Whether Sensible Business Tool or Deceptive Scheme to Conceal, the Special Purpose Entities Are here to Stay

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Abstract

This study examines whether the corporate use of Special Purpose Entities (hereafter, SPE) has changed in the wake of many well-publicized business failures and laws that followed them. In response to the Enron scandal, the Financial Accounting Standards Board (hereafter, FASB) released revised guidance in 2003 (49R) on consolidation procedures involving SPEs. Again, as the Financial Crisis unfolded in 2008, the FASB issued yet another standard, Statement No. 166, on the topic. On surface, having to consolidate SPEs may make their use less attractive to management. We discuss whether SPEs are an appropriate business practice or a deceptive tool of concealment as we test whether the use of reported SPEs by S&P 500 firms declined as a result of the Sarbanes Oxley Law (hereafter, SOX), and whether the use of SPE (or Variable Interest Entities, VIE's) in the banking sector declined as a result of the Financial Credit Crisis of 2008, or the subsequent passage of the Dodd-Frank law. Using a random sample of 30 S&P 500 firms, we compare the average number of reported SPEs pre (2001) and post (2004) SOX. We use another sample of 30 financial institutions to compare average number of reported SPE/VIEs during pre/post SOX (2001 vs. 2004), pre/post financial crisis of 2008 (2006 vs. 2009), and pre-post Dodd Frank Law (2010 vs. 2012) periods. The results show that major business failures, credit crisis, and the subsequent laws have not curbed the appetite of the business community for SPEs.

Keywords: Special purpose entities, SOX, Credit crisis, Dodd Frank Law

1. Introduction

As Enron collapsed in December 2001, the investing community soon discovered that the Company had engaged in creative accounting, defied and/or aggressively interpreted FASB standards. Enron's extensive use of SPEs enabled the Company to hide debt. SPE's enable off-balance sheet financing arrangements, a form of financing which would allow debt to be kept off of the balance sheet; these were not as common prior to1970s. SPEs are defined as "entities created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company" (Hargraves & Benston, 2002).

Use of SPEs was not unique to Enron. SPEs have been used extensively worldwide. As the Financial Crisis of 2008 unfolded, SPE's made headlines in the global banking sector in the form of "Variable Interest Entities" (hereafter, VIE). Again, SPE/VIE consolidation was suspect. The FASB promptly issued Statement No. 166 to further clarify the regulatory requirements. The emergence of the SPE allowed businesses to perform legitimate business functions, such as risk transfer and securitizations, but SPEs can also be used for off-balance sheet financing. Often SPEs became a vehicle for "hiding" debt with no disclosure as to their existence. At the same time, accounting standards lagged the development of SPEs offering opportunities to exploit loopholes.

In this study, we examine whether there is a shift in the number of SPE usage amongst the S&P 500 firms from pre to post-Enron period, and whether there is a significant change in the volume of SPEs utilized among banking and financial companies before and after SOX, before and after the credit crisis of 2008, and before and after the passing of Dodd-Frank Law.

In the following sections, we discuss whether the use of SPE is an appropriate practice or if it should be curtailed in the interest of transparency. We explore the origins of SPE's, the standards for consolidation and disclosure, and management's motivations for use and abuse. Ultimately, we conclude that SPEs serve an important business purposes with one caveat: they must be clearly disclosed to the investing community and consolidated when required. Therefore the crux of the problem is not the Special Purpose Entity itself, but lack of transparency and adherence to proper accounting standards.

2. Literature Review

2.1 Background

A SPE is "a legal entity created at the direction of a sponsoring firm for a specific purpose or purposes", as stated by the Basel Committee on Banking Supervision's Report on SPEs (Basel Committee 2009). A sponsor firm, such as Enron, creates an SPE for a specific business purpose; the entity does not have an office or physical place of business and it does not have a management that makes substantive decisions. In other words, it is established solely for the directives of the sponsoring firm and is not an autonomous entity. It is also important to note that SPEs can "take the form of a corporation, trust, partnership, or LLC" (Basel Committee 2009). This fact will come into importance during the collection of data on SPEs for the S&P 500 firms, as these entities will be listed in the affiliates section of corporate 10-K reports.

In order to create an SPE, the sponsoring company simply sells a qualifying asset or receivable. A newly formed SPE then issues enough debt and equity securities to obtain enough capital to purchase the receivables or assets from the sponsoring company. Often, the sponsoring company will even guarantee the debt issued by the SPE, which encourages securities sales. Ultimately, these SPE's enable sponsoring firms to remove these various assets from their balance sheets while skirting the associated debt assumed in the securitization. The sponsoring company now has displaced a burdensome asset from its own balance sheet, and has also come into a whole new bunch of capital that it can use as it sees fit (Byrnes, 2002).

Although the accounting for SPEs has changed since Enron, the debacle has given SPEs a "bad name" for being synonymous with misleading, if not fraudulent financial reporting. Clauss and Reed dub this perception of disdain toward SPEs as "the Enron effect" (Clauss 2003). Certainly, this "Enron effect" has consequences for any firms considering using SPEs, whether or not they utilize them properly, disclose them, and consolidate when necessary.

2.2 Legitimate Business Use of SPEs

While it is important to understand that SPEs are not "stand-alone" entities, it is also important to understand some of the major management motivations for the use of SPEs. Contrary to the negative image of SPEs that has been portrayed recently, SPEs serve important viable business functions that support their use. First and foremost, SPEs are entities that provide for the legitimate transfer of risk from bankruptcy and litigation. For instance, a firm who would like to start a new, high risk project, may elect to establish a Special Purpose Entity in order to isolate the risks of failure for their own shareholders. If the special project were to cause damages (i.e. result in litigation) or fail financially, the investors and sponsor company would be protected, because the SPE is a separate legal entity. SPE's are typically described as pass-through or pay-through structures. In their very nature, these structures are passive tax vehicles do not require any tax at the entity level. This is largely a benefit that many companies like to take advantage of, and can be performed in a valid manner, so long as the correct conditions are in place. After all, "[t]ax evasion is illegal; tax avoidance is legal" (Tavakoli, 2003). Furthermore, in order for transactions with an SPE to claim legitimacy, they must include documentation as a *true sale* when appropriate. As previously mentioned, SPEs are usually set up as either a trust or a corporation, which affords protection to the sponsoring firm. Certainly, the element of risk transfer that an SPE can provide serves to protect investors and stakeholders, which is a legitimate business tools and reason why SPEs should be continued to be permitted.

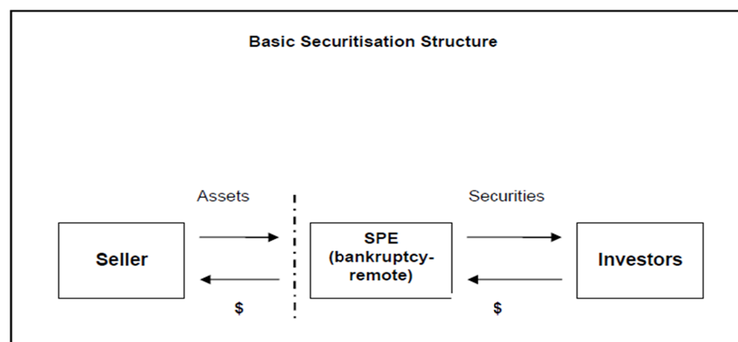
Interestingly, it is not only common for corporate entities to utilize special purpose entities, but state governments have also become prolific in utilizing SPEs, albeit for a different purpose than risk transfer. According to Schwarcz, (2012), state governments primarily use SPEs to "bypass various restrictions…notably constitutional debt limits." As a result of the use of SPEs, states are better able to raise the necessary capital than contend with general obligation bond borrowing limits. The supporters of state sponsored SPEs contend that debt limits are usually outdated, and do not allow for states to provide for their citizens. Since debt limits are set into law, political squabbling in the legislative branch often prevents an increase in the limit, and thus, the executive branch has the need to obtain additional financing, and "states such as New York, New Jersey, and Virginia use minimal general obligation bonds" for their financing needs (Schwarcz 2012). Clearly, the use of state sponsored SPEs has become a contentious issue.

Just as there are supporters, detractors of state sponsored SPEs also abound. The detractors contend that the use of SPEs in state governments lowers transparency and creates misleading governmental financial picture. This then hurts lenders and misleads ratings agencies especially the SPEs are not always required to be shown as component units under current Government Accounting Standards Board (GASB) standards. States are only required to show an SPE as a component unit when the SPE is:

1. Fiscally Dependent on the State, and
2. In a Non-Temporary financial benefit or burden relationship with the State. (GASB Statement No. 14)

For example, a sewerage authority may be established by a state government and in order to fund its operations, will have to issue debt. The state government may not directly provide the necessary funding for the entity, but may only need to approve the debt issue. Thus, the sewerage authority would not be directly fiscally dependent on the state and as such, would not be shown as a component unit in the government wide financial statements. This lack of financial transparency has the ability to be highly material, as in the case of the State of New York, whose financial statements "showed $48.5 billion of debt but failed to show another $80 billion of state SPE debt" (Schwarcz 2012). In this case, the hidden state SPE debt is almost double the reportable debt! Sure, the ability to hide debt off balance sheet speaks to the argument of the detractors of SPE use in state government. However, we believe that the current GASB standards should be revised in order to be more inclusive in regards to what constitutes a component unit of a government, such as requiring the listing of any established government "authority", regardless of the fiscal dependency of the SPE. A revision will increase financial transparency in the government-reporting arena, while still allowing states the benefit of easier access to the necessary funding to care for its citizens. Again, SPE use in this context appears to be warranted and used for a legitimate purposes rather than a deceitful one. Nevertheless, GASB inclusion requirements should be bolstered, just as the FASB has done in 2003.

The use of SPEs for the transfer of risk and debt financing for government as well as corporate entities are important uses for SPEs. However, special purpose entities are also commonly used in the banking industry, for securitization purposes. SPEs are used extensively in the sale of collateralized debt obligations (CDOs) and other mortgage backed securities, which recently, have been in the limelight due to the recent financial crisis. In fact, the securitization of non-mortgage securities has grown extensively "from the late 1990's, and by 2004, amounted to $1.8 trillion" (National Bureau of Economic Research 561). Due to the extreme impact the banking sector can have on the entire economy and the sheer dollar value size of the securitization market, it is critical to understand SPE use in this industry. A sponsoring firm establishes SPEs, which in this situation can be termed "SPVs", in order to facilitate the securitization of various debt obligations, such as mortgages and asset backed commercial paper. The sponsoring firm typically sets up an SPV with a designated trustee, and sells a pool of loans to the SPV where they are deposited. The sponsoring firm (usually a bank) is paid cash for the loans, and thus can now lend to more consumers. As such, the SPV will now receive the monthly interest and principal payments from debtors and can now issue securities such as mortgage-backed securities, because the pool of mortgage loans backs them. These new securities are usually sold in tranches, separated by a degree of default risk. The following diagram illustrates the securitization process (source: National Bureau of Economic Research):



A SPV essentially "acts as a depository for a specific group of assets in a securitization" (Bond Market Report 2001). One may ask, why is the use of SPVs necessary in these transactions at all? Why use SPVs as "depositories"? The crux of the reason lies in the fact that an SPV contains an element of "bankruptcy remoteness" (Bond Market Report 2001). SPVs are created for specific purposes and are restricted in their activities, which are set forth by the

sponsoring firm. Thus, an SPV cannot take on other financial liabilities and can only facilitate the securitization of debt securities in this case. It is this element of "bankruptcy remoteness" that attracts investors because they are not assuming any risks of the sponsoring firm, who is not bankruptcy remote. This is similar to the transfer of risk use of SPVs because investors "only are willing to take on a specified degree of risk associated with the specific pool of securitized assets in which they are investing" (Bond Market Report 2001). Therefore, SPVs perform a critical role in allowing investors to have greater control of their risk exposure when investing in mortgage backed securities and other collateralized debt obligations. The securitization process also produces positive results for consumers, for without securitizations the cost of obtaining capital (loans) would increase, due to a further limited money supply. When an SPV purchases loans from a bank, the bank now has additional funds to lend, thus available for additional lending. It is for these reasons that SPVs serve legitimate purposes in the banking sector and should continue to be used for the benefit of both investors and consumers alike.

2.3 FASB Standards Pre & Post Enron: A Step in the Right Direction?

While understanding the uses for SPEs aides in formulating why SPEs exist and should continue to be used, in order to understand fully the issues of accounting for SPEs it is imperative that the accounting guidelines governing such entities are presented. To protect all stakeholders, public companies must adhere to all Financial Accounting Standards Board (FASB) accounting requirements. Quite frankly, before 2003, accounting standards in regards to the accounting for SPEs could only be described as inadequate. The "old" standards simply failed to protect investors, creditors, employees, and the entire public because they were premised on an outdated definition of control. The fact is, SPE use originated in the early 1970's as a vehicle for synthetic leasing, however, the major standard governing consolidation was ARB #51, which was issued in 1959. The fact that ARB #51, which based consolidation requirements solely on "majority control" through the ownership of capital stock, was not designed to deal with consolidation requirements for SPEs, where control is usually attained through legal documentation. As such, ARB #51 provided no specific guidelines on the consolidation of SPEs.

From ARB #51, the Emerging Issues Task Force (EITF) of the FASB developed Issue 90-15, which required additional rules for determining when an SPE should be consolidated by a sponsoring firm. Principally, EITF 90-15 established the "3% rule", which states that the sponsor of an SPE was not required to consolidate an SPE as long as 3% of the capitalization of the SPE is equity of a 3rd party (obviously less than 50% ownership control as well). It is important to note that the 3rd party must be independent of the sponsoring firm. As can be seen in the Enron scandal, the required 3rd party was not always independent. In one example, Enron established an SPE named "Chewco" in order to buy out CALPERS from their JEDI joint venture. Chewco's "independent third party" was Michael Kopper, an aide to Enron CFO. Using Kopper as the independent third party, Enron avoided consolidating Chewco's financial results into Enron's financial statements. Systematically, Enron hid literally thousands of SPE financials from the prying eyes of investors and analysts, taking advantage of outdated accounting standards. Even though Kopper and other non-independent third party investors were used, this was not the crux of the problem. Pre-Enron GAAP SPE consolidation standards focused on the control view, meaning control through the ownership of capital stock. SPEs are inherently established through the use of legal documents, whereby Enron and other firms gain control, not through stock ownership. Again, ARB #51 pre-dated the origin of SPEs and was not issued to deal with entity relationships through which control is exerted through means other than stock ownership. Thus, the definition of control as set forth in ARB #51 was not met, and the SPE would not have to be consolidated. Most of the other "Pre-Enron" standards include opinions and statements regarding or in relation to specific transactions and uses of SPEs. For the sake of brevity, these additional standards are listed below:

STANDARD	SCOPE OF STANDARD/TOPIC
EITF Issue 96-21	Leasing Transactions involving Special Purpose Entities
EITF Topic D-14	Transactions Involving Special Purpose Entities
EITF Issue 96-16	Majority Voting Interests; Minority Has Certain Veto Rights
EITF Issue 96-20	Qualified SPEs Receiving Transferred Financial Assets
SFAS 125 & 140	Transfer and Servicing of Financial Assets

Although pre-Enron FASB standards proved ineffective in protecting stakeholders, current SPE consolidation standards fare much better in aiding to curb accounting abuses. In response to the widespread abuse of SPEs by Enron, the FASB issued Interpretation 46R in December 2003. Chief among the promulgated standards is FIN 46R,

the idea of the Variable Interest Entity (VIE). According to FIN 46R, VIEs are entities that meet one or more of the following criteria that equity investors lack essential characteristics such as:

i. Direct or indirect ability through voting rights.

ii. The obligation to absorb losses.

iii. The right to receive returns.

In short, SPEs can be VIEs. The term VIE is more inclusive and includes other entities in which a firm may have variable interests. This focus is consistent with the FASB's new variable interests view, versus the old control view, to be used when evaluating whether an affiliate should be consolidated or not. Under the variable interests view, a corporation must consolidate a VIE if it has variable interests and it is the "primary beneficiary" of the VIE. The primary beneficiary's variable interests absorbs the majority of the returns and losses of the VIE and therefore should be consolidated. Also, the primary beneficiary usually has the ability to make economic decisions about the VIE's activities, although not always. As will be discussed later, sometimes the primary beneficiary receives the majority of the returns or losses but may not have the sole ability to make decisions. This is one of the inherent limitations of FIN 46R and will be analyzed in greater detail. Apart from expanding the traditional idea of control, FIN 46R also revised the previously debated 3% third party equity requirement, and subsequently raised that requirement to 10%. However, VIEs must still be evaluated on the basis of voting criteria and then be evaluated based on variable interests. In brief, FIN 46R closed the "loophole" of an outdated and extremely specific definition of control (majority voting rights) and recognizes that even if a firm does not control a VIE but receives a majority of the benefits and absorbs a majority of the liabilities, that VIE should be subject to consolidation. Thus, in a post-Enron environment, firms are no longer able to use SPEs and state they do not have voting rights control in order to avoid consolidation.

Consolidation requirements under International Financial Reporting Standards (IFRS) follow similar requirements. Nevertheless, because IFRS are weighted towards a "principles based" approach, they leave much room for judgment. Under IFRS SIC-12, SPEs should be "consolidated when the substance of the relationship indicates that an entity controls the SPE" (E&Y Bulletin 2011). We believe this assertion leaves the door wide open for consolidation abuse, and the impending convergence of U.S. GAAP and IFRS is likely to prove difficult with regard to SPE accounting.

2.4 SPE's and the Credit Crisis

With the collapse of Lehman Brothers, the entire financial system froze leading to a worldwide economic meltdown. Precarious lending and unwarranted risks had served as a source of the problem especially since true risk exposure in derivative trading among counter parties was not transparent. There was no real way to measure a bank's true risk level in derivative trading. This was because banks were failing to capture a true portrayal of their SPE usage and transparency was quite limited (Denning, 2013). Banks were failing to capture or report true SPE usage in the form of Variable Interest Entities (VIE's). The VIE's essentially function as SPE's. The like problem here is consolidation. Major banks use VIE's extensively to borrow fund, purchase assets, and like Enron, fail to include them on their consolidated balance sheet. The overwhelming claim among major banks is that their investment in the excluded VIE's is minimal or even temporary. Some go so far as to assert that because they are not responsible for the design or operation of a VIE's dealings, they are justified in omitting the entity from their balance sheet (Partnoy & Eisinger, 2013). The implementation of FASB Statement No. 140 in late 2000 forced banks to include large losses on their consolidated balance sheets. After the fall of Enron, the FASB had issued FIN 46 and its revision FIN 46 [R] requiring consolidation of an entity if it fails to meet the QSPE (qualified special purpose entities) qualifications. Whichever company holds a majority of the VIE's expected losses or expected residual returns is considered to be the primary beneficiary and is consequently responsible for consolidating the entity into its balance sheet (Henry, Holzmann & Yang, 2008). With the stricter requirements for QSPE's in place, banks avoided working with borrowers to restructure loans for fear that they might have to incur the additional associated risk on their balance sheets. For some period of time, the QSPE structure acted as a considerable barrier to banks, investors, and homeowners alike. In the Spring of 2007, Congress joined together with regulators, policymakers and the ASF (American Securitization Forum) to assist struggling homeowners and created the elastic interpretation for SFAS 140. This initiative resulted in SEC to sign off on the idea that a "reasonably foreseeable" default gives banks the same authority as an actual default.

In December 2007, FASB chairman, Robert Herz asserted "[t]he board has never formally endorsed [this relaxed interpretation]" (Reason, 2008). Under the new policy of the plan, banks and lenders now have the ability to apply

loan amendments to a significant number of borrowers at a time without even speaking with them. Once a borrower has made two payments under any changes made, it becomes an assumed acceptance of the contract. These changes ultimately helped banks to services large volumes of mortgages at a time in conjunction with a lessened risk factor (Reason, 2008). Once these sub-prime mortgages began to default, the fuse was lit and the impending explosion was inevitable.

As time went on, the defaulting mortgages and mortgage-backed securities quickly lost value leaving the VIE's with a pile of worthless assets. This made it difficult for these vehicles to raise the capital they needed and in response, turned to their sponsoring bank for funding. A conflicting situation then arose that argues for consolidating the vehicle and in addition, a decline in asset value on the bank's balance sheet. The forced consolidation then devalued the VIE as a major source of liquidity in funding mortgages which consequently put a further downward pressure on the real estate and other associated markets. This sequence of events repeated in significant volume among all major banks in the financial industry finally burst the growing credit bubble and thus was coined the financial crisis of 2008 (Henry, Holzmann & Yang, 2008). These banks' risk removal using VIE‟s certainly played a significant role in the culmination of the credit crisis which then prompted the FASB to create yet another amendment to its original set of VIE and SPE related statements. FASB Statement No. 166 revoked the idea of a qualifying special purpose entity described in FASB 140 and withdrew the exception from applying FIN 46R to qualifying SPE‟s. This policy clearly defines the term "participating interest" to set forth specific conditions for reporting an asset transfer as a sale. The overall purpose of this revision was to enhance the understanding for appropriate accounting treatment with regards to SPE and VIE consolidation methods to avoid yet another financial eruption (FASB Statement No. 166). The FASB thought they had covered it all with Sarbanes Oxley, but they were vastly mistaken. Whether FASB No. 166 is effective in addressing the core issues presented by SPE‟s/VIE‟s usage in the Banking and Financial sector remains to be seen.

2.5 The Dodd-Frank Wall Street Reform and Consumer Protection Act

In response to this financial crisis and subsequent recession, another significant legislation was passed in 2010. Although the Dodd-Frank Act did not specifically target SPE usage, it did have regulations on the way they use securitization transactions. As discussed previously, these are exchanges in which corporate SPE's issue securities to investors and then use the proceeds to purchase financial assets. These assets are then used to repay the securities issued in the first place. This piece of legislation tackled three essential issues: (1) improving disclosure to investors in the securities about the nature of the underlying financial assets; (2) limiting conflicts of interest between originators of those financial assets and investors in securities issued by corporate SPE's purchasing those assets; and (3) increasing rating agency scrutiny of securitization transactions (Schwartz, 2012). Although these first two issues addressed in Dodd-Frank had little direct application for SPE's, the overall goals of the Dodd-Frank Act aimed at improving investor disclosure, limiting conflicts of interest and increasing rating agency scrutiny had some significance for SPE's. This regulation, to provide investors with more transparent information, was implemented to help alleviate the excessive leverage that banking companies used SPE's for to back subprime mortgages. Additionally, limiting conflicts of interest was meant to help lessen the complexities associated with the SPV securities (Geffen & Fleming, 2011). This recent legislation was employed in hopes of protecting investors and ultimately limiting banking and financial companies from abusing SPE's and bringing about another financial crisis. Only time will tell to determine whether or not this act will have any effective preventative results, however the following statistical analysis aims to predict this based on SPE usage over the past decade.

3. Analysis & Results

3.1 Part 1: SPE usage amongst S&P 500 Firms Pre- and Post-SOX

We first attempt to discern whether the SPE usage amongst S&P 500 firms was impacted by the FASB standard change, FIN 46R, in 2003. A statistically significant change in the volume of SPE use would imply that the standards change had a partial impact firm's decisions to use SPEs. Of course, individual factors such as company size, industry, and other factors also influence the usage of SPEs.

Using a random number generator technique, we select a random sample of thirty firms that were listed in the S&P 500 in 2001 (pre-Enron) and in 2004 (post-Enron). It is important to note that "post-Enron" is explicitly described as the year 2004 in order to give proper time for any changes in SPE use to occur after FIN 46R came into effect. A two-tailed t-Test was used to determine if the average number of SPEs amongst the S&P 500 firms has changed (either increased or decreased). The analysis gives us insight into the relevance of the SPEs for public companies.

We examine 10-K reports filed with the Securities and Exchange Commission (hereinafter SEC) for data on SPE usage. Here, we are interested in Exhibit 21, Subsidiaries, as SPEs that a firm has control over will be listed here. Specifically, we are interested in Limited Partnerships (LPs), Limited Liability Partnerships (LLPs), Limited Liability Corporations (LLCs) and Trusts. SPEs have a propensity to be organized in one of these entity types. In fact, SPEs are organized "usually in Limited Partnership or Limited Liability Company format, although trusts have been used" (Clauss 2003). The major reason that this has held to be the case lies in the fact that these entities are pass-through entities for tax purposes. Thus, SPEs are created as pass through entities "to afford maximum flexibility in allocating tax benefits to those investors that can best use them" (Feng 2009). Because of this widely known fact, we believe our SPE identification on Form 10-K will be reasonably accurate.

All firms comprising the S&P 500 in 2001 and 2004 were assigned a number (1 – 500). Subsequently, 30 random numbers were generated and corresponded to 30 firms. The sample firms represent a wide range of industries, from financial services to industrial goods. We note that two firms originally selected did not have SEC Form 10-Ks available. Two additional randomly selected firms replaced these firms.

Next, we examine Exhibit 21 on SEC Form 10-K, Subsidiaries, and specifically search for L.P., L.L.P., L.L.C., or Trust type entities. Any subsidiary or affiliate that contains these acronyms or the words "limited partnership", "limited liability partnership", "limited liability corporation", "limited" or "trust" will be flagged as an SPE in this study. The 10-K filings examined exclude subsidiaries that are deemed "insignificant" under Item 601(b)(21) of Regulation S-K. Because of this, a limitation of this study is only the subsidiaries listed in Exhibit 21 can be determined and we recognize the possibility that additional SPEs may exist. Table 1 presents the number of SPEs used by the sample firms, both in 2001 and in 2004.

Table 1. Use of SPE's by Sample S&P 500 Firms

	SPEs in 2001	**Change**	**SPEs in 2004**
Average # of SPEs	42.57	7.9	50.47
Standard Deviation	41.69	5.80	47.48
% Change		18.6%	
t-test		-0.5295	

The two-tail test of whether volume of SPSs changed from 2001 to 2004 was not significant, t = -0.5295, p < 0..05; the directional one-tail test of increase in SPSs from 2001 to 2004 was not significant at p< 0.10.

The results reveal that the number of SPEs use by S&P 500 firms has increased, as twenty of the thirty (or 66%) sampled firms show an increase in the number of SPEs in use from 2001 to 2004. Conversely, eight out of the thirty firms sampled (26.6%) have decreased their SPE usage from 2001 to 2004, albeit the decrease was significantly smaller than the increases. Interestingly, two of the firms kept their same number of SPEs in use, possibly indicating that the use of SPEs are not a significant part of their respective business models. The firm with the largest number of SPEs is from the financial sector. This is not surprising given that investment banks engage in various securitization vehicles, often listed as subsidiaries.

3.2 Part 2: SPE usage in the Banking and Financial Sector

In part 2 of the study, we attempt to discern whether the SPE usage in the banking and financial sector was impacted by the FASB standard change, FIN 46R, in 2003, or by the 2008 credit crisis, or by the passage of Dodd Frank Law.

The sample was chosen from the banking and financial derivative sectors in the Fortune 1000 listings. Companies listed in the Fortune Magazine compilation are suggested to be a superior benchmark for U.S. large-cap blue-chip stocks with a higher return and lower volatility over S&P 500 companies. Additionally, the S&P 500 listing appears to have a subjective bias toward companies having more volatile earnings and market capitalization. It is argued that the S&P 500 is a narrow representation of 500 stocks only representing 10 economic sectors (Carty & Blank, 2003). Three sets of data was gathered: 1) SPE usage in years 2001 and 2004 for before and after SOX comparison, 2) SPE usage in years 2006 and 2009 for before and after the credit bubble burst comparison, and 3) SPE usage in years 2010 and 2012 for before and after the Dodd-Frank Law comparison.

During the data collection process, the sample list had to be modified. Some of the companies in the initial selection simply did not exist during 2001 and/or 2004. This meant having to remove them from the sample and was the case for approximately 6 of the firms on the list. As expected, many of the companies in the sample went bankrupt during

the financial crisis or were purchased by other firms on the list. Close to 10 of the selections in the sample were removed for this reason. A handful of others had no list of subsidiaries at all and to keep with consistency, were removed from the final sample. Any companies that were consolidated or any that bought bankrupt firms also had to be removed. The reason for this is because the bank or financial company's list of subsidiaries would now include their own plus any acquired during a merger or acquisition. This would cause a spike in the number of SPE's for a certain period and skew the data noticeably. Twenty-one firms from the initial sample of 51 companies were removed for one of these reasons. The final sample of 30 firms were banks or diversified financial firms and were listed in the Fortune 1000 throughout the time period under consideration.

Again, we examined the 10-K filing of each company in our final sample for a full listing of the company's subsidiaries including its SPE's in Exhibit 21. It is important to note that Special Purpose Entities may be categorized in a number of ways. These include: Special Purpose Corporations, Master Trusts, Owners Trusts, Grantor Trusts, Real Estate Mortgage Investment Conduits (REMIC's), Financial Asset Securitization Investment Trust (FASIT), Multi-seller Conduits, Single Seller Conduits, and Domestically Domiciled Corporations (Tavakoli, 2003). Due to the complexity of filtering each company's list of subsidiaries under specific categories, all subsidiaries were counted as special purpose entities no matter the volume for each company. In collecting the sets of data for each of the six years, a simple count of each company's list of subsidiaries was compiled into a chart for comparison purposes. Table 2 provides data on SPE usage by the 30 financial institutions in our sample. The average number of SPE's before SOX was approximately 206.7 and in 2004, after the Enron Scandal, the average rose to 224.7, an over all increase of 8.71% with a range of 1 to 1,800 SPEs. The average number of SPE's increased after the credit crisis unfolded from an average of 232.1 in 2006 to 265.83 in 2009, representing an overall increase of 14.53%. The data for 2010 and 2012 shows negligible (.20%) increase suggesting that that the Dodd-Frank Act may have had a more influential impact curbing the increase of SPE usage. However, none of the pre/post percentage changes in SPE use are significant.

Table 2. Use of SPE in the Banking/Financial Sector

	SPE's in 2001	**Change**	**SPE's in 2004**	**SPE's in 2006**	**Change**	**SPE's in 2009**	**SPE's in 2010**	**Change**	**SPE's in 2012**
Average	206.70	18	224.70	232.10	33.73	265.83	204.63	0.4	205.03
Std. Dev.	155.86	21.77	177.62	187.70	10.26	197.96	205.29	-1.35	203.93
n	30		30	30		30	30		30
% Change		8.7%			14.5%			0.2%	
t-test		-0.169			-0.294			0.005	

4. Discussion

Many larger companies today use various off-balance sheet SPEs and VIEs worth billions of dollars to conduct swaps with financial institutions. Often these SPEs and VIEs are off-balance sheet transactions that are not reflected in the financial statements, leaving investors unable to assess the risks the companies may actually be taking.

Contrary to expectation that having to consolidate SPEs may make their use less attractive to management, our random sample of thirty S&P 500 firms did not indicate a significant change in the volume of SPE use post-Enron. These results are replicated in the sample from the banking an financial sector where the implementation of the Sarbanes Oxley Act in conjunction with FIN 46, made no significant difference in the average number of SPE's and VIE's used. Furthermore, the implementation of FAS 166 along with the aftermath of the credit bubble burst which was followed by the Dodd-Frank Act have had no significant impact on the average number of SPE's and VIE's used. Generalizability of the results is, however, limited given the small sample size even though a random sample generator for a representative sample was used.

Consolidation and disclosure requirements concerning Special Purpose Entities will continue to evolve over time. As scandals involving SPEs wax and wane, new standards will be proposed and adopted, hopefully with the intent of improving the quality of financial reporting. Towards that end, the International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 10, which became effective as of January 1, 2013. IFRS 10 outlines the requirements for the preparation and presentation of consolidated financial statements, requiring entities to consolidate entities it controls. Another relevant standard that became effective on 1 January 2013 is IFRS 12, which requires a wide range of disclosures about a reporting entity's interests in subsidiaries, joint arrangements, associates and even unconsolidated 'structured entities'.

Given prior regulatory efforts, how successful the new standards are in promoting transparency is debatable. As our small sample tests show, the volume of SPE use has not changed for either the S&P 500 sample or banking sample in response to critical development. Companies continue to use SPEs to effectively structure their transactions, suggesting that the benefits of use are far greater than the risk of off balance sheet financing. Although, the "Enron Effect" has given the SPEs a negative public perception, it has not curbed the appetite for their use. SPE use is deemed beneficial both for corporations and ultimately for investors. Be that as it may, it cannot be emphasized enough that SPEs must be consolidated and disclosed in accordance with promulgated standards. A big-four accounting firm, PWC, concludes similarly in its research bulletin: "the future of SPVs depends on the ability to offer clarity to investors and constantly balance risk" (PWC 2011). Current FASB standards seemed to have closed the loophole exploited by Enron. The danger of SPE use for investors lies in the secrecy of their use.

4.1 Policy Implications

Despite significant regulatory oversight of recent years, financial statement regulations need to be reformed to require more transparency. It is perhaps not possible to ban or dramatically reduce the circumstances under which off-balance sheet entities are permitted as a matter of policy. After all, SPEs do serve legitimate business purposes. At the very least however, policymakers ought to discourage transactions and transaction structures that are motivated primarily and largely by accounting and reporting considerations rather than economics. Trustworthy communication with investors, not just mere compliance with rules should be the focus of financial reporting.

A diverse mix of entities such as, private, government, and non-profit organizations, raise capital in the $3.7 trillion municipal securities (muni) market. Financial statements are typically prepared using the GASB or FASB accounting standards. The GASB and FASB should consider convergence opportunities in areas that are not uniquely governmental (e.g., leases). Significant differences exist between the financial statements prepared using GASB and FASB beyond presentation. Investors or taxpayers would find it difficult to compare the financial statements of a state university prepared using GASB with the financial statements of its private-sector counterpart (e.g., a private university) prepared using FASB. Muni market investors may consider it beneficial if certain governmental enterprises use the FASB accounting standards. Finally, the need for more future focused, results oriented performance reporting will have to be addressed in the government sector. Without transparency, accountability may be irreparably compromised.

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