

# Enron's financial mistakes

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The history of accounting scams is as old as accounting and in the past it was mostly, if not all, unintentional and less crooked. But, when fraudulent accounting practices were found as a means to favorably convert financial information, efforts were started to think seriously about the techniques of misstating the statements and intentionally deceive the stakeholders, especially investors. The accounting scams in the US such as Enron and WorldCom have attracted the attention of professionals as well as general public from every nook and corner of the world.

The collapse of Enron, the seventh largest corporation in the country, as a result of accounting scams, was a real shock to the entire business community in general and accounting professionals in particular and the first of its type in the history of the country. The WorldCom, one of the biggest telecommunication corporations was found committed accounting fraud during 1990s and that led to its eventual bankruptcy. In March 2002, the U. S. Securities and Exchange Commission (SEC) enquired for information on accounting practices and the loans it extended to the officers from WorldCom.

In April 2002, Standard & Poor's, Moody's and Fitch downgraded WorldCom's credit ratings soon after the company cut 3, 700 jobs. The U. S. Justice Department has launched an independent probe into the WorldCom scandal and it finally came out with the stunning report that many of the accounting practices of the company were of crooked and deceptive in nature. Some of the reported corporate scandals are exhibited in the following Corporate Scandal Sheet. Enron- The Only Fall of a Giant..? Is Enron the only big company to file for bankruptcy?

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Many of the big and famous American firms like Polaroid Regal Cinema, Federal Mogul and Bethlehem Steel have gone belly up. In fact the number of high profile bankruptcies has considerably increased. In 2001 there were more than 32 bankruptcies of companies with billions of dollars in liabilities. This is a huge turnaround from the previous years. Defaults between 1992 and 1998 were pretty low in number. The bankruptcies this time are vastly different from the earlier ones. During the past years the bankruptcies were more specific to the company while now entire industries are in trouble especially in movies, hospitals and steel.

The attitude towards bankruptcies also has changed. Unlike in the past when companies that went bankrupt were given years to try to work out their problems, now, Midway Airlines, a troubled carrier, which following the attacks of September 11 was declared bankrupt and closed for good on the same day (Albrecht, 2003). The Story Behind the Collapse The institution of the American capitalism that had touched and closely advocate to the rest of the world, that every system simply failed by the collapse of Enron's corporation. Enron corporate failure hits almost all areas like management, Board of directors, Internal and external audit function.

Yet the greatest failure of American free market capitalism was the failure of the securities exchange commission. The most shocking matter in the United States business world is Enron Corporation, one of the most innovative, fastest growing and best managed business houses filing the bankruptcy in the year of 2001 (Consumer Federation of America). The investigation related to the cause may take long periods to get result but the exact reason

by which the company failed to operate is the financial oversight issues or Froude in the accounting process.

However the report shows the truth that the accounting system is failed to give the real picture of the firm's condition. But the independent auditors were didn't shown any interest to challenge with the management about the fraud. The company was started in the year of 1985 by a merger of Houston natural Gas and intermonth as Enron Corporation. Gradually the company becomes countries first nationwide natural gas pipeline network. Meanwhile the firm's business activities shifted from the regulated transportation of natural gas in the unregulated energy trading.

The management was guided to the company to make more money through buying and selling financial agreements linked to the value of energy assets than the actual possession of the tangible assets (Louth). And the management of Enron Corporation declares that the company's revenue was grown as tremendous height from 1990 to 2000 period. In 1990 it was \$10 billion and in 2000 it reached to \$101 billion and ranked as the 7th place among the fortune 500 companies in terms of revenue (O'Harrow).

The real fact of the corporation was begun in august 2001 by the resignation of CEO Jeffrey Skilling on unrevealed reason. The company reported its first quarter loss in 4 years and stated as poor performance in the business. Hence the during the third quarter loss reached to \$618 million against \$ 292 million profit a year before. Ultimately the fact comes out when the company approaches to the Securities and Exchange Commission that it is going to restate its earnings from 1997 (Fulcrum Financial Inquiry, 2004).

Under this degraded position several committees were formed in the house and the discussion were hold to clarify case related to Enron's fall. Hence the committees were found that the final reason for collapse is the mistake done by the financemanager. Ultimately it caused for the collapse of world's 7th largest fortune 500 company Enron Corporation (McNamee, 2002). Auditing Issues The US federal securities law states to the publicly traded corporations that it should have certified by an independent auditor to its accounting report.

The Enron gives much attention to the outside auditors but the auditor failed to challenge with the management to show financial mistakes did by the company. Hence this cause to the bankruptcy problem and a sharp fall in the stock price (Saporito). Meanwhile the outside investors were misled by the report that it is far larger than generally published. And subsequently the company dismissed the auditor to admit some mistakes in the company report. Under the auditors problem the Securities and Exchange Commission proposed a new board that it is responsible for disciplinary actions.

Accounting issues The Enron corporation argument involves several issues related to accounting. One issue is the rules governing whether the financial announcement of special purpose body established by a corporation should be combined with the corporation's financial statement and another issues is, the consolidation is not necessary among other things if an independent third party invests as little as 3% of the capital. Similarly certain other concern like autonomy allowed in valuing derivatives particularly non exchange traded energy agreements.

However certain issues concerned to the management under accounting process are its arrangements towards liabilities, which pushed the accounting to give wrong statement (CNN Money, 2004). Pension Issues Similar to the other multinational corporation the Enron followed certain employee retirement plan- " 401(K)" in which the employees can contribute a part of their pay on a tax - deferred basis. In the year of 2000 nearly 62% of the assets were held in the company under 401(k) retirement plan. Ultimately the year many employees from the Enron Corporation have its largest percentage of stock in their 401(k) plan.

Under the bankruptcy the value of employee stocks were declined and it caused for beginning of another problem in the corporation (Smith, 2002). Corporate governance issues The role of the board of directors in an organization is to supervise the corporate management to uphold the concentration of shareholders. Meanwhile a conflict raised in the Enron Corporation when Chief Financial Officer attempt to make a private partnership with third party. Securities analyst issues The main aim to keep the securities analyst is to provide information and to make research regarding the various securities followed by a company to its clients.

Under which he recommends the most return oriented stock to buy or to sell or to hold. These recommendations were largely followed by various investors throughout the market. However the analysts couldn't support the Enron stock because it needs a large infusion of funds from the market. After the collapse its stocks were fallen nearly 99% and majority of the analysts firms were suggested sell option to their clients (LACE Financial, 2003).

Finding this recommendation majority shareholders sold their stock at very little price.

So this is another topmost reason for devalue of company stock price. Derivatives issues Enron business majority of the dealings appears in the derivative contracts and it is based on the oil price, gas, electricity and the prices related to the other variables. For concern if Enron trade the long term contracts to vend energy at fixed price, which allows the buyer to hedge their security from the risk. Since the market in which Enron traded is largely unregulated, with no reporting requirements and modest information available concerned with Enron derivative activities.

However on the other hand, the trading process may have been gainful and problem free and Enron's financial obscurity may consequence of other distinct operations. The failure occurs The problem would occur when Enron's senior executives remarkably lay, skilling and faster. Yet they tried to convince that they were operating with the approval of board of directors. However the board of directors continuously supporting the outside auditor and they audit the company accounts according to the influence of board of directors.

The accounting system also developed to confirm with generally accepted accounting principles as interpreted by the joint agreement of Arthur Anderson auditors and the consulting unit. But each player in the Enron system believed that they are operating in the same system and each system is linked to the confirmation of others department. Hence everybody in the system was believed and confident about the supplementary players in the system. But even the credit rating organization with their strong <https://assignbuster.com/enrons-financial-mistakes/>

accounting system and with analytical expertise failed to understand the Enron's truth.

And they failed to give a superior recommendation and warning of possible failure to the investing public and financial institutions. The in desperate endeavor to keep up with hostile earnings targets, Enron's managers become so arbitrary in consigning the firm's capital in 1999. However the international energy division offered the skilling with a plan that consider earning just \$100 million in profit on a capital base of \$7 billion. By that performances an amount to loss of several hundred million in terms of financial profits, the CFO faced significant pressure to use deceiving strategy to put off day of estimation.

But certainty in the Enron's accounts the morality plays a major role. The major part of theresponsibility must be allocated to the plan of the company's performance measures and internal management. The case of Enron Corporation is concern that it is one of the most complex mistake chains imaginable and cases of multiple failure of management multiple mistakes. Once the arrogance becomes the dominant behavior of the senior management at Enron, another dangerous effect took place that had to do with pushing boundaries.

Enron got so used to believing it could alter the rules of the diversion, that it used arrangement so complicated that the only imaginable purpose was to give the manifestation of enhanced performance while disguise of the reality. Hence the corporate culture is the critical part of a company. But when an organization culture is start to discourage the delivery of bad news it will affect the people to speak about what they see. Under this aspect the <https://assignbuster.com/enrons-financial-mistakes/>



potential disputes between the senior management and board lead the collectively responsible for its failure.

However it states that the transaction in the company was found excellent in service but the main responsible factor is the management. So Enron's outside advisor also failed to protect the interest of shareholders. Conflict of interest Traveler and Citibank merged in the year 2000. Since then the two have won market share in underwriting and advising on mergers and acquisition from traditional investment banks like Goldman Sachs, Morgan Stanley and Merrill Lynch. They have done so in part by using huge balance sheets to offer both loans and investment banking services to their clients.

Rivals complain that JP Morgan and Citigroup have made loans at a loss in order to win more lucrative investment banking business. These banks, rivals say, are able to avoid disclosure at least in the short-term, thanks to favorable accounting rules that do not require commercial banks to mark the loan portfolio to the market. However, both the banks deny lending at lower standards. If this is what happened with Enron, then what about its Indian connection the Dabhol Power Project (DPC); In Dabhol, Enron owns 65 percent of stake.

Other promoters include GE and US Contractor Bechtel who own 10 percent each and Maharashtra State Electricity Board owning the remaining 15 percent. Indian banks and institutions have sanctioned a total loan of Rs. 6194 crore. And a disbursement of more than 90 percent has already been completed. This includes non-fund exposure of Rs. 3200 crore on account of guarantees to exposure taken by overseas banks and export credit agencies. The individual exposures according to the media are Rs. 2121 crore for IDBI, <https://assignbuster.com/enrons-financial-mistakes/>

Rs. 1473 crore for ICICI, Rs. 1749 crore for State Bank of India, Rs. 454 crore for IFCI.

This write-off of such a large lending would close curtains for many of these institutions IDBI and ICICI have already called for a bailout package earlier last year. Things were a lot different when the loan was sanctioned. The interest return was good but now they do not know where they stand with respect to the foreign creditors. They are listening to the legal counsel White and Case. Indian FIs maintain that Dabhol is not a part of the bankruptcy proceedings and Enron's holdings in DPC is pledged with them and cannot be auctioned by a liquidator.

However, they do agree that legal impediments exist and every thing depends on whether the Indian FIs can push through the third party sale of Enron's equity. Six major companies have shown their interest in Dabhol three Indian (BSES Tata Power and GAIL) and three foreign (Gas de France, Royal Dutch Shell and TotalFiaElf). These high level bankruptcies call for a proper mechanism which the banks and FIs need to keep in place and stop myopic lending to the highly leveraged firms with greater risks. Investment banking divisions' and the commercial banking divisions should be separated so that the conflict of interest does not arise.

Given the sheer size of the bankrupt companies, it would be no surprise if banks drown along with the sinking companies. Conclusion So why are banks lending blindly to highly leveraged companies? Are there no warning signals? The banks often blame the external credit rating agencies as they lend based on the agencies' ratings. With the new Basle norms coming up which gives an open hand to the banks to do their own ratings and lend on this

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basis, the problem of blaming the external agencies may be solved. However, the area requiring scrutiny is the role of the bankers.

In the case of Enron, the role of JP Morgan and Citigroup is in the spotlight. These two financial conglomerates in their current form do both investment banking and commercial banking. This service was extended to Enron only because of the abolition of Glass-Steagall Act. This Act had imposed statutory barriers between commercial banking, investment banking and insurance. The conflicts of interests between the two banking activities may have played a role in Enron's collapse. References Albrecht, Steve W (2003) " Business Fraud - Enron and others.

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