

Enron accounting ethics flashcard



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To a large extent, the accounting profession is self-regulated through various professional associations rather than being regulated by the government.

The AICPA, the IMA, and the IIA have internal means to enforce the codes of ethics. Furthermore, the professional organizations for CPAs in each state, known as state societies of CPAs, have mechanisms for enforcing their codes of ethics, which are usually very similar to the AICPA Code. Violations of ethical standards can lead to a person's being publicly expelled from the professional organization. Because of the extreme importance of a professional accountant's reputation, expulsion is a strong disciplinary measure.

However, ethical violations can lead to even more adverse consequences for CPAs because of state and federal laws. The state government issues a CPA's license to practice, usually through an organization known as the state board of accountancy. Since state laws governing the practice of accountancy typically include important parts of the AICPA Code, the Code thus gains legal enforceability. Consequently, ethical violations can result in the state's revoking a CPA's license to practice on a temporary or even permanent basis. Because a licensed CPA is also likely to belong to the AICPA and the state society of CPAs, investigations of ethics violations may be carried out jointly by the AICPA, the state society, and the state board of accountancy.

CPAs in public practice who audit the financial statements of public corporations are subject to federal securities laws and regulations, including the Securities Exchange Act of 1934. The Securities and Exchange

Commission (SEC), which administers these laws, has broad powers to regulate corporations that sell their stock to the public. One important SEC requirement is that these corporations' financial statements be audited by an independent CPA. The SEC has the authority to establish and enforce auditing standards and procedures, including what constitutes independence for a CPA. The SEC has largely delegated standard setting to the private sector but retains oversight and enforcement responsibilities. In 1998 the SEC and the AICPA jointly announced the creation of the Independence Standards Board (ISB), a private-sector body whose mission is to improve auditor independence standards.

In announcing the formation of the ISB, the SEC reaffirmed the crucial importance of the CPA's independence: "[M]aintaining the independence of auditors of financial statements ... is crucial to the credibility of financial reporting and, in turn, to the capital formation process" ABOUT ENRON Enron Creditors Recovery Corp. " ECRC") is the new name for Enron Corp. After Enron's Plan of Reorganization was approved by the United States Bankruptcy Court for the Southern District of New York, the new board of directors decided to change the name of Enron Corp. to reflect the current corporate purpose. ECRC's sole mission is to reorganize and liquidate certain of the operations and assets of the " pre-bankruptcy" Enron for the benefit of creditors. Enron's bankruptcy in 2001 is one of the largest and most complex bankruptcies in U.

S. history. In November 2004, Enron emerged from bankruptcy and the company began its mission of reorganizing and distributing assets to its creditors. In connection with Enron's emergence from bankruptcy in

November 2004, a new board of directors was appointed, and they adopted this mandate: obtain the highest value from the company's remaining assets and distribute the proceeds to the company's creditors. As part of its efforts, ECRC has successfully undertaken legal action to hold responsible the major financial institutions that it contends assisted the pre-bankruptcy Enron deceive the public. Those legal efforts have, to date, resulted in settlements of almost \$2 billion in cash.

Additionally, as part of these settlements, the defendants have agreed not to receive distributions upon claims against Enron worth approximately \$1.38 billion. * Once ECRC has completed all outstanding litigation and monetized all assets, it will make a final distribution to creditors. After that, the company will cease to exist.

COMPANY HISTORY Enron traces its roots to the Northern Natural Gas Company, which was formed in 1932 in Omaha, Nebraska. It was reorganized in 1979 as the leading subsidiary of a holding company, Inter North. In 1985, it bought the smaller Houston Natural Gas and changed its name to Enron in the process. The merged company initially named itself "HNG/InterNorth Inc.", even though InterNorth was the nominal survivor.

It built a large headquarters complex in Omaha. However, the departure of ex-Inter north CEO Samuel Segnar six months after the merger allowed former HNG CEO Kenneth Lay to become CEO of the newly merged company. Lay soon moved Enron's headquarters to Houston and began to thoroughly re-brand the business. Lay originally favored the name "

Enteron”; but when it was pointed out that the term approximated a Greek word referring to the intestine, it was quickly shortened to “ Enron.

” The final name was decided upon only after business cards, stationery, and other items had been printed reading Enteron, reflecting the confused state of affairs in the company at the time. Enron’s infamous “ crooked E” logo was designed by the late American graphic designer Paul Rand. Enron was originally involved in transmitting and distributing electricity and gas throughout the United States and developing, building, and operating power plants, pipelines, and it also dealt with rule of law and other infrastructure worldwide. Enron owned a large network of natural gas pipelines which stretched ocean to ocean and border to border including Northern Natural Gas, Florida Gas Transmission, Transwestern Pipeline Company and a partnership in Northern Border Pipeline from Canada. These were the cash cows that made all of the other ENRON companies, ventures and investments possible. They were the only part of ENRON that made significant profits.

In 1998, Enron moved into the water sector, creating the Azurix Corporation, which it part-floated on the New York Stock Exchange (NYSE) in June 1999. Azurix failed to break into the water utility market, and one of its major concessions, in Buenos Aires, was a large-scale money-loser. In April 2001, Enron announced Enron grew wealthy, it claimed, via its pioneering, due largely to marketing and promoting power and communications bandwidth commodities and related derivatives as tradable financial instruments, including exotic items such as weather derivatives. Enron was named “ America’s Most Innovative Company” by Fortune magazine for six

consecutive years, from 1996 to 2001. It was on the Fortune's "100 Best Companies to Work for in America" list in 2000, and had offices that were, in hindsight, stunning in their opulence.

Enron was hailed by many, including labor and the workforce, as an overall great company, praised for its large long-term pensions, benefits for its workers and extremely effective management until its exposure in corporate fraud. The first analyst to publicly disclose Enron's financial flaws was Daniel Scotto who in August 2001 issued a report entitled "All Stressed up and no place to go" which encouraged investors to sell Enron stocks and bonds at any and all costs. As was later discovered, many of Enron's recorded assets and profits were inflated, or even wholly fraudulent and nonexistent. Debts and losses were put into entities formed "offshore" that were not included in the firm's financial statements, and other sophisticated and arcane financial transactions between Enron and related companies were used to take unprofitable entities off the company's books. Its most valuable asset and the largest source of honest income, the 1930s-era Northern Natural Gas, was eventually purchased back by a group of Omaha investors, who moved its headquarters back to Omaha, and is now a unit of Warren Buffett's Mid-American Energy Holdings Corp. NNG was put up as collateral for a \$2.

5 billion capital infusion by Dynegy Corporation when Dynegy was planning to buy Enron. When Dynegy looked closely at Enron's books, they backed out of the deal and fired their CEO, Chuck Watson. The new chairman and interim CEO, the late Daniel Dienstbier, had been president of NNG and an Enron executive at one time and an acquaintance of Warren Buffett. NNG continues to be profitable today. WHAT HAPPENED TO ENRON? AN

OVERVIEW The collapse of Enron caught almost everyone by surprise, from employees and investors to analysts and creditors. But how did the seventh largest company in the Fortune 500 plummet into bankruptcy and implode so quickly? The Enron story comes in three stages.

Stage 1: The Company leveraged itself through debt, which it used to grow its non-core Wholesale energy operations and service business. Some of this debt was reportable on the Company's balance sheet, and some was not. No problem for the company, as long as the stock price held up. Stage 2: The stock price fell. When that happened, off-balance-sheet liabilities put pressure on debt agreements, and eventually led to credit downgrades.

Stage 3: The margins in this business are very thin and lower credit quality increased Enron's cost of borrowing to the point where the whole company fell into liquidity trap.

Movement of Enron's share price (USD) Enron: A Background Enron was born in July 1985 when Houston Natural Gas merged with Omaha-based Inter-North. Kenneth Lay, an energy economist became chairman and chief executive. As the energy markets, and in particular the electrical power markets were deregulated, Enron's business expanded into brokering and trading electricity and other energy commodities. The deregulation of these markets was a key Enron strategy as it invested time and money in lobbying Congress and state legislatures for access to what traditionally had been publicly provided utility markets.

Some of Enron's top executives became frequently named corporate political patrons of the Republican Party. Enron needed the federal government to

allow it to sell energy and other commodities. According to the Center for Responsive Politics, between 1989 and 2001, Enron contributed nearly \$6 million to federal parties and candidates. It was one of the first amongst energy companies to begin trading through the Internet, offering a free service that attracted a vast amount of customers. But while Enron boasted about the value of products that it bought and sold online – a mind-boggling \$880bn in just two years – the company remained silent about whether these trading operations were actually making any money. At about this time, it is believed that Enron began to use sophisticated accounting techniques to keep its share price high, raise investment against its own assets and stock and maintain the impression of a highly successful company. Enron's 2000 annual report reported global revenues of \$100bn.

Income had risen by 40% in three years. The Chronology of the fall: 20 Feb, 2001 A Fortune story calls Enron a highly impenetrable Co. that is piling on debt while keeping the Wall Street in dark. On 14 Aug, 2001 Jeff Skilling resigned as chief executive, citing personal reasons. Kenneth Lay became chief executive once again. 2 Oct, 2001 Arthur Andersen legal counsel instructs workers who audit Enron's books to destroy all but the most basic documents.

16 Oct, 2001 Enron reports a third quarter loss of \$618 million. 24 Oct 2001 CFO Andrew Fastow who ran some of the controversial SPE's is replaced. 8 Nov 2001 The company took the highly unusual move of restating its profits for the past four years. It admitted accounting errors, inflating income by \$586 million since 1997. It effectively admitted that it had inflated its profits by concealing debts in the complicated partnership arrangements.

2Dec, 2001 Enron filed for Chapter 11 bankruptcy protection and on the same day hit Dynegy Corp. with a \$10 billion breach-of-contract lawsuit. 12 Dec 2001 Anderson CEO Jo Berardino testifies that his firm discovered possible illegal acts committed by Enron. 9 Jan 2002 U. S.

Justice department launches criminal investigation. Hence within three months Enron had gone from being a company claiming assets worth almost \$62bn to bankruptcy. Its share price collapsed from about \$95 to below \$1. Role of Andersen: Arthur Andersen – one of the world's five leading accounting firms – was the auditor to Enron.

When the scandal broke. Andersen's chief auditor for Enron, David Duncan, ordered the shredding of thousands of documents that might prove compromising. Andersen has dismissed Mr. Duncan and Andersen's chief executive at the time of the Enron collapse, Jo Berardino, resigned at the end of March 2002. Besides obstruction of justice, Andersen also faces charges that it improperly approved of Enron's off-balance-sheet partnerships, called "special purpose entities", which the company used illicitly to hide losses from investors.

Creative Accounting: The Special Purpose Entities (SPE's) At the heart of Enron's demise was the creation of partnerships with shell companies, these shell companies, run by Enron executives who profited richly from them, allowed Enron to keep hundreds of millions of dollars in debt off its books. But once stock analysts and financial journalists heard about these arrangements, investors began to lose confidence in the company's finances. The results: a run on the stock, lowered credit ratings and insolvency. How

Enron used SPE's for off balance sheet financing: The above flow chart explains how Enron used the SPE's taking most of its debt off balance sheet. Merrill Lynch handled the sales pitch for one such vehicle, LJM2 Co-Investment.

According to claims and counter-claims filed in Delaware court hearings; many of the most prominent names in world finance – including Citigroup, JP Morgan Chase, CIBC, Deutsche Bank and Dresdner Bank – were still involved in the partnership, directly or indirectly, when Enron filed for bankruptcy. Originally, it appears that initially Enron was using SPE's appropriately by placing non energy related business into separate legal entities. What they did wrong was that they apparently tried to manufacture earnings by manipulating the capital structure of the SPEs; hide their losses; did not have independent outside partners that prevented full disclosure and did not disclose the risks in their financial statements. There should be no interlocking management: The managers of the off balance sheet entity cannot be the same as the parent company in order to avoid conflicts of interest. The ownership percentage of the off balance sheet entity should be higher than 3% and the outside investors should not be controlled or affiliated with the parent: This was clearly not the case at Enron. Enron, in order to circumvent the outside ownership rules funneled money through a series of partnerships that appeared to be independent businesses, but which were controlled by Enron management.

The scope and importance of the off-balance sheet vehicles were not widely known among investors in Enron stock, but they were no secret to many Wall

Street firms. By the end of 1999, according to company estimates, it had moved \$27bn of its total \$60bn in assets off balance