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Special Business Entity Reporting: One Plugged Hole is better than none

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This discussion includes an overview of special business entities and their status and outlines legitimate uses. It also illustrates what can and has happened, when individuals who lack integrity direct special business entities. Problems are identified that can arise when special business entities are not used as they were intended, namely, inaccurate financial reporting. The company in the illustration walked the line between legal and illegal, but was past the line of what was morally right, and in the shareholder's best interest. The discussion concludes with an accounting solution for the special business entity problems.

BACKGROUND

A discussion of special business entities (SBE) is not complete without an investigation of how Enron utilized them to achieve its financial performance. The story of Enron is fascinating (McLean et al. 2003). For years, corporate executives and officers were able to manipulate the company's financials to show profits that shattered analyst expectations and made millions for shareholders. They did all of this without the knowledge of most of their employees, federal regulators, and one of the largest accounting firms, Arthur Andersen PPC. News of Enron's accounting fraud shocked the markets, if not the whole country, and left everyone asking the question; how did they do it?

The answer is neither short nor simple. If it was, then it is highly unlikely that Enron officers would have been able to keep regulator and auditors off their tracks for so many years. Enron defrauded investors through the creative use of many advanced accounting concepts, most notably with SBEs.

WHAT IS A SBA?

Since the 1970s, publicly traded firms establish separate business entities to finance their operations at favorable rates. These businesses are known as a special purpose entity (SPE), special purpose vehicle, off-balance-sheet structure, or variable interest entity (VIE). Although many firms consolidate these separate business entities into their financial statements, others avoid consolidation. These separate business entities perform important business purposes (Demere et al. 2015). Yet, many have concerns due

to Enron's use of these entities that contributed to Enron's demise (Madrack 2002; Benston & Hartgraves 2002).

The Financial Accounting Standards Board (FASB) employs the concept of entities whose activities and powers are significantly limited by their charter or other contractual arrangement (FASB 2000; FASB 2009). A SBE can take the form of a trust, partnership, joint venture, or corporation although it can have neither independent management nor employees. One of the key determinants as to whether an entity qualifies as an SBE, is the length of time it is in existence and the scope of its activities. Because they typically fulfill a special purpose, their lives are limited to the time needed to fulfill that purpose, and their activity is restricted to only what is necessary to fulfill that purpose. The purposes can take many forms. Some of the more common purposes are to hide debt (whether for financial reporting purposes, or for liability protection), to gain certain tax advantages, to ensure stability along a company's supply chain, and to hide associations with other organizations or owners. Companies often create a SBE for projects that are risky. By passing the risky project on to the SBE, the main company avoids the risk. In the world of banking and insurance, a SBE is used as a legal entity created at the direction of a sponsoring firm...whose operations are typically limited to the acquisition and financing of specific assets or liabilities (Goodhart 2011). Leading up to the 2009 financial crisis, SBE's were established to securitize loans. The value of these mortgage-backed securities plummeted during the financial crisis due to the defaults of subprime loans (Demyanyk & Van Hemert 2011; Shiller 2012; Jahmani et al. 2016).

SBEs are created when the transferor or sponsor transfers assets to a separate legal entity. The SBE then issues stock or debt which is collateralized by the assets received from the sponsoring company. The SBE then transfers the cash received from the investors to the sponsoring entity. This can be achieved in many different ways depending on the end goal of the sponsoring entity.

Enron used SBEs as a way to hide liabilities and losses in order to boost the strength of their financial statements (Benston & Hartgraves 2002). According to FASB, 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 of the companies in the group directly or indirectly has a controlling financial interest in the other companies (FASB 2015). Ordinarily, the majority holder of a class of equity funded by independent third parties should consolidate (assuming the equity meets certain criteria dealing with size, ability to exercise control, and exposure to risk and rewards). If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SBE or its sponsor should consolidate the SBE (Madrack 2002).

The sponsoring entity or the entity that transferred the assets to the SBE should consolidate the SBE with their own financials. However, if two conditions are met, the sponsoring entity can keep the SBE off their books. First, an independent owner (one who is not the sponsoring entity, or an entity related to the sponsoring entity) must make a substantive capital investment in the SBE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction (Powers et al., 2002). Although the SEC has set a 3% minimum necessary for a 'substantial capital investment', the level of capital necessary can vary depending on the facts and circumstances of any specific case. Second, the independent owner must exercise control over the SBE to avoid consolidation. Third, according to the FASB Accounting Standards Codification (ASC) Glossary, control is the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise (Collins 2016). This rule allows a corporation to own up to 97% of an SBE and be the primary beneficiary of funds raised by the SBE, and as long as the 3% owner had a majority of the voting rights, then the corporation could keep the liability off its books. Enron used this to keep the SBE's separate from Enron's books.

SBE UTILIZATION

SBEs serve a variety of legitimate purposes. Some of the more common uses of SBEs are for financing arrangements, securitization of assets, shifting risk, and hiding association with certain owners or business partners. FASB and SEC use the term SBE and VIE interchangeable without distinction (FASB 2009 codification 810 topic).

Financing

One of the uses of SBEs is for financing. In finance, there are essentially two ways to raise capital; debt and equity. Debt is generally cheaper because there is less risk (creditors are paid before shareholders in the case of bankruptcy) and because interest payments are tax deductible. However, regular repayments are required to the creditors. Equity is more flexible because regular payments (dividends) are not required like they are with debt. Equity, however, is a more expensive way to finance projects. The lack of regular payments and subordinated liquidation priority makes equity more risky to investors than debt, and the investors expect a greater return for taking that risk. SBE special purpose entities allow for a hybrid use of both securities to get the cheaper financing from debt and the flexibility from equity (Schwarcz 2012a). SBEs can also be used if a company has poor credit and needs to secure financing. If company A needs financing and either can't obtain financing or can't obtain favorable rates, then company A can set up company B as an SBE. The SBE will have an outside owner who holds 3% of the capital and a majority of the voting interest. Company A will transfer assets to company B and use those assets to secure a loan. Company B will then transfer the cash to company A. This strategy can keep company A's poor credit history from affecting its ability to obtain financing (Na'im 2006).

Securitization

Securitization is one of the most common uses for SBEs. Securitization is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a security (Andres 2008; Schwarcz 2012b; Landsman et al. 2006). One example, which has received abundant scrutiny recently because of the role they played in the recent financial crisis, is a mortgage-backed security (MBS). MBSs are created when a bank originates many mortgage loans, bundles them together, and sells them to a SBE. With securitization, SBEs are usually set up as trusts with the sponsoring entity as the beneficiary. The SBE then issues securities to investors and uses the proceeds to repay the sponsoring entity that provided the mortgages. The securities themselves are backed by the mortgages held by the SBE, which are backed by the real estate the mortgage loan was used to purchase. In theory, any tangible asset can be securitized in this same manner.

Shifting Risk

SBEs can also be used to shift risk. To do this, a corporation will set up an SBE and sell risky assets to it. Dell, for example, has a joint venture with Dell Financial Services ("DFS") and Tyco International who owns a majority of DFS (Kulkarni 2012). Dell sells its accounts receivables and customer financing to DFS. This shifts the risk of non-collection onto DFS (and Tyco), and Dell receives cash earlier. DFS and Tyco get these receivables at a discount to make up for the time value of money and the risk of non-collection. Securitization, as discussed above, is another way of transferring risk. Banks that sell their loans to SBEs who securitize them are essentially shifting the risk of non-payment on the loans to the investors in the asset-backed securities. Like with Dell, the banks sell these loans at a discount to account for the time value of money and risk of non-payment. The investors who buy these asset-backed securities are willing to take on the risk with the hopes of seeing a healthy return on their investment.

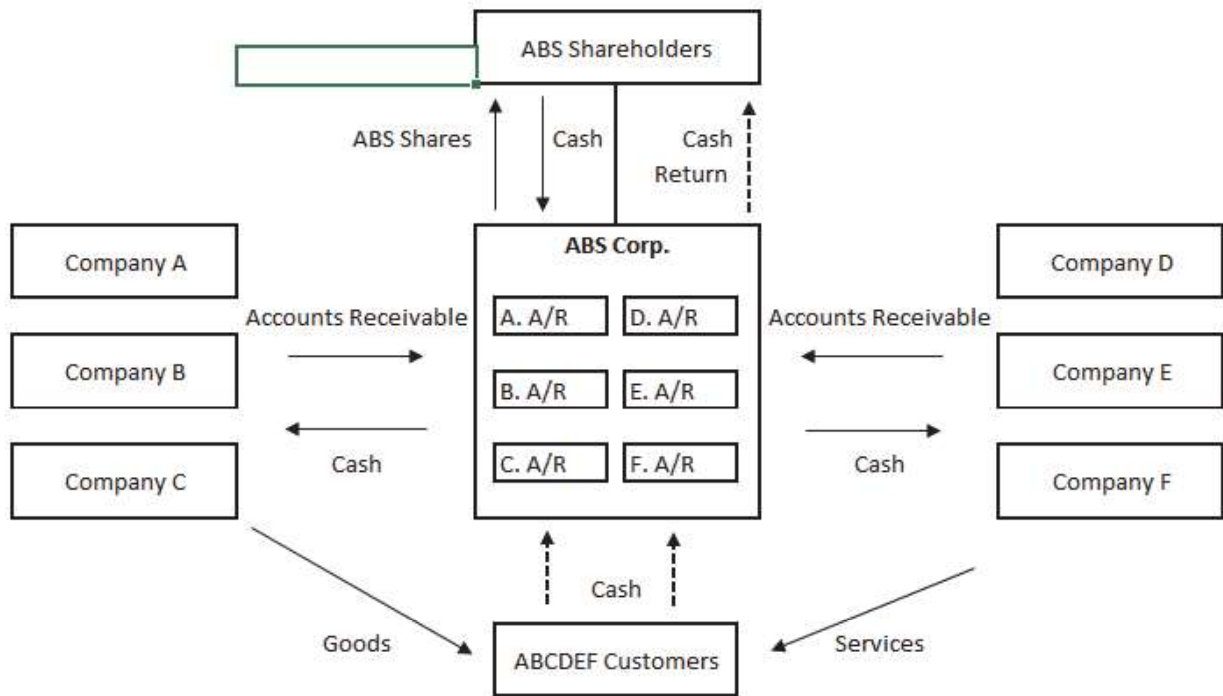
Hiding Associations with Owners or Partners

SBEs can be used as a way to hide a company’s association with an owner or another company. If McDonalds and Burger King wanted to save money on facilities and personnel by taking advantage of economies of scale, they could conceivably create an SBE tasked with production of all hamburger patties and French fries. The SBE could have an outside investor who put forth the minimum amount of capital and retains voting control. It could own a manufacturing plant that creates the *food* and ships it to McDonalds and Burger King distribution centers. Consumers and investors may not take too kindly to rivals using the exact same food, so by creating an SBE, neither McDonalds nor Burger King will have to claim the SBE in their financial statements.

Illustrations

Figure 1 illustrates a few of these concepts through the use of the ABS Corporation, a factious SBE. First, ABS shareholders purchase shares of ABS with cash. At the same time, A-F companies are selling goods and services to customers on credit. ABS uses the cash received from shareholders to purchase receivables from A-F companies at a discount to offset the time value of money and the risk of non-payment. The customers then pay ABS for the products and services provided by A-F companies. ABS Corp. pays its minimal operating expenses, and distributes the rest of the receivables income to its shareholders. Ideally, the amount received by ABS and distributed to shareholders is greater than the amount paid for the receivables. A-F companies benefit because they shifted risk of non-payment to another entity, and they do not have to wait 30+ days for their receivables to come in. ABS shareholders benefit because they (typically) receive a positive return on their investment because of the risk they took.

**FIGURE 1
ABS CORPORATION, SPECIAL BUSINESS ENTITY OPERATING FLOWCHART**



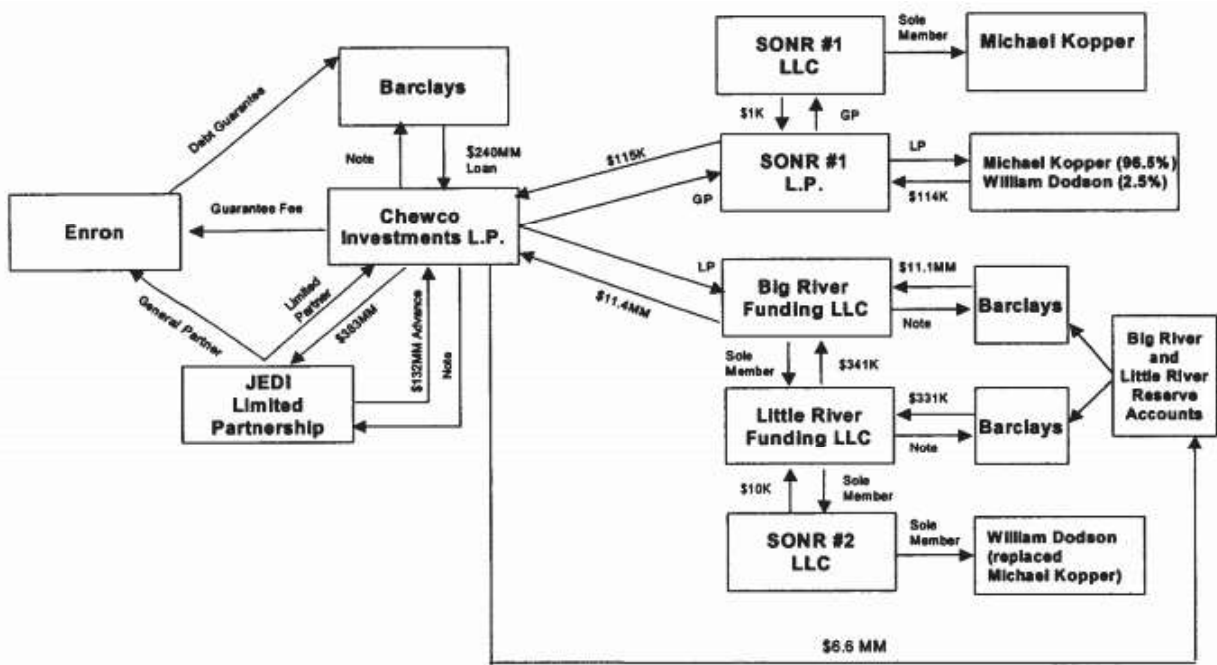
Chewco Investments L.P.

Enron used SBEs to hide debt and losses from shareholders. They created multiple SBEs starting in 1997 with this purpose. High level Enron employees often set up and managed the ‘outside investor’ of the SBEs and were highly compensated for doing so. They were paid exorbitant ‘management fees’ as

officers of these other entities for their role in the fraud. These fees were paid out of borrowed funds, not from income of the entities, and were well in excess of anything that could be considered reasonable seeing as the only activity performed by many of these entities was acquiring funds, paying interest, and preparing financial statements (Powers et al. 2002). These SBEs included Chewco, LJM1, Rhythms, Raptor I-IV, and many others.

As seen in Figure 2 (reproduced from Powers et al. 2002), the structure of the SBEs used by Enron were incredibly complex. Chewco was actually one of the simpler of the many SBEs used.

FIGURE 2
ENRON SBE CHEWCO INVESTMENTS OPERATING FLOWCHART



Chewco Investments L.P. founded in 1997 and was probably Enron’s first use of an SBE to hide a significant investment from shareholders. In 1993, Enron created a joint energy venture with the California state pension fund (Calpers) called Joint Energy Development Investments (JEDI) (Catanach & Rhoades-Catanach 2003). In 1997 Enron wanted Calpers to join in another investment, Jedi II, but Calpers agreed only if it could end its investment in JEDI. Enron didn’t want to recognize the debt needed to buy out Calpers, so it created Chewco, named for the Star Wars character Chewbacca, to serve as the “outside investment” and buy out Calpers (Powers et. al. 2002; Baker & Hayes 2004).

Chewco took out a loan, guaranteed by Enron, and bought out Calpers’ share of JEDI. Chewco was formed with an Enron employee, Kopper, serving as the COO. Kopper was not a senior officer at Enron, so his involvement in Chewco would not require a proxy statement disclosure. Also, because Kopper didn’t have influence in Enron’s decision making, Chewco was considered an ‘outside investor’ separate from Enron. Kopper was paid \$500K per year in ‘management fees’ for running Chewco, and received almost \$10 million in total compensation and gains for his role. In October of 2001 Arthur Andersen, Enron’s auditors, determined that Chewco fell short of the 3% minimum outside investment required to keep from consolidating an SBE. Because of this, Enron announced that it would restate its financial statements from 1997-2000. Over those four years, the JEDI SBE allowed Enron to hide over \$2.5 billion in debt while recognizing \$400 million in income. This restatement significantly fueled Enron’s decline (Powers et al. 2002; Giroux 2009).

The Raptor partnerships were more SBEs that Enron used to boost financial statements. Between the four Raptor SBEs, Enron was able to avoid the recognition of almost \$1 billion from July 2000 through September 2001.

FASB RULING

Enron's fraud left the American people lacking faith in the reporting of public companies. In an attempt to restore investor confidence, multiple laws and rulings were issued including Sarbanes-Oxley (Sarbanes 2002). To deal specifically with the use of SBEs to hide liabilities, FASB issued a ruling that tightened the reporting rules for SBEs.

FASB (2003) adopted Financial Accounting Interpretation ("FIN") 46(R) for newly created entities. FIN was issued as an interpretation of earlier GAAP and a replacement of FIN 46. Existing entities were not grandfathered and therefore must comply with this revised guidance. FIN 46(R) divides legal entities into two groups: those consolidated through "voting interests" (the original definition) and those consolidated by 'variable interests' (Crawford 2003). Entities consolidating through voting interests are following the original definition that a parent who holds a majority voting interest (a controlling interest) in a subsidiary must consolidate the subsidiary's financials into their own. With FIN 46(R), the guidelines for consolidation include 'variable interest' entities (VIEs). VIEs are entities controlled by another corporation through means other than voting interest, such as contractual obligations. FIN 46(R) also increased the minimum outside equity requirement from 3% to 10% (FASB 2003; Crawford 2003).

FIN 46(R) presents detail about the treatment of VIEs although it continues to consider special business entities as equivalent to VIEs (FASB 2003). VIEs are consolidated if any of the following conditions are met. 1) The total investment at risk [in the VIE] is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. 2) The group of holders of the equity investment at risk lacks one of the characteristics of a controlling financial interest. Characteristics of a controlling financial interest include the ability through voting or other interests to make significant decisions about the entity's activities, the obligation to absorb any losses suffered by the entity, and the right to receive residual returns made by the entity. The equity investors as a group are deemed to not meet the first criteria listed of a controlling financial interest if voting rights of some investors are not in proportion to their obligation to absorb losses, and their right to residual earnings of the entity. FIN 46(R) looks at the substance of the relationship over the form when deciding whether consolidation is required. By expanding the definition of control, FASB sought to increase the accuracy of related entity reporting.

The *primary beneficiary* is the entity that benefits from the existence of a VIE. It stands to reason that the company benefitting the most from the existence of the VIE should be the one to account for it on its books. FIN 46(R) gives three criteria that if a company meets any one, it is deemed the primary beneficiary. A company is deemed to be the primary beneficiary of a VIE if 1). Its variable interest in the VIE absorbs a majority of the entity's expected losses, 2). Its variable interest in the VIE absorbs a majority of the entity's expected gains, or 3). It has the ability to make economic decisions about the VIE's activities. According to this definition, a company may have to consolidate a VIE even if it has no control over the entity. Receiving the benefits of the VIE, or being responsible to absorb the losses of the VIE are enough to merit consolidation.

If you look at this concept in a simpler situation, it is easy to see the logic in this definition. If an individual owns a donut shop and has a manager who makes all of the business decisions, and a cook who makes the donuts. The manager 'controls' the operation of the business, but in almost every situation, if a business makes money, the owner benefits the most. If the donut shop loses money, the manager will not be expected to cover the losses. The owner takes the risk, and is entitled to the rewards. This same concept applies to the complex VIEs. Enron set up VIEs with an individual in control according to the standards of control set about pre-FIN 46(R), but Enron ultimately benefitted the most. The 'owners' may have made a few million dollars on the deal, but these entities allowed Enron to hide billions in debt. If the entities happened to defy their design and make money, Enron would have likely been the one to

benefit. The primary beneficiary is re-determined at each balance sheet date to account for any changes in the structure of the VIE (Soroosh & Ciesielski 2004; Langmead & Soroosh 2011).

POST FIN 46(R)

SBEs have lost some of their potency as financial statement manipulation tools, but they are still useful for the legitimate purposes. They continue to be tools for financing certain projects in a way that the borrower can realize the benefits of both debt and equity financing. They continue to be used by the banking industry to securitize assets, from debt obligations to real estate. They continue to be used to shift risk away from a company that is not willing to take the risk to a company or individuals who will accept that risk with hopes of profiting from it. Even with the increased regulation relating to them, SBEs are still important entities in the American business environment (Callahan et al. 2012; Gurun et al. 2012).

In 2009, FASB superseded current GAAP guidance by issuing the accounting codification (FASB 2009a). Any accounting literature not included in the codification is considered non-authoritative. Accounting standard updates (ASU) are used to amend or issue new accounting guidance within the codification. The accounting guidance for VIEs is included in Topic 860 Transfers and Servicing. Since the codification creation, only two accounting standards updates have been issued that impact the recognition and accounting for VIEs in Topic 860. ASU 2009-16 (FASB 2009b) clarified the transfer of assets pertaining to securitization transactions and ASU 2014-11 (FASB 2014b) changes the accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting.

Two ASUs pertaining to VIEs have been included in the Codification Topic 810 Consolidations. ASU 2009-17 (FASB 2009c) clarifies and amends FIN 46 (R) guidance to strengthen the consolidation requirement criteria for VIEs. While ASU 2014-07 (FASB 2014a) applied VIE reporting guidance to common control leasing arrangements. Given that so few changes to the VIE reporting guidance has been made, the status quo appears to be working.

CONCLUSION

FASB has taken a stab at eliminating the *loopholes* in the regulations governing the consolidation of financial statements. Although there is support for businesses making money and against governmental or quasi-governmental regulation, there is even more support on the side of the investor. However all these new interpretations and standards have only changed old and vague regulations. The line between when to consolidate and when not to consolidate may only be slightly clearer. An idealist would love to scrap all of these unclear and inconsistent regulations and rewrite the standards in a way that would make everything black and white, but because of how integral financial reporting is to all other areas of our economy, that could do more harm than good. With so many other equally confusing areas of regulation such as tax, investing, and lending, so heavily influenced by financial reporting, they would almost all have to be redone at the same time. Thus, new regulations may help for a time, but it may be on par with covering a hole in a shower head in order to keep the water out. There are so many other vague areas in our financial reporting regulations for unethical businesses to exploit, but perhaps one plugged hole is better than none.

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