



America's most Innovative Company



Analysis of Enron's Aggressive Accounting Methods

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Agenda

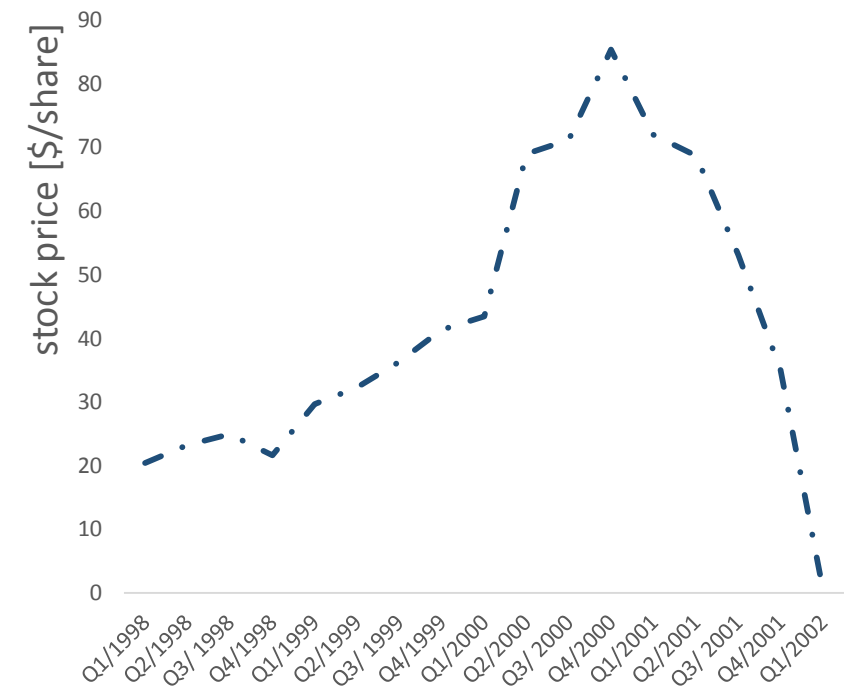
- Introduction in the case
 - Key facts about Enron
 - Usage of SPE
- Clarifying the questions
 1. Responsible parties of the Crisis of Confidence
 2. Meanwhile prohibited accounting services
 3. Violation of auditing standards?
- Conclusion
- Discussion



Enron's claim to fame

- Business: Energy and Internet services
- Revenues in 2000: \$ 100bn
- Operating income: \$ 1.3bn
- Seven biggest US-American corporation
- Largest corporate bankruptcy at that time in the US
- Awarded as „America's most innovative Company“ for six Years in a row

Enron's stock price at the beginning of the quarters from 1998-2002

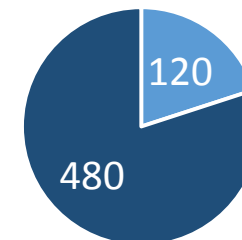




Restatements lead to a free fall of stock value

- October 16: correction of balance sheet entries
 - November 08: restatement of earnings from the last 5 years
 - December 02: bankruptcy
- \$ 1.2bn
 - \$ 600m
 - \$ 60bn
-

A	L + E
+ \$ 1.2bn notes receivable	+ \$ 1.2bn stock
\$600m less earnings	



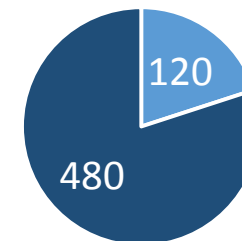
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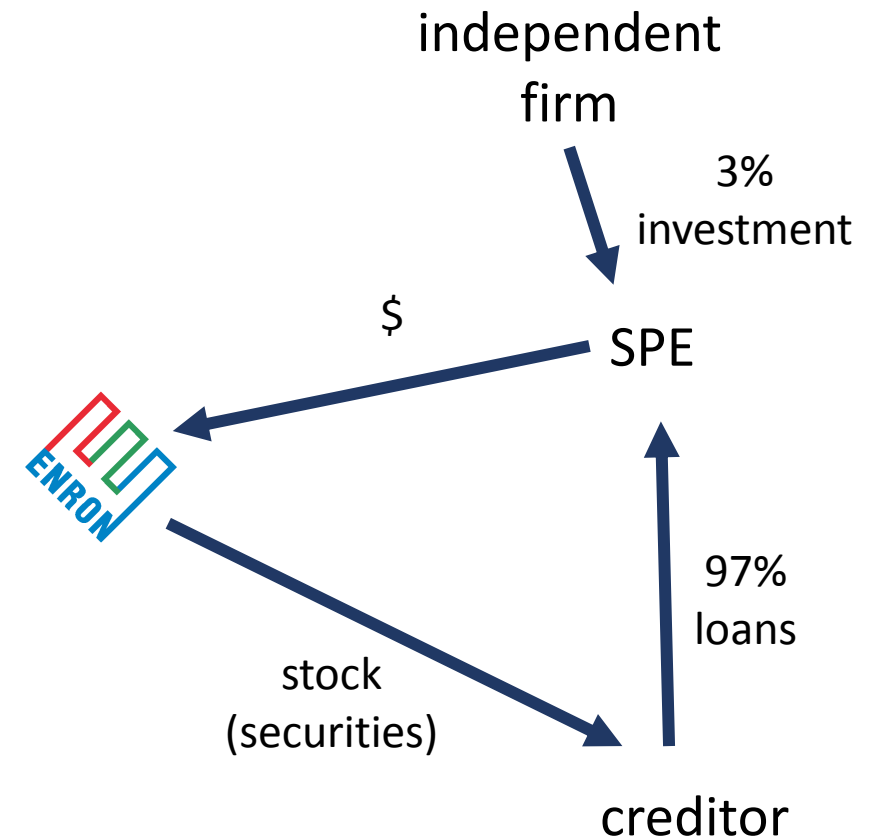


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Enron abused a leak in the regulation system for (debt) financing

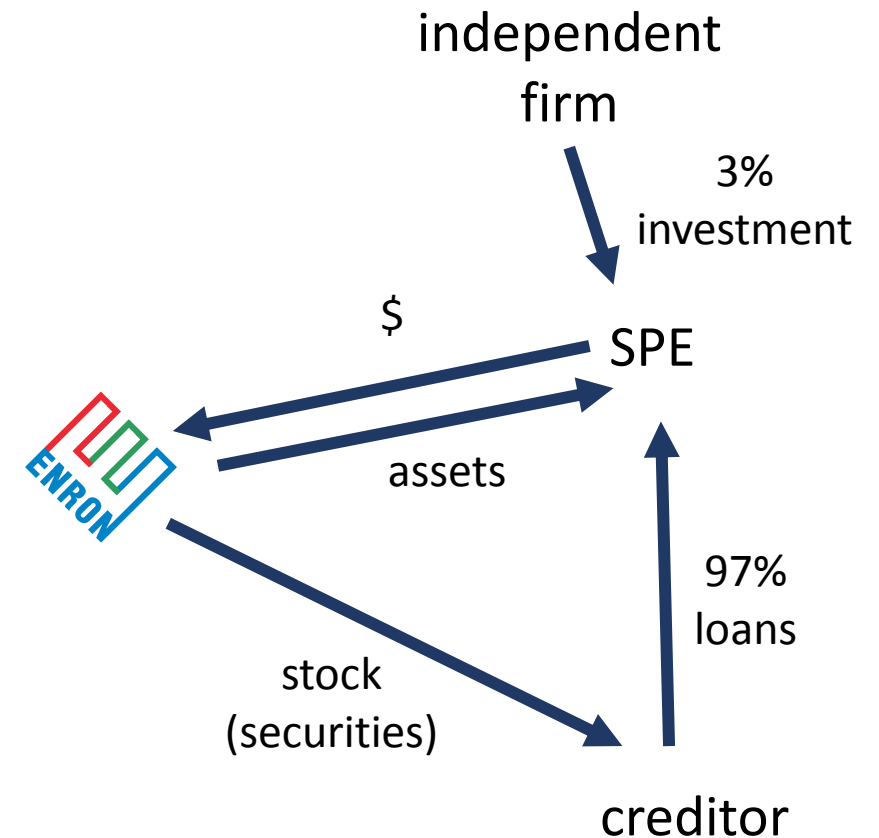
- Principals of Enron's SPE
 - 3% of the SPE's capital was contributed by independent firms
 - 97% were guaranteed by loans, collateralized with Enron's stock
 - No need for integration in consolidated reports
- Applications
 - Debt financing without (own) debt
 - Squeezing profit out of misinvestments





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Task 1: Which parties were most responsible for the crisis of confidence?

- Enron
- Andersen
- Regulatory Institutions
- Others



Various layers supported dubious practices at Enron

- Management/board/CEO encouraged aggressive accounting (SPE or mark-to-market)
- Accountants, esp. CFO A. Fastow who mainly organized the SPE
- Focus on short-term success instead of sustainable growth
- All employees like Watkins who should have acted against dubious practices



Anderson issued unqualified opinions for 15 years

“In our opinion, the financial statements [...] present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries [...], in conformity with accounting principles generally accepted in the United States.”

Arthur Andersen LLP in the Enron Annual Report 2000



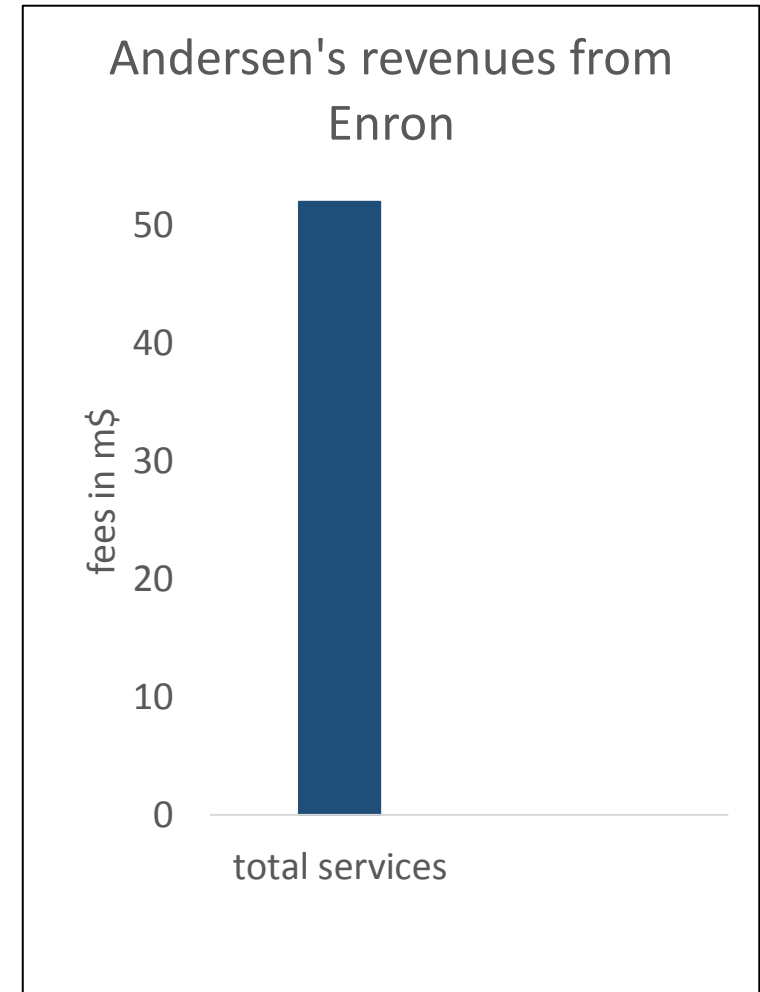
Andersen's behaviour harmed the image of its sector, because

- The “conscience of the industry” did not make the aggressive accounting and disclosures transparent
- It focused to increase turnover through consulting instead of ensuring fair presentation
- It shredded documents which were relevant to the SEC investigation of the Enron case
- It should have dropped Enron as a client instead of helping them keeping the SPE system alive



How independent was Andersen?

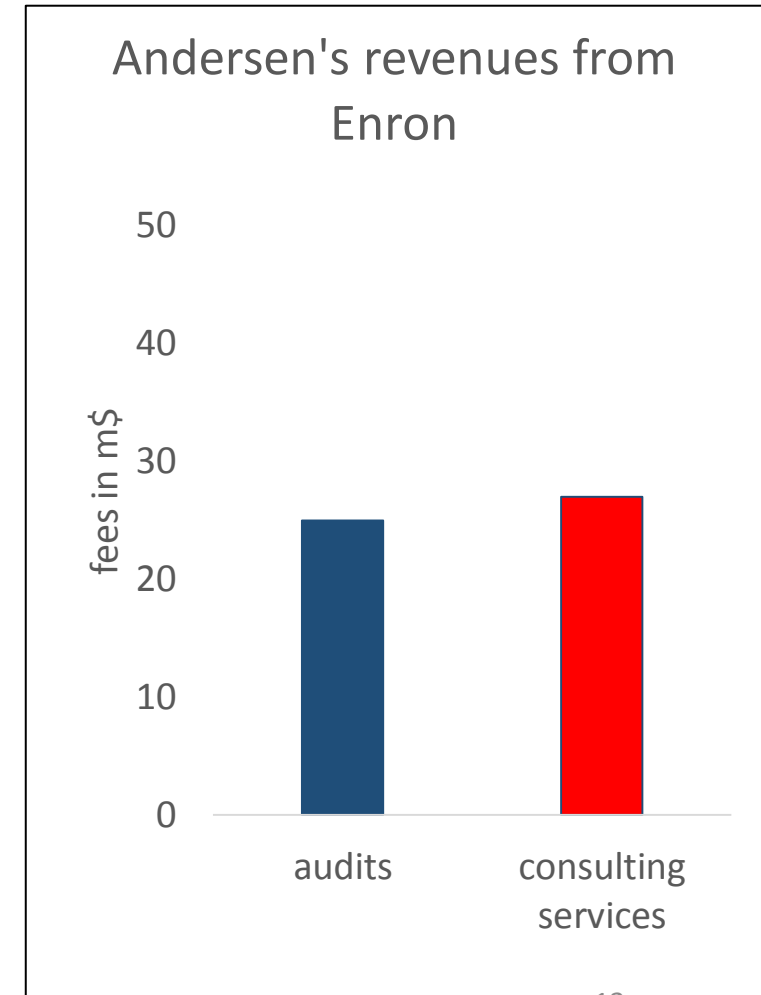
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- Andersen charged ca. \$ 1m a week
- Half of the fees resulted out of consulting services





Regulators did not close the gap to prohibit the aggressive accounting

- SEC or FASB should have acted against the foul quasi-subidiaries of Enron
 - Obligation to integrate them in the consolidated financial statement
- The permission for Enron to applicate the mark-to-market method should have been withdrawn after its excessive use
- Stricter control of Andersen's independence would have been necessary



Who else could be responsible?

- Investors and creditors who contributed the SPEs' capital
- ...



The Sarbanes-Oxley Act strenghtens the auditors' regulations

Henceforth, auditors are prohibited to

1. conduct internal bookkeeping

→ The accounts would be managed and audited by the same firm.

2. do management consulting services

→ Deep involvement in the client's processes reduces mental independence

3. Conduct valuation and appraisal services

→ Auditor's has power and interest in a good client performance

for their auditing clients.



Andersen's violations discovered in the Power Report

- No complete disclosure of mistakes (p.17), instead hiding transaction in the footnotes (p. 202)
- Lack of objectivity (p.132)
- Helped to structure the SPEs instead of disclosing them (p.24, 132)
- Neglected the risks of material misstatement of the financial statements (p.126)
- No issuance of an adverse audit opinion
- Lack of real and perceived independence

→ Assurance engagement did not enhance the degree of confidence



Enron could not keep up with the required pace of growth

- Enron's exponential growth ended in a bubble
- The Enron case showed the necessity of effective regulation in liberal markets
- The independence of auditors has to be guaranteed



Please rate the following statements

- Joseph Berardino (Andersen CEO): *„at the end of the day, we do not cause companies to fail.“*
- *„The revenues from consulting services are necessary to hire excellent professionals for the auditings.“*



References

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