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The collapse of Enron was entirely related to the accounting practices adopted by the company. It is a number of these questionable, and in some cases straight out fraudulent, accounting practices that pertained to the most dramatic collapse of a major company in years.

An analysis of some of these accounting practices brings to light the problems with the use of concepts such as mark-to-market accounting and the use of special purpose entity's (SPE's). To say that the collapse "seemed to be a thumb in the nose of the efficient market hypothesis (EMH)" is a statement misguided in the understanding of this concept. One can explain this through the fact that a number of the basic principals of the EMH were satisfied during the time of the Enron collapse. Furthermore, the interrelation of agency theory and EMH, suggests that the basic ideals surrounding agency theory also applied to the Enron Case at some point in time, however the continuation of this principal deteriorated as time went on. Among a number of questionable and fraudulent accounting practices were two key concepts that hid the true value of the firm so it was not "readily apparent to anyone except a forensic accountant" (Sewer, 2002).

These concepts were the use of Special purpose entities (SPE's) and mark-to-market accounting. The reason to choose analysis of these concepts is that neither is fraudulent in itself, however its application in this case caused a review of these principals. Enron's use of special purpose entities has been one of the most widely discussed accounting issues of recent times. The use of special purpose entities is common amongst almost all, if not all organizations. A key problem with the way Enron had set up its SPE's was that it had not established "corporate separateness" that is "a corporation
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separate from its shareholder, directors and officers, even when it is wholly owned by another corporation” (Thompson, 2004). This is evident in the entity known as LJM.

This entity was chaired by Andy Fastow, the then CFO of Enron. In the documentary “ Enron: The smartest Guys in The Room”, Fastow is seen pitching the idea of LJM to investors, at one point he is seen explaining the advantages of being the chairman of LJM as well as the CFO of Enron, which is then followed by a question “ Is there a conflict of interest? ” to which he responds, and I quote, “ I will always be on the LJM side of the transaction” (Enron: The Smartest Guys in The Room). Fastow has clearly contradicted himself and footage highlights the issue of corporate separateness. The reason for the use of SPE’s is to “ partition specific parts, assets and liabilities of a business to achieve various tax, accounting or liability avoiding goals” (Thompson, 2004). The problem with Enron’s SPE’s was the sheer quantity of them, “ in its year 200 Annual Report, Enron lists three thousand affiliates and related companies, including SPE’s” (Thompson, 2004).

While SPE’s are used because it allows “ the return on an asset to be maximised, and risk minimised, by transferring it to and SPE, which must at some point repay the debt which it has incurred to the vendor company” (Deakin, Konzellman, 2004). The issue lies in the fact that US Generally Accepted Accounting Principles “ provides that the assets and liabilities of an SPE do not need to appear on the balance sheet of the vendor company which has set it up” (Deakin, Konzellman, 2004) this allowed for Enron to set up multiple companies into which it could hide debt from investors. A former employee states in an interview on the documentary “ Enron: the Smartest <https://assignbuster.com/the-collapse-of-enron-seemed-to-be-a-thumb-in-the-nose-to-the-efficient-markets-hypothesis-and-agency-theory-discuss/>

Guys in the Room” that “ Enron loved these deals because they produce cash but don’t have to show the debt on the balance sheet” (Enron: The Smartest Guys in The Room). This evidence highlights the unethical use of SPE’s that Enron chose to adopt in the preparation of its financial statements. The other major Accounting flaw evident at Enron was the use of mark-to-market accounting.

Despite the likely overstatements that mark-to-market accounting would allow of fair value assets, “ Enron’s use of fair value accounting was never an issue in the criminal case against Lay and Skilling... however it did draw to attention the importance of fair value accounting to Enron” (Haldeman, 2006). The balance sheet of Enron included a number of current and noncurrent accounts called “ Price risk management assets” (Haldeman, 2006), these accounts were the fair value accounts that related to Enron’s assets. “ In January 1992 Skilling and Enron persuaded the SEC to allow them to use mark-to-market accounting to value there long term gas contracts and derivatives” (Haldeman, 2006) this gave Enron the “ Potential to book future profits on the day the deal was signed” (Enron: The Smartest Guys in The Room) and in turn allowed “ Enron’s profits to be what ever they said they were” (Enron: The Smartest Guys in The Room). An example of the use of these “ fair” value accounting methods is Enron’s building of a power plant in India. India could not pay for the energy that Enron produced which led to a loss of 1 billion dollars, however multi-million dollar bonuses were paid to executives based on “ imaginary profits” developed from the fair-value accounting approach (Enron: The Smartest Guys in The Room).

From the evidence above, we can see that the information that was produced from mark-to-market accounting did not allow for the true and fair view of the companies performance. The application of the efficient market hypothesis flows onward from the above issues as one can establish that the market responded to the information at their disposal. An efficient market was originally defined by Fama as “ a market that adjusts rapidly to new information”; this definition was then changed to “ a market in which prices fully reflect available information” (Godfrey et al, 2006). From the evidence so far brought forward in this text it, is understandable that the stock price continued to rise as the information produced by Enron suggested that there performance was sound and evidence that there was a problem at Enron was not yet available. Therefore using the principle of the efficient market hypothesis one can establish that the “ price [did indeed] ‘ fully reflect’ the available information” (Godfrey et al, 2006).

To further support this claim, I will use a theoretical foundation of the EMH, that is “ market efficiency does not mean all information has been correctly presented by a firm or properly interpreted by individual decision makers” (Godfrey et al, 2006) this evidence reinforces that the market will only react to the information at their disposal. In even further support to this claim I will use information highlighted in the documentary “ Enron: The smartest Guys in the Room” which takes into account the context of the situation in its support of the efficient market hypothesis. During the period in which Enron’s price was increasing “ as long as a company met or exceeded analysts expectations the stock went higher” (Enron: The Smartest Guys in The Room), given that the above text establishes that the information

presented by a firm need not be correctly presented for an efficient market to react, the fact that Enron was continuously exceeding analyst expectations suggests that the share price was fully reflecting the available information. A key issue to take note of here is that “ analysts were blind to the issues of Enron because they trusted the information that was given to them and the integrity of management” (Enron: The Smartest Guys in The Room) so the buy ratings that were provided by analysts were not correct however the market was reacting to the information it was provided. The final piece of evidence that proves the efficient market hypothesis in the Enron case is the price response after the problems were identified.

It took the company “ which held 65 billion in assets in 2001...24 days to go bankrupt”, in the 16 month period where analysts began to question the profitability of Enron the share price fell from “ a high of \$90 per share to a low of under \$1 per share before the giant energy trading company went bankrupt” (Encarta, 2008). The above information clearly identifies the supporting information behind the efficient market hypothesis and the Enron case. The agency theory was clearly an issue in Enron’s case because the managers of the firm were transferring wealth from the shareholders to themselves in the form of stock performance. Not only was there the Shareholders to Management agency problem there was also an employer to employee agency problem.

With regard to the shareholder to management problem, the shareholders had placed a large amount of decision-making capability onto the management team and had not successfully monitored the agent’s

behaviour. Given that the managers had all come to Enron with a strong
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reputation, it was expected that they “ would act in the interest of the shareholders. [As such the shareholders] had monitored the managers performance very little” (Godfrey et al, 2008). In actual fact “ Skilling based his ideals on the book ‘ The Selfish Genion’” which continuously enforces a Darwinian perspective, that is survival of the fittest. As a shareholder, it would have been in the best interests to implement monitoring costs to “ measure, observe and control” Schillings behaviour. Unfortunately this would not have been enough.

The introduction of Fastow, described as “ a genius” in a number of sources, allowed for the performance of Enron to appear strong even in dire times. The use of SPE’s and mark-to-market accounting allowed for the “ reduction of monitoring costs by incurring bonding costs [in the form of quarterly statements]” that allowed Enron to perform better than it appeared. Another point that links the EMH with the agency theory is that “ the principal will remunerate the agent according to the principals expectations of how much the agent’s behaviour is likely to be contrary to the principals interests” (Godfrey et al, 2008). Given that managers of Enron were all major shareholders of the company the focus was on driving the share price up which was done by a process called “ pump and dump; this process involved buying up the share price and then selling out” (Enron: The Smartest Guys in The Room) this allowed the directors to maintain high remuneration because they were achieving high share prices for the principals and also allowed them to gain from share price rises before selling out at the top.

Finally, the principal-agent relationship that occurs between Skilling and Fastow is that of an employee to employer. This relationship is important <https://assignbuster.com/the-collapse-of-enron-seemed-to-be-a-thumb-in-the-nose-to-the-efficient-markets-hypothesis-and-agency-theory-discuss/>

because it “ emphasises the importance of the ability to monitor employee’s work efforts” (Akdere, Azvedo, 2004). Skilling and Ken Lay claim that they were unaware of what Fastow was doing with regards to the financial statements, however, Skilling and Lay were acting as the agents for the shareholders as well as acting as the principals for Fastow. Their involvement in such transactions as the one with LJM were “ not only disclosed to the board at a meeting which took place in 1999, but the board approved of [Fastow’s] participation, following a recommendation to this effect from the then CEO and Chairman, Ken Lay” (Deakin, Konzelmann, 2004). From this we can clearly see that Lay, Skilling and Fastow were all part of the agency problem that occurred.

The Enron case has paved the way for an analysis into flawed accounting principals. Specifically, discussed in this paper, the use of SPE’s and mark-to-market accounting. While these principals are still accepted the regulation of them has increased and accounting practices have become more stringent. The case has also allowed one to understand the principles of the efficient market theory, if anything it has identified the flaws related to this theory and emphasises that, with any analysis, garbage in leads to garbage out.

The efficient market theory still managed to uphold its principals that the price in an efficient market will fully reflect the available information. We have also discovered, that agency problems will arise in firms and the use of monitoring and bonding costs can minimise the possibility of agency problems, however cannot over come them all. References: Serwer, Andy. 2002, ‘ Dirty Rotten Numbers: Enron has made us shine a light on the books of America’s public companies.

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