

# Critical thinking on bigger than enron

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A) Briefly discuss the treatment of employee stock options under each of the following:

1. Previous FASB/APB/CAP on Stock Options [Hint APB Opinion #25]

APB Opinion 25 calculated stock options employing the intrinsic value technique, in which compensation expense appeared to be realized as the stock price surplus at the grant date divided by the price of option exercise. This technique however overlooked any possibility that the stock price might go beyond the exercise price, since most stock options possessed exercise prices as a minimum equivalent to contemporary market values, compensation expense thus not acknowledged.

2. FASB SFAS No. 123 as originally published.

The FASB endeavored to identify the actuality of stock-option price by proposing SFAS 123, which necessitated gauging the stock option price rooted on the countless dynamics that reproduce its fundamental price. Consequently, entire compensation expense was rooted on the stock options fair value projected to depend on the grant date. This entails that no alterations would be created after the grant date in reaction to ensuing stock price alterations. This was done using Black-Scholes as well as binomial option-pricing models.

3. FASB SFAS No. 123 as amended or revised (123R)

This was done in October 2001 at a time Enron revealed accounting errors in excess of \$1 billion. The financial fraud wave disclosures augmented the transparency demand in corporate book keeping. This is when FASB came up with SFAS 123 (Revised), which was Share-Based Payment. This meant that

public and nonpublic corporations having calendar financial year-ends to identify stock-based compensation within their revenue statements

B) Mr. James Hooton of Arthur Andersen called Auditors the “ keepers of the Holy Grail”. What did Mr. Hooton mean by this? What is the role that auditors play in society? How do Auditors assist in the establishment of an efficient marketplace?

The keepers of the Grail are renowned for shielding the Holy Grail and preserving it for the worthy. Mr. James Hooton was referring to the auditors to this respect to mean that they were the ones responsible of keeping the accounting rules pure and they are supposed to challenge any malpractices in terms of accounting as it was the case in Carl Bass and the technical group.

The primary role of auditors is to provide clients with autonomous expert judgment and information regarding the accuracy and fairness of the financial statements.

In contemporary society there is an extremely synchronized market, therefore audit and auditors append value to ones company via providing autonomous integrity to financial statements; qualified counsel to management; and elucidations to improve systems and efficacy

C) Mr. Lieberman (U. S. Senator) and Mr. Levitt (Former Chairman of the SEC) had different views on stock options. Specifically they discussed the topic in terms of the need to hire and attract managerial talent. Briefly discuss those arguments. What is your opinion on that argument? Is there a solution to the problem?

Mr. Lieberman was in opposition to expensing stock options. His argument

was that this was a slap on entrepreneurship. He claimed that this would thwart companies from employing high-quality personnel therefore obliterating companies in the process distorting their earnings. Mr. Levitt's argument was that for stock option to be employed to persuade an employee to arrive at a company therefore stock option had to be embodied as a cost. My opinion is that since stock options are a peculiar thing from an accounting standpoint and that they are an approach that money is moved from shareholders to executives, when one produces additional stock options, the stock that the standard shareholder possesses becomes less valuable. However, following Enron's mishaps, I will bet on MR. Levitt anytime.

So the solution that was trying to capture the fact that it was compensation, it was valuable; it was a cost of production, but it wasn't transferred from the company to the executives. It was transferred from the shareholders.

D) In 1994 given the support of Senator Lieberman and others the US Senate passed a non-binding resolution that passed by a vote of 88-9 to require FASB to reconsider their position on the expensing of stock options. What happened as a result of this action? How did the then SEC Chairman Arthur Levitt enter into the equation? In retrospect, how did Mr. Levitt characterize his actions? What do you think about FASB giving in to the pressure? Is it possible this can happen again? What safeguards can be employed to try to make this not repeat?

The accounting board produced an attractive good concession, which was, in place of necessitating expensing from proceeds, it supposed the corporation has to reveal by a formula what influence the expensing of options at the

time they were approved would have on the wages of the corporation. It is possibly more apparent.

However where Arthur Levitt came in when he had apprehension that if Congress brought about a law that would muzzle FASB, therefore killing the autonomous standard setting. That is why he went to FASB at that time, and urged them not to go ahead with the rule suggestion. However he claimed that that was almost certainly the solitary major mistake he made at the helm of SEC.

E) Discuss the fraud at Sunbeam involving the CEO Al “ Chainsaw” Dunlop. What accounting mechanisms were abused? Discuss the “ Cookie Jar Reserves” or “ Slush-Fund” and how they work. What actions can be taken by an Auditor to ensure that such “ Reserves” and “ Funds” are not established and abused by Management?

This was an extremely invasive fraud, concerning inappropriate income recognition, sales returns reserves understatements and appalling debts, exploitation of the rules prevailing consignment sales, in addition to other exploitations. Whilst the amounts implicated appear inconsequential when contrasted to Enron and WorldCom amounts, the issue at Sunbeam is enlightening. Most Sunbeams’ problems were instigated by an obnoxious and narcissistic CEO. Besides, Sunbeam’s peripheral auditor throughout the phase of the scheme was Arthur Andersen. Sunbeam can be scrutinized as being an element of a range of audit malfunctions widening from Waste Management to Enron.

Cookie Jar reserves is an application that is attained when corporations depict impractical assumptions when computing sales returns estimates,

loan losses or guarantee costs. These accretions are then concealed in cookie jars throughout good times and expended all through bad times. Slush fund accounting integrates a circumstance which some income from a quarter are concealed just in case the proceeds from next quarter is not sufficient for the executive to make their bonuses.

F) Discuss the Fraud at Waste Management. How did management “ pull-off” the Fraud? When the Auditors (Arthur Andersen) caught them what happened? Discuss the long-term agreement between Andersen and Waste Management. What does this agreement constitute? How and when did the SEC fin out about the scandal and the arrangement? What did the SEC do in light of this unprecedented “ agreement” between Andersen and Waste Management? Discuss the impact of the destruction of documents in the Waste Management case and the “ Harbinger” of things to come at Enron. Do you believe in some way that the SEC assisted in the same behavior occurring at Enron by not severely punishing Andersen?

Executives exaggerated proceeds by \$1. 7 Billion to acquire income target. They gathered millions in unscrupulous gains whereas deceived shareholders lost over \$6 Billion. The executives desecrated, and aided and encouraged infringements of, antifraud, reporting, and record-keeping necessities of the centralized securities laws. They deceitfully influenced the corporation's economic results to meet prearranged income targets. The corporation's revenues were not increasing fast enough to attain these targets, so they as an alternative resorted to inappropriately eradicating and postponing present period expenses to increase income. They employed a multitude of improper accounting practices to achieve this objective.

They covered their plot in a diversity of conducts. They made fake and deceptive statements concerning the corporation's accounting practices, fiscal condition, and potential predictions in filings with the Commission, reports to shareholders, and press releases. They as well employed accounting exploitations recognized as netting and geography to create reported results emerge better than they essentially were and shun public analysis. Netting was used to get rid of roughly \$490 million in present period working expenses and accrued prior period accounting misstatements by counterbalancing them in opposition to unconnected on one occasion achievements on the sale or assets exchange. Geography entries were to move tens of millions of dollars flanked by a variety of line items on the corporations' income statement to make the fiscals look the way they want to show them.

Arthur Andersen LLP, their long time auditor, aided in their fraud by continually issuing unprofessional audit reports regarding the corporation's substantially fake and deceptive yearly financial statements. Andersen however recognized the corporation's inappropriate accounting practices and enumerated much of the influence of those practices on the corporation's financial statements. They yearly presented corporation management with a Proposed Adjusting Journal Entries to make right errors that devalued expenses and exaggerated income in the corporation's financial statements. However the scheme was unraveled when a new CEO structured an evaluation of the corporation's accounting practices. The review led to the summary of the corporation's financial statements. This led to the acknowledgment that the company had misstated the pre-tax income by

roughly \$1. 7 billion.

As news of the company's overstatement of earnings became public, Waste Management's shareholders lost in excess of \$6 billion in the market value of their savings when the stock price plummeted by in excess of 33%.

G) Discuss the Private Securities Litigation Act (PSLA) passed by Congress over the Presidential veto. What impact did the PSLA have on audits and auditors?

Congress passed the Act, alleging that the class action mechanism was being employed to damage the U. S. economy via irritant filings, aims of deep-pocket individuals, vexatious detection requirements, and exploitation by class action attorneys of the clients whom they ostensibly stand for. The act consequently forced new limitations that incorporated a discriminating importunate set for securities class actions; injure caps, and compulsory permits for perky litigation.

The result was that several securities fraud petitioners required breaking away from the new strictures underneath the act by passing up federal court on the whole. Whereas in the ancient times security incidences were uncommon in courts of the state, law-based class proceedings for securities swindle now became regular. Congress carried out a hearing in 1997 to assess these properties of the PSLRA, and later on enacted SLUSA to curtail this move from national to State courts and thwart definite State private securities class action lawsuits claiming fraud from being employed to aggravate the goals of the Reform Act.

In the Act of 1995, The Private Securities Litigation Reform forced some of the similar requirements on public company auditors. They were as follows:



Audits must take account of procedures planned to provide sensible assurance of distinguishing unlawful acts that would contain a direct and substantial effect on monetary statement totals. Each audit has to comprise procedures to recognize related-party dealings that are material. Each audit has to include an assessment of the capability of the issuer of financial reports to carry on as a going worry.

H) Discuss the issue of Mr. Carl Bass at Arthur Andersen (the Quality Control partner for the worldwide firm). What did Mr. Bass allege and what happened to Mr. Bass? How did Enron figure into the demise of Mr. Bass? Why did Andersen give into the Enron Senior Management?

Carl Bass was the appointment partner for the 1997 and 1998 JEDI Audit for Enron. Bass had found that there were inconsistencies with financial statements of the company and had told the management about this repeatedly. However, because of his constant intrusion into Enron's books, Mr. Bass was removed from that review committee and replaced by another auditor. The management was the responsible culprit on this. This is because Enron's management was one of the largest of the firm's clients; so Andersen was under its command. So they did this to please Enron.

I) A common theme in the scandals was that senior management did not let the Board know what was happening. In a post Sarbanes-Oxley world, what specific items or procedures may keep this from happening in the future? How has Sarbanes-Oxley addressed any of the concerns brought up in the program Bigger Than Enron? Do you think the measures found in Sarbanes-Oxley will be effective?

The Sarbanes-Oxley Act has indicated a new era of lucidity and liability for corporate fiscal reporting. It has commenced a tornado of activity, as public corporation ramp up attempts to meet its new fiscal reporting standards and identify weaknesses in their interior controls. Sarbanes-Oxley has as well taught everybody the significance of knowing how the whole company works.

SOX denote more to business than straightforward legislation. It's symbolic of what many see as a essential and hard shift in how businesses work, a move from a " what-you-don't-know-can't-hurt-you" approach at management rank to an " honesty-is-the-best-policy" attitude.

In the long term however, I am not certain in this will work but we tend to hope for the best.

J) The former Chief Accountant at the SEC Mr. Lynn Turner described a system of people working at the large accounting and brokerage firms who would do nothing all day except think of was to circumvent GAAP. Such groups have led to the call for a " principles-based system" instead of a " rules-based system" of GAAP. Can you describe what is meant by such a system and how it may work? What is your opinion on the large audit firms participating in such an activity?

Basically acknowledged, principles-based accounting offers a theoretical basis for accountants to pursue as opposed to a list of comprehensive rules. Following a principles-based approach, it involves laying out the key purposes of good reporting in the question area and then offers supervision explaining the purpose and relating it to some widespread examples.

Whereas rules are at times inevitable, the intention is not to attempt to give

specific leadership or rules for each probable circumstance.

However, the problem arises when standards setters draw near the hard task of influencing the suitable height of comprehensive guidance to attain adequate comparability and reliability in financial statements. A principles-based standard repeatedly becomes a rules-based standard in an effort to amplify comparability and consistency. Therefore in my opinion both should be employed in a complementary manner

K) Please provide me your honest opinion on the applicability of this topic to Accounting & Auditing and whether you personally found the exercise helpful in fulfilling your education in Accounting & Auditing. Any feedback at all will receive extra credit on this assignment."

Personally, I am enlightened from this exercise. I have been able to research the issues regarding scandals in big companies especially attributed to accounting and auditing errors. I was able to critically think of whether the companies were really at fault or were this, the faults of the auditing firm, Andersen. I have really gained from this exercise and I am grateful.