

# Enron's financial statements before the bankruptcy declaration

[Finance](#), [Banks](#)



This article discusses the warning signs and or signals that started featuring in Enrons financial statements before the bankruptcy declaration in 2001. These warnings basically touched on the nature of company's reporting procedures as profit and /or revenue measurements. As a measure of success and performance Enron used revenues instead of profits as drivers. The move was aimed at window dressing. That is, manipulation of accounting figures to show the company as blue chip or as a good performer in terms of growth and innovation (Singeton et al 126). Additionally, the move was geared to mask debts and portraying an optimal capital structure as well.

Major causes of Enron firm's fraud

Revenue accounting techniques

In contrast with other firms' growth strategy, Enron's management manipulated two principles of accounting to depict a positive growth. First, most of the firm's energy contracts were treated as financial contracts. This allowed the firm to record to recognize future returns of the investments in the current accounting period. According to accruals concept of accounting, revenues ought to be recognized in the periods which they dot relate. As evidenced from the article, failure to comply with this accounting principle led to the firm's bankruptcy. Additionally, the approach taken by the firm's management to interpret revenue and /or income from the company's online trading platform lead to the accounting frauds and the eventual bankruptcy of the firm.

Enron accounting staff had adopted an aggressive accounting model known as the merchant model.

Under this model, Enron reported the overall cash flow from the online trading as revenue. This led to unusual increase in the company profit margin compared to other competitors in the industry who employed a more conservative approach. For instance, within a time span of four years, the firm's revenue has risen from the lows of \$ 13. 3 billion to highs of \$100. 8 billion representing an increase of about 750 %. In contrast, most competitors such as Merrill Ltd recognized brokerage fees as revenue from the entire value of trade and thus the noted difference in the profitability growth levels. Again, the unusual growth in profit levels reported by Enron Ltd had arisen from the employment of incentive plans based on NPV (Net present value) rather than the real and/or the actual cash flows that would result from such deals. Similarly, in addition to the merchant model, the firm had employed MTM methodology to account for the energy contracts (Dharan and Bufkins 102) . This also led to overstatement of the net profit of the company. A move aimed at portraying the firm as a high performer.

Employment of merchant and MTN methodology resulted to increased revenue and decreased the cost of revenue by more than 50%. Therefore, overstatement of sales and understatement of sales cost resulted to an overstated net return for any given fiscal year. Evidence from the article shows that, had the management employed the traditional approaches in reporting revenue, the \$ 100. 8 billion reported in 2000 fiscal year would scale down to \$6. 3 billion (Dharan and Bufkins 99). Market-to-marker

accounting which was the major contributor of the company's downfall had started in early 1992. This move was initiated after appointment of Skillings who sought approval to use the accounting approach from the then commission of securities and exchange. This move led to a major downturn for Enron Ltd as the management began to shift their attention from performance emphasis to revenue growth. Focus was also changed from major objectives of any profit making firm such as profitability and cash flow growth. Change of focus resulted in the major accounting frauds as the management endeavored to present the firm as stable and financially sound. Nevertheless, the wholesale unit of the business was most affected by the scandals.

As evidenced from the article, the wholesale unit generated approximately 1.8% of the total operating income signifying the extent of inflation. Moreover, the inflation of revenue practice had affected not only the firm but also the overall industry as well. Research shows that many other companies employed the mark-to-market accounting. These companies employed the move in an effort to cut down pressure from Enron limited and also to remain competitive in the industry. As a result, several companies employing this approach moved to the top category of the top performing countries.

Warning signals/ red flags in Enron's financial statements

Segment profit reporting

Segmental disclosures provided primary warning of the company's window dressing practice. Data provided in segment reports showed that the

company used mark-to-market procedures in reporting for these subdivisions. For instance, retail and wholesale energy divisions reported increasing profits due to employment of mark-to-market accounting. In contrast, the departments and/or divisions that were notable to use this approach did not show any profits. This led to the conclusion that reported returns mostly came from the gains arising from the accounting approach used. Similarly, other divisions were growing at a rapid phase but did not depict corresponding increases in profit.

### Cash flow signals

Proof of poor quality of earnings by the cash flow statement also acted as one of the major signal or red flag of an underlying fraud in the company. Under CFO analysis, accruals are deemed positive when the net profit is higher than CFO (cash-flow from operations). In such instances, the quality of earning is usually low. Though Enron management was aware of this measure, they concentrated on ensuring that net income was always lower than the cash flow generated from operations. This loophole served as a warning of the possible fraud in the company reported financial statement.

Additionally, free cash flow measure also raised concerns regarding the company's valuation concepts and earnings quality. Free cash flow is arrived at by subtracting investment returns from returns generated out of the firm's routine operations. Free cash flow is used as a measure for the stability of any given firm in the long-run. A firm going concern concept is threatened if it reports negative cash flows (Kwork, 109). Enron Ltd had reported a huge

negative cash flow in the 1997 fiscal year. Though the company later reported a positive flow of cash in 2000, the amount would still result to a liability and/or payables when subtracted from the 1997 deficit.

### Profitability measures

Measures of profitability employed by the firm also indicated some signals of possible accounting fraud in the company. This was because of the unusual growth in the profit margin over short periods. For instance, within a time span of four years, the firm's revenue has risen from the lows of \$ 13. 3 billion to highs of \$100. 8 billion representing an increase of about 750 %. Annual reports show that the firm's earnings were relatively small compared to the company's revenue. This would imply that the overall net income did not grow at the same rate with the revenues. For example, revenue grew at a rate of about 164. 6% on an annual basis. In contrast during the same period, profits were noted to grow at an average rate of 2% per annum (Dharan and Bufkins 107).

Similarly, the gross profit ratios were noted to decline from 1996. Disparities in revenue and net income made many people to doubt the credibility of the company's published financial statements. Also the decline in the profit margin of the firm revealed a great red flag as the growth in the company revenue was expected to match profitability. Reports of the examiner of bankrupt of the firm appointed by the court showed that the profits were manipulated up to 95% because of the employment of MTN and the Merchant accounting models and/or techniques.

## Forensic accounting

Forensic accounting is one of the major red flag or signal of the possible accounting fraud by the company. Due to the media popularity of the company brought about by its relative size and growth, reporters began to analyze or to dig deep into the company's statements (Dharan and Bufkins 105). As a result, many articles publications stated to raise concern about the exaggerated revenues of energy traders. Reports also questioned the stability of the company in the long-run. Also profits of the company were contrasted with other competing firms in 2000 when Jeff Skillings pronounced that the new valuation of the share for the company would be \$ i26. The results of the analysis led to various publications questioning the credibility of Enron's financial statements. Financial ratios were also analyzed and the company performance under these measures was not as reported by media. Therefore, forensic accounting acted as a major red flag.

## Work cited

Dharan, Bala and Bufkins, William. Red flags in Enron's Reporting of Revenue and Key Financial measures. Corporate Fiasco and their Implications, 2004; 97-112.

Kwork, Benny. Accounting irregularities in financial statements. Farnham, UK. Gower Publishing, Ltd., 2005.

Singleton, Tommie, Bologna, Jackson and Singleton, Aaron. Fraud auditing and forensic accounting. Hoboken, NJ: John Wiley and Sons publishers, 2006.

<https://assignbuster.com/enrons-financial-statements-before-the-bankruptcy-declaration/>