case study 3.2 solution

Enron Boss to Turn Himself In

**ENRON: THE KEY PLAYERS**

To be indicted

Kenneth Lay

To be indicted overnight on charges relating to accounting fraud that drove Enron into bankruptcy.

Guilty pleas

Andrew Fastow

Pleaded guilty in January to two counts of wire fraud and conspiracy to commit wire and securities fraud. His wife Lea, a one-time director and assistant treasurer of corporate finance at Enron, faces one year in jail after pleading guilty to a single count of filing a false income tax return.

Awaiting trial

Jeffrey Skilling

Former CEO was indicted on 35 counts of securities fraud, insider trading, wire fraud and conspiracy in February. He pleaded not guilty and is free on bond.

Richard Causey

Former chief accountant was indicted in January. He faces 31 counts of fraud, conspiracy and insider trading.

The company

Enron could emerge from Chapter 11 bankruptcy protection by July 15, the deadline for when a bankruptcy judge may issue his approval of the company’s reorganisation plan. Under the plan, creditors stand to receive 20c for every dollar owed – 92 per cent in cash and the rest in equity in Prisma Energy International, which owns Enron’s foreign assets. Enron’s other assets have been sold, or are in the process of being sold.

Thirty months after the collapse of Enron shook US market capitalism to its core, former boss Ken Lay will turn himself in to the FBI today and appear in court to face criminal charges that he conspired to defraud investors.

A friend of President George W Bush and a member of Houston society, Mr Lay, 62, is expected to suffer the indignity of wearing handcuffs as he is paraded like the catch of the day for the media on his way into the courtroom.

He will plead not guilty to the long-awaited charges, which are yet to be specified but were said to include fraud and insider trading.

‘I have been advised that I have been indicted,’ Mr Lay said last night. ‘I will surrender in the morning.  
I have done nothing wrong and the indictment is not justified.’

Mr Lay became the public face of corporate greed after Enron – the energy trader he built into the seventh-largest US company by sales – filed for bankruptcy in December 2001.

Thousands lost their jobs and billions of dollars of shareholder wealth evaporated in what was then the largest bankruptcy filing in US history.

The collapse of telecommunications giant WorldCom almost two years ago dwarfed Enron in terms of assets destroyed but the Enron disaster dented America’s faith in the capital markets by revealing that some companies’ balance sheets were garbage wrapped in glossy paper.

As rumours that the indictment was imminent drew stronger in past weeks, Mr Lay broke his silence to profess his innocence, blaming underlings such as former chief financial officer Andrew Fastow for cooking up the off-balance-sheet schemes that hid Enron’s ballooning debt.

The Enron collapse brought down accounting giant Arthur Andersen and prompted Washington to enact corporate governance reforms.

Mr Lay, whose wealth was largely tied up in Enron stock, suffered along with investors. Worth more than $US400 million at the start of 2001, Mr Lay told *The New York Times* recently that of his remaining $US20 million, about $US19 million would be used for legal fees and to pay off debt.

The indictment is a huge step in a two-year investigation by the Justice Department, which has so far yielded criminal charges against 30 individuals, including Fastow and Jeffrey Skilling, who resigned as Enron chief executive in August 2001 after only six months in charge.

Skilling’s departure ended Mr Lay’s thoughts of moving on from Enron, ensuring the Texas titan, who was once rumoured to be in line for a cabinet post in the Bush administration, was at the helm when the ship went down.

Enron investigators are believed to have focused on this period, when Mr Lay made numerous public announcements expressing confidence in Enron while he was selling the stock and while whistleblowers such as Sherron Watkins – later named one of *Time* magazine’s Persons of the Year in 2002 – were sending him warning emails.

Federal prosecutors scored a coup in January when Fastow pleaded guilty to two counts of conspiracy and agreed to assist the investigation.

A similar strategy was used in the WorldCom investigation, with prosecutors waiting for CFO Scott Sullivan to agree to co-operate before they charged CEO Bernie Ebbers.

SOURCE: Rodney Dalton, New York Correspondent, ‘Enron boss to turn himself in’, *The Australian*, 9 July 2004, p. 17.

Questions

1 Briefly highlight key aspects of the Enron financial disaster.

A student is expected to complete a web search in order to outline, in chronological order, key events in the Enron timeline and corporate collapse.

However, the key accounting issues revealed in nearly every recent corporate crash are:

(a) Revenues have been overstated. They have been recognised before they have been realised (in advance of receiving the cash or having an unavoidable claim to a certain amount of cash).

(b) Expenses have been understated. Expenditure has been deferred as an asset in situations where there are going to be no future economic benefits related to that expenditure. This has been particularly evident in relation to intangible items (research and expenditure, advertising, goodwill, other identifiable intangibles, set-up costs). It also relates to management errors in under-estimating the economic benefits of tangible assets used up during the period (for example, inventory obsolescence, depreciation, amortisation, impairment). The expense understatement also relates to inadequate provisions for transactions arising during those periods (for example, employee benefits, restoration of the environment, warranty claims, taxation).

(c) Assets have been overstated for reasons already identified above (receivables that will not be collected, intangibles that will generate no future benefits, inventory that is obsolete, property, plant and equipment with values that cannot be recovered).

(d) Liabilities that have been understated through omission, misstatements, or reliance on the legal form, rather that the underlying substance of the financial arrangement. Liabilities in relation to stakeholder claims are understated (for example, employee benefits, restoration of the environment, warranty claims). Liabilities related to executory costs are not shown (for example, operating leases, construction contracts, purchase contracts, employment contracts). Liabilities in relation to future contingencies are excluded, and those contingencies are no longer remote or immaterial (for example, legal suits, guarantees). Liabilities have been labelled as owners’ equity (for example, preference shares that are secured and redeemable).

(e) The parties responsible for oversight have failed. This includes the management, directors and the auditors.

2 Mr Lay, the CEO of Enron, is to be charged with fraud and insider trading.

(a) What is ‘insider trading’?

Insider trading is using private information gained in your employment position, and which is not available publicly to other investors or stakeholders, to make a financial gain in the market.

(b) Why does company law view ‘insider trading’ so severely?

The company law is concerned not just that such behaviour is immoral, but that it will severely impact on market confidence. The regulations under corporations law, and its enforcement, is aimed at providing equity for all stakeholders related to the operations of companies and maintaining the confidence of the general public in the equities market.

3 The article said ‘that some companies’ balance sheets were garbage wrapped in glossy paper’.

(a) What is a balance sheet supposed to reveal about a reporting entity?

A balance sheet is a statement of financial position at a point in time identifying the monetary balances in the assets and the claims against those assets (inside − owners’ equity, and outside – liabilities).

(b) What is the balance sheet equation?

The balance sheet equation: A = L + OE or OE = A − L.

(c) Why might any of the assets, liability or owners’ equity, or their balances, be incorrect?

Different interpretations could be made of the term ‘incorrect’. Does it mean that they were inconsistent with the economic reality, yet consistent with the regulations, or does it mean they were inconsistent with the regulations, or inconsistent with particular critics’ interpretations of those regulations?

In answering the following should be considered:

• Element definition – conflict may have arisen in terms of what represents an asset, a liability, and owners’ equity. The definitions are subject to different interpretations.

• Element recognition – conflict may have arisen in terms of the recognition criterion (probability and reliability of measurement), which are subjective in nature.

• Transaction measurement – accounting uses a range of different measures for assets and liabilities including historical cost, residual historical cost, fair value, market value, recoverable amount, value in use, value in exchange, net realisable value, deprival value and net present value. The assessment of what each term means is not always clear, and objective determination of the stated figures may be even more difficult.

• Estimation – many of the accounting measures used require management or expert estimation of future variables. This estimation process by its very nature will lead to differences in outcomes (examples of estimates include asset lives, residual values, pattern of use, expected collection, future claims, changes in wage level, interest rates, exchange rates, regulations, technological changes, economic growth, and so on).

• Accounting method choice – within existing regulations management is given considerable choice (for example, to capitalise or expense certain outlays, to use accelerated or straight line depreciation, to use FIFO or weighted average inventory, to use the direct or indirect approach for bad debts, to revalue assets or use the cost method, and so on).

• Disclosure methods – information can be revealed directly in the accounts, or in the notes to the accounts, or by other disclosures (directors’ statement, news release).

• Intentional or unintentional material errors or omissions in terms of accounts and account balances.

4 What is ‘off-balance-sheet’ debt?

Off-balance-sheet financing refers to obligations of the entity that are not included in the balance sheet as a liability. This arises from intentional or unintentional error, or in relation to what has been known as ‘executory contracts’. Executory contracts are those contracts that are either equally performed or unperformed at a given point in time. Common examples might be building contracts, future sales contracts, employment contracts or lease agreements. Given that there has not been performance by the other party (builder, customer, employee, lessor) there is no need to recognise either the asset or the liability. However, in these cases there is often a legal contractual obligation in place that the entity cannot avoid and yet no record of this appears on the balance sheet.

5 How did the collapse of Enron bring down the giant auditing firm of Arthur Andersen?

The collapse of Enron brought down the giant accounting firm of Arthur Andersen in at least two ways:

• First, because there were massive claims against Arthur Andersen and its partners, the liquidation of the business was really the only option.

• Second, the business would have been unlikely to have survived, as clients would have left en masse for other accounting service providers.

6 Is it ethical for the CEO to sell shares in the company while at the same time making ‘numerous announcements expressing confidence in Enron’?

It is not necessarily legally or morally wrong for the CEO to provide advice to others to acquire shares in a company while at the same time selling shares in that company. The CEO may have a particular need for cash at that time, or may wish to diversify risk, or be aware of better alternative investments. However, it is not just a matter of doing what is right, but being seen to be doing what is right. It would, therefore, seem inappropriate ethically for a CEO to provide positive advice to others to invest in the company while he himself is selling off his/her shares in that same company. A debate on managerial ethics is encouraged with perhaps the introduction of agency theory.