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FRAUDULENT FINANCIAL REPORTING TECHNIQUES: ANALYSIS OF ACCOUNTING AND AUDITING ENFORCEMENT RELEASES[1]

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Abstract

Earnings management is intentional structuring of reporting and the active manipulation of accounting results for the purpose of creating an altered impression of business performance. It usually concerns taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings. Aim of the study is to explain some common techniques in detail and to present real life public company cases. In line with this aim Security Exchange Commissions' (SEC) Accounting and Auditing Enforcement Releases are investigated and related examples are found. The real company cases are matched with the techniques explained to give a clear picture through the understanding of fraudulent financial reporting.

Keywords: fraudulent reporting, earnings management

JEL Classification Codes: M41, M42, M49

Introduction

In the heading of the current study fraudulent reporting is chosen since it is the common language today but there are different approaches in defining the "earnings management" concept[3]. In the various sources below concepts are used to describe events and actions covering the definition of earnings management. These are;

- Creative Accounting
- Accounting Hocus Pocus

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[1]*Early version of this study was presented in a master thesis entitled as "Earnings Management and It's Role in Financial Reporting"*

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[3] Thus earnings management and fraudulent reporting terms are used interchangeably throughout the current study.

- Cookbook Accounting
- Accounting Illusions
- Accounting Gimmicks
- Accounting Anomalies
- Accounting Irregularities
- Accounting Fraud
- Accounting Tricks
- Accounting Chicanery
- Financial Shenanigans
- Fraudulent Financial Reporting
- Financial Reporting Manipulation
- Conventional Accounting

Schipper (1989) defines earnings management as purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999).

Improper Revenue Recognition

Revenue is typically the single largest item reported in a company's financial statements. As with the all-important bottom line and cash flows, companies' reported revenues are not only significant to these companies' financial statements in dollar terms, but also in the weight and importance that investors place on them in making investment decisions. Trends and growth in the top line of a company's income statement are barometers investors use when assessing the company's past performance and future prospects (Turner, 1999). Revenue is defined in Financial Accounting Standards Board (FASB) Concept Statement No. 6, Elements of Financial Statement, as follows:"Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

Revenue recognition is the practical application of the timing problem in the accounting. It deals with the problem of recording revenue in the right period. More than half of the financial reporting frauds among U.S. public companies from 1987 to 1997 involved overstating revenue, according to a study conducted by the Committee of Sponsoring Organizations of the Treadway Commission.

International Financial Reporting Standard 18 and related Capital Market Board of Turkey standard defines the criteria to record revenue as;

- The seller has transferred to the buyer the significant risks and rewards of ownership;
- The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the seller; and
- The costs incurred or to be incurred in respect of the transaction can be measured reliable

Staff Accounting Bulletin of United States SEC 101 describes a basic framework for analyzing revenue recognition by focusing on four principles established in GAAP. Those principles state that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred or services have been rendered,
- The seller's price to the buyer is fixed or determinable, and,
- Collectability is reasonably assured.

Premature revenue recognition and fictitious revenue recognition differ in the degree to which aggressive accounting actions are taken. In the case of premature revenue, revenue is recognized for a legimate sale in a period prior to that called for by generally accepted accounting principles. In contrast, fictitious revenue recognition entails the recording of revenue for a nonexistent sale. It is often difficult, however, to assign a label to such revenue recognition practices because of the large gray area that exists between what is considered to be premature and what is considered to be fictitious revenue recognition (Mulford and Comiskey, 2002).

Bill and Hold Sales

Under bill and hold accounting, a customer agrees to a future purchase and future payment. The product remains with the seller until the agreed-upon date, and the obligation to pay is deferred until shipment. The seller continues to hold the product in inventory, but it records the sale even though the customer will not receive the product until a later period. Generally, the customer is not obligated to pay until the product is shipped in that later period (Schilit, 2002).

As its name implies, a legitimate sales order may be received, processed and readied for shipment even though the customer is not ready, willing or able to accept delivery of the product at that time. In an example involving this scenario, the seller holds the goods or ships them to a different location, such as a third-party warehouse, until the customer is ready to accept shipment. The seller, however, recognizes revenue immediately or upon shipment to the interim location, often in violation of generally accepted accounting principles (Frank et al., 2005).

Case 1

In November 1996, Sunbeam extend the selling season for its gas grills and convince retailers to buy grills nearly six months before they were needed. In exchange for major discounts, retailers agreed to purchase merchandise that they would not physically receive until months later and would not pay for until six months after billing. In the meantime, the goods would be shipped out of the grill factory in Neosho, Missouri, to third party warehouses leased by Sunbeam, where they would be held until the customers requested them. By doing this company booked the sales and profits from all of the $35 million in bill and hold transactions. When outside auditors later reviewed the documents, they reversed a staggering $29 million of the $25 million and shifted the sales to future quarters (AAER, 92).

Recording Revenue upon Shipment Even though the Customer Can Return the Product

Many businesses permit the buyer a right of return if it is not satisfied with the goods. If a customer chooses to return the product, the seller has recorded revenue prematurely. Generally, revenue should not be recorded until the return period has lapsed, unless the seller can reliably predict the amount of the returns and account for them accordingly (Schilit, 2002).

Case 2

At the end of the fourth quarter of 1996, Informix recorded a $9.2 million sale but failed to deliver the required software code prior to year-end. Then, in

January 1997, Informix delivered a beta version of the software code that did not function with the hardware. It took Informix another six months to deliver usable software code. As a result, Informix recorded revenue in the first quarter rather than the third quarter of 1997 (AAER, 1215).

Case 3

In the second quarter of fiscal 1998, Cylink recognized over $900,000 in revenue on a transaction that was not final because the customer still had up to 90 days to cancel the order. In another instance, Cylink recognized revenue on orders from a distributor even though the defendants had reason to believe the distributor could not pay for the product. Cylink recognized revenue on software product orders that were contingent on the customers' rights to exchange the software for Cylink hardware products. Under both the Company's revenue recognition policy and generally accepted accounting principles, it was improper for Cylink to recognize revenue on these transactions (AAER, 1312).

Side Letters

Sometimes a sales transaction may include what appears to be a legimate order from a creditworthy customer. This separate agreement or side letter as they have become known effectively neutralizes the purchase transaction between the company and its customer. There is nothing inherently wrong with a side letter that is generally known by company management and is used to clarify or modify terms of a sales agreement without somehow undermining the agreement as a whole. The problem with side agreements arises when they are maintained outside of normal reporting channels and are used to negate some or all terms of the disclosed agreement (Mulford and Comiskey, 2002).

Case 4

Former sales personnel, managers, and others at the Informix Company used a variety of written and oral side agreements with customers as a means to inflate revenues and earnings. The terms of the side agreements varied and included provisions (AAER, 1215);

- allowing resellers to return and to receive a refund or credit for unsold licenses;
- committing the Company to use its own sales force to find customers for resellers;
- offering to assign future end-user orders to resellers;
- extending payment dates beyond twelve months;

- committing the Company to purchase computer hardware or services from customers
- under terms that effectively refunded all, or a substantial portion, of the license fees paid by the customer;
- diverting the Company's own future service revenues to customers as a means of refunding their license fees; and paying fictitious consulting or other fees to customers to be repaid to the Company as license fees

Selling to a Related Party

Whenever the buyer has some other affiliation with the seller, the quality of revenue becomes somewhat suspect. Thus, a sale to a vendor, a relative, a corporate director, or a business partner raises doubt as to whether the transaction can be considered at arm’s length. A sale to an affiliated party may be entirely appropriate. The question raised, however, concerns the appropriate amount to be recorded.

Case 5

For its fiscal year ended March 31, 1996, CEC reported total revenues of $1.2 million, substantially all of which it recognized from an asset exchange transaction with a related party. In the transaction, CEC transferred a parcel of vacant land in Utah to the related party in exchange for a promissory note collateralized by CEC preferred stock that was owned by the related party. CEC received no cash down payment and had no reasonable basis to believe the related party was able to pay for the land. Recognition of revenue under such circumstances was not in conformity with GAAP, and thus substantially all of CEC's reported revenue for its fiscal year ended March 31, 1996 was overstated (AAER, 1220).

Contract Accounting

With contract accounting, revenue is recognized in one of two ways: the percentage of completion method, which recognizes revenue as progress is made toward completion and the completed contract method, which recognizes revenue when a contract is complete. With the percentage of completion method revenue is recognized even before a product or service is formally delivered, so it can be abused by anyone interested in misleading financial statement readers. Aggressive estimates of progress toward completion can be made by increasing the costs incurred on a contract through overly optimistic estimates of the costs to complete one (Mulford and Comiskey, 2002).

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Case 6

Paragon Company measured its income earned on its golf course construction contracts pursuant to the percentage-of-completion method of contract accounting, which permits the proportionate recognition of total revenue, cost and gross margin based on the percentage of work estimated complete under a contract. Through the first quarter of 1997, Paragon developed its percentage-of-completion estimates under the cost method, determining them solely with reference to costs incurred-to-date as a percentage of the project's estimated total costs. In the second quarter of 1997, Paragon changed the way it recognized revenue on construction contracts from the cost method to, what the Company called, the "earned value" method. Under the "earned value" method, Paragon based its percentage-of-completion estimates on management's subjective estimates as to its progress instead of solely on the basis of objective criteria, such as costs incurred. As a result of the change in method for estimating percentage-of-completion, the Company experienced a material increase in revenue and gross margin for each reporting period from the second quarter of 1997 through the first quarter of 1998 (AAER, 1676).

Grossing Up Revenue

Sometimes firms works with agencies to reach the final customer. Agent intermediates between buyers and sellers and charges a commission for his participation. The agent buys and sells for the account of the client, but the client assumes all risk. In this kind of business relations agency takes the whole amount arising from the transaction and after taking the predetermined commission passes the remaining to the real seller. Here are two Case 1s of using this relation as a toll of earnings management.

In determining whether it should report revenue gross or net, a registrant should consider whether it (Moody, 2000).

- is acting as principal
- takes title to the products
- has the risks and rewards of ownership
- is acting as an agent or broker and being compensated on a commission or fee basis

Case 7

PLCN contracts with airlines, hotels and others to find customers for their excess capacity. For its efforts, PLCN pockets the difference between the amount received from the actual customer and the amount that PLCN pays to the airline or other supplier.

PLCN sells a $160 airline ticket to a customer for $200, keeping the $40 spread as its fee for the matchmaking service. In fact revenue of the company is $40 here but records the full amount of $200 as revenue, this is grossed up revenue. PLCN should not include amounts owed to its airline and hotel partners in its revenue line item, since these costs are merely a pass-through and serve only to boost the company's revenue base (AAER, 1786).

Case 8

PZZA sells pizza mainly through franchises. One service provided to the franchises was securing for them commissary products and the equipment needed to make and sell the pizza. PZZA would purchase these items, mark them up around 10 percent, and sell them to franchises. Curiously, PZZA included these pass-through reimbursable costs as revenue. During the first nine months of 1995, PZZA recorded $171.8 million of revenue, including pass-through costs of $78.7 million. In other words, by grossing up its revenue to include the pass-through, PZZA artificially inflated its revenue by 84.6 percent (AAER, 1786).

Channel Stuffing

Channel stuffing is closely related to revenue recognition for shipments made in the absence of outstanding orders. However, in the case of channel stuffing, orders are in fact received. Channel stuffing refers to shipments of product to distributors who are encouraged to overbuy under the short term offer of deep discounts. While at the time of shipment, an order is in hand, revenue is recognized somewhat prematurely by the seller because its customers are purchasing goods that will not be needed or resold until a later period. The seller is effectively borrowing sales from a later period. In such cases, sales are not sustainable.

An unusual volume of sales to distributors or resellers at or near the end of the fiscal period may be an indication of channel stuffing (Hurtt et al., 2000).

Case 9

BandL materially overstated its net income for 1993 by improperly recognizing revenue from the sale of contact lenses through its Contact Lens Division (CLD) and the sale of sunglasses through its Asia-Pacific Division (APD). These overstatements of revenue resulted from the activities of certain of the individual Respondents and other employees of BandL. The portion of the overstatement relating to the CLD arose from sales of significant amounts of contact lenses to the CLD s distributors less than two weeks before BandL s 1993 fiscal year-end in connection with a marketing program that effectively resulted in consignment sales. The portion of the overstatement relating to the APD arose from certain APD personnel recording fraudulent sales. As a result of the foregoing, BandL violated the anti-fraud and reporting provisions of the federal securities laws by filing with the Commission materially false and misleading financial statements for its fiscal year ended December 25, 1993, which overstated revenue by $42.1 million and net income by at least $17.6 million (Mulford and Comiskey, 2002).

Releasing Revenue that was Improperly Held Back Before a Merger

Inflating revenue right after the closing of an acquisition is a pretty simple trick. Once the merger is announced, instruct the target company to hold back revenue until after the merger closes. As a result, the revenue reported by the newly merged company improperly includes revenue that was earned by the target company before the merger.

Case 10

Merger of 3Com and USRX is a good example for the case; because the companies had differing fiscal year ends, a two month "stub period" was created just before the closing. Apparently, USRX held back an enormous amount of revenue so that it would be available to 3Com after the merger closed. 3Com had included in its August 1997 quarter revenue that USRX deferred during the stub period. USRX reported a minuscule $15.2 million of revenue for the stub period, a tiny fraction of the company's recent sales level. During the March 1997 quarter, in contrast, USRX had recorded $690.2 million. Rather than recognizing the revenue during the normal course of business, USRX apparently held back well over $600 million (AAER, 1215).

Income Smoothing

The income smoothing hypothesis asserts that managers select accounting policies to minimize the variance of reported earnings. More specifically, managers may decrease reported earnings when operating performance is unusually high and increase reported earnings when operating performance is usually low (Yoon and Miller, 2002). Increasing current income is the primary management intent and it is a function of a proposed management wish to have smoothly increasing income over time (Gibbins, 2002).

Case 11

Consider a company whose software product must be continuously upgraded and supported to maintain market share. Customers pay cash for the product up-front and the company defers recognition of part of this revenue because management believes the revenue is not earned until customer support has been provided. The deferred revenue is recognized as support is provided and uncertainties about the costs of support are resolved, so that the proportion of revenue that is deferred may vary from quarter to quarter. As it turns out, the estimates managers make the implement this revenue recognition policy mean that when sales are unusually high relatively more is transferred into the unearned revenue reserves, and conversely when sales are unusually low. Thus, because of management's best judgments about when their firm's revenues from this product are earned, reported revenues and earnings are smoother than would otherwise occur were revenue to be recognized entirely at the point of sale (Dechow and Skinner, 2000).

Selling Undervalued Assets

The key principles used to identify and value assets are historical cost and conservatism. Under the historical cost concept, assets are valued at their original acquisition cost, rather than fair values, replacement values or values in use. By requiring that transactions be recorded at historical exchange prices that can typically be more readily verified, accounting reduces measurement error and manager's ability to overstate the value of resources that they have acquired or developed. Of course, historical cost also limits the information that is available to investors about increases in value of the firm's assets, since exchange prices are usually lower than fair values or values in use (Healy, 2001).

Case 12

General Electric was able to use the pooling method to help boost its profits when it acquired Utah International in 1976 by exchanging stock worth approximately \$1.9 billion. General Electric recorded Utah's assets at their book value of \$547.8 million, thus suppressing about \$1.4 billion in value. The unrecorded asset value would be reported as a gain when General Electric sold these assets. In addition, even if the assets were not later sold, their below market valuation allowed General Electric to understate its expenses, cost of sales and depreciation and thereby overstate net income.

Contingencies

For the purposes of contingency accounting and the disclosure, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to the possible gain or loss to an

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enterprise that will ultimately be resolved when one or more future events occur or fail to occur. The resolution of the uncertainty may confirm the acquisition of an asset or reduction of a liability, or the loss to impairment of an asset or incurrence of a liability (Hawkins, 1995). Because, the need for the high level of judgment contingencies can be easily used for the earnings management attempts.

Case 13

Management at the Lee Pharmaceuticals had become aware of high levels of contamination in its soil and groundwater as early as 1987. Consultants hired by the company confirmed the company's role in the contamination in 1989. Estimates of the cost to clean up the property that ranged from $465,200 to $700,000 were available to management of the company by 1991. Given the probable nature of the obligation for cleanup and availability of a reasonable estimate of the cost, the company should have accrued a loss. In accordance with generally accepted accounting principles, the amount accrued would have been the lower amount of the estimated loss range. Yet the company made no such loss accrual through 1996, significantly overstating its financial results and position (AAER, 1311).

Cookie Jar Reserves

Enable companies to beat earnings estimates by a controlled amount no matter how the business actually performs. In periods of strong financial performance, cookie jar reserves enable companies to reduce earnings by overstating reserves, over accruing expenses, and using one-time write offs. In periods of weak financial performance, cookie jar reserves can be used to increase earnings by reversing accruals and reserves to reduce current period expenses. This accounting strategy obviously misleads investors (Schilit, 2002).

Case 14

Assume that a company made a cash sale for $900. The correct entry would be:

------------------------- / -----------------------------		
CASH	900	
SALES REVENUE		900
------------------------ -----------------------------		

This transaction increases both assets and revenue. An accounting trick that a company uses when it wants to defer some sales revenue until later is to record a liability initially and to wait until the following year to transfer the liability to revenue. This trick shifts income from a year in which a company may have a large profit to a later year in which profits are expected to be weaker. The journal entries to set up and later tap a reserve are as follows;

For this year,

------------------------ / ----------------------------		
CASH	600	
DEFERRED REVENUE		600
------------------------ ------------------------------		

For next year,

------------------------ / ----------------------------		
DEFERRED REVENUE	600	
SALES REVENUE		600
------------------------ ------------------------------		

The result is that this year's sales revenue is recorded as having been earned in a later period (Schilit, 2002).

Case 15

Sunbeam took a total restructuring charge of $337.6 million at year-end 1996. However, management padded this charge with at least $35 million in improper restructuring and other reserves and accruals, excessive write-downs, and prematurely recognized expenses that materially distorted the Company's reported results of operations for fiscal year 1996, and would materially distort its reported results of operations in all quarters of fiscal year 1997, as these improper reserves were drawn into income.

The most substantial contribution to Sunbeam's improper reserves came from $18.7 million in 1996 restructuring costs that management knew or was reckless in not knowing were not in conformity with generally accepted accounting principles. Sunbeam also created a $12 million litigation reserve against its potential liability for an environmental remediation. However, this reserve amount was not established in conformity with generally accepted accounting principles and improperly overstated Sunbeam's probable liability in that matter by at least $6 million (AAER, 1220).

Big Bath

Big bath charges are one-time restructuring charges. Current earnings will be reduced by over estimating these onetime charges. By reversing the excessive reserve, future earnings will increase.

Case 16

Rite Aid Corporation took a large restructuring charge in anticipation of closing 379 stores. The SEC compelled Rite Aid to reduce the size of its restructuring charge from $290 million to $230 million, add major expenses to its operating costs, and restate its profits (Amor and Warner, 2003).

Inventory Fraud

One form of business activity involves generating revenue by selling goods to customers. A supply of these goods is called inventory and can include goods in the process of being produced, or work-in-process inventory, as well as finished goods inventory. A precise and complete inventory valuation is needed in order to accurately report the results of operations and to correctly state the financial position of an entity (Byington and Christensen, 2003).

Case 17

Centennial overstated its inventory values and levels in a variety of ways. It falsified invoices to support inflated inventory pricing, manipulated inventory counts, understated the cost of sales and included phony inventory. For example, in the spring of 1996, Centennial's former chief executive officer and its former chief financial officer caused 27,000 PC cards to be manufactured. Although these computer cards looked like the typical product that Centennial manufactured, they consisted of outer metal casing only and had no inner circuitry. These dummy PC cards were included in inventory and counted by the independent auditors during Centennial's annual audit. These empty cards constituted a material amount of the finished goods inventory Centennial reported on its balance sheet for the quarters ended June 30, 1996 and September 30, 1996. As of December 31, 1996, Centennial's inventory was overstated by $8.8 million, or 78% (AAER, 1311).

Case 18

In the Matter of Sunbeam Corporation, there are examples of improper accounting for inventories. In the first instance, that Sunbeam recorded an excessive restructuring reserve in one year that decreased the value of perfectly good inventory, and when that inventory was sold in the next year at regular prices, Sunbeam recognized inflated profit margins and thus overstated income. In the second instance, Sunbeam sold its spare parts inventory to a supplier at the end of the year, but improperly recognized income on the sale. The sale price had no practical relationship to any payment Sunbeam might obtain; by its terms, the contract would terminate in January 1998, absent agreement between the parties on the value of the inventory. Moreover, Sunbeam agreed to pay certain fees to its customer and guaranteed a 5% profit on the resale of the inventory (AAER, 1393).

Adjusting Earning Per Share

The existence of consensus analyst's estimates, combined with many investor's willingness to bolt quickly when the analysts are surprised, intensifies the pressures and conflicts and factors that both managers and auditors must deal with as they make their judgments in financial reporting. Many analysts say that they always consider the business fundamentals and underlying developments along with earnings per share (Parfet, 2000). Any company can manufacture growth in its earnings per share by pouring capital into low returning projects. So long as new project returns more than the after tax cost of debt capital, it will increase earnings per share (Stewart, 2002).

Case 19

Enron is classic example of the over investment syndrome. Driven by their desire to maximize earnings per share growth, Enron management sunk billions in capital into low returning investments. James Chanos, the renowned investor who shorted Enron stock a year before the bankruptcy, betting on its fall, based his decision on measuring that Enron was only earning a %7 return on its capital, far less than he thought investors should require from a risky company like Enron.

Cost Capitalization

If a company makes entries in its accounts that effectively reclassify or transfer a given expenditure from an operating expense to a capital asset, that action will have the following effects on the company's financial statements (AAER, 1786):

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- The reclassification or transfer will reduce the company's operating expenses, and the company's pre-tax net income consequently will increase by the amount reclassified or transferred;
- The value of the company's capital assets and total assets will increase by the amount reclassified or transferred; and
- The value of the company's net worth will increase.

Case 20

For fiscal years 1995 and 1996, AOL capitalized most of the costs of acquiring new subscribers as deferred membership acquisition costs including the costs associated with sending disks to potential customers and the fees paid to computer equipment manufacturers who bundled AOL software onto their equipment and reported those costs as an asset on its balance sheet, instead of expensing those costs as incurred. Substantially all customers were derived from the above direct marketing program. For fiscal years 1993, 1994 and 1995, AOL amortized deferred membership acquisition costs on a straight-line basis over a 12 month period. Beginning July 1, 1995, the company increased that amortization period to 24 months (AAER, 1416).

Case 21

Advertising costs were a significant expense for American Classic, and the capitalization of these costs in the first quarter of 1999 reduced American Classic's net loss by 29%. First, the Management's Discussion and Analysis section compared operating results for the first quarters of 1999 and 1998 without disclosing that the capitalization of advertising costs substantially improved reported results for the first quarter of 1999. Second, the financial statements in the first quarter 1999 understated American Classic's net loss for the period by 29%, and understated its selling, general and administrative expenses, because the capitalization and deferral to later quarters of certain advertising costs deviated from generally accepted accounting principles. Third, American Classic deviated from generally accepted accounting principles by failing to disclose in its first quarter 1999 that it had changed accounting treatment for its advertising costs (AAER, 1416).

Purchased In-Process Research and Development

Unreasonably large write-offs of in-process research and development are being used to hype the company's stock price. Amounts paid in the business combination are written of immediately as in-process research and development when they should have been allocated to other, capitalized assets. The excessive up-front write-off avoids future amortization and depreciation expense. At the same time, since management claimed to have valued the in-process research and development based on the future cash flows, exaggeration of that value implies significant, auditor-certified profits after the projects are completed (Turner and Godwin, 1999).

Special Purpose Entities

A special-purpose entity, sometimes called a special-purpose vehicle, can be defined as an entity created to carry out a specific or limited purpose. The creator of the special-purpose entity is called the sponsor. The special-purpose entity can take any organizational form, so the sponsor can set it up as a corporation, partnership, trust, or joint venture. The organizational form facilitates the particular purpose or goal of the particular special-purpose entity.

Case 22

Generically, special-purpose entity s work as an entity that goes between the corporation and a group of investors, usually in the form of creditors. The creditor lends money to the special-purpose entity and the special-purpose entity in turn transfers the cash to Enron; simultaneously, Enron transfers assets to the Special Purpose Entity. As these assets generate cash, the special-purpose entity pays off its debts to the creditors. All special-purpose entity s serve two purposes, one legitimate and one illegitimate. The legitimate purpose of the special-purpose entity occurs when the corporation dedicates assets in sufficient quantity and quality to entice creditors to give the corporation a loan at a favorable interest rate. The creditors willingly do this because of the credit enhancements given to the assets contained in the special-purpose entity. The illegitimate purpose comes when business enterprises employ special-purpose entity s to hide debt (Arya et al., 2003).

Concluding Comments

Throughout the study numbers of examples are given by examining the related AAERs. This transparency policy adapted by SEC after the Sarbanes Oxley Act. Capital Market Board of Turkey must publish this kind of enforcement releases. The current study suggests this kind of act for the Turkish financial reporting environment. The Sarbanes-Oxley Act changed corporate governance, including the responsibilities of directors and officers, the regulation of accounting firms that audit public companies, corporate reporting, and enforcement. A further point is that a board of the directors of the company wants to manage earnings will be able to do so in the short term, whatever the accounting regulations. Examples in the study show that there are countless of ways for managing earnings. Putting stones into the boxes in order to hide inventory fraud is a good example, it is almost impossible to discover such cases. Effectiveness of the audit must be improved and must be assisted with internal auditing function.

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