

ENRON – REVISITING THE ACCOUNTING AND AUDITING

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ENRON – THE COMPANY

- **1985 Houston Natural Gas merges with InterNorth.**
- **During the 1990s, ENRON went from a gas-pipeline company to the biggest energy trader in the US.**
- **It move away from owning “hard” assets.**
- **Traded energy, broadband, and all sorts of financial products.**
- **At one point ENRON had a market value of \$77 billion and reported \$101 billion of revenue in 2001.**



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ENRON – THE ACCOUNTING

- **ENRON is not the only company with accounting issues:**
 - **Revenue recognition issues: Telecom companies, Xerox, EMC, Computer Associates, and many high tech companies.**
 - **Off-balance sheet financing: PNC Financial Services, Sunrise Assisted Living, Elan, and others.**



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ENRON - WHAT WENT WRONG?

- **Bad investments in “new economy” ventures.**
- **Off-balance-sheet entities (SPEs) created to eliminate losses and remove liabilities from books.**
- **Many off-balance-sheet loans collateralized by Enron stock.**
- **Opaque reporting encouraged short sellers.**
- **Form over substance in reporting.**



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Typical Enron 'special-purpose vehicle'

1. Enron creates a "special-purpose vehicle," technically an independent company. Lenders and investors put up cash.
2. Enron sells an asset, anything from an actual plant to shares of another company's stock, to the SPV.
3. Enron gets the lender and investor money, but instead of counting as debt to Enron, it counts as debt only to the SPV. It counts as income to Enron.



Robert Dibrell / Chronicle



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APPARENT FAILURES – 20/20 HINDSIGHT

- Arrogant corporate culture.
- Opaque reporting posture with investors.
- Finance and accounting staff largely recruited from Andersen. Independence compromised?
- Special investigation by main legal counsel – not independent counsel.
- Andersen apparently consciously decided not to resign in 2000 in spite of “red flags” and fraud signal from its decision aid.



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ENRON - LOTS OF QUESTIONS

- Opaque disclosure / “bad” accounting?
- How could the CFO be at the center of conflict of interest concerns ?
- Was management conduct unethical?
- Whose watching the company? Where were the...
 - Board of directors / Audit committee?
 - Attorneys (in-house and external)?
 - Auditors?



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AUDIT COMMITTEES

- Strengthening the requirements for financial experts on audit committees.
- Need financial expertise to understand increasingly complex issues.
- Need to be proactive and engaged.
- Need to challenge management and the auditors.



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REVISED ACCOUNTING

- **FASB Reform**
- **Need for new Standards:**
 - **Consolidation of Special Purpose Entities**
 - ◆ **“control” - based standard regarding SPE’s**
 - **Determining fair value of forward contracts**
 - ◆ **Rules for determining value where contracts are not traded or thinly traded.**



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POSSIBLE EFFECTS ON AUDITING PROFESSION

- **New body as industry regulator**
- **Eliminating the ability of the auditors to do nonaudit services for their clients.**
- **Prohibit revolving door for audit partners – not employable w/ clients.**
- **Mandatory rotation of audit firms.**
- **Major increase in the level of audit firm peer review work.**



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THE AFTERMATH

- What will become of Enron and Andersen?



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