CHAPTER 1

INTRODUCTION

Business practices have always been connected with fraud and have always been affected by financial collapses. Recent accounting scandals like Enron, WorldCom, Parmalat, Tyco etc have cost not only billions of dollars to the stakeholders but also have damaged the accounting profession.

Frauds are “the on purpose misleading presentation of financial information by one or more persons, who are member of the company’s personnel or management, as a consequence of manipulation, creation or falsification of documents or files, withholding assets, registration of fictive transactions, false appraisals & valuations, etc.”(I.B.R.1998)

Enron is the largest bankruptcy in the US corporate history. In just fifteen years Enron grew as one of ten largest US companies and became the shinning example of the US corporate world. Enron stock price rose to $83.3 in 2001 and its market capitalization exceeded $60 billion. Enron was rated the most innovative company in America in fortune magazine (Palepu 2002) but the Enron’s success was based on inflated earnings and fraudulent accounting practices. The dramatic fall of Enron has shaken the confidence of investors.

In the words of Der (2002):

“The heat is on for corporate America. In the wake of Enron debacle, the quality of earnings is being questioned as never before…earnings jitter may yet rock the markets. More shaky accounting practices could come to light. Some companies won't have registered the full impact of downturn on their books, while others still message their numbers…investors have every reason to be twitchy".

Four former Merrill Lynch executives and a former mid-level Enron finance executive are in prison after being convicted of helping push through a loan to Enron disguised as a sale. Former accountancy giant Andersen, which failed to audit the Enron books correctly, collapsed with the loss of 7,500 jobs in the US, and 1,500 in the UK. (BBC 2006)

Enron's place in US corporate history cannot be disputed, especially its innovatory drive, nor can its ground breaking innovations in energy market or WorldCom status as internet provider. These innovative companies have one thing in common that they are collapsed. (Oliver 2003) and all these corporate have used financial reporting to mask their financial difficulties and "due to which profession of accounting has suffered serious erosion of confidence ……in its standards, in its relevance of its work and financial reporting process" (D.Miller 1990)

The Enron's collapse has been evolved into many dimensions resulting into raising questions about external auditors, corporate governance, ethical practices of directors and financial reporting issues.

The concept of financial transparency has got more momentum in the wake of Enron, WorldCom and Parmalat scandals. There is every reason to believe that these corporate have used financial reporting to mask their real face. “Eronist”are being detected all over the world and investors ask questions companies they own. In the financial system of present day institutional and individual investors rely on the financial statements everyday if these statement lose their transparency and cannot be trusted then the investor are victimized and suffer immensely. Lack in reliability of financial statements damage the fundamental purpose of securities. (Weiss 2004)In this thesis I have examined the Enron case in relation to the financial reporting and shareholders value. I have tried to answer the following research question in this thesis.

Can quality financial reporting minimize the financial losses to investors and create value to shareholders in the long run (a case study of Enron)?

In this thesis I have investigated that: if Enron had produced quality financial reports then the financial losses of the investors could have been minimized and that quality reporting can create value to the shareholder in long run.

This thesis can be divided into four parts in the first part of the thesis I have presented the corporate objective of shareholder wealth maximization. I have presented shareholder value creation models and discussed the social responsibility of corporate. In the second part I have discussed the financial reporting, disclosure issues, how environment can affect the financial reporting and financial reporting in United States to create better understanding of Enron case and have also discussed principle, rule base accounting methods and also have discussed financial reporting in relation to shareholder value.

In the third part I have presented the literature review on Enron which form the basis of this thesis and in the fourth and final part of the thesis I have I have discussed the Enron case in detail and have discussed the ideas which I developed in first and second part of thesis. I have discussed the financial reporting, disclosure issues, how environment can affect the financial reporting and financial reporting in United States to create better understanding of Enron case and also discussed principle and rule base accounting and also have discussed financial reporting in relation to shareholder value.

CHAPTER 2

2.1 SHAREHOLDER WEALTH MAXIMIZATION

The nineteenth-century economist, J. B. Say states: that an entrepreneur creates value for society from shifting resources to areas of low productivity to areas of high productivity (Smith 2004) therefore it can be argued that an entrepreneur not only creates value to the company but also creates value to the society.

It is a common view that shareholders are the real owners of the firm therefore the authority of shareholders towards business is not a new notion. It is received wisdom that the performance of business and investment decisions should be taken by keeping in view of maximizing the return to shareholders. Rappaport (1986), view is that business strategies should be judged by economic returns they generate for their shareholders which are measured as dividend and increase in the share price. Other strategies which management develop to create a competitive advantage should also create greatest value to the shareholders.

Aswath (2001) discussed the reasons why the shareholder wealth maximization objective should be the main objective of a firm.1) stock prices are the most observable by all measures which can be used to find out the performance of the firm. 2) The rational investors reflect the long term effects of the firm decisions.3) it is the trading of stocks through which gains can be realized. However where there are arguments in favor of shareholder price maximization there are also voices against this objective.

Kean (1979) believes that share price maximization objective as inappropriate and presented a different view that appropriate goal for the company should be “maximize value of the firm subject to maximizing the share price”. In 1992 a report published by Professor Michael Porter and 25 other academic states that” US firms are too short sighted in their investment decisions. It states that too much emphasis is on stock prices and shareholders returns as flaw in the US corporate Governance system (Ardalan 2003)

According to Kirloy (1999) view shareholder wealth can only be created if the performance of the management is more than the expectations of market and presents the idea of wealth creation as a creative endeavor and try to create customer and shareholder wealth relation.

2.2 MEASURES OF SHAREHOLDER VALUE

Different measures are used by researchers to estimate the shareholder value however all of them has their merits and demerits. According to conceptual framework of shareholder value the company creates value to its shareholder when returns are greater than capital opportunity cost (Liow, 2004). Return on investment and Return on equity has been criticized for insufficient with shareholder wealth maximization objective.

Economic Value Added (EVA) compares Earning before income tax (EBIT) with weighted average cost of capital (WACC). A positive EVA indicates that shareholder value is created whereas A negative EVA suggests otherwise. Critics say that it is based on accounting criteria and it does not take into account depreciation (Walters 1999). There are other techniques which are used for estimated the shareholders value. There are other methods which are used as Return on Investment, Net present Values, balance score cards, and share prices value.

2.3 SHAREHOLDER VALUE CREATION MODEL

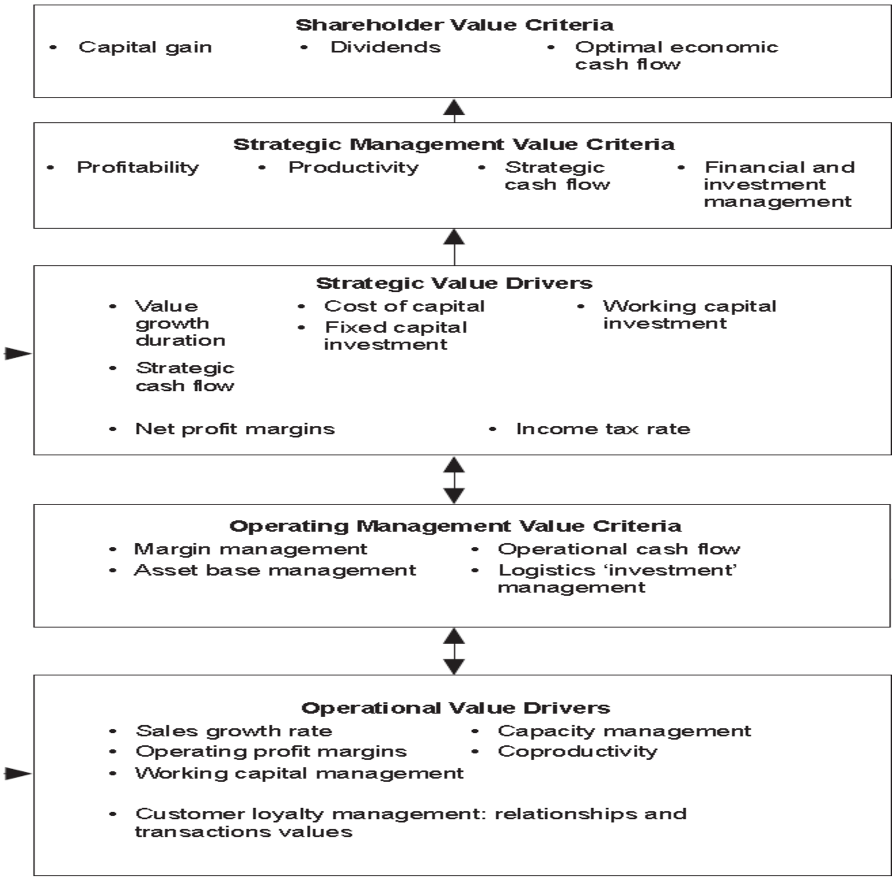
Value creation model proposed by Walters (1999) incorporates operational and strategic perspectives. He suggested that activities of strategic management should be planned against strategic management criteria. In his view profitability should be measured net of all charges as to maximize the profits is a strategic management task. How efficiently assets of a company are used by the management is measured by Asset Base Management, Operational cash flow measures the ability of operating managers and financial and investment requires senior management for financing structuring. Proper functioning from operational value drivers to strategic management value leads to value creation of shareholders according to this model. The total economic value of an entity is[1]

Corporate value = debt + shareholder value therefore

Shareholder value = corporate value - debt Rappaport (1986)

[1] Corporate value consist of present value of cash flows and Residual value which represent the present value of business attributed to the period beyond the forecast period.

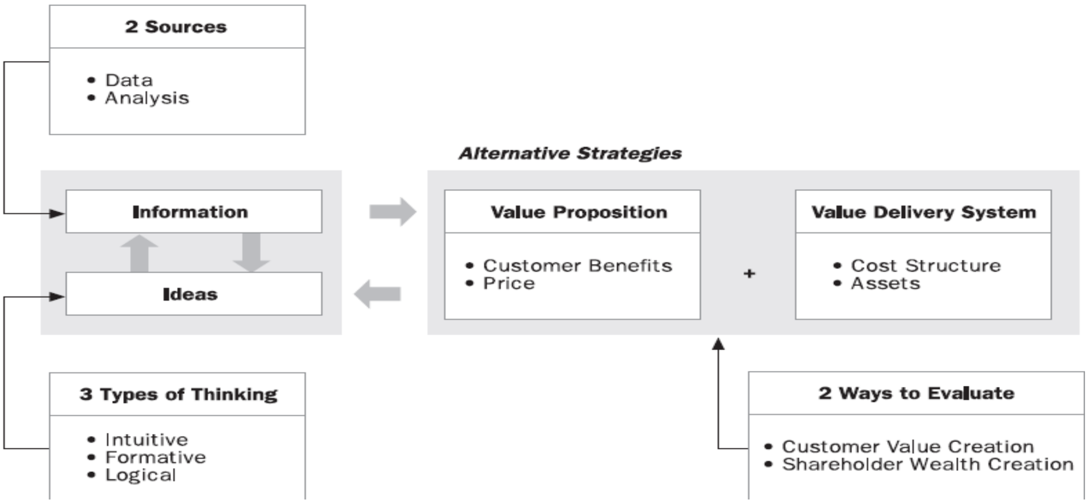
VALUE CREATION MODEL



source: Walters, D. (1999) 'The Implications of Shareholder Value Planning and Management for Logistics Decision Making' Journal of Physical distribution and Logistic management Vol. 29 No

Another model which was developed by Kilroy (1999) makes a bridge between shareholders wealth and customer value. According to Kilroy wealth creation is a creative process and its role is played by management and employees and it begins with customer value creation. There are three processes of involvement for strategy development which involves intuitive thinking, formative and logical thinking. And he presents the idea of "hybrid thinking". The Hybrid thinking process involves the assessment of idea through intuitive insight; it is first bring in the form as potential value proposition then it is tested against the customer value creation potential and then after development of alternative strategy it is evaluated in terms of its shareholder wealth creation potential.

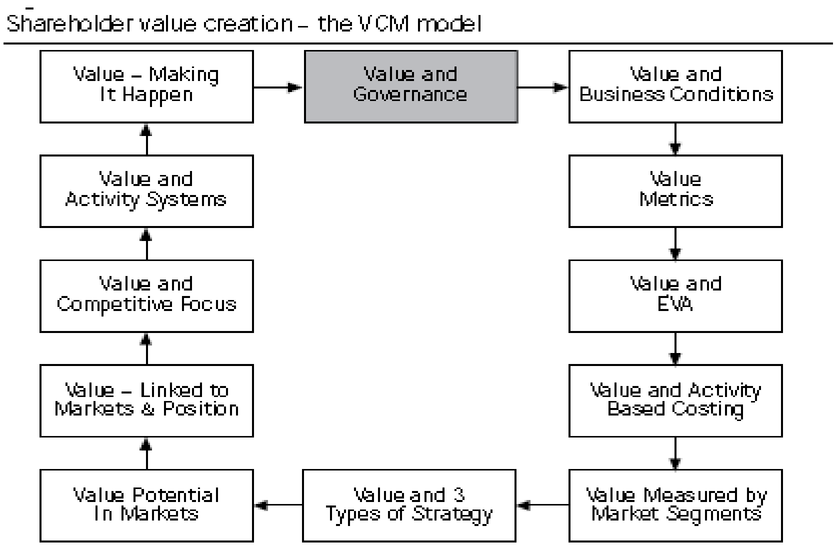
VALEUE CREATION MODEL



Source: Kilrory, D.B. (1999) creating the Future: how creativity and innovation drive shareholder wealth Management decision 37/4 pp 363-371

According to Kilrloy (1999) it is imperative for shareholder wealth creation that a company creates value for their customers. However there is no doubt that wealth to the shareholders can only be delivered if management delivers good performance in excess of its operations.

Another model (McDonald 1998) raises important questions about how directors and managers access accurate, non judgmental institutionally biased information to create company strategic decision to create value to the shareholder. The McDonald (1998) model gives answer to this question to some extent. He interlinks the shareholders wealth creation with value creating management (VCM) and presents a VCM model. He calls it value base management which combines behavioral science with corporate finance and strategic marketing. The key element for the success of the VCM is the managerial involvement and relies on external consultancies and group of internal planners. Managers design their strategies based on customer portfolio analysis.



source: Mcdonald,T. (1998) "Stop Strategic Planning and Create Shareholder value Management decision" Vol.36 No.7 pp 456-459

2.4 MANAGEMENT VS SHAREHOLDERS

It is often argued that the objectives of the management may differs from objectives of shareholders which means the management may not act in the best interest of the shareholders therefore agency problem arises here. The ownership of the large multinational companies is widely spread and control of the business is mainly in the hands of management. Agency theory deals with the conflict of interest between managers and shareholders. Researchers have developed the agency theory with different perspectives. A study conducted by Porta, Silanes and Vishny (2000) in which they used a sample of firms from 33 countries and look at the dividend policies of large multinational companies. They developed two models on the basis of their analysis and found that quality of the legal protection of investors is as important for dividend policies as it is for other key corporate decision. Bebchuk and Fried (2003) they viewed executive compensation as an instrument for addressing the agency problem and discussed option plan design, payments to departing executive stealth composition retirement benefits. They found that executive compensations are greatly influenced by managerial power in companies with separation of ownership and control. Managerial power and rent extraction play an important role in executive compensation and has significant implications for corporate governance. (Bebchuk and Fried 2003)

2.5 SOCIAL RESPONSIBILITY AND SHAREHOLDERS WEALTH

Is shareholder wealth maximization consistent with concern for social responsibility? In the wake of recent scandals of large corporate like Palmarat Enron WorldCom etc. The public confidence has been shaken and more emphasis is give on the social responsibilities of firms. Corporate social responsibility is described in the context of relationship between business and society. A study by snider and martin (2003) in which they present a view of most successful firms, shows that there should be more focus on the societal issues and also on the issue that what organizations say and do with regard to their stakeholders

Another study by Hall (1998) shows that the effect of corporate social actions on shareholders wealth. In 2002 communication concerning CSR, The European Commission stated that:

"The main function of enterprise is to create value through producing goods and services that society demands, there by grating profit for its owners and shareholders as for as well as welfare of society,……. New social and market pressures are gradually leading to a change in the values and in the horizon." (Hall 1998)

Now a days this perception is taking growth among the enterprises increase the business and shareholders values can not achieved only by maximizing profits but it can be achieved through the market oriented and responsible behavior. In the wake of Enron collapse there has been dramatic increase for the importance of corporate social responsibility the issues such as reputation, risk management, competitive advantages are the driving forces rather then the discharge of accountability. (Owen 2005)

CEO of Enron Kenneth Lay reported how the corporate behaviors were guided by its vision and values with mutual respect among communities, stakeholders and is affected by companies operation. The integrity which examines the impacts such as positive or negative on the environment and on society.

(http://www.mallenbaker.net/csr/CSRfiles/enron.html)

However from this point of view of Enron and CSR, it is obvious that Enron has fooled the society. They gave the image which was quickly turned out to be a mistruth because they were failed to tell us what was going on inside the company.

CHAPTER 3

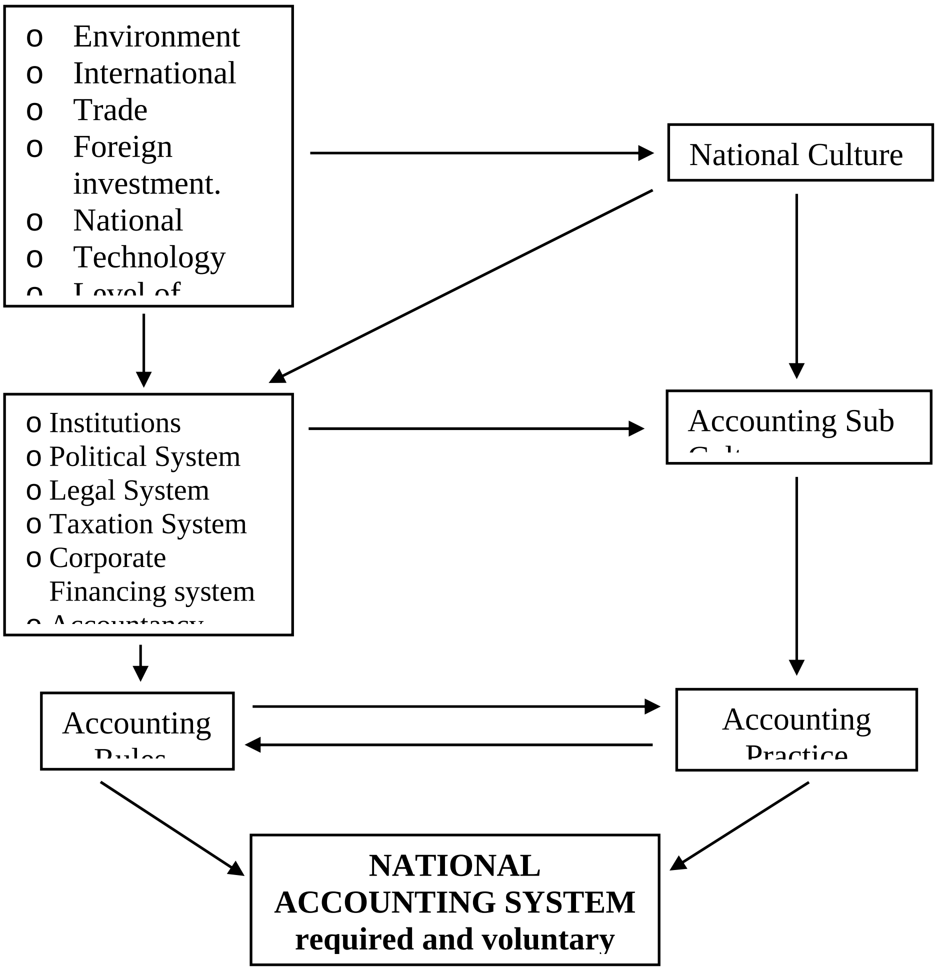
3.1 FINANCIAL REPORTING

Understanding of the conceptual basis of financial reporting system and preparation of financial statements is the perquisite to conduct an analysis about financial reporting. In recent years growth and globalization of multinational companies has raised the issue of quality financial reports. Accounting frauds such as Enron, Parmalat, WorldCom etc in the last couple of years and volatility of stock returns and risk to investors has been a concern.

The important issue here is that, can greater transparency quality reporting increase the value of shareholder and reduces the risk to the investors and ultimately reduces the risk to the market participants. It is not only laws, regulations and standards which make the quality of the financial reporting but it is also affected by other institutional factors such as nature of corporate governance stakeholder model shareholder model and legal system, investor protection and disclosure standards. (Wang 2005)

There are macro economic factors which shape the financial reporting system of a country. Gray (1988) discussed these factors such as Environmental, Institutional and cultural which are linked with each other. Each country has its own set of rules that govern the financial reporting of enterprises located in that country.

FACTORS EFFECTING FINANCIAL REPORTING



Source : Flower.J, Ebbers.G (2002) , Global Financial Reporting

3.2 DISCLOSURE OF FINANCIAL INFORMATION AND MARKET RISK

Levit (1998) chairman of the SEC said "I firmly believe that the success of capital is directly dependent on the quality of accounting and disclosure system. Disclosure systems that are founded on high quality standards give investors confidence in the credibility of financial reporting and without investor confidence, market can not thrive."

"Quality" and "transparency" terms are interchangeably used for disclosure of the financial reports and accounting standards. Kothari (2000) argued that quality financial reporting can reduce the market risk. Ball, Kothari and Robin (2000) view transparency as a combination of properties of timelines and conservatism. The term 'timelines' suggests that to what extent current period financials are incorporated in current period economic events whereas 'conservatism' suggests the concept of how bad news reflect in economic events than good news. These are determinants which effect disclosure of financial information, financial accounting standards and securities laws. The quality of disclosure is important for transparency of financial statements. However possible impact of weak enforcement of standards is in two ways. First it has negative impact on the shareholders protection and also on the growth of the financial markets which cause unattractiveness for the investors. And secondly in the absence of poor enforcement of accounting standards the disclosure quality is likely to suffer.

3.3 FINANCIAL REPORTING IN USA

As my thesis is based on the Enron therefore it is important a brief discussion about the financial reporting in USA to create better understanding of the case. The financial accounting in United States is regulated by private body sector , Financial Accounting Standard Board (FASB) but the authority of the accounting standards is underpinned by the Security Exchange Commission (SEC) which is a regulatory agency established by congress in 1934. SEC has jurisdiction over the listed companies on all stock exchanges in US. Although SEC has the legal authority to prescribe the accounting and reporting standards for public companies yet it has been relying on private sector for development of Generally Accepted Accounting principles (GAAP) in United States. (Flower 2002) In the pure capitalist economies such as USA the influence of the capital markets such as stock exchange is too much. According to Schuetze (1994) in USA the financial reporting and system has developed in such a way that public companies present the facts with great transparency. In his view the information is king and also Queen. The public companies present the fact and let the market decide how the facts should affect the prices of the stock.

3.4 PRINCIPLE BASE ACCOUNTING VS RULE BASED ACCOUNTING

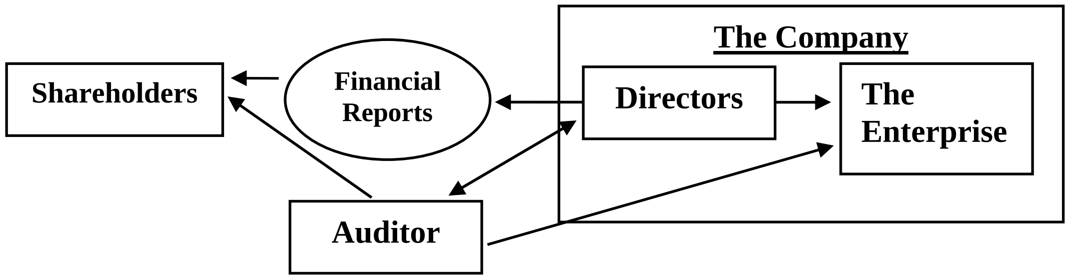
In United States public companies follow the rule based accounting standards. According to which first accounting rules are set and they must be followed in order to comply with the US GAAP. As an example if a company lease an asset the company has to follow strict specific rules that a lease is a capital transaction or an operating transaction. However treatment of both ways on the balance sheet of the company will produce different effect on the company economic activity. The critics of the rule based accounting argue that it allows the dishonest companies to follow rules technically with intention of betraying the stakeholders. In the case of the Enron it followed that the company appears to have followed the GAAP rules technically and creating in complex and numerous capital transactions and capital structures. According to Liesman (2002) it seems that the only purpose of adding these "Byzantine Transactions" was to keep billions of dollars of debts off the balance sheet and also hiding many of liabilities from the view of creditors and investors. On the other hand principles based accounting follow few exact rules and general principles are put forward and companies must ensure that their financial statements fairly represent the principles. Nobes (2005) discussed the issue that whether United States standard setting process should adopt the "Rule based" approach and move towards the "principle based" approach as adopted by the International Accounting Standard Board (IASB). He concludes that the complexity of rules can be reduced by adopting more Nelson (2003) suggests that standard should be based on rules because rules create more accuracy and more clarity.

3.5 FINANCIAL REPORTING AND SHAREHOLDERS VALUE

There is no doubt that financial reporting plays a major role in communication between investors and corporate. Independently audited and presenting fair view of financial statements is the main source of getting information on the companies. For this point of view following those principles in accounting which considers shareholder value management are of primary interest. (Meyer 2002) The quality reporting of the business provides the opportunity to consolidate the information in performing the financial calculations which are relevant to reporting and planning processes. In the words of SEC commissioner Glassman (2003) “Let me first tell that to the matter of the improving financial disclosure…... the good news is that the better the disclosure it will reward a company shareholder value and on a macro economic level, lead to more efficient market.”

It is conceivable that those companies which will produce quality disclosures can perform better on the performance front and shareholder value objective. Study by Lundholm (1996) showed that better disclosures can lead to the greater agreement among the investors about companies prospects, returns and finally to its value. This simple model shows the relationship among enterprise directors, auditors and shareholders and flow of information among these.

Model of Financial Reporting



Source: Wang (2005) The Role of Financial Reporting played in Corporate Governance

CHAPTER 4

4.1 RESEARCH METHODOLOGY

The conceptual framework in this research is positivistic. In which researchers draw conclusions based on empirically determined knowledge.

In this thesis I have adopted descriptive and explanatory approach as a methodological approach. There are two major approaches to research methodologies in social sciences i.e. Qualitative and Quantitative research Methodology. I have used qualitative research methodology for this thesis.

Qualitative research defined by Van Maanen (1983:9)as:

"An array of interpretative techniques which seek to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occuring phenomena in the social world."

Quantitative research is concerned about the number of logics and objectivity. Here question arises which one approach is to use qualitative, qualtiative or combination of both i.e triangulation.

Qualitative research is widely used in business researches as observed by Gummesson (1991). Many researchers believe (Jankowich's 2000) that knowledge does not exist in vacuum, and your work only has value in relation to other people. Your work and your finding will be significant to extend that they are same as or different from, other's people work and findings. The thesis presented here is largely based on the literature review, reports and court cases. Therefore research presented in this thesis is descriptive and to some extent explanatory. These methodologies are defined by Riley at al 2002 as descriptive research is concerned with what, when, where and who questions, whereas explanatory research goes beyond this and is concerned with why and how questions. This definitions is seems to be reflection of a famous saying of Rutyard Kippling. I keep six intelligent tools with me what, when, where, why, how and who. If I compare this thesis on the scale of positivist and interpretive research I would come to the point that it is based on interpretive research I would come to the point that it is based on interpretive research or in the words of Smith et al.2003 the social contortionism steaming from the views of expert and analyzing their ideas.

Researches has presented many benefits for this approach such as how processes change over the time and how the new ideas are emerged and mix with the existing theories. However researchers have also pointed out some problems with qualitative research for example Smith et al.2003 explain this phenomena as qualitative studies are sometimes feel very untidy because it is harder to control their pace progress and end point. Qualitative method has many forms for example pure hypothesis testing data mining middling speculative hypothesis in induction simulation and content analysis. The information gathering and data sources for this thesis is literature review: the primary resources of data which I have used in this thesis are from literature a review which is taken from general books articles and reports and court cases in public domain.

4.2 LITERATURE REVIEW

Literature review is a critical part of research which should provide background, justification for the undertaken research. It also demonstrate the quality of awareness and understanding of existing work in field (Sharp 1994)

The literature review can be used in two ways; some researchers used literature view to identify theories and ideas that will be tested by using data. This approach is known as deductive approach. However in some research, the researchers try to explore data and develop theories to the literature, this is called inductive approach. In this thesis I have used the deductive approach I have used the theory of shareholder wealth maximization and have tested against the Enron. I have tried to build a relation between the share holder value and financial reporting.

The literature review in this research can be divided in two parts. First part of literature review is mainly analytical in which I have presented the views from different researchers about the collapse of Enron and is based on different accounting auditing, financial reporting and corporate governess issues. In the second part of the literature review I have discussed the impact and regulatory reforms in the post Enron era in U.S.A and Europe.

4.3 CASE STUDY

The case study technique is commonly used which is quite popular method among masters level students conducting research in short period of time. It allows researchers to analyze the data and come to the conclusion about the research questions According to Riley, Would, Clark (2000) a case study method is a research strategy which may involve observations they divide case study into further three categories being single, multiple and scenario study.

The research method which adopted here is case study which is based on prior literature. The case study can be used in two different styles as categorized by Scapens (1990). The first one is descriptive explorative and the other is descriptive interpretative case study. Yin 1989 states that case study can be regarded as effective method conducting investigation in qualitative research. It is believed that to conduct the case study evidence should not be conducted from single source but broader variety of sources should be used. I have conducted this case study in following stages At the first stage I have identified the research question and have made a theoretical background to this thesis and explanation of the underlying theories. In the second stage, data was collected through various resources such as from prior literature on Enron, articles, journals, newspaper reports, court cases, annual reports, shareholder meeting reports, and corporate statement released. The bankruptcy reports and senate reports were obtained from website of Securities Exchange Commission and Findlaw.com.

In the third stage of case study through the analysis of data obtained from different sources I have tried to identify the problem within the framework of Enron and test theory. In the fourth part of this case study I have drawn up conclusion and try to make a relation between financial reporting and shareholder value.

CHAPTER 5

5.1 LITERATURE REVIEW

Literature review undertaken in this thesis is mainly concerned with Enron Corporation and can be divided in various ways. In this literature review I have used the literature on Enron which address the case from corporate governance, financial reporting, shareholders value and its impact on UK and EU as all these areas are interrelated and the Enron case provide the classic example of it.

Baker (2003) has analyzed the fall of Enron from different perspectives he discussed the business model of Enron and external factors such as deregulation of industry in that era. He has examined the growth of Enron which transformed itself from regulated gas distribution Company into an international trading company and through all the stages of its collapse he investigated Enron as American public private partnership. Then Baker (2005) views Enron's bankruptcy as an accounting failure in which the investors and creditors of the company were misled and presented with false financial information .In his view the bankruptcy losses of the investors could have been reduced to some extent if they had been provided with the transparent financial information and its result.

Here the onus of proof lies on the auditing company which was responsible to present the fair view of its financial statements which was Arthur Andersen but special purpose entities were audited by KPMG. The auditor's role in the whole episode has been in lime light. However the point of concern is that no claims with respect to amending on the Accounting Standards has arisen in litigation surrounding corporate collapse however the auditors has been target of criticism. According to business week (2002) major U.S investigations / Lawsuit in 2002 were as below

COMPANY	**AUDITOR**
Adelphia	Deloitte & Touche
Computer Associates	Ernst & Young
Enron	Arthur Andersen
Global Crossing	Arthur Andersen
Micro Strategy	PricewaterhouseCoopers
People Soft	Ernst Young
PNC financial Services	Ernst Young
Qwest	Arthur Andersen
Parmalat	Grant Thornton

Source: Business Week, 2002, pp 42-3

However there is need that the corporate regulator and professional bodies to support the idea that quality of the financial reporting should be guaranteed through compliance with regulations.

In a well developed society regulations should be directed to produce quality and reliability rather than just standardization of rules (Oliver 2002)

Morrison (2004) investigates the transparency of the financial information and she explores the role of the Arthur Andersen in Enron and deals with the two important questions:

1. Did Andersen participate in the Enron Fraud?
2. Did Enron obstruct Justice?

In her paper she explored the evidences available publicly related to Enron and Andersen, and the roles of politicians and financial institutions. After a series of event studies at transaction levels she concluded that:

"Andersen could not have participated in the frauds because Andersen was never auditor of the SPEs where the frauds were committed. The frauds were committed by Enron officers within SPEs in collusion with numerous supposedly reputable financial institutions who were also not Andersen clients."(Baker 2002)

Sharon Watkins raised her concerns over the accounting treatment of funds to Mr. Ken Lay CEO at Enron.

"Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay …..? We have recognized 550 million of fair value gains on stock via our swaps with Raptor, much of that declined significantly-

Avici by 98%, from $178 million to $5 million, the new power Co by $70%, from $20/share to$ 6/share."(Watkins 2003 p.361).

According to some researchers the model of financial reporting has not been successful to value drivers in the new economy. The continuous expansion of Enron into intangible form of business such as technology processes created the business model in which true value was difficult to determine. This produced gap in the book value and market valuation of many companies. In the past years this trend has been quite aggressive. In earlier study by Collin et al. (1997) shows that intangible intensive industries have been increased from 7% to 21% in 1993.

Chatzekal (2002) view that the changing nature of finance enterprise and accounting capability should be in parallel and the one way to achieve is through reviewing the accounting for intangibles and he raises the important question of how to reduce the opportunity for new Enron in future.

According to Howell (2002) the most problematic asset to evaluate are financial instruments whose values are reflected by underlying asset not reflected on the balance sheet itself. In his view Enron and other companies valued their assets highly and shown increment in the earning of the company. Enron itself created a lot of special purpose entities whose debts were not reflected in the balance sheet.

The timing of the expense and revenue recognition, debt obligation is thought to be other accounting issues which have impact on the financial condition of the company. The misuse of these concepts has resulted in the creation of the Enron scandal.

Enron's 'mark to market' approach by use of which they show profits on long term contracts as earned which were being signed. The use of SPEs then brought profits into Enron. The fall of these contracts ultimately started a process of SPEs fall and Enron's fall consequently. (Oliver 2002)

The use of mark to market approach for the basis of its valuation of contracts was dubious. The acquisitions and selling of different businesses also causes concerns in the Enron. Joanne and john (2006) discussed the same issue and use the term 'Hypermodern Organization' they agued that the continuous growth of Enron as an organization was based on hyper flexibility in terms of size and survival of its business units. In reaction to the market opportunities Enron acquired and disposed off businesses. It acquired Portland General Corporation to enter to the market of utility electricity. And in 2000 it sold the business of Sierra Pacific Resources. Fox (2003) states that Enron executives explained the sale of the Portland General by saying that the company was bought to learn about electricity business. "Enron employees doubted that strategy as one former managing director said 'we didn't need to buy a company to get a few electricity traders, "that's like if u want a glass of beer, you buy a brewery" (Fox 2002. p.173).

While the research has been conducted on the corporate governance, financial reporting and business models which make the theoretical background of collapse of Enron a huge amount of work has been done on the technical part using different ratio analysis. The financial ratio analysis is conducted for two primary purposes which is 1) to compare with standard different companies publish comparative ratios in the industry 2) to predict the future prospects of the company for this analysis there are two subdivisions which are a) to forecast the future variables and b) asses the credit rating and to predict the future collapse of the company (Barnes 1987)

The financial analysis conducted by Kastantin (2005), showed that during the period 1996-2001 there was increase in the revenue of the company while the net income decreased from 5.66% to 0 .97%. In this research different ratios were used like price to earning, Price to book value, ratio Return on asset, and use of Net margin and use of risk management activities. It’s common that the innovative companies heavily invest on research and development expenditure that under the US accounting standards can not be capitalized.

“If these non capitalized expenditures are expensed when incurred and the expenditures successfully ac accomplished their objectives, then return on assets should increase in the future since the reported as set base excludes these non-capitalized expenditures. If the return on as sets ratio de creases in future periods, then the non- capitalized expenditures would seem not have been successful and, therefore, should not be taken into investor account in justifying excess P/B and P/E ratios.”

In this ratio analysis they used Net profit margin, Return on Assets, Return on Equity, Debt Ratio and Debt to Equity ratio. They found that Enron's net profit margin declined from 4.4% to 0.5% in 1996 which was decline for more than 88%. They also found that firms return on asset shown the similar decline. The financial position of the firm improved after 1997 but still remained at the level of 50%. At the point when Enron's financial position was deteriorating a strong buy indication from the security analyst is questionable.

It is also important at this point to discuss the role of institutional investors. Institutional shareholders who are also the long term investors and are actively monitor of the management. Navissi (2006) found relationship in the institutional shareholding and corporate value they found that examination of shareholding by institutional investors does not consider the level of monitoring by these investors and also that corporate value depends on that there is close monitoring in corporate and institutional investors. The study also showed that shareholdings by active institutional investors up to 30 percent increase the value of the firm and more than 30 percent decrease the corporate value of firm.

However if we see Enron through institutions , equity analyst, and investment banks perspective we find that these entities remain loyal to Enron throughout until its demise, even after the buyout of Azurix, losses at Enron's Broadband, the Dabhol, and the Blockbuster deal went burst. Merrill Lynch analyst Donato Eassey gave "buy" recommendation on Enron stock in April 18 2001, the report which was titled as

“Raising the Bar--- Again” commented that the Enron’s stock price, then at $60 can go up to $100 in next 12 months. Eassey raised his projection for Enron’s earnings and said, “We reiterate our buy opinions” (Fox p, 241)

When senate investigated the role of financial institutions in the bankruptcy of Enron it was found that investment banks helped the company disguised its financial position. The Associated press was reported:

"The evidence indicates that Enron would not have been able to engage in the extent of the accounting deceptions it did, involving billions of dollars, were it not for the active participation of major financial institutions willing to go along with and even expand upon Enron's activities," investigator Robert Roach said at the hearing” (http://www.nysscpa.org/home/2002/702/4week/article29.htm)

Coffee (2003) has discussed the same issue in his working paper “what caused Enron” states: as in late as October 2001 sixteen or seventeen security analysts recommended buy or strong buy for Enron’s stock however the stock price of Enron already in 2000 was six times of its book value and 70 times earnings, however the first brokerage firm which recommended “sell” recommendation for Enron was prudential securities which at that time was not engaged in the investment banking business.

Giovanni and Andrew (2002) discussed the institutional activism in Europe they argued that crisis in public model security and reforms in stock market exchanges and birth of the single market in Europe has changed the domestic institutional investors approach towards Corporate Governance. European institutional investors are now looking outside Europe boundaries for greater profits and competencies and they are putting more pressure on their portfolio companies to increase the shareholder value. (Carriere 2002)

According to Cariola (2005) view the most valuable asset of the firm is the human capital and ‘talent’ which is involved in conducting the business activities which builds up “complementarities” with the asset in place.

As far as the business model of Enron is concerned, According to Saint –Onge argues that Enron had indulged itself into market based activities and that there was not an adequate experience to guide this move. This inexperience in the market based activities caused a system without check and points. In his view any company when move itself from a tangible based environment to an intangible base environment it needs to bring practices and values to the system being adopted. (Chatzkel 2003)

Saint-Onge refers to Lev (2001) statement : “difference in outcome is derived from DNA of companies i.e. which is the organizational infrastructure, its capabilities, culture and leadership…these are the elements that create the working context for operating and managing intangibles”

Researchers have given a lot of emphasis on the U.S corporate governance. Corporate governance attempts to address the separation ownership from control that characterizes the current capitalist free market model. In broad sense it’s about ensuring that companies are properly held to account. In the aftermath of Enron serious questions have been raised about the U.S corporate governance system. There is no doubt that performance of a company depends on the quality of decisions taken by managers regarding its products and services. In the wake of making decisions managers quality depends on the incentives they are offered. The changing nature of business models and globalization is demanding change in the corporate governance system.

Enrique (2003) have studied the reaction of Enron and discussed its aftermath. He found that the reaction on collapse of the Enron on Europe and UK has been Different than USA. In his view Block holders of European Companies must have been working more effectively than the institutional investors and monitors in USA. After Enron in USA there are quite a few companies who faced serious problems in Europe such as : Marconi (UK), Élan (Ireland) Parmalat (Itlay EMtv, I(Germany), Vivendi (France), Swiss Life (Switzerland), Bipop (Italy) Free. Other examples include Freedomland and Cirio (Italy), KpnWest and World Online (the Netherlands), MobilCom and ComRoad (Germany), ABB (Sweden-U.K.), Lernout & Hauspie (Belgium), BZ Group (Switzerland), France Telecom (France). (Alessandro Penati, Le Inutili Enron d'Europa [TheUseless Enrons of Europe], CORRIERE DELLA SERA (Milan), Mar. 6, 2003, at 18.) US corporate scandals have provided justification that in Europe there is a serious need of reviewing the Corporate Governance system thus creating a momentum for 'political activism' on this issue. There is a greater need of independent directors who are capable of monitoring managers, who can raise tough questions and review the most important decision which can affect the future corporate value of company. (Higgs 2003)

Higgs (2003) recommended that half of the board members should be non executive directors and the role of CEO and the chairman should be separate. In his view independence of auditors and directors is very important. Luca Enrique 2003 discussed the developments in EU countries in the post Enron era. On May 25, 2003, the European commission issued to council and European parliament setting out its agenda to modernize European Corporate Law and to enhance corporate governance in E.U. With respect to U.K post Enron corporate Governance reform there has been study on non executive directors commissioned by government funded organizations and also some initiatives on audit and accounting issues.

In France Enron aftermath brought changes in accounting reforms which were in line with Sarbanes-Oxley Act provisions. The French government issued the " project de loi de securite financere". Article of which states that auditors will be not allowed to provide non audit services to their clients and also these auditors has to be selected by the non executive Board members. A statement of Corporate governance has to be disclosed which should explain internal control procedures and board functions.

CHAPTER 6

DISCUSSION AND ANALYSIS

6.1 BACKGROUND OF ENRON

Enron was formed with the merger of Houston natural Gas and Inter North. Enron was originally established as distribution of electricity gas throughout the United States and construction of power plants pipe lines etc. Enron expanded its business throughout the 1990s. Their operations were seen as so successful that it was rated as America's most innovative company for five consecutive years in "Fortune Magazine" and was also America's seventh largest company and largest natural gas Pipeline Company in America. Ex Harvard Business Review Editor described Enron as the 'the great radical innovator'. However a year after the price of Enron share dropped to less than $1. (Oliver 2003)

TIMELINE WITH ENRON CRITICAL EVENTS WHICH TOOK PLACE FROM ITS BIRTH TO DEMISE[2]

1985: Enron establishment by the InterNorth and Houston natural gas group and Ken lay appointed as the chief executive and chairman of the company.

1989: The establishments of new trading division Gas Bank which become afterward Enron Finance Corp. and Enron Gas Services.

1990: Jeff Skilling joins Enron and will lead the Enron finance operations.

[2] These dates are taken from various sources such as newspapers, reports and online resources and are time sensitive e.g. washingtonpost.com, www.ft.com etc.

1993: Beginning of operation of Teesside Power Plant in England which is developed by Enron.

1994: Enron enters into the Electricity trade.

1995: Skilling division renamed as Enron Capital and Trade Resources.

1998: Creation of Azurix, Water Company.

1999: Enron's broadband services launched Enron online is launched which becomes the largest e-commerce site in the world.

2001: Jeff Skilling resigned as CEO and replaced by Kenneth Lay.

Aug 2001: Enron's vice president wrote letter to CEO to express her concern about the accounting and reporting issues of the company.

Oct 2001: Enron made a series of disclosures such as restatement of its financial statements. Enron CEO announced that Enron is now taking "after tax non recurring charges of $1.01 in the third quarter. And also call for reduction in shareholder equity amounting to $1.2 billion. (Fox 2002)

Dec 2001: Enron was filed for bankruptcy New York

Sep 2003: Former Enron treasurer Ben F. Glisan Jr. pleads guilty of conspiracy to commit securities fraud, becoming the first executive at the scandalridden firm to go to prison. Glisan also will forfeit $1.3 million in profit (Washingtonpost.com)

Jan 2004: Former Enron chief financial officer Andrew Fastow and his wife, Lea Fastow plead guilty to charges related to accounting fraud**.**

May 2005: US Supreme Court overturns former Arthur Andersen convictions.

May 2006: Skilling was convicted 19 of 28 counts of charges and Lay was convicted all six counts of charges.

July 2006: Natwest three British bankers extradited to USA in relation to fraud charges relating to Enron

6.2 BUSINESS OF ENRON

Enron had owned about 37000 miles of pipelines which were spreading through intra and interstate pipelines and it was transporting natural gas between producers and utilities. (Palepu 2003). "Enron was an exemplar conglomerate" and it was an innovator of new energy contacting. In the beginning of 1980s most of the contracts between gas producers and the pipelines were contracts "take or pay".[3] (Oliver 2003). However later in the mid 1980s due to the deregulation of the prices more flexible arrangements were allowed between the pipelines and producers of the gas. Enron took advantage of these deregulations in prices and contracts because Enron owned

[3] "Pay or take contracts" are those contracts where pipelines agreed either to purchase a predetermined quantity at a given price or liable to pay a equivalent amount in case of failure to fulfil the contract.

largest network of pipelines and regulatory changes had led to use of spot market transactions. (Baker 2003)

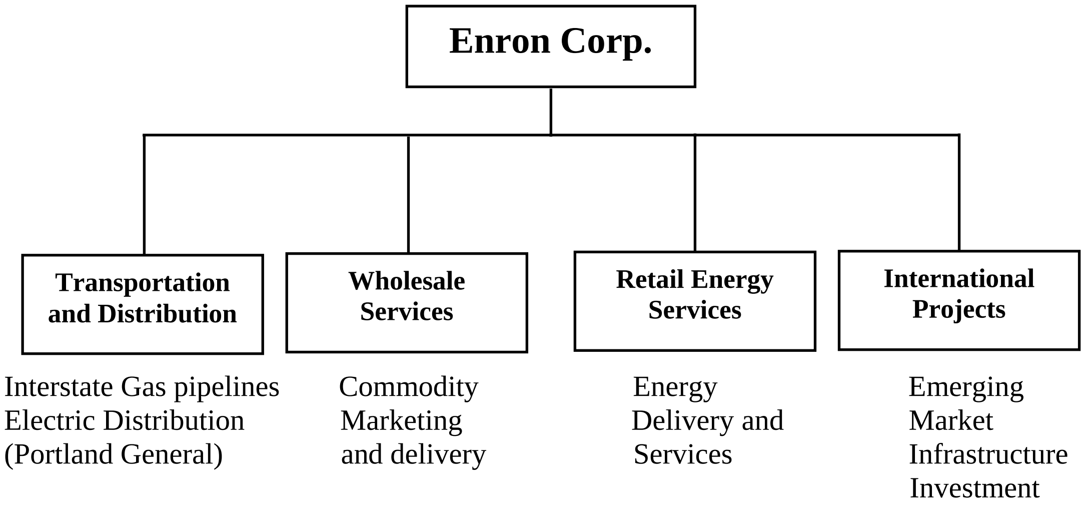
6.3 ENRON'S TRADING MODEL

In the beginning of 1990s Skilling started to work to put together Enron into a new entity that was ready to go into new century. Pokalsky who worked with Skilling in 1990s once said "I had impression that Jeff wanted to see himself recognized by his peers as someone … who had changed the world"(Fox 2003 p 35). However before he could change the world he had to make some changes in Enron. The first market which he targeted was Electric Power. However to some extent Enron had been successful in applying the gas bank trading model to the electricity. However it was difficult to fulfill this commitment during the peak periods because unlike gas, electricity can not be stored and it leads to high changes in electricity prices compare to gas. (Palepu 2003)

Then in 1990s it diversified itself into commodities related to non energy. Its activities expanded from energy trading to e-business operations. By 2001 Enron became a conglomerate that was dealing with gas pipelines, paper plants, power plants, coal, steel, electricity plants broadband and water plants at international level and started trading in financial markets. (Palepu 2003)

Investments of Enron resulted in hundred of subsidiaries and other related entities which were called as Special Purpose Entities.

STRUCTURE OF ENRON



Source: Enron Corporation Organizational meeting, December 12, 2001, New York

(*www.enron/com/corp/pressroom/chapter11/creditor presentation.ppt*)

Most of the activities of Enron were now undertaken through 'myriad corporate entities' consolidated, Limited Liability Partnerships (LLPs), Joint ventures and Special Purpose Entities (SPEs).

6.4 FINDINGS AND ANALYSIS

The findings in the Enron case is based on literature review and also the court cases and reports in which Enron and its executives have been found guilty and investigation reports.

1. During 1996 to 1998 approximately 60% of Enron's earnings were generated through the business which was not Enron's core business activity and about 30% to 40% of the earnings were generated in which Enron wasn't engaged five years earlier. (Powers et al 2002)

2. The accounts of Chewco[4]. LJM1 and LJM2 were not audited by the Andersen in which frauds were committed.(Morrison 2004)

3. Enron had swapped $500 millions with Raptor; much of this stock had been declined significantly. The New Power Co. 70% from $20/share to $6/share; Avici by 98% i.e. from $178mm to $5mm.(www.washingtonpost.com/letter)

4. In December 1997 Enron provided guaranty of $240 million to by Barclay to Chewco for which Chewco agreed to pay guaranty fee of $10 million plus 315 basis point on average outstanding balance of the loan and this fee of providing guarantee was not calculated based on any analysis of risk.(powers et al 2002)

5. Enron's Board of Directors oversaw the related party transactions. They were involved in the Chewco transactions and also permitted Fastow to go with LJM1 and LJM2 despite there was conflict of interest and also they also created raptor vehicles and oversaw the relationships between LJM and Enron.(Powers *et al* 2002).

6. Enron sold a stake in 1999 to Merrill Lynch of a $7 million in three energy generating barges. This deal was disguised loan as Enron promised to pay

[4] Chewco investments L.P was limited partnership formed in 1997. It was the first SPE under Fastow Enron's finance Group

back and also it committed fraud when it booked the loan as $12 million profit just to meet the earnings estimates. In this case jury convicted Enron's executives and four Merrill Lynch & Co. officials.

(http://www.washingtonpost.com/wp-dyn/articles/A23034-2004Nov3.html)

7. In Powers 2002 report, it was found that there were serious issues concerning the reporting of party related transactions to the shareholders. Enron failed to disclose those facts to the shareholders which were important for the substance of transaction. Statement of accounting standard No. 57 provides the requirements under (GAAP) Generally Accepted Accounting Principles concerning the disclosure of party related transactions in the financial statements. According to this standard the financial statements must include certain specific information i.e. a description of transactions, nature of transaction and relationship involved amount and amounts due from or to related parties. However the management of Enron, Auditors and other outside counselor to make judgments for deciding what entities should be qualified as "related party".

8. A report prepared by subcommittee on investigation (2002)[5] found that Enron's Board of Directors knowingly allowed practicing high risk

[5] During April 2002, the Subcommittee staff interviewed thirteen past and present Enron Board members, These lengthy interviews, lasting between three and eight hours, were conducted with the following Enron Board members: Robert A. Belfer; Norman P. Blake, Jr.; Ronnie C. Chan; John H. Duncan; Dr. Wendy L. Gramm; Dr. Robert K. Jaedicke; Dr. Charles A. LeMaistre; Dr. John Mendelsohn; Paulo Ferraz Pereira; Frank Savage; Lord John Wakeham; Charls Walker; and Herbert S. Winokur, Jr.

accounting practices and that Enron's executives intentionally allowed off the book activities for the purpose of making its financial condition appear better on financial statements and failed to make a public disclosure of the off the book activities. It also held responsible for excessive compensation of executives of the company.

9. Enron paid approximately $17m of taxation between 1996 to 2000 despite posting pre tax profit $ 1.79 billion and also they received rebates of $ 381 m (Hill et al 2002)

6.5 REGULATORY REFORMS IN GAS INDUSTRY AND ENRON

The US electric power industry in 1980s was mainly regulated industry. The energy crisis in 1970s made the US congress to pass the pass a number of laws. During 1980s US Federal Energy Regulatory Commission issued an order according to which it allowed natural gas pipe lines to become open access transporter. Whereas in the distribution companies were regulated and vertically integrated (Baker 2002) and in the wake of these regulatory changes Enron was one of the company which was created (Baker 2005).

These regulatory changes of the natural gas market, allowed deregulation of prices and also permitted the companies to have more flexible arrangement between produces and pipeline which ultimately increased the spot market transactions. The changes in regulation brought changes in the strategy of Enron. Its new strategy was to focus on becoming a dominant player in marketplace for energy derivatives. Even though the Enron share prices rose through the 1996 to 2000 however its earning per share (EPS) showed significant variability (Lev 2003). Until 1996 Enron had 44.1% of its assets invested in property, plant and equipment. By the start of 2000 the whole scenario was changed and they were reduced to 17.9%this was conscious activity developed by Enron chief financial Officer (Baker 2002). Andrew Fastow quoted as "we transformed finance as merchant organization… essentially we would buy and sell risk positions". (Wharton 2002)

6.6 USE OF SPECIAL PURPOSE ENTITIES

In order to shift, the accounting structure used by Enron is know as Special Purpose Entities (Baker 2005, 2003) Enron used SPE in order to fund the acquisition of gas reserves from producers.(Palepu 2003)

Batson (2003) concluded in the second interim report that Enron used persuasive structured finance techniques involving SPEs aggressive accounting and also that made their financial statements in such a way that it had very little resemblance to the actual financial condition of the company. In year (2000) by use of six accounting techniques Enron produced 96% of its reported net income and 105% of its reported funds. These techniques[6] were:

[6] These techniques are taken from third interim report. *Neal Batson et al 2003*

a. FAS 140 transactions Enron used these transactions as a sale to the SPEs for accounting purposes

b. Tax transactions these transactions were engineered in such a way that it allows Enron to be beneficiary of future tax speculative tax deductions as current income on its financial statement.

c. Non- Economic Hedges these transaction were also discussed by Powers (2002) report through this technique Enron hedged decrease in value of its investments

d. Share Trust transactions these were off balance sheet financing structures.

e. Minority interest transactions and Prepay transactions were loans in economic substance however it was not reported as debt but were repotted as price risk management liabilities. Therefore its key reported financial ratios were not accurate.

In the second interim report examiners found that there were two key factors due to which Enron engaged itself in SPE transaction 1) need the cash 2) to maintain its credit rating.

6.7 'MARK-to-MARKET' APPROACH

Enron used mark-to-market approach on long term in energy contracts as discuss by Baker (2002), Oliver (2003) and Palepu (2003) 'according to which allowed them to show profits as earned on the contracts being signed which mean that once a long term contract is signed the present values of the stream of future in flows under the contract was recognized as revenues and the present values of the expected cost of full filling the contract were expensed.’

6.8 REACTION TO THE ENRON

In reaction to the Enron scandal there has been brought changes the regulations in USA and Europe one of the law was Sarbanes-Oxley Act of 2002 among many provisions the law required both Chief Executive Officers and Chief Financial Officers to certify in the annual report that they have reviewed the annual report and it does not consist of any omissions and untrue statements (Baker 2002) However there has been a lot of criticism on this act. (Olverio and Newman 2006) discussed flaws in the Act. The most serious laws are about redundancy of opinion by auditors. Reaction in Europe and uk has been discussed in literature review chapter

6.9 DISCUSSION

In the previous sector I have discuss some technical issues in creative accounting practices by Enron in this chapter I would discuss the border impact of Enron in the light of theoretical perspective.

6.9.1FINANCIAL REPORTING AND ENRON

It is important that the financial information must be reliable transparent consistent and comparable in a way this can be achieved by introducing high quality set generally accepted accounting principle.

There are convincing evidences by the professional bodies or the regulators of corporate world to insure that the idea of quality financial reporting and accounting data can be guaranteed through mandating compliance with prescribe practices. It should be considered that the regulations intend to protect the users of data. (Oliver page pp. 328)

In Enron, financial reporting to issues proved problematic which were Complex and long term contracts in Enron's business trading Enron reliance on structure finance transactions which involved creating of special purpose entities. (Palepu 2003)

The complexity of the financial accounting standards has created a variety of fraudulent schemes. From the above analysis it is clear that the significance of the off balance sheet arrangement were not properly informed to the Enron investors. Transparency of the financial statements enables creditors, investors and the market to evaluate the performance and the economic conditions of the entity. If the financial statement is transparent and present the fair view of the entity then the users of financial reports i.e., creditors and investors and other stake holders are not surprised by the unknown transactions or events.

Therefore the reliability comprehensiveness and understandability of the financial statements is important for public companies. Transparency is also important for the corporate governance of company because it helps the executives and board of directors to evaluate the effectiveness of management and to take better decisions when necessary. For quality reporting it is also essential to be quality standards in place. However it has been observed that the accounting rules in the US have contributed to this where the ownership of entities has more significance compared to the control of it. However according to international accounting board the principle of 'substance over form' is more important with reference to the special purpose entities. If in Enron the principle of substance over form had been use it might have created a different impact on the financial statement of Enron (ACCA views on Enron)

It has been argued by SEC that the US investors can only be protected by the use of US GAAP this argument however this argument is accompanied by the impression that US GAAP possessed the quality that insure the protection of investors (Zard 2006) which has not been the case in Enron. Therefore SEC has recently shown some support towards the global accounting standards. Research conducted by accounting and investment firms suggested that the global standards in accounting will improve the comparability of transparency and has effect on certain performance evaluation metrics. (Weiss 2004)

When companies use aggressive tactics to increase the reported earnings theses methods should be recognized as unacceptable. According to New York times article "while the accounting rules allow for interpretation ranging from conservative to aggressive companies are effectively graded pass-fail either the received a signature from there accountants attesting to their compliances with the rules, or they do not. There is no indication in the company's audited results whether or not it is fulfilling its numbers through aggressive tactics." (WEISS 2004)

Literature on financial reporting such as Daouk (2000), Bhattacharya, Wu(1999), Robin, Ball, and La Porta et al 1997 has suggested that the implication of those laws which gives the shareholders protection, are as important as disclosure standards. In other words if there is weak enforcement of shareholders disclosure standards and shareholders rights then there is more probability that the quality of disclosure would tend to be poor, regardless of disclosure standards. Kothari (2000) Suggest that the impact of enforcement on disclosure quality in two ways, shareholders weak protection has negative impact on the development and growth of capital markets in also make entities unattractive to the investors.

Baker (2003) Highlighted flaws in the US financial system which became more apparent by these accounting and auditing scandals he suggests that there is conflict among those who are involved in issuing securities and those who are involved in financial reporting.

6.9.2 ROLE OF AUDITORS

As far as the responsibility of making accounting estimates in financial statements lies with accountant however the Auditors of the company has the responsibility to elevate the reasonableness of those accounting estimates which are made by management. SAS No. 57 [3, Para. 14] states:

The Auditors also considered whether the difference between estimates best supported by Audit evidence and the estimated included in the financial statements, which are individually reasonable indicate a possible bias on the part of Entity's management. For example if each accounting estimate including in the financial statement was individually reasonable, but the effect of difference between each estimate and the estimate best supported by the audit evidence was to increase income, the Auditor should re considered the estimates taken as a whole.

However if the outside auditors of the company making sure that number present in financial statements present true and fare picture within the rules and of generally accepted accounting principles (GAAP) then it become difficult for fraudulent companies to play games with their books.(Glassman 2003)

The special purpose entities books were not audited by Arthur Andersen however we have seen the previous analysis that it was not the special purpose entities which were involved itself rather it was more about the transaction between Enron and SPEs, Arthur Andresen were failed to notice or ignore the transactions by Enron which distorted the financial picture of the company and the market which relies on such picture was misled. It was found that pictures are not always true. They are distorted to produce desire results here is need of here is the need to examine that to what extent these distortions consist of unethical procedures. (Duska & Duska 2003 pp.

9)There is no doubt that out right frauds can be difficult to detect if big hands are involved and management is not so clever.

6.9.3 WHAT SORT OF DISCLOSURE REQUIRED?

Here a question arise how much information need to be disclose and to what extant failure to disclose can lead to market misconduct. If somebody is with holding information with the view of that the other person would not react in a desire way then it is conceive able that he is manipulating things. (Duska& Duska 2003 pp. 15)

The common set of measurement which is use for the purpose is generally accounting principles (GAAP) but even in some situations the GAAP failed to disclose to overcome the problems of disclosures. For example the problem of determine and disclosing asset value[7]. If we consider the Enron case it was found that Enron was selling its assets to Special Purpose Entities (SPE) and which were also limited partnerships and most of which were under the control of Enron. They were only 3% ownerships of SPE by the people independent or outside of Enron. By manipulating its books Enron showed $63 million of gain even the assets and liabilities of those SPEs were still under the control and ownership of Enron. (Duska & Duska pp. 17)

6.9.4 AUDITORS VS FINANCIAL REPORTING

[7] Asset value means asset to owners or what the company would be willing to pay the owners, which can determined by what the company expects to be able to do with the assets and it depends on following three factors. 1. Amount of anticipated future cash flows. 2. Timing of the cash flows. 3. The interest rates.

Independent auditing is thought to be the primary business of the auditing firms but recently the trend has been changed according to a report Pricewaterhousecoopers in 2002 earned only 40% from their auditing services and 29% of the earnings came from tax consulting, management consulting and rest from corporate finance services. Marriot International Inc. paid Arthur Andersen over $1 million for audit and over $30 for other information technology and other services. (Byrnes et al 2002)

Although in theoretical terms the auditors of a company is a mater for shareholders but practically the appointment is controlled by the management. It is a general argument that for there should be more auditor independence for greater transparency of financial statements and to avoid the conflict of interests. The conflicts of interest can exist if a member renders professional services for a client or a employer or his or her firm has a relationship with another person, product or entity or service that could, in members professional judgment, be viewed by the client, employer, or other appropriate parties as impairing members objectivity. (Duska & Duska 2003) For example in case of Enron Weil (2001) raised important questions about "Arthur Andersen's" role as double duty and its independence. He reported that Arthur Andersen in addition to performing as an external auditor, Arthur Andersen LLP was also performing internal audit services for Enron. This raises question about the auditing firms and the degree of independence to which they have been auditing its own work and also raises question for the behaviors of the auditors. Although Andersen official say that their firms independence wasn't affected by the size or nature of the fee paid by Enron which was $52 in 2000(this includes $25 million for audit and $27 million for other services such as tax and consulting services. (Weil 2001)

Therefore here the important argument comes from Hamilton and Callahan 1998 that it is important that there should be independence for management advisory services for auditors and quote an example that suppose a auditor rise question about the technique which the consulting branch of the company is applying. He might be asked to overlook this because of a number of reasons. The worries about the interest of the firm being audited which is paying the accountant more than truth is to violate the duty of the accountant to third part users.

If the accounting is the language of the business then it’s the responsibility of the auditor to see that language has been used in a proper way such that the message is communicated to properly. In a system this is the role of the independent auditor “to see whether the company’s estimates are based on the formulas that seems reasonable in the light of whatever evidence is available and that the choice of formulas is applied consistently from years to years” (Duska&Duska 2003)

Mayhem and Pike 2002 (thesis) found that the impact of investor selection on auditor’s independence. They found strong increases in auditors reporting objective the conducted experimental design’s results suggested that different institutions rules which provide power to investors over the hiring and firing of auditors could greatly increase the auditor independence and also would increase the overall efficiency of the financial markets.

Auditors who are being paid by the clients for their services, it is the primary responsibility of the auditors to look out for the interest of the public, and should not look out at the primary interest of the accountants who employs them it the conflict of interest occur.(accounting ethics)

6.9.5 ROLE OF ENRON'S DIRECTORS

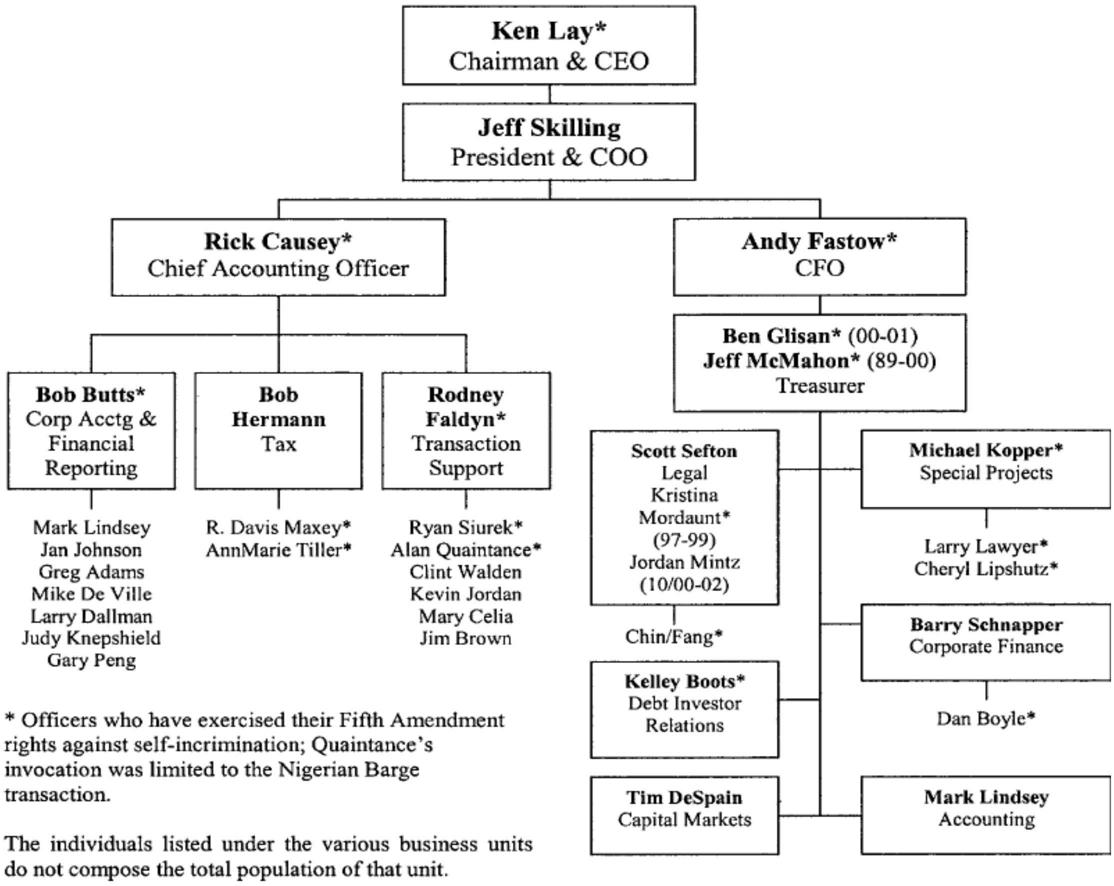
Enron's failure has raised many questions about the roles of chief executives and corporate governance system of modern corporations. It is commonly believed that weak corporate governance system leads to financial frauds e.g. Beasley 1996 , Dechow et al 1996. Zandstra 2002 suggest that it was not only lace of regulations or the accounting issues which crash Enron but it was also deception by directors and failure of board of directors of Enron the function in ethical and moral and irresponsible manner. The board of directors of Enron failed to safeguard to Enron shareholders by engaging by involving in appropriate interest transactions off book activities and executive compensation. Powers et al 2002 shows that Enron board of directors completely oversight the transactions between Enron and The special purpose entities.

In the 2nd quarter of 2000 Skilling and Causey executed a plan to inflate the share price fraudulently they reported earnings per share of 34% however it was supposed to be 32% predicted by the analyst based on the performance of Enron in that quarter.

Schilling and Causey improperly released into earning millions of dollars from the reserve account which has not any business and it was only shown just to show higher earnings per share than it achieved.

The Audit Committee also failed to perform its responsibilities who had the power to question about the deals being made. The committee failed to raise questions about Enron despite having top accounting professionals.

The following chart shows that the involvement of Enron’s executives.



Source : Neal Batson et al 2003 report

6.9.6 FINANCIAL INSTITUTIONS AND ENRON

It is convincible that Enron could not have shown deceptive picture to the investors without the financial institutions favor. In late 2000 and beginning of 2001, institutional investors had owned about 60% of its stock[8]. The fund managers were failed to recognize Enron's risk (palupe 2002). In the third interim report of Batson (2003) investigated this issue taking into consideration the transactions between SPEs

[8] These include many prestigious firms such as Janus capital Corp. Barclays Global Investment, Fidelity Management and Research smith Barney asset management, vanguard group, California Public Employees Retirement Fund, etc.

and these financial institutions Citigroup, JP Morgan Chase, Barclays, BT/Deutche ,CIBC , Merrill Lynch. The report used two theories of potential liabilities, aiding and abetting and breach of fiduciary duty i.e. to find out that whether is sufficient evidences that these institutions aided and abetted wrongful conduct of Enron's officer which constitute the breach of fiduciary duty.

Equitable subordination that the debtor claims should be equally subordinated of other creditors. The examiners found that there were close relationship between Citigroup Corp. and Enron and Citigroup has been playing role in assisting Enron.

Citigroup Corp. during the five year period from 1997 to 2001 Citigroup received approximately $188 million in revenue on those transactions which were related to Enron. The examiners concluded that Citigroup ignored or violated its own guidelines while transacting with Enron's SPEs and also that Citigroup had knowledge of breach of fiduciary duty by Enron's officers. The examiners found that JP Morgan, Barclays and BT Deutsce also had the actual knowledge of wrongful act of Enron's fiduciary duty and also these financial institutions assisted in completing and closing the SPEs transactions.(Batson 2003)

On 17 March 2003 the security exchange commission charged Merrill Lynch& Co. and its four of its former executives with aiding and abetting Enron Corp. securities frauds which were involved in two fraudulent year end transactions in 1999 which had the purpose and effect on the reported financial results.

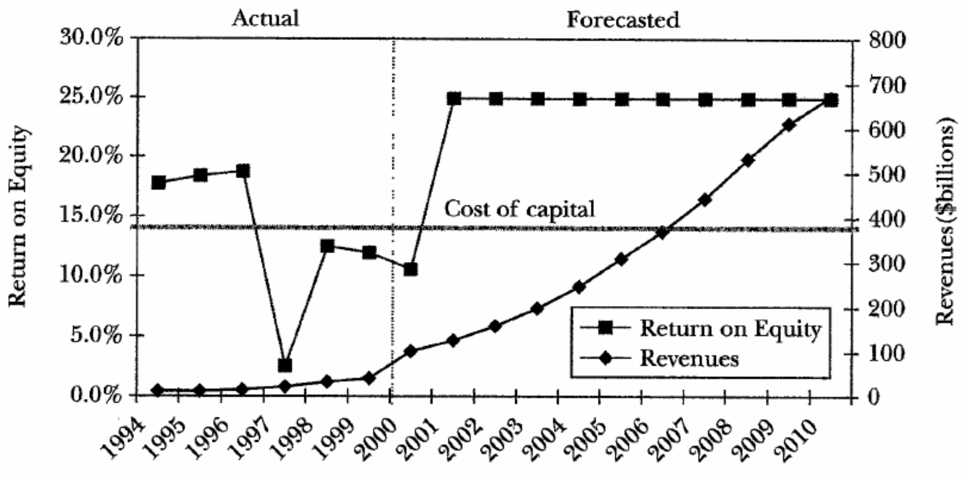
(http://www.sec.gov/news/press/2003-32.htm)

In the light of these reports I can be argued that its not only regulatory and financial reporting or corporate governance issues but also pose ethical and moral dilemma to the corporate world.

6.9.7 ENRON'S SHAREHOLDERS VALUE

In chapter No. 2 of this thesis I have presented some theoretical background relating to the corporate objective of shareholder value now I will explain the idea of shareholder value in the perspective of Enron which also makes a part of my research question that did Enron created value to its shareholders and a relationship between financial reporting and shareholder value. It is commonly agreed that creating shareholder value and corporate profitability are quite similar and the stock price used for this purpose. Palepu, Healy (2003) forecasted the return on equity and revenues of the Enron from 1994 to 2010 and tested against actual.

Forecasted Return on Equity and Revenues for Enron Consistent with a $90 Stock Price



Source: *Palepu (2002) The fall of Enron*

In this analysis they used the following valuation model:

$$V = BVE\left\{1 + \frac{E(ROE_1) - Re}{(1 + Re)} + \frac{(E(ROE_2) - Re) * (1 + g_1)}{(1 + Re)^2} + \frac{(E(ROE_3) - Re) * (1 + g_2)}{(1 + Re)^3} + \cdots\right\}$$

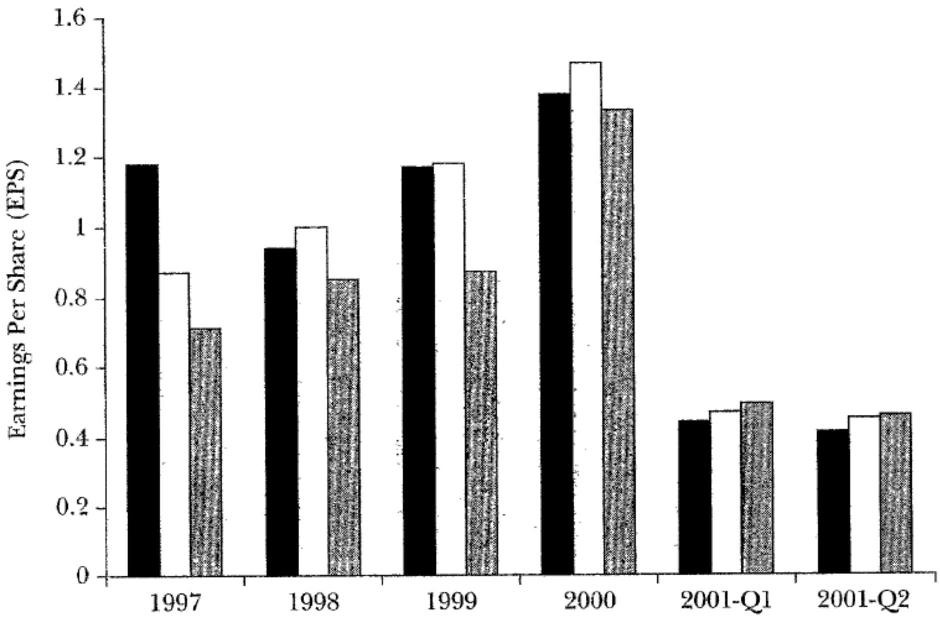
They found that the Enron stock price which was $90 in 2000 at the time was consistent with the ROE and its revenues but the important point here is that theses earnings and returns were based on the information which was fraudulent therefore any assumption that stock price of Enron in (2000) created value to its shareholders would be wrong. This is the reason the fund managers were led to wrong decision. Palepu (2003) states that:

"Several reasons have been proposed that why the leading managers were so slowing to recognize the problem to Enron, they were misled by the accounting statements or by sell side annalists or the incentives of fund managers to seek out high quality information were poor."

There is no doubt that earnings are the major input into investors these valuations model do affect the prices of the securities.

Lev (2003) also analyzed the earnings of the Enron. The three bars of indicates from left to right ‘financial analysts forecast’ ‘consensus forecast’ and original forecast. As Enron stock was contributed by its partnerships and then they counted profits from these partnerships. Therefore Enron offered ‘open and shut’ case of earning manipulation. They did this by substantially overstating their assets and understating its liabilities in the financial statements. It is apparent that increase in share prices were not because of Enron’s performance and its strategies rather it was based on false financial reports and other factors which ultimately caused investors billions of dollars loss.

Enron Corp. Analysts Forecasts, Originally reported and subsequently restated Earning Per Share



Notes: The left bar in each year's triplet indicates analysts' consensus forecast, followed by originally reported and subsequently restated earnings per share (EPS). Analysts forecasts are the latest consensus of individual forecasts made in the preceding year (or quarter) and were obtained from I/B/E/S (a financial service reporting on analysts' forecasts of corporate earnings; I/B/E/S is now part of Thomson Financial's First Call; ⟨http://www.firstcall.com⟩). Reported EPS are "diluted," namely reflecting potential conversion of securities to common stock or exercise of stock options. Restated numbers are from Enron's 8-K report filed on November 8, 2001.

Source: Lev (2003) Corporate Earnings: Facts or Fiction

6.9.8 FUTURE OF FINANCIAL REPORTING AND RECOMMENDATIONS

There is no doubt that confidence of investors in quality and integrity of financial reports has been shaken. Attacks on the auditors responsibilities and accountants professionalism has become more common in post Enron era. And many believe that financial reporting stands at the crossroads but good financial reporting will keep playing its role in communicating between corporate and investors. Audited financial statements are still most important source of information. However there is need to adopt principles which can create shareholder value could address as communication purposes with shareholders. There is need to create the standards which can create value to shareholders and to introduce methods to communicate the performance to the investors. Following are some recommendations:

In this age of globalization global markets, global competition, global investors and global companies requires global accounting principles that can be applied to companies globally therefore if the financial statements are prepared using a one set of universally accounting standards then it will be easy to extend the understanding of these reports.

Principle base accounting standards should be adopted than rule based accounting principles because this approach makes financial reporting more relevant to the investors.

The issue of auditor independence should be revised and appointment should be that the External Auditors of the company are fewer dependants on the executives of the corporation. There should be full disclosure of the audit and consulting fees in the annual reports and accounts.

High quality standards should be made to ensure the enforcement of high quality disclosures. And disclosure in the notes can be helpful for the investors' therefore wider disclosure relating to corporate governance and performance of the firm and standards for reporting and measuring should be specific to the respective industries and consistently be applied in understandable form. International Accounting Standard Board approach of substance over form should be globally accepted.

CHAPTER 7

7.1 CONCLUSION

The aim of this thesis is to examine and discuss the major scandal of Enron in relation quality financial reporting and corporate objective of shareholder wealth maximization. Through the analysis of Enron case I have tried to show that how the directors of the Enron used financial reporting to mask the real financial position of the company. Discussion and analysis also showed that financial reporting was not the only factor for demise of Enron there were other factors such as business model of Enron, Auditors independence, deregulation energy industry in USA, flaws in US Generally Accepted Accounting Principles (GAAP), Accounting Standards and corporate Governance. But there is consensus that Enron executives used financial reporting as a tool to mask the real financial position of the company and also all these factors are linked directly or indirectly with financial reporting.

I have tried to provide evidences of the corrupt practices of the Enron executives and their contribution in reporting the fraudulent financial statements. In essence the lack of presentation of high quality information, poor corporate governance and environment of corruption lead to downfall of Enron. The discussion and analysis of this thesis suggest that Financial Reporting of a company can be key factor in disclosing or hiding financial health. In this whole paper I have emphasized on quest of transparent financial statements which can not only be achieved through enforcing quality Accounting Standards but it is influenced by a number of other institutional factors which I have discussed throughout in the discussion part of this paper using the Enron case.

‘Transparency’ and ‘Accountability’ are the two key words and lack of both in the financial systems result in scandals like the Enron. It is a basic conception in finance that ‘increased debts can increase the financial risk’ of an entity but how the investors of a company would know if debts do not appear on the financial statements of the company? Therefore it can be argued that if Enron had presented their financial reports with transparency and had shown their assets and liabilities accordingly, the financial losses to the investors would have been minimized. Financial analysts use financial information for valuations purposes and forecast the earnings of the company which has impact on the security prices. The Enron’s earnings were inflated fraudulently and debts were shown as profits. Which in turn inflated the stock prices but it did not create value to the shareholders as these prices were based on false information. Therefore it can be argued that quality reporting can lead to quality forecast and estimates, which will be based on true and fair view and can help investors in quality decisions and it can create value to shareholders and value to corporate in the long run.

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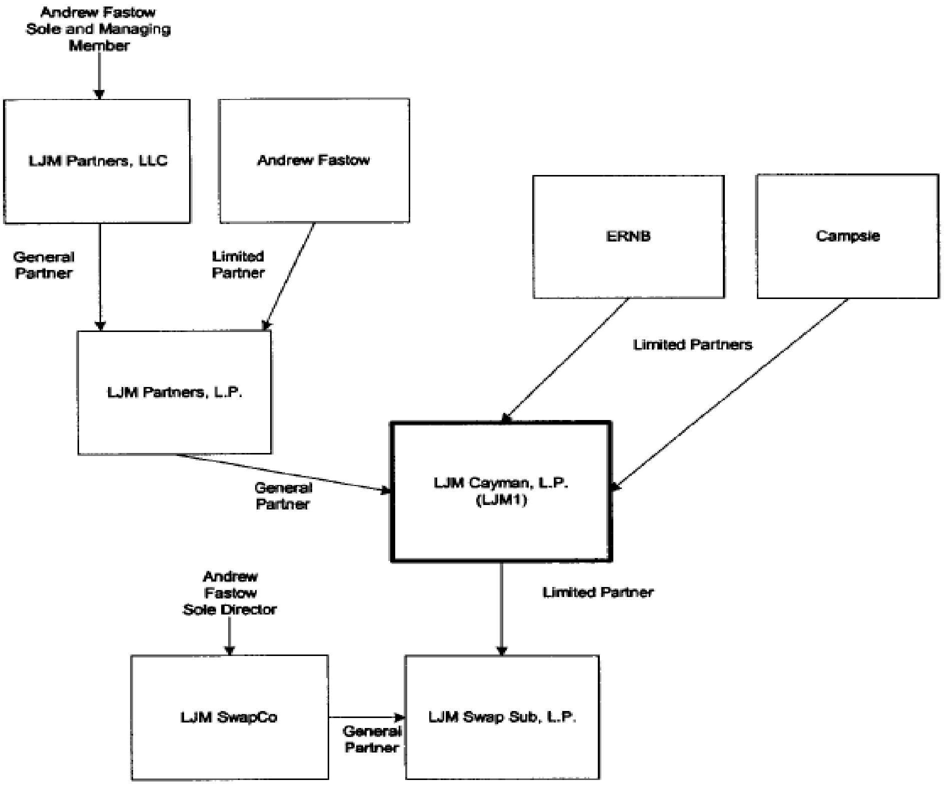
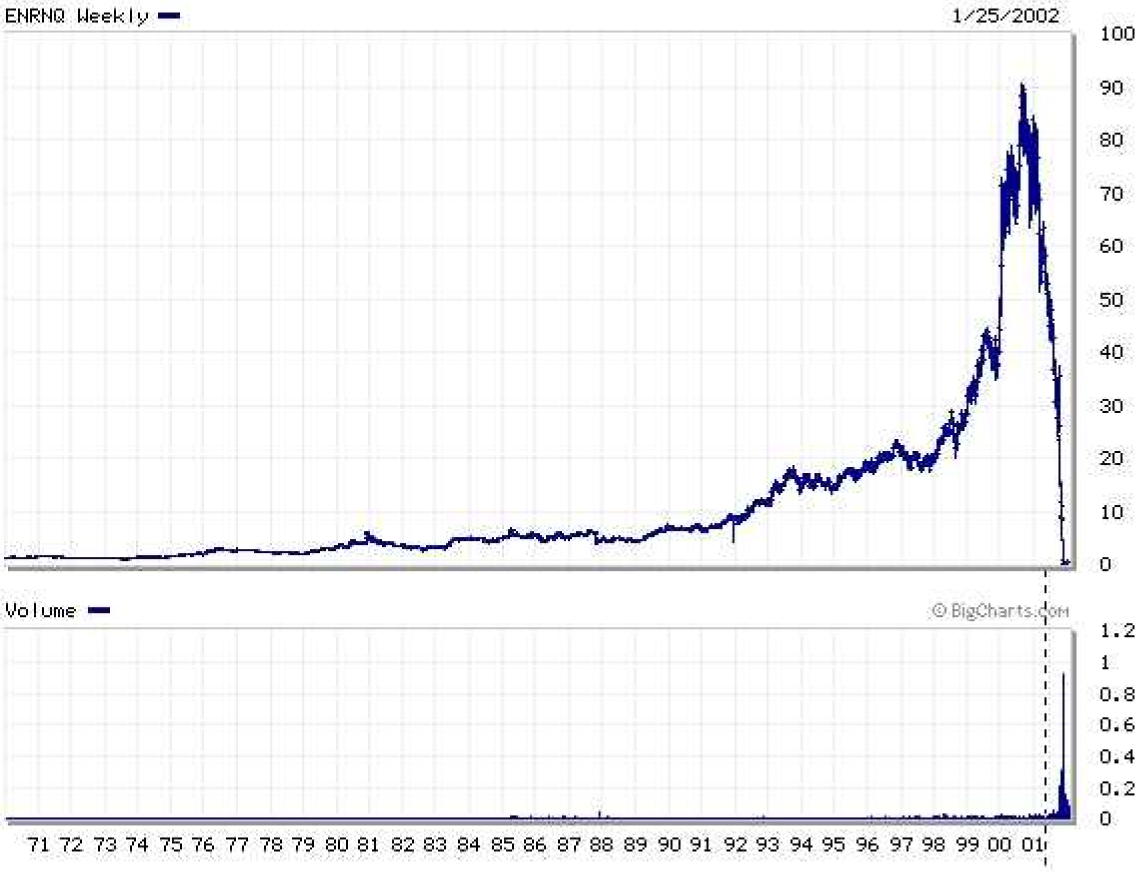
Appendix

Diagram of LJM1 Structure



Source: Powers et al (2002) www.findlaw.com

Enron corporation



Graph from Bigcharts.com.

Enron's collapse was spectacular, but the warning was very clear as early as the end of 1999. This is a classic example of an uncontrolled share price rate increase, followed by the share price exceeding the share price capacity, chaos and then collapse. This stock was "too good to be true". Up until 1999, this was a consistent and excellent investment, but speculators should have sold the stock in 2000.

Source: http://www.ecotao.com/holism/add/enron/Enron.html

The last rally followed CEO Kenneth Lay's advice to employees to buy stock, although he had been selling, recovering $16.1 million from sold shares. A strong company would have recovered, starting from a much lower but viable share price, but Enron had hidden billions of dollars in debts and operating losses through complex accounting schemes. Once these became known, investors disappeared.

Source: http://www.ecotao.com/holism/add/enron/Enron.html