

# How fall of enron raised concerns about accounting issues



**ASSIGN  
BUSTER**

Enron Corporation of Houston was one of the largest companies in the world. From the start of the 1990s to mid 2000, Enron's stock price increased from about \$7 per share to a peak of \$90 per share. By December 31, 2000, Enron reported its turnover of \$101 billion, and its market capitalization exceeded \$60 billion, 70 times earnings and six times book value. Enron was rated the most innovative large company in the world. However, it turned to bankrupt in December 2001 after it was revealed that the company had hidden \$658 million in debt and overstated profits of \$591 million between 1997 and 2000. The stock price dropped down to less than \$1 per share. Shareholders' equity was reduced by total of \$1. 7 billion and thousands of employees who had their tax deferred retirement plans tied to the Enron stock lost wealth. Arthur Andersen, the accounting firm responsible for Enron's auditing, was destroyed because of the violation of complying the US GAAP in conducting an audit and conflict of interest over the significant consulting fees paid by Enron. Enron undertook creative accounting schemes to take full advantages of accounting limitations in managing its earnings and balance sheet to paint a rosy picture of its performance.

The fall of Enron has raised broad public and official concerns about accounting issues and the subsequent disclosures of misconduct by its auditor, Arthur Andersen. This report will be delineated the major events of Enron's financial collapse and the financial reporting issues. Furthermore, it will be considered the issues of accounting standards and auditing.

Results of findings

Accounting issues

## 1. Off balance sheet financing (SPEs)

After investigation commenced, it was discovered that Enron used complex structures which are referred to as Special Purpose Entities (SPEs) to hide tax and debts off balance sheet. SPEs are independent entities created for limited purposes. “ Under GAAP rules, Enron was not required to consolidate these SPEs with its financial statements if independent third parties had controlling (more than 50%) financial interest and “ substantial” equity interest in the SPE, where “ substantial” was defined as at least 3% of the SPEs’ asset.” (Benston, 2003) Therefore, because of their complex nature, it is easily to be used to manipulate a corporation’s financial results, where most of the misstatements of Enron were associated with SPEs. On October 2001, Enron was revealed that they violated GAAP that require at least 3 percent of assets to be owned by independent equity investors. There are five important accounting issues involved in SPEs.

First, Chewco , one of the Enron ‘ s SPEs was created for Enron to acquire the partnership interest without recognizing any additional debt showing on its balance sheet. (Paul, 2003) However, it was found that Chewco was not an independent owner, but a subsidiary of Enron. It violated the minimum 3% rule, but the Andersen who was the auditor of Enron, did not realize this failure since Enron was at risk for all of its debt. Second, those SPEs were managed by Enron’s chief financial officer, Andrew Fastow for the purpose of transfer money to the Enron’s executives as fees. It was simply a real fraud, and those SPEs were not independent entities which should be consolidated. Third, net profits made with those SPEs were not controlled by Enron were improperly recorded on Enron’s book. Fourth, Enron sponsored SPEs with its <https://assignbuster.com/how-fall-of-enron-raised-concerns-about-accounting-issues/>

own stock, taking notes receivable in return. Fifth, SPEs allowed Enron to avoid losses showing on its balance sheet, because those SPEs sold Enron put options when its market price declined, the losses were offset by the put option obligations of the SPEs. (Benston, 2002) However, those SPEs were actually using Enron's own stock and financial guarantees to carry out these hedges.

## 2. Revenue Recognition

In 2000, Enron moved away from supply of gas into “ market making” in energy, buying and selling wholesale services and taking the risk of dealing with derivatives. This allowed them to classify themselves as “ agents” of their customers rather than merchants. Under US GAAP agents are allowed to report trading and brokerage fees as revenue, although there is no cash flow inflow to the business. Also, some of the SPEs paid Enron fees for guarantees on loans made by the SPEs. Enron recorded the up-front payments as current revenue. According to matching concept of income determination of GAAP, the revenue should be recognised only over the period of the guarantees. Enron violated the requirements of GAAP.

Furthermore, Benston (2003, P. 27) argued that the company involved several sizable “ shame sales”, where the buyers simultaneously or after a prearranged delay sold back to Enron the same or similar assets at close to the price they “ paid”. Enron recorded the sales contracts as profit, but did not recognize the purchase contracts as an offsetting expense. These “ unrealised” revenue overstated the turnover of the business and understated its risk.

### 3. Market to Market

Enron adopted mark-to market accounting basis to value its long-term energy contracts. Under mark to market rules, the contracts and assets are revalued in market prices, and the present value of the future inflows under the contracts was recognized as revenue. EITF Issue 98-10 requires energy-trading contracts to be stated at fair values that may be determined by estimated net present value. (Benston, 2002) However, there are often no quoted prices upon which to base valuations. It is more based on director's assumption rather than market value. Therefore, it is easily allowed managers to manipulate the profits. Enron was revealed \$763 million of additional net assets in Enron's accounts by marking these contracts up to market value, although these were the unrealised gains but they were reported as part of annual earnings.

In the view of mark to market basis, it is worth to look at the fair value. As FASB allowed "the values" of derivatives to be determined by marking to model, even the market value are not determined from arm's length transaction. Many of the cases shows that Enron did not make reasonable assumptions what they should record the gains. Particular examples made by Benston, (2003) are Enron's broadband investment and joint venture with Blockbuster, Inc., Braveheart and energy contracts. In 2000 Enron invested more than \$1 billion in broadband and reported revenue of \$408 million, it also assigned a fair value of \$125 million even though the venture was only two weeks old and had not generated any profit. For the energy contracts, Enron calculated its total profit over the life of the contract and record the

profit immediately. In October 2001, Enron claimed \$106 million additional profit generated from manipulating mark to market. (Benston, 2002)

#### 4. Stock Issued to and Held by SPEs

GAAP does not permit a corporation to record stock as income increases in the value of its own stock unless it has been paid for in cash or its equivalent. However, JEDI, one of the Enron's SPE, recorded the increase in Enron's stock as income for the amount of the increased market value. Hence, as Enron accounted for its investment in JEDI with equity method, it recorded in its increases as investment return. (Benston, 2002) Then when the market price of Enron stock increased and the SPEs increased their assets, Enron recognized the gains as increases in its equity investments in the SPEs.

#### 5. Inadequate disclosure of related-party transactions and conflicts of interest

Enron involved many transactions with its SPEs whose general partner's managing member Andrew Fastow, a senior officer of Enron. Enron's proxy statements in 2000 and 2001 stated that "the general partner is entitled to receive a percentage of the profits of LJM1 in excess of the general partner's proportion of total capital contributed to LJM1, depending upon the performance of the investment made by LJM1." (Benston, 2002) However, there was nowhere disclosed the information about how much Fastow received and the relationship of any of those entities to Enron. Enron also was revealed that it had entered various transactions to hedge certain merchant investments and other assets with its unconsolidated equity

<https://assignbuster.com/how-fall-of-enron-raised-concerns-about-accounting-issues/>

affiliates. Without clear disclosures there, it was difficult for investors and analysts to raise questions about these off-balance sheet transactions. (Ohly, 2002)

Also, as discussed above, Enron did not make transaction with its SPEs at arms' length. It raised the problem of conflict of interest. Andrew Fastow and the employees who reported to him took their own advantages from these transactions. They benefited at least \$40 million from dealing with the SPEs which they were general and limited partners. Benston (2002, P. 29) said "these practices appear to have violated both FASB disclosure requirements and the SEC requirement to disclose transactions exceeding \$60, 000 in which an executive officer of a corporation has a material interest."

#### Changes after Enron

After the collapse of Enron, US federal law enacted an act called Sarbanes-Oxley Act in 2002 to set new and enhanced standards for US public company boards, management and public accounting firms, protecting damage from accounting scandals such as Enron. "The spirit of Sarbanes-Oxley Act is unquestionably on the side of truth and fairness. It is to improve the effectiveness and independence of audit and to strengthen accounting regulation are all needed desperately." (Brown, 2002)

One of the incentives in this Act is to ensure that corporate managers especially chief executives report the financial conditions of their companies fairly and materially in conformity with SEC. (Benston, 2002) It also requires CEOs to repay any incentive based compensation if profits are found to have

been misstated. Criminal penalties up to 25 years for deliberate wrongdoing were founded.

Another obvious change is to ensure auditor independence. It prohibited auditors to conduct non audit services for audit clients. The auditor of Enron, Andersen, earned more from Enron in consulting fees (\$27 million) than in auditing fees (\$25 million). It was critically argued that auditors could easily compromise their audits in holding on to lucrative non audit service with undue incentives (Benston, 2002). The Sarbanes-Oxley Act of 2002 requires that only the audit committees of boards of directors, rather than the corporate managers, may hire and fire external auditors and that the audit committee be composed only of independent directors. Brown, (2002) Sarbanes-Oxley Act also concern about the rotation of audit partners within the firm. Revsine (2002) said “ Reassignment and firm rotation convey large independence benefits with seemingly tolerable costs and appear desirable.”

Influences:

The fall of Enron still has influences for today's preparers and users of published financial statements although it has past 10 years. Government corporate, professional bodies and investors lost confidence in company's activities and management integrity. Questions have also been asked about the effectiveness of existing rules for both accounting and auditors in US. However, the UK's regulators and accounting professions claimed that Enron's fraud and misstatement would not happen in the UK.

Substance over the form



US GAAP contains more detailed rules and guidance than IFRS, but some of the rules are inconsistent with the US conceptual framework. In contrast, IFRS is described as principle based. It contains more broad guidelines and less specific, case-based guidance.

Under UK or international accounting standards, some people believed that Enron scandal would not happen, as the rules are harsher. The rules-based approach to accounting applied by the USA provides companies with an incentive to comply the letters but avoid the spirit of the rules. However, a more principle-based approach such as UK and IFRS, would not allow the removal of material liabilities from Enron's balance sheet via its SPEs under IFRS 5 which requires that the substance of an entity's transactions is reported in its financial statements. It allows auditors to focus on form and not on substance.

#### True and fair view

In the UK, true and fair view is more important than adhering to detailed rules. " The use of the phrase in the UK must be seen in the context of the statutory requirement for financial statements to present " true and fair view" which is widely regarded in UK accounting practice as having a broader range than the US phrase " fairly present". ( Roberts, Weetman, Gordon, 2008) In the UK, true and fair view stands above any specific set of rules. It requires corporate managers and their auditors to exercise judgments and take more risk when presenting opinions about the financial affairs of a company. (Benston, 2002) Therefore, it might discourage the company or its auditors from making fraud.

## Convergence between IFRSs and FASB

To eliminate the major differences between these two sets of standards, IFRSs and FASB announced in 2002 that they would work together to achieve convergence and make effort to develop a common set of high quality global standards remains a priority of both standards. In October 2004, they also announced that they would develop a common conceptual framework as a foundation for developing principles-based standards that are internally consistent and internationally converged. ( Roberts, Weetman, Gordon, 2008)

## Auditor independence

Enron's auditor, Arthur Andersen, has been accused of applying lax standards in their audits because of a conflict of interest over the significant consulting fees generated by Enron. ( Pau I and Krishna , 2003) After the disclosure of the highly respected accounting firm of Arthur Andersen audited unqualifiedly Enron's financial statements, it is urgent to reform or enhance the auditor standards to maintain public and government' s confidence in the independent auditors.

In the UK, it is defined the primary role of audit committees as ensuring the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective and does a thorough job, and by fostering a culture and an expectation of effective oversight.( Roberts, Weetman and Gordon, 2008) It requires auditors to monitor the processes of making financial statements, review the company's financial control and risk management systems, monitor and review the effectiveness of the

<https://assignbuster.com/how-fall-of-enron-raised-concerns-about-accounting-issues/>

company's internal audit function and for external auditors, it develops policy on the engagement of the external auditor to supply non-audit services which need to fully disclose the audit and consulting fees in the annual report and accounts.

### Conclusion and recommendations

The fall of Enron raised broad debate not only what went wrong, but also the adequate and sufficient corporate disclosure. However, the disclosure failures and shortcomings associated with Enron made public attention on accounting and disclosure policies in many ways that never have imagined and enhanced the financial reporting regulation and strength regulatory oversight and corporate governance. In my opinion, US GAAP was substantially responsible for Enron's accounting debacle. It provided incentives for corporate managers and auditors to exploit advantages of the loopholes of the US rules-based GAAP.

I believe, although the case of Enron would not happen in the UK, the accounting regulation can never keep up with the rapid changing market and there is no certain accounting standard to make devious people to be honest. Therefore, auditors, managers, shareholders, analysts, regulators and directors need to literate in financial reporting. Furthermore, in my opinion, UK and IFRSs principles-based standards are superiority than US GAAP. US standard setters should set broader statements of principle, applied with good judgment and respect for the substance of underlying transactions and events.