for a set of rules under Sarbanes-Oxley, that have not been clarified by the SEC, PCAOB and the courts.

In a recent article entitled, *What Every Director Should Know About the New Environment*, the author makes the following observations about directors operating in today's business climate.

1. The Board's role in setting the tone for an organization's culture and its ethics has become increasingly more important.

2. With greater emphasis being placed on Sarbox compliance, board members need to be concerned about applying a "check the box" approach and reading the rules too narrowly.

3. The courts, in particular those in Delaware, are now shaping a new set of rules defining the "*good-faith obligation*" of directors.

4. There are generally two parts to the good-faith obligation:

    a): Duty of *loyalty* and *care*:

5. Courts are looking at directors' behavior more closely than ever.

    a) Board members need to:
        Come to board meetings prepared
        Have thorough discussions in the boardroom

Ask hard questions of management
Apply sound judgment to make the right decisions.

6. Board members must be actively engaged to search for outside information about their company.

   Note: The courts are holding that simply relying on company-generated information is insufficient.

7. Board members need to be educated on important "hot" topics such as executive compensation, etc.

8. There is greater pressure being placed on ensuring there is a separation between the CEO and chairman of the board.

9. There is greater importance on boards establishing a strong succession plan for its CEO and other executives.

What do the directors think about the new environment?

PWC published a study entitled, *What Directors Think.* The study was based on interviews of more than 1,200 corporate directors about how they are coping with the new demands on their time and talent.

Excerpts from the study follow:

a. Director compensation has increased for 60% of the respondents over the past 12 months.

b. 92% believe the audit committee chairman should receive additional compensation.

c. 77% believe that Congress should revisit the Sarbanes-Oxley Act and correct some of the unintended consequences.

d. 75% state their former CEO should not sit on the board.

e. 68% state that they believe their risk as a director has increased over the past 12 months.

In an article entitled *"Things to Do When Asked to Serve as a Director/Audit Committee Member (Besides Saying "No"),* the author provides some valuable insights into the future roles of audit committee and board members:

1. Audit committees bear increasingly greater responsibilities and public exposure these days, and committee members' duties are becoming more complex.

2. Audit committee members have greater exposure to litigation than Board members, yet do not get paid as much or not at all.

3. Audit committees should take several actions to protect themselves:

a. Always meet prior to each quarterly release to oversee the process.

b. Make sure the audit committee and board are involved in reviewing the MD&A.

c. Meet with the auditors.

4. Indemnification, exculpation and D&O insurance:

a. Make sure that the company has adequate insurance and that the duties and functions are limited.

The challenges of the audit committee

A role of greater risk than serving on the company's board is serving on its audit committee. In fact, the role of the audit committee chairman is by far, the riskiest of all board members. Historically, the audit committee, in particular its chairman, is responsible for safeguarding the integrity of the company's financial controls and disclosures. Now, under the Act, that responsibility has been enhanced with new corporate governance rules. In particular, audit committees must do the following:

1. Select and hire the external auditors

2. Review internal controls

3. Resolve accounting disputes and monitor disclosures

4. Select one audit committee member to be a designated "financial expert" who is familiar with GAAP.

CEOs beware- a lesson for all CEOs- the Ebbers WorldCom case

In March 2005, former WorldCom CEO Bernard Ebbers received a life sentence in being found guilty of securities fraud, conspiracy, and seven counts of filing false statements with the SEC.

What is most important about this case is not the verdict but rather the fact that the jury repudiated the "aw shucks" defense made by Ebbers. Specifically, Ebbers asserted that he was not aware of the billions of dollars of improper accounting adjustments being made and that as the CEO of a sizeable company, he was not responsible for the details that occurred below his position. [24]

The fact that Ebbers was such a detail-oriented executive that kept track of the cost of office coffee filters did not help his defense.

CEOs are on notice that basing a defense on the fact that the CEO did not know the details might not be sufficient to persuade a jury of the CEO's innocence. Kenneth Lay of Enron used a similar defense during his 2006 trial and was found guilt, prior to his death right after his sentencing.

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[24] AccountingWeb.Com.

Where are the audit committee prospects?

According to the Wall Street Journal, the greatest demand for audit committee members is coming from retired partners from national CPA firms, as well former CFOs from SEC companies. Moreover, compensation for audit committee members, in particular the chairman, has risen significantly. In general, compensation consists of the following:

1. Board member annual fees range from $30,000 to $50,000 per member for between 200 to 300 hours of work per year, on average. (Average compensation per hour is $100 to $250).

2. On average, an audit committee chairman receives from $10,000 to $40,000 in additional compensation.

3. Offering stock options to audit committee members is out of favor for most companies.

How great is the personal liability exposure for a board member?

In her article, *So You've Been Asked to Sit on a Board of Directors: Are you Aware of Your Personal Liability*[25], author Claire A. King, JD, addresses the issue of personal liability for board members and officers. Directors and officers are subject to substantial risk of personal liability associated with lawsuits against them.

Possible claims against directors and officers include:

- Corporation makes a claim against former directors and officers for improper conduct while they were in office.

- Directors can sue other directors.

- Shareholders can sue directors and officers, individually or in a class action claim, for losses suffered by the corporation. Examples of claims include those for inaccurate or inadequate disclosure, and for statements made in private placement materials.

- Competitors can sue for unfair trade practices and anti-trust violations.

- Federal and state regulatory agencies can sue.

- If securities are involved, the Chairman of the Board, CEO and CFO are exposed to the greatest risk, however the Sarbanes-Oxley Act expands the risk to all directors and audit committee members.

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[25] Statistics and information from this section were extracted from So You've Been Asked to Sit on a Board of Directors: Are you Aware of Your Personal Liability, Claire A. King, JD, Director of Risk Management, Aon Insurance Services. © Aon Insurance Services, All Rights Reserved.

The most common plaintiff's group differs depending on whether the entity is public or non-public as follows:

Type of company	Most common plaintiff
Public entities	Shareholders- 47% of all claims
Non-public entities	Employees- 49% of all claims

Employment claims:

According to Ms. King, major liability exposure exists for directors and officers with respect to employee suits that include:

- Discrimination
- Harassment
- Retaliation[26]
- Wrongful termination due to breach of contract
- Assault and battery
- Defamation (slander or libel)
- Fraud

Officers, but typically not directors, can be held personally liable for their own actions or inactions against employees including those for harassment or discrimination.

The increases in D&O insurance premiums

Directors and officers (D&O) insurance has been rising at an alarming rate and expected to continue to increase. Although the new Sarbanes-Oxley requirements on board members and audit committee members are primarily to blame for the premium increases, insurance rates have increased across the board for both SEC and non-public entities.

The increase in premiums does not mean that the coverage is better. On the contrary, higher D&O insurance premiums have been coupled with *restrictions of coverage*.

Restrictions placed by some carriers on coverage include:[27]

- Increases in premiums of 200 to 400%
- Increasing deductibles from $1 million to $5 or 10 million or from $5 million to $25 million for larger companies
- Reluctance to offer extended–period policies
- Triggering coverage only when a claim has been filed instead of when the accounting issue is discovered. If the claim is filed after the policy ends, there is no coverage

[26] The Sarbanes-Oxley Act makes retaliation against informants in securities fraud cases, a criminal offense.
[27] *Cover Me* (CFO)

- Excluding certain acts from coverage such as:
    - Intentional wrongful acts
    - Earnings restatement
    - Corporate entity coverage

Board and audit committee members are taking control of their legal protection by applying two steps in their due diligence prior to accepting an appointment to a company's board or audit committee:

1. Members are now requiring the company to *indemnify the director for damages incurred in his or her capacity as a director*.

    a. An indemnification agreement will not protect the officer or director in certain situations such as:
        - In bankruptcy, liquidation or the inability to pay
        - If such payment is against public policy
        - If the bylaws or corporate charter do not provide for such an indemnification provision.

2. Members are insisting that the company demonstrate that the company's *D&O insurance is adequate and in full effect*.

    a. Homeowners and personal umbrella policies generally do not cover personal liability of corporate officers and directors.

    b. Directors and officers might want to obtain a second policy that is owned by the director or officer, personally, which will be triggered to the extent that the corporate policy is not paid.

    c. D&O coverage should be separate from other insurance such as employment practices liability (EPL) insurance.

An indemnification agreement from a company to its directors or board members is only as good as the viability of the entity. Thus, the quality of the D&O insurance in effect becomes very important in protecting the directors.

D&O Insurance:
Directors and officers liability insurance generally provides for coverage in the event there is a "wrongful act" by an officer or director while serving in his or her capacity as an officer or director.

Usually a policy provides three areas of coverage:
- Protection for the organization
- Reimbursement to the organization for a contractual obligation to indemnify directors and officers
- Coverage for the individual directors and officers.

Note: According to Aon Insurance, some D&O policies are endorsed to provide Employment Practices Liability (EPL) coverage. Yet, the EPL coverage may not provide for coverage that is separate from the D&O coverage. Thus, the D&O coverage is essentially reduced by the portion carved out for EPL coverage.

3. Higher malpractice insurance rates:

Small firms and large alike continue to pay the price for the Enron disaster. The Big Four are in a difficult position whereby rates are already rising so that there is less coverage at a higher cost. Although this should be a problem limited to the Big Four, unfortunately it has trickled down to all CPA firms. In fact, several writers of malpractice insurance have left the industry.

4. Higher audit fees:

It is clear that the CPA profession has made the audit a commodity, given to the lowest bidder. The result is that there has been pressure on firms to make audits more profitable by doing less work for fixed-fee engagements. With the amount of audit work likely to increase in the future, based on new auditing and accounting requirements, fees are expected to increase as well.

With the demise of Andersen and rampant lawsuits against the remaining Big 4 accounting firms, audit fees have continued to rise through 2006 until they started to level off in 2007 through 2009. During this period of time, the Big 4 also purged marginal clients from their client lists to eliminate the significant risk associated with auditing them. The current plateau of audit fees is certainly higher than a decade ago, indicative of the higher inherent risk associated with auditing a public company.

What is driving the change toward higher fees and more selective choice of clients are several factors including:

1. The problems with Enron, Worldcom and others placed auditing at the top of the high risk financial services.

2. Malpractice insurance rates have increased.

3. With the prohibitions in consulting services by the Sarbanes-Oxley Act, auditing is no longer considered a loss leader to generate consulting services. Instead, firms are treating auditing as a profit center with the need to increase hourly rates and fees to reflect greater risk.

4. With Sarbanes-Oxley and additional accounting and auditing standards, more time is being incurred to perform audits and assisting audit committees with implementing the Sarbanes requirements. Instead of absorbing that time as part of fixed audit fees, firms are passing along the additional cost to their clients.

The impact of the fee increases among the Big Four is good for smaller firms that have received ex-Big Four clients who switched for lower fees.

For smaller firms performing non-SEC audits, the pressure continue to be the greatest. Many of the changes to GAAP and auditing standards apply to all accountants and auditors, regardless of SEC or non-SEC work. Non-SEC clients will not necessarily have the pressure on them to perform a "better audit" since previous abuses have been usually limited to SEC company audits. Yet, the auditor of a non-SEC company is now required to perform additional procedures to perform the audit in accordance with generally accepted auditing standards. For example, the expanded audit work to deal with fraud requires all auditors to perform more work as it relates to discovering fraud. Who pays for it? For SEC auditors, they simply pass along the additional cost, blaming the extra work on Congress. For non-SEC auditors, many auditors absorb a portion of the additional cost as closely held clients push back on increases to that commodity called the audit.

Observation: Finally, the accounting profession is starting to receive the types of fees that it deserves for conducting audits. In general, firms have not been properly compensated for the amount of risk incurred in issuing an audit opinion. This is true for auditors of both public and non-public entities. Although SEC auditors clearly have a much easier time assessing higher fees to their audit clients in light of Sarbanes-Oxley's compliance requirements, the hope is that the higher SEC audit fees will ultimately set the benchmark for higher audit fees charged for non-public company audits. Once audit fees increase, fees for compilation and review engagements should follow.

5. The cost of Sarhanes compliance exceeded estimates

There have been numerous surveys conducted to determine the true cost of complying with Sarbanes-Oxley. In general, most studies evaluate the total cost as consisting of three components: a) audit fee, b) Section 404 compliance costs, and c) Other internal/external costs of compliance.

Although external fees to outside auditors and consultants can be quantified, determining the internal costs can be difficult and distortive depending on what assumptions are made.

Studies on costs have been made for the years through 2007 and 2008, with no data available for 2009.

Here is what appears to be the best information on costs:

Estimated Cost of Sarbanes-Oxley Compliance

Market capitalization	Estimated total costs*
Less than $75 million	$850,000
$75 million to $699 million	2.5 million
$700 million or greater	5.5 million

* Consists of external audit costs, Section 404 costs, and other internal/external costs.
Source: FEI Audit Fee Survey.

The cost of complying with Sarbanes has stabilized as of 2008 audits. Data for 2009 audits has not been published but the costs are expected to be about the same as 2008. This leveling off of costs suggests that the implementation issues of Sarbanes and Section 404 compliance have been worked through by the companies and their auditors.

Observation: Although overall costs may have leveled off, total costs far exceed the amount that was estimated by the SEC at the inception of Sarbanes to be $91,000 per year for each public company. If one uses an average estimated cost of $2.5 million per public company and there are 18,000 public companies, the total cost of Sarbanes is approximately $45 billion. Now, assuming Sarbanes has been in effect for seven years (2003-2009), the estimated total cost of compliance, since inception, has been $315,000 ($45 billion x 7 years). Query whether the public receives $310 billion of benefit from companies having to comply with Sarbanes-Oxley. Did Sarbanes protect the public from the Madoff scandal or the financial crisis with Lehman Brothers and AIG?

In September 2009, the SEC completed a study of the costs of Sarbanes-Oxley entitled, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements.*

The Study is based on a six month survey conducted by the SEC of SEC company respondents and noted the following results in assessing the cost of Section 404 compliance:

Estimated Cost of Section 404 Compliance

Market capitalization	Estimated total costs*
Less than $75 million	$581,000
$75 million to $699 million	935,000
$700 million or greater	3.6 million
Overall average	$1,783,000

* Consists of external and internal costs of compliance.

Source: *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, SEC, September 2009.

On average, estimated costs of Section 404 compliance was $1,783,000 of which $1.2 million consisted of internal control costs and the remainder $583,000 was audits of those internal control costs.

Even though the cost of complying with Section 404 are high, respondents to the SEC report had mixed views as to whether Sarbanes is worthwhile:

- 72 percent that Section 404 improved their companies' internal control structure.
- Only 38 percent of respondents though that Sarbanes boosted their confidence in other companies' financial reports.
- Only 22 percent stated that Section 404 raised investor confidence.

In summary, companies recognize that Section 404 compliance may improve the quality of their companies' internal control. However, they do not see that benefit translating into a benefit to the investors in terms of increasing confidence in the quality of financial reports.

SEC delays effective date of Section 404 for smaller companies

In October 2009, the SEC announced what it calls its last extension of Section 404(b) auditor compliance certification for smaller public companies. The six-month extension requires small public companies with a market capitalization of $75 million or less (non-accelerated filers) to start complying with Section 404(b) auditor's certification report when it files its annual report for the fiscal year ending on or after June 15, 2010. Previously, the implementation date was December 15, 2009.

Small public companies would still have to comply with Section 404(a) which consists of the requirement that management assess the effectiveness of internal controls over financial reporting.

Observation: As of the early part of 2010, there is legislation that has passed the House of Representatives that would exempt public companies with market capitalization of $75 million of less from having the comply with Section 404 of Sarbanes. Currently, the bill is in the Senate.

6. Some European companies have delisted from the U. S. exchanges

There are numerous non-U. S. companies listed on the NY Stock Exchange. Many have questioned whether it makes sense to stay listed in the United States in light of the additional cost to comply with Sarbanes Oxley.

8. Smaller companies are fed up and going private

The significant cost of complying with Sarbanes has resulted in many small companies going private and has held off several public offerings of small businesses. Since the inception of Sarbanes, a significant number of public companies delisted their stock and went private. Many of those companies were smaller entities that noted that one key factor of delisting was the cost to comply with Sabanes Oxley.

A summary of factors that lead to the decisions to delist follows:

1. *Access to public market capital is no longer important*:
    - Private capital is abundant from sources including venture capital companies
    - Due to the availability of real time information, investors can provide private capital to companies without the need of the public markets to monitor those companies

2. *Smaller public companies do not benefit from the public markets like the larger companies do:*

    - Larger companies such as General Electric and Microsoft benefit from the public markets through liquidity and coverage from analysts
    - Smaller to mid-sized companies do not receive the needed liquidity from the public markets as institutional investors ignore them, and analysts and banks do not give them adequate coverage due to lack of significant investment banking fees

3. *Private companies can now attract top executive talent as many CEOs and CFOs would prefer to work for a private company in the wake of the new Sarbanes requirements:*

- Many CEOs and CFOs are concerned about the personal legal liability and risks to personal reputation associated with working for a public company.

4. *The direct and indirect costs of staying public exceed the benefits*:

- Both the financial and regulatory costs of staying public continue to increase with Sarbanes
- Because most public investors do not understand the financial information they receive from public companies, they are more inclined to sue the companies upon being injured

Grant Thornton LLP noted that the number of U.S. public companies announcing privatization plans increased 30 percent since the Sarbanes-Oxley Act became effective.[28]

The typical successful going private transaction that has occurred involves:

a. A relatively small company with revenues around $80 million and a market capitalization of $40 million.

b. Fairly inexpensive price per earnings ratio (5.5 times EBITDA).

c. A company in the consumer, information technology, or industrials sectors.

d. An acquisition by management using private capital.

[28] More Small to Mid-Size Public Companies Contemplating Going Private (Grant Thorton)

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What was the first change that was made as a direct consequence of the Enron scandal?
   a. Interpretation No. 46 of ARB No. 51 issued by the FASB
   b. Sarbanes-Oxley Act of 2002 passed by Congress
   c. SAS No. 99 issued by the Auditing Standards Board
   d. Public Company Accounting Oversight Board's assumption of responsibility for issuing all new auditing standards

2. What does the Sarbanes-Oxley Act of 2002 do?
   a. changes the rules for SPEs
   b. creates limitations for registered accounting firms
   c. presents fraud standards that are more severe and more encompassing
   d. requires the board of directors to certify fair presentation of financial statements

3. The Public Company Accounting Oversight Board (PCAOB) is:
   a. an agent of the United States government
   b. funded by state taxes
   c. made up of 3 full-time members
   d. required to inspect registered public accounting firms

4. Under Sarbanes-Oxley, registered accounting firms are responsible for:
   a. conducting inspections of other registered accounting firms
   b. enforcing compliance with the Act
   c. paying registration fees to the PCAOB
   d. submitting reports to the SEC, Federal regulator, and Attorney General

5. What must be adopted by registered accounting firms?
   a. limits on partner compensation
   b. required partner commitment to the issuer client
   c. the audit report must be reviewed by two or more auditors
   d. the auditor must detect audit fraud

6. During the audit, what additional services may a registered accounting firm perform for an audit client?
   a. approved tax services
   b. internal audit outsourcing services
   c. legal services unrelated to the audit
   d. management functions

7. How does Sarbanes-Oxley affect corporate officers?
   a. personal loans must be approved by the board
   b. they are prohibited from acquiring, through a purchase or transfer, any of the issuer’s equity securities during their employment
   c. they do not receive bonuses and/or profits until the board approves the audit report
   d. they must certify that the annual or quarterly report contains no false statements of material fact

8. What is the punishment for false certification by a CEO or CFO?
   a. up to 10 years imprisonment
   b. fined and imprisoned up to 10 years
   c. $1-5 million fine plus 10-20 years imprisonment
   d. up to $25 million fine and 25 years imprisonment

9. According to the GAO’s report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, what percent of respondents said that the non-Big 4’s lack of technical skills or knowledge of their industry is the reason for sticking with the Big 4?
   a. 42%
   b. 76%
   c. 80%
   d. 91%

10. According to the GAO’s report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, what makes competing with the Big 4 unappealing to smaller accounting firms?
    a. a merger would disrupt business operations
    b. litigation risks and insurance costs
    c. the Big 4 has five times as many partners as the average accounting firm
    d. the Big 4 has ten times the staff as the average accounting firm

11. What change does the SEC recommend that the FASB institute?
    a. FASB funding should be optional
    b. FASB should speed up its process of standard setting
    c. new accounting pronouncements should be rules-based
    d. standards should be specific and rules-based

12. What FASB statement reclassifies many hybrid financial instruments?
    a. FASB Interpretation No. 46R
    b. FASB No. 150
    c. FASB No. 132
    d. FASB No. 123R

13. What radically alters the rules for consolidating variable interest entities (VIEs)?
    a. ARB No. 51, *Consolidated Financial Statements*
    b. FASB Staff Bulletins (FSBs)
    c. Interpretation No. 46R
    d. the Sarbanes-Oxley Act of 2002

14. Under Interpretation No. 46R, a non-variable interest entity (non-VIE) is:
    a. consolidated only when there is more than 50% ownership in voting equity
    b. given most of its financial support by the primary beneficiary
    c. not able to support itself
    d. required to be consolidated

15. A variable interest is:
    a. an interest in a VIE that is fixed
    b. a means through which one entity provides financial support to a VIE
    c. financial support in the form of ownership of voting or nonvoting equity only
    d. financial support whose variable component acts like a liability

16. What is a primary beneficiary?
    a. a form of financial support given by one entity or individual to a VIE
    b. an entity that has a controlling financial interest in a VIE
    c. an entity that cannot finance its activities without receiving additional support
    d. an investment that is categorized in the stockholder's equity portion of the balance sheet

17. When an individual is the primary beneficiary:
    a. very little of the VIE's expected losses will be absorbed
    b. it must consolidate only if it does not issue personal financial statements
    c. a test must be performed to determine whether it is the primary beneficiary
    d. the VIE will not be consolidated

18. In determining whether it the primary beneficiary, an entity or individual should consider:
    a. that related party variable interests should be ignored and treated as independent third party variable interests
    b. that there can be multiple primary beneficiaries
    c. that there is bias toward a decision maker being the primary beneficiary
    d. its variable interests' rights and obligations

19. Which of following areas is not generally covered by D&O insurance:
    a. protection for the organization
    b. reimbursement for an indemnification agreement
    c. coverage for the individual director or officer
    d. coverage for employment practices liability (EPL) that is separate from the D&O coverage.

20. According to “What Every Director Should Know About the New Environment,” what assertion is made by the courts?
    a. board members’ behavior is independent of company actions
    b. reliance on company-generated information is not good enough
    c. the former rules defining directors’ “good-faith obligation” are sufficient
    d. the CEO should have a greater connection to the chairman of the board

21. According to Grant Thornton, which is an example of a typical successful privatization transaction?
    a. a large company with revenues in the trillions
    b. a company in the financial sector
    c. management using private capital for an acquisition
    d. price per earning ratio is rather expensive

SUGGESTED SOLUTIONS

1. What was the first change that was made as a direct consequence of the Enron scandal?
   a. Incorrect. On the timeline of events that were directly related to Enron, the issuance of Interpretation No. 46 of ARB No. 51 by the FASB was third, occurring in January 2003. This Interpretation presents changes to the SPE rules.
   b. **Correct. Sarbanes-Oxley Act of 2002 was passed by Congress in July 2002. Its purpose is to contend with the accountability of corporations and auditors.**
   c. Incorrect. SAS No. 99 was issued by the Auditing Standards Board (ASB) in late 2002, after Congress passed Sarbanes-Oxley. This statement presented more severe and more encompassing fraud standards.
   d. Incorrect. In 2003, responsibility for issuing all new auditing standards, which had belonged to the AICPA's Auditing Standards Board (ASB), was assumed by the Public Company Accounting Oversight Board (PCAOB).

2. What does the Sarbanes-Oxley Act of 2002 do?
   a. Incorrect. The Interpretation No. 46 of ARB No. 51 by the FASB changes the rules for SPEs.
   b. **Correct. The Sarbanes-Oxley Act of 2002 creates limitations for registered accounting firms. For example the auditors must provide a list of activities that they are prohibited from performing for the SEC audit client.**
   c. Incorrect. SAS No. 99, issued by the Auditing Standards Board (ASB), presents fraud standards that are more severe and more encompassing.
   d. Incorrect. The Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to certify fair presentation of financial statements.

3. The Public Company Accounting Oversight Board (PCAOB) is:
   a. Incorrect. The PCAOB is not an agent of the United States government. However, the board is subject to oversight by the SEC.
   b. Incorrect. The PCAOB is funded through required fees from SEC issuers and all registered accounting firms, not from state taxes.
   c. Incorrect. The PCAOB is made up of five full-time members who are selected based on their integrity, reputation, and their understanding of responsibilities and nature of financial disclosures, and of accountants' obligations in the issuance of audit reports.
   d. **Correct. The PCAOB is required to inspect annually the registered public accounting firms with more than 100 annual audit reports on issuers, and those with fewer than 100 annual reports must be inspected every three years.**

4. Under Sarbanes-Oxley, registered accounting firms are responsible for:
   a. Incorrect. Under Sarbanes-Oxley, the PCAOB is responsible for conducting inspections of registered accounting firms.
   b. Incorrect. Under Sarbanes-Oxley, the PCAOB is responsible for enforcing compliance with the Act.
   c. **Correct. Under Sarbanes-Oxley, registered accounting firms are responsible for paying registration fees to the PCAOB.**
   d. Incorrect. Under Sarbanes-Oxley, the PCAOB is responsible for submitting a report to the SEC, Federal regulator, Attorney General of the U.S., or Attorney General of the state.

5. What must be adopted by registered accounting firms?
   a. **Correct. Under Sarbanes-Oxley, registered accounting firms now have limits on partner compensation, which can create a lack of independence if partners do not comply.**
   b. Incorrect. Under Sarbanes-Oxley, there is a required partner rotation rule, which prohibits a firm from performing audit services that the lead or review partner has performed for the client for five consecutive years.
   c. Incorrect. Under Sarbanes-Oxley, the audit report must be reviewed by either an independent reviewer or a qualified second person within the firm, which excludes the person responsible for the audit.
   d. Incorrect. The auditor is not required to detect audit risk, but they must consider it under SAS No. 99.

6. During the audit, what additional non-audit services may a registered accounting firm perform for an audit client?
   a. **Correct. During the audit, a registered accounting firm may perform tax services if the activity is approved in advance by the audit committee of the issuer. This approval must be disclosed.**
   b. Incorrect. A registered accounting firm may not perform internal audit outsourcing services for an audit client during the audit. The reasoning is that if the firm performs other services, the auditor cannot be independent due to bias.
   c. Incorrect. During the audit, a registered accounting firm may not perform legal services unrelated to the audit for an audit client. The reasoning is that if the firm performs other services, the auditor cannot be independent due to bias.
   d. Incorrect. During the audit, a registered accounting firm may not perform a registered accounting firm may not perform management functions for an audit client. The reasoning is that if the firm performs other services, the auditor cannot be independent due to bias.

7. How does Sarbanes-Oxley affect corporate officers?
   a. Incorrect. Under Sarbanes-Oxley, personal loans are prohibited. However, there are a few exceptions.
   b. Incorrect. Under Sarbanes-Oxley, corporate officers are prohibited from acquiring, through a purchase or transfer, any of the issuer's equity securities during any blackout period.
   c. Incorrect. Under Sarbanes-Oxley, corporate officers must forfeit bonuses and/or profits if restatements of financial statements are issued due to material noncompliance that results from financial reporting misconduct.
   d. **Correct. Under Sarbanes-Oxley, corporate officers must certify that the annual or quarterly report contains no false statements of material fact.**

8. What is the punishment for false certification by a CEO or CFO?
   a. Incorrect. The punishment for both destructing corporate records and knowingly or willfully violating certain SEC rules is up to 10 years imprisonment.
   b. Incorrect. The punishment for failing to maintain audit and review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded is a fine and imprisonment up to 10 years.
   c. **Correct. The punishment for a CEO or CFO falsely certifying the annual or quarterly report is $1-5 million fine plus 10-20 years imprisonment.**
   d. Incorrect. The punishment for securities fraud in violation of the SEC Act of 1934 and other SEC violations is a fine up to $25 million and 25 years imprisonment.

9. According to the GAO's report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, what percent of respondents said that the non-Big 4's lack of technical skills or knowledge of their industry is the reason for sticking with the Big 4?
   a. Incorrect. According to the GAO's report, 42% of respondents said there were not enough alternatives for audit and attest services.
   b. Incorrect. According to the GAO's report, 76% of respondents said they would be unwilling to expand choices if market forces had to operate without government intervention.
   c. Incorrect. According to the GAO's report, 80% of respondents said that, if they had to choose another auditor, industry specialization or expertise was an important factor that would be considered.
   d. **Correct. According to the GAO's report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, 91% of respondents said that the non-Big 4's lack of technical skills or knowledge of their industry is the reason for sticking with the Big 4.**

10. According to the GAO's report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, what makes competing with the Big 4 unappealing to smaller accounting firms?
    a. Incorrect. A merger of the next tier of non-Big 4 firms would not be enough to compete with the Big 4, because they would still lack resources. Furthermore, there would be a hesitance from the capital markets to go with any company other than the Big 4. Business operations would not be terribly disrupted by a merger.
    b. **Correct. According to the GAO's report, 83% of non-Big 4 respondents stated that litigation risks and insurance costs associated with auditing large public companies made competing with the Big 4 unappealing.**
    c. Incorrect. According to the GAO's report, the Big 4 has almost three times as many partners as the average for the next three largest firms.
    d. Incorrect. According to the GAO's report, the Big 4 has over five times the staff as the average for the next three largest firms.

11. What change does the SEC recommend that the FASB institute?
    a. Incorrect. The SEC recommends that FASB funding be mandatory to ensure FASB's independence.
    b. **Correct. The SEC recommends that the FASB should speed up its process of standard setting and change its focus to areas such as revenue recognition and consolidations.**
    c. Incorrect. The SEC recommends that new accounting pronouncements should be principle-based to allow for more flexibility in the changing marketplace.
    d. Incorrect. The SEC recommends that standards should be principle-based.

12. What FASB statement reclassifies many hybrid financial instruments?
    a. Incorrect. FASB Interpretation No. 46R deals with the consolidation rules for off-balance sheet entities.
    b. **Correct. FASB No. 150 reclassifies many hybrid financial instruments from the equity section of the balance sheet to the liability section.**
    c. Incorrect. FASB No. 132 deals with disclosures of defined benefit plans.
    d. Incorrect. FASB No. 123R deals with accounting for stock options.

13. What radically alters the rules for consolidating variable interest entities (VIEs)?
    a. Incorrect. ARB No. 51, *Consolidated Financial Statements*, provides guidance for consolidation of entities. Generally, when one entity directly or indirectly has a controlling financial interest in another entity, it should consolidate.
    b. Incorrect. The eleven FASB Staff Bulletins (FSBs) clarify the language found in Interpretation No. 46R.
    c. **Correct. Interpretation No. 46R radically alters the rules for consolidating variable entities (VIEs).**
    d. Incorrect. The Sarbanes-Oxley Act of 2002 introduced several new requirements. Of those relating to consolidation is the requirement to adopt rules for greater disclosure of off-balance sheet transactions. Further, the powers of the PCAOB, which was created by Sarbanes-Oxley, placed pressure on the FASB to make changes to the SPE rules.

14. Under Interpretation No. 46, a non-variable interest entity (non-VIE) is:
    a. **Correct. A non-variable interest entity is consolidated only when there is more than 50% ownership in voting equity.**
    b. Incorrect. A variable interest entity is given most of its financial support by the primary beneficiary. A non-variable interest entity does not need financial support from a primary beneficiary, since it is self-supportive.
    c. Incorrect. A non-variable interest entity is able to support itself without additional outside financial support.
    d. Incorrect. Under Interpretation No. 46, a non-variable interest entity is <u>*not*</u> required to be consolidated.

15. A variable interest is:
    a. Incorrect. As its name indicates, a variable interest is an interest in a VIE that is variable, since it changes with the changes in the fair value of the net assets of the VIE.
    b. **Correct. Either an entity or an individual provides financial support to a VIE through a variable interest. The providing entity or individual might have to absorb a portion of the VIE's expected losses or receive a portion of the VIE's expected residual returns as a consequence.**
    c. Incorrect. A variable interest can be in the form of ownership (ownership of voting or nonvoting equity) or no ownership (guarantees, certain lease arrangements, debt, management and other service fees).
    d. Incorrect. The variable component of a variable interest acts like an equity investment.

16. What is primary beneficiary?
    a. Incorrect. Variable interest (VI) is a form of financial support provided by an either an entity or an individual to a VIE in the form of a guarantee, loan, lease payments, management fees, etc.
    b. **Correct. A primary beneficiary is an entity or individual that has a controlling financial interest in a VIE. That controlling financial interest is achieved by having the power to direct the significant activities of the VIE, and having the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could be significant to the VIE.**
    c. Incorrect. A variable interest entity (VIE) is an entity that cannot finance its activities without receiving additional support.
    d. Incorrect. Equity includes any investment that is categorized in the stockholder's equity section of the balance sheet, including both common and preferred stock.

17. When an individual is the primary beneficiary:
    a. Incorrect. When the primary beneficiary is an individual, the variable interest will absorb the majority of the VIE's expected losses or will receive a majority of the VIE's expected residual returns.
    b. Incorrect. Even if an individual issues personal financial statements, it will not consolidate.
    c. Incorrect. Because the result has no impact on the individual, an individual does not need to perform a test to determine whether it is the primary beneficiary.
    d. **Correct. When an individual is the primary beneficiary, the VIE will not be consolidated. Only an entity that is the primary beneficiary will consolidate the VIE.**

18. In determining whether it will absorb the majority of expected losses or receive a majority of the expected residual returns of the VIE, an entity or individual should consider:
    a. Incorrect. Under the tie-breaker rules, the variable interests held by related parties and defacto agents should be considered should be considered as the entity's or individual's own.
    b. Incorrect. There can be only one primary beneficiary of a VIE.
    c. Incorrect. There is no bias toward a decision maker being the primary beneficiary within FIN 46R. In general fees paid to a decision maker are included in the computations just like payments to third parties.
    d. **Correct. In determining whether it is the primary beneficiary, an entity or individual should consider the variable interests' rights and obligations and their relationship with variable interests held by other parties.**

19. Which of following areas is not generally covered by D&O insurance:
    a. Incorrect. Generally, the organization is protected under the D&O policy.
    b. Incorrect. D&O insurance generally covers reimbursement of the organization for a contractual obligation to indemnify directors and officers.
    c. Incorrect. D&O coverage does include protection of the individual director or officer
    d. Correct. Coverage for employment practices liability (EPL) that is separate from the D&O coverage is typically not part of the D&O protection. In such situations, the D&O coverage is reduced by the portion carved out fo the EPL coverage.

20. According to "What Every Director Should Know About the New Environment," what assertion is made by the courts?
    a. Incorrect. Board members' behavior has been looked at more closely than ever, since their behavior is not independent of company actions.
    b. Correct. The courts have asserted that reliance on company-generated information is insufficient.
    c. Incorrect. The courts are developing a new set of rules defining directors' "good-faith obligation," since the rules are not sufficient.
    d. Incorrect. The CEO should be separated from the chairman of the board even more than is currently expected.

21. According to Grant Thornton, which is an example of a typical successful privatization transaction?
    a. Incorrect. An example of a typical successful privatization transaction that has occurred is a fairly small company with about $80 million in revenues and $40 million market capitalization.
    b. Incorrect. An example of a typical successful privatization transaction that has occurred is a company in the consumer, information technology, or industrials sectors.
    c. Correct. An example of a typical successful privatization transaction that has occurred is management using private capital for an acquisition.
    d. Incorrect. An example of a typical successful privatization transaction that has occurred is a price per earning ratio that is rather inexpensive (5.5 times EBITDA).

Exhibit 1
The Sarbanes-Oxley Act of 2002- Key Provisions

Act Provision	Description of Provision
Applicability	The Act applies to registered public accounting firms who audit public companies. The Act does not apply to public accounting firms that do not audit public companies. A violation of the Act is deemed a violation of the SEC Act of 1934.
Public Oversight Board	New Public Company Accounting Oversight Board to oversee the audit of public companies. The SEC has oversight and enforcement authority over the Board. Five (5) full-time members appointed from among prominent individuals of integrity and reputation who have: • Demonstrated commitment to the investors and public • Understand the responsibilities and nature of financial disclosures, and • Understand the obligations of accountants in the issuance of audit reports. Maximum of two (2) members can be from public accounting. Term: 5 years per term with scattered terms for the initial board, with a maximum of two terms. No members of the Board may share in any profits or receive payments from a public accounting firm other than fixed continuing payments. Funding of Board by required fees from: • Each SEC issuer (based on market capitalization) • Registered accounting firms. Board must submit an annual report to the SEC and the Senate Banking Committee and House Financial Services Committee.
Accounting and Auditing standards	• New Board may adopt auditing, accounting and other standards, subject to SEC approval, or may accept standards by professional groups (e.g., FASB, ASB, AICPA). • The Board has full authority to modify, supplement, revise, or repeal any portion of any professional standards (e.g., FASB, ASB, AICPA). • SEC shall conduct a study on the adoption of the U. S. financial reporting system of a principles-based accounting system.

Act Provision	Description of Provision
Powers/actions of the Board	Board has the following powers, subject to approval of the SEC: • Register public accounting firms that prepare audit reports for issuers • Conduct inspections of registered public accounting firms, including audit work papers and other documents • Conduct investigations and disciplinary proceedings against registered public accounting firms including suspension or revocation of registration by the firm • Enforce compliance with the Act (Bill) • Establish auditing, quality control, ethics, independence, and other standards for the preparation of audit reports Board may refer an investigation to the SEC, Federal regulator, Attorney General or state(s) or United States, or other authorities. Board may impose suspensions or revocations of firms, and civil money penalties of up to $15 million depending on the nature of the violation.
Auditors Registration	Auditors of SEC companies must register with the Board and provide information such as: • Annual fees received from each issuer for audit services, and non-audit services • Statement of quality control policies • Information relating to criminal, civil, or administrative actions pending against the firm • Other information required by the Board Registered public accounting firms must pay registration fees to the Board. Foreign firms that issue audit reports on any issuer, are subject to the Act.
Auditor Inspections and Reviews	Board shall conduct inspections of each registered public accounting firm: • Annually- more than 100 annual audit reports issued • At least every 3 years- 100 or fewer annual reports A written report of the findings of the Board's inspections shall be made available for public review. • Any criticisms of potential defects in the firm's quality control systems shall not be made public if addressed by the firm within 12 months of the inspection report date.

Act Provision	Description of Provision
Auditors' Conflicts of Interest – Prohibited Activities	Registered public accounting firms cannot perform any of the following non-audit services to an issuer, contemporaneously with the audit: • Financial information systems design and implementation • Internal audit outsourcing services • Bookkeeping or other services related to the accounting records or financial statements of the audit client • Appraisal/valuation services, fairness opinions, or contribution-in-kind reports, • Actuarial services • Management functions or human resources • Broker or dealer, investment adviser, or investment banking services • Legal services and expert services unrelated to the audit, and • Any other service that the Board determines impermissible. A firm may engage in any non-audit service, including tax services, that are not described above, only if the activity is approved in advance by the audit committee of the issuer. Such approval must be disclosed to investors in periodic reports. The issuer CFO, CAO, CEO, controller, or other equivalent person cannot have been employed by the firm and participated in the audit of the issuer during the one-year period preceding the date of the initiation of the audit.
Auditor Requirements	Auditors must: • Prepare and maintain audit work papers for a period of *not less than 7 years* from the audit. • Provide a *concurring or second partner review* and approval of all audit reports and *concurring approval by a qualified person of the firm, other than the person in charge of the audit*, or by an independent reviewer. • Describe in the audit report (or a separate report) the *scope of the auditor's testing of the internal control structure and procedures of the issuer and present:* o The auditor's findings from the testing, o An evaluation of the internal control structure for the preparing financial statements in accordance with GAAP, and that receipts and expenditures are made based on authorizations of management and the directors, and o A description of material weaknesses in the internal controls.

Act Provision	Description of Provision
Other Auditor Changes	Audit partner rotation every 5 years. Study to be performed on the effects of a mandatory rotation of accounting firms as auditors. Firm must report to the audit committee all communications with management, and all critical accounting policies and practices
Securities Analysts	SEC shall adopt rules to require each registered analyst, broker or dealer to disclose in public appearances, and research reports, any conflicts of interests
Corporate Accountability	CEOs, CFOs must certify in each annual or quarterly report that: • The signing officer has reviewed the report • Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact so that the statements are not misleading, and, • Based on the officer's knowledge, the financial statements, and other financial information included in the report, *"fairly present, in all material respects, the financial condition and results of operations of the issuer."* • The signing officers: o are responsible for internal controls o have designed internal controls to ensure that material information is made known to such officers by others, o have evaluated the effectiveness of the internal controls as of a date within 90 days prior to the report, and, o have presented in the report their conclusion about the effectiveness of their internal controls. • The signing officers have disclosed to the issuer's auditors and the audit committee: o All significant deficiencies in the design/operation of internal controls, and, o Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls • The signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls.

Act Provision	Description of Provision
Executive Restrictions	Bars insider stock sales during blackout periods If there is a restatement due to a material noncompliance with any financial reporting requirement, the CEO and CFO shall reimburse the issuer for: • Any bonus or other incentive-based or equity-based compensation received during the 12-month period following the issuance of the financial reporting, and, • Any profits realized from the sale of securities during that 12-month period. Issuer may not directly or indirectly, arrange for any loans or extensions of credit to any director or executive officer of the issuer. • Home improvement loans and manufactured home loans are exempt from the restriction.
Corporate Disclosures	Each financial report shall reflect all material correcting adjustments (audit entries) identified by the public accounting firm.
	Each annual and quarterly report must disclose the following items if material: • Off-balance sheet transactions • Relationships with unconsolidated entities • Obligations and contingent obligations,
	Pro Forma data: • Cannot contain an untrue statement of material fact, or omit to state a material fact, and, • Must reconcile with the financial condition and results of operations under GAAP.
Real Time Disclosure of Financial Information	Each issuer shall disclose on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, such as: Trend and qualitative information and graphic presentations as the SEC determines is necessary.
Additional Cost of Act	$776 million additional funding for the SEC including funds for: • Increase compensation and benefits including the hiring of an additional 200 professionals at the SEC, and, • Enhancement of information technology, security, and other activities in light of the September 11th terrorist attacks.

<table>
<tr><th>Act Provision</th><th>Description of Provision</th></tr>
<tr><td>Audit Committees-Corporate Governance</td><td>Directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm and the preapproval of their audit and non-audit services (exclusive of non-audit services that are not permissible under the Act).
• De minimis non-audit services (not more than 5 percent of total revenues paid to by the issuer to the auditor) need no preapproval by the audit committee.

Each public accounting firm must report directly to the audit committee.

Each members of the audit committee:
• Must be a member of the board of directors
• Must be independent by not accepting any consulting, advisory, or other compensatory fees from the issuer, or be an affiliated person of the issuer or its subsidiary.

Audit committees must establish procedures for:
• The handling of complaints regarding accounting, internal controls, and auditing matters, and,
• The confidential, anonymous submission by employees of concerns regarding questionable accounting and auditing matters.

Issuer must disclose whether the audit committee is comprised of at least one member who is a "<u>financial expert</u>" who:
• Understands GAAP,
• Has experience in the preparation or auditing of financial statements and application of such principles in connection with the accounting for estimates, accruals, reserves.
• Experience with internal accounting controls, and,
• Understanding of audit committee functions</td></tr>
<tr><td>Protection for Whistle Blowers</td><td>No officer, employee, contractor, subcontractor, or agent of an issuer may be discharged, demoted, suspended, threatened, harassed, or discriminated against because such employee provided information, or caused information to be provided, or assists in the investigation that involves a violation of any rule or regulation under the SEC.</td></tr>
</table>

Act Provision	Description of Provision
Professional Responsibility for Attorneys	New rules to: • Require an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company. The reporting must be made to the chief legal counsel or the CEO of the company, and, • If the counsel or office does not appropriately respond, the attorney must report to the audit committee or other committee of the board of directors.
Penalties	*Up to 25 years imprisonment* for securities fraud. *Up to 20 years imprisonment* for a person who: • alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States. • Commits securities, mail or wire fraud *Up to 20 years imprisonment and up to $5 million fine* for a willful certification of false financial statements by an officer. *Up to 10 years imprisonment* for knowingly or willfully violating other SEC rules. Tort actions for violations under the SEC Act of 1934 may be brought no later than the earlier of a) 2 years after the discovery of the facts of the violation, or, b) 5 years after such violation. *Up to 10 years imprisonment* for knowingly retaliating or taking action harmful to any person who is a whistleblower.
Other Studies	GAO shall conduct a study to identify: • Factors that have lead to the consolidation of the public accounting firms since 1989 and the reduction in the number of firms capable of providing audit services to large national and multi-national organizations, and, • The present and future impact of such consolidations, and ways to increase competition and the number of firms capable of providing audit services. • The problems faced by organizations from limited competition among public accounting firms. • Whether federal/state regulations impede competition among accounting firms.

Glossary

Carrying amounts – Amounts at which the assets, liabilities, and non-controlling interests of the VIE would have been carried in the consolidated financial statements if Interpretation 46R had been effective when the entity first met the conditions to be considered a primary beneficiary.

Equity investment – All equity interests that are required to be reported as equity in that entity's financial statements.

Investment-grade financing – Financing typically obtained from a bank or other lender at rates customarily offered to the lender's best customers.

Nonrecourse financing – A type of debt for which a borrower is not personally liable. If you default on a nonrecourse loan, the lender must recover the amount you owe by foreclosing on the property by which the loan is secured. At-risk rules limit the amount of loss you can take from activities with nonrecourse financing.

Off-balance sheet entity – A way of raising money that does not appear on the balance sheet. This term came into household use during the Enron bankruptcy. Many of the energy traders' problems stemmed from setting up inappropriate off-balance sheet entities.

Primary beneficiary – The entity or individual that has a controlling financing interest in a VIE. If the primary beneficiary is an entity, it consolidates the VIE, while if it is an individual, it does not consolidate the VIE.

Sarbanes-Oxley Act – The Sarbanes-Oxley Act of 2002, was signed into law by U.S. President George W. Bush and became effective on July 30, 2002. The Act contains sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and lawyers. It adopts tough new provisions intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers, and protecting the interests of workers and shareholders.

Variable Interest Entity – A variable interest entity has one or both of the following characteristics: (1) its equity at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) as a group, the equity investors lack one or more of the following characteristics: (a) the power through voting rights to direct the entity's activities that most significantly impact the entity's economic performance, (b) obligation to absorb expected losses, or (c) right to receive expected residual returns.

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