Managerial Finance
The Enron fallout: Was Enron an accounting failure?
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The Enron Fallout: Was Enron an Accounting Failure?

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Abstract

This paper traces the development of Enron Corp. from a regulated natural gas distribution company to a worldwide energy trading company to its ultimate demise in bankruptcy in December 2001. The paper examines whether Enron should be viewed as an accounting failure, with investors and creditors being severely misled by false financial statements, or whether it was a business failure that was obscured by accounting practices that strained the limits of credibility. It is the contention of this paper that astute financial analysis would have revealed the instability of the Enron business model, thereby alerting investors and creditors to the lack of creditworthiness of the company. At the same time, the paper argues that had there been an appropriate level of transparency in the financial statements, investors and creditors would have been provided with a more realistic view of the company's financial position and its results of operations, thereby facilitating their ability to assess the viability of the company and avoid their bankruptcy losses.

Keywords: Creditworthiness, transparency, deregulation, financial analysis, SPEs

1. Introduction

This paper traces the development of Enron Corp from a regulated natural gas distribution company to a worldwide energy trading company to its ultimate demise in bankruptcy in December 2001. The paper discusses whether the Enron bankruptcy should be viewed as an accounting failure, with investors and creditors being misled by false financial statements, or whether it was a business failure that was obscured by accounting practices that strained the limits of credibility. It is the contention of this paper that astute financial analysis would have revealed the instability of the Enron Corp. business model, thereby alerting investors and creditors to the lack of creditworthiness of the company. At the same time, the paper argues that had there been an appropriate level of transparency in the financial statements, investors and creditors would have been provided with a more realistic view of the company's financial position and its results of operations, thereby facilitating their ability to assess the viability of the company and avoid their bankruptcy losses.

The remainder of the paper proceeds as follows. The first section discusses how deregulation in the electric power industry in the 1980s served as a prelude to the creation of Enron Corp. The second section examines deregulation in the natural gas distribution industry and discusses how Enron was designed to take advantage of business opportunities that arose during the deregulatory process. The third section explains how Enron changed its business strategy from being the largest producer of wholesale electric power and natural gas in the country to becoming the largest trader of energy products and it assesses whether this change in business strategy was successful. The fourth section discusses how Enron used of off-balance sheet financing to hide its lack of creditworthiness. The fifth section discusses Enron use of misleading accounting practices in relation to capital stock transactions, revenue recognition and footnote disclosure. A final section concludes the paper.

2. Deregulation of the Electric Power Industry

Up until recently, the electric power industry in the United States consisted primarily of regulated electric utility companies. The structure of the electric power industry was the result of federal legislation that had been enacted during the 1930s, the purpose of which was to prevent abuses that had arisen prior to the Great Depression. In essence, the laws prohibited regulated electric utilities from operating in more than one state and subjected such companies to rate of return regulation, whereby prices were set as a function of a fixed allowable rate of return on shareholders' equity. The energy crises of the 1970s, promoted the US Congress to pass a number of laws that were intended to reduce America's dependence on crude oil from the Middle East, including certain laws that partially deregulated the electric power industry. As the energy crises subsided during the 1980s, many of the deregulation initiatives were not fully implemented. However, these laws did not disappear; instead, individuals and companies who saw advantages to be gained from the energy initiatives continued planning and lobbying and working towards their goals. Enron was one of the companies that was created in the wake of the US government's energy initiatives of the late 1970s and 1980s.

2.1 The Regulatory/Legal Framework of Deregulated Electricity Production in the US

The Public Utility Regulatory Policies Act of 1978 (PURPA) was enacted by Congress to encourage energy conservation and increased electricity production. Title IT of PURP A required the US Federal Energy Regulatory Commission (FERC) to issue regulations to encourage small power production (i.e. alternative energy) and cogeneration (i.e. the simultaneous generation of electricity and useful thermal energy). As a part of its general framework, FERC stipulated that regulated electric companies had to purchase power from "qualified facilities" (QFs). QFs were defined as "small power production facilities" and "cogeneration" facilities. A small power production facility was defined as a power plant producing less than 80 megawatts of electricity that was fueled by an alternative energy source, such as water, wind, solar, biomass, wood, municipal waste, other solid waste, or geothermal energy. A qualified cogeneration facility was defined as a power plant that produced both electricity and useful thermal energy, such as steam or heat. A qualified cogeneration facility could be of any size as long as the percent of thermal energy produced was not less than 5% of the total energy output (Baker, 1992).

To become a QF, a developer had to file an application with the FERC. The importance of becoming a QF was obvious in that regulated electric utilities were not required to purchase electricity from other than QFs, and in most states the regulated companies would not agree to purchase electricity unless a project was a QF. Prior to the passage of PURPA there had been some power sales agreements negotiated on an arm's length basis between industrial companies and regulated electric utilities. This was common in the Gulf Coast of Texas where there are large petrochemical facilities fueled by natural gas. Houston Natural Gas Company (the original name of Enron Corp.) was one of the primary suppliers of natural gas to both petrochemical and cogeneration facilities in the 1980s (Baker, 1992).

2.2 Project Financing of Independent Power Projects

In the 1980s, independent power projects were financed primarily through project financing. In a project financing, the lender looks to the cash flows and the assets of the project as collateral for the loan. Therefore, it is important that there be a long-term contract for the sale of the facility's output (i.e. electricity), and the long-term contract had to be with a creditworthy entity (i.e. a regulated electric utility company). Project financing of independent power projects developed slowly during the initial years after the passage of the PURPA law in 1978. Few financial institutions took an interest in providing financing for such projects. There were several reasons for this reluctance, including lack of experience on the part of developers, unfamiliarity with project financing on the part of lenders, and the use of new and unproven technologies. As the experience of both developers and lenders increased, the number of banks and other financial institutions active in the field of project financing also increased. In the 1980s, the primary financial institutions providing loans to independent power projects were banks with experience in project financing in areas such as mining, pipelines, and oil and gas exploration. Among these banks were Citibank, Barclays, Morgan Guaranty and Chase Manhattan Bank. These banks subsequently became the primary lenders to Enron Corp. (Baker, 1992).

At the inception of the independent power industry, lenders refused to lend more than seventy- five percent of the total costs of a project. Since developers of independent power projects were often thinly capitalized, there was a need for equity capital or subordinated debt. In the early 1980s, equity capital for independent power projects was easier to obtain than subsequently because of the existence of tax incentives provided by the US government, including a 10% investment tax credit, five year depreciation write-offs, and additional tax credits of up to 15% for alternative energy. These tax incentives were a form of public private partnership, in that taxpayers were subsidizing the creation of the independent power industry. These tax incentives allowed investments in independent power projects to seem less risky from an investor's perspective. The risk was reduced because most of investment could be deducted as an expense for federal income tax purposes or taken directly as a credit against federal income taxes. These tax incentives spawned a large sub industry of lawyers, investment bankers and accountants who structured project financing arrangements for independent power projects (Baker, 1992).

By the end of the 1980s all of the tax subsidies for independent power projects were eliminated by Congress because of growing federal budget deficits. Afterwards, investments in independent power projects had to be evaluated based on criteria other than the tax subsidies that the investments produced. This caused a consolidation in the independent power industry which favored more efficient producers. Since the economics of electric power generation favor natural gas combustion turbines, developers who controlled natural gas supplies were in a position to become dominant players in the independent power industry. Recognizing the potential to become dominant players, both Houston Natural Gas Company and Inter-North (the original predecessor companies of Enron Corp.) entered the independent power business in the mid 1980s.

3. Deregulation of Natural Gas and the Creation of Enron

Kenneth Lay joined Enron Corp. in 1984 when it was still called Houston Natural Gas Company. Lay had a strategic vision regarding the future of the natural gas distribution industry which focused on deregulation and growth through mergers, acquisitions and overseas expansion.

This strategy included a move into independent power production, with natural gas as the cornerstone. In July 1985, Houston Natural Gas Company merged with Northern Natural Gas Company to form Enron Corp. (Enron Corp., 2002). The primary asset of the combined company was an interstate gas distribution network consisting of approximately 37,000 miles of pipe. After lobbying efforts by Ken Lay and others, in October 1985, the US Federal Energy Regulatory Commission (FERC) issued Order No. 436, allowing natural gas pipelines to become open-access transporters. Previously, gas distribution companies were regulated and vertically integrated (Strategic Management Wharton, 2002). The FERC order deregulated the natural gas industry by separating the production, long-distance transmission and local distribution functions, leaving each function to a different set of participants. Ultimately, Enron retained the interstate pipeline distribution network while phasing out its exploration and local distribution activities. Kenneth Lay became the Chairman of Enron Corp. in February 1986 (Strategic Management Wharton, 2002).

3.1 Transforming the Regulated Gas Distribution Industry

Between 1986 and 1996 Enron's business strategy was focused on three primary areas. The first area involved a transformation of the natural gas pipeline business from a regulated company to an open access, merchant transporter of natural gas. This transformation allowed Enron to sell natural gas throughout the United States at unregulated prices. Enron's pipeline network was enlarged through acquisitions of other pipeline systems in Florida and the Pacific Northwest. In 1989, Enron created GasBank, an entity who's purpose was the wholesale trading of natural gas futures contracts. GasBank allowed buyers and sellers of natural gas to enter into forward commitments to hedge the risk of variable spot market prices. As GasBank developed, Enron became the largest natural gas merchant in North America (Enron Corp., 2002).

3.2 Expansion Outside of the United States

The second focus of the Enron business strategy was to become a developer of independent power plants outside the United States. One of Enron's first overseas projects was the development of a 1,875 megawatt (MW) power plant in Teesside, England. Upon completion in 1993, the Teesside project became the world's largest natural gas-fired power plant. After the Channel Tunnel, Teesside was the largest project financing ever completed in the UK (Enron Corp., 2002). Lord Wakeham, the former Secretary of State for Energy in the Conservative Government, played an important role in the development of the Teesside project. Subsequently, Lord Wakeham became a member of Enron's Board of Directors. He was a member of the Audit Committee of the Board at the time of Enron's bankruptcy and was therefore in a position to know about Enron's business strategy (BBC, 2002).

Enron's overseas expansion strategy also encompassed the development of a very large (2,450 MW) power project located near Mumbai, India (the Dabhol project). The first phase of the Dabhol project began in late 1996 and it achieved commercial operation in May 1999. However, by the beginning of 2002, the project was not yet complete, and the Indian Government was contemplating terminating the power purchase agreement for the project (*The Financial Express,* 2002). Other Enron projects included the development of a 790 MW gas fired power plant at Sutton Bridge, England and the acquisition of Wessex Water Company, also located in England (Enron Corp., 2002). This latter acquisition, along with the acquisition of a wind energy company, Zond Energy, appeared to signal a diversification away from Enron's primary focus on natural gas-fired power plants.

3.3 Investing in Independent Power Production

The third focus of Enron's business strategy was to invest in independent power projects in the US, both as a supplier of natural gas to the projects and as an equity participant. The US Energy Policy Act of 1992 changed the structure of the electric power industry by creating a competitive wholesale market for electricity and granting open access to transmission lines similar to what had happened in the natural gas industry (Batteles, 1999). There was, however, a remaining barrier to the rapid expansion of the independent power industry, namely, the Public Utilities Holding Company Act of 1935. This law had been enacted during the Great Depression to prevent abuses in the electric power industry like those perpetuated by Samuel Insul. During the 1920s, Insul's Chicago Edison holding company was a multi-tiered corporate entity with ownership interests in dozens of electricity companies throughout the US. After the 1929 stock market crash, the Insul holding company collapsed, much like Enron did in 2001. In 1993, after significant lobbying efforts with the federal government, Enron was granted an exemption from the Public Utilities Holding Company Act of 1935. This exemption eliminated the remaining barrier to Enron's rapid expansion in the independent power industry (Labaton, 2002). Furthermore, the exemption allowed Enron to acquire an entire electric power company, an action which would have been prohibited only a few years earlier (Kahn and Gerth, 2001).

In late 1996, Enron announced that it would acquire Portland General Electric Company. When this merger was completed in January 1997, it combined Enron, which by then was the largest marketer of natural gas and wholesale electricity in North America, with Portland General, a profitable electric utility located in one of the fastest growing regions of the US. With ownership of more than 5,900 megawatts of electricity generating capacity and more than 37,000 miles of natural gas pipeline, the combined company was well-positioned to become a dominant player in the deregulated natural gas and electric power industries (Enron Corp., 1996). In the following quotation from the press release which announced the merger, Kenneth Lay explained Enron's business strategy:

> This proposed merger with Portland General represents an outstanding opportunity for us to create the leading energy company of the future in the North American energy markets. By combining the natural gas and electricity marketing and risk management expertise of Enron with the wholesale and retail electricity expertise of Portland General, along with its related assets and skilled employees, we are uniquely positioned to be the leader in the increasingly competitive natural gas and electricity marketplace. This strategic merger is expected to be accretive to Enron's earnings per share beginning in the first year after completion of the merger, and is thus consistent with our long-term compound annual earnings growth target of at least 15 percent. The deregulation of the electricity market in North America represents one of the most significant industry restructurings ever. Just as coal was the primary energy source of the 19th Century, and oil was the primary fuel of the 20th Century, we believe natural gas and electricity will converge as the primary sources of energy in North America and many other markets around the world for the 21st Century. Ten years ago, Enron successfully

> embarked on a new strategy to compete in the newly deregulated natural gas market in North America. Customer choice and competition in natural gas, at the wholesale level and more recently at the retail level, have been a great success for consumers and the American economy. By applying the experience gained in the natural gas market, Enron has become, in a very short period of time, the largest independent marketer of wholesale electricity in North America. As the move toward deregulation in the retail sector proliferates, Enron is poised to participate as a leader in the evolution toward a converged gas and electricity market, with more product choices and competitive prices for all customers, large and small, both wholesale and retail (Enron Corp., 1996).

Despite the enthusiasm surrounding the merger between Enron and Portland General, within three years, Enron tried to sell Portland General to another company (Enron Corp., 2001). This was because the business strategy of becoming the dominant player in the deregulated natural gas and electric power industries was proving to be not as profitable as Lay had hoped.

Consequently, Enron's deregulation strategy was replaced in the late 1990s with a new strategy which was to become the dominant broker in energy related products and other types of commodities and services, including metals and broadband communication (Strategic Management Wharton, 2002). This change of business strategy will be discussed in the following section.

4. A Change in Enron's Business Strategy

In 1985, when Enron was created, its primary business strategy was to maximize the potential of its interstate gas pipeline network. At that time, regulated gas pipeline companies were vertically integrated, controlling the natural gas from wellhead to consumer. The deregulation process of the 1990s separated the production, transmission and local distribution functions and forced the surviving companies to operate in a market environment. This new environment allowed intermediaries to create contracts for future delivery of natural gas. Prior to deregulation, large industrial users of natural gas, including regulated electric power companies, could reliably forecast their future fuel costs by reference to a regulated tariff. After deregulation, large users of natural gas had to protect themselves by entering into contracts for future delivery of natural gas at agreed upon prices and quantities. Between the contract date and the delivery date, the price of the gas could vary. The supplier of the natural gas could discover that it had promised to sell at a price that was lower than the current price, while the purchaser might find that it could buy gas for less than it had agreed to pay. Consequently, a market for natural gas derivatives contracts (e.g. forwards, futures and options) began to develop. In the late 1990s, Enron changed its business strategy to a focus on becoming the dominant player in the marketplace for energy derivatives. This change in Enron's business strategy allowed it to continue to be the largest merchant of natural gas and electricity in North America without maintaining a large investment in tangible fixed assets such as pipelines and power plants (Strategic Management Wharton, 2002).

4.1 Was the Change in Strategy Successful?

Even though Enron's share price rose steadily from 1996 through 2000, there was a significant variance its earnings per share growth. The annual 15% growth target for earnings per share, set by Ken Lay in 1996, was not met. As Table 1 indicates, Enron's diluted earnings per share fell 4% in 1997, rose 16% in 1998, rose 26% in 1999, and fell 12% in 2000. The volatility of Enron's EPS was explained to the financial community by pointing to non-recurring impairment charges and the cumulative effect of accounting changes. In the face of a strong bull market, these explanations were taken at face value. Enron's price earnings multiple rose from 23.7 in 1997 to 74.3 in 2000. Enron was counted as one of America's best companies. The question is whether there were problems lurking behind the numbers.

TABLE 1

ENRON CORP. *Source: Enron Corp. Annual Reports*

Selected Financial Information

(dollar amounts in millions)	2000	1999	1998	1997	1996
Net Revenues	$ 100,789	$ 40,112	$31,260	$20,273	$13,289
Net Income	979	893	703	515	493
Current Assets	30,381	7,255	5,933	4,669	3,979
Investments and Other Assets	23,379	15,445	12,760	9,583	5,046
Property, Plant and Equipment	11,743	10,681	10,657	9,170	7,112
Total Assets	65,503	33,381	29,350	23,422	16,137
Current Liabilities	28,406	6,759	6,107	4,412	3,708
Long-Term Liabilities	25,627	17,052	16,195	13,392	8,706
Total Liabilities	54,033	23,811	22,302	17,804	12,414
Stockholders' Equity	11,470	9,570	7,048	5,618	3,723
Common Size Balance Sheet Data:					
Current Assets	46.4%	21. 7%	20.2%	19.9%	24.7%
Investments and Other Assets	35.7%	46.3%	43.5%	40.9%	31.3%
Property, Plant and Equipment	17.9%	32.0%	36.3%	39.2%	44.1%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%
Current Liabilities	43.4%	20.2%	20.8%	18.8%	23.0%
Long-Term Liabilities	39.1%	51.1%	55.2%	57.2%	54.0%
Total Liabilities	82.5%	71.3%	76.0%	76.0%	76.9%
Stockholders' Equity	17.5%	28.7%	24.0%	24.0%	23.1%
Ratio Analysis:					
Current Assets/Current Liabilities	1.07	1.07	0.97	1.06	1.07
Total Liabilities/Stockholders' Equity	4.71	2.49	3.16	3.17	3.33
Net Profit Margin	0.97%	2.23%	2.25%	2.54%	3.71%
Asset Turnover	1.54	1.20	1.07	0.87	0.82
Return on Assets	1.49%	2.68%	2.40%	2.20%	3.06%
Assets/Stockholders' Equity	5.71	3.49	4.16	4.17	4.33
Return on Stockholders' Equity	8.54%	9.33%	9.97%	9.17%	13.24%
Diluted Earnings Per Share	$ 1.12	$ 1.27	$ 1.01	$ 0.87	$ 0.91
Annual Growth in Earnings Per Share	-12%	26%	16%	-4%	
Closing Share Price	$ 83.25	$ 44.75	$ 28.53	$ 20.59	$31.91
Price/Earnings Ratio	74.3	35.2	28.2	23.7	35.1

As a broker in energy derivatives, Enron agreed to pay if either party to the derivative contract defaulted. Without this agreement it would not have been possible to create a market in energy derivatives. In addition, Enron often needed to make payments for derivative contracts before receiving payment from the counter party. Consequently, Enron needed large amounts of liquid capital to trade energy derivative contracts. In 1996, property, plant and equipment comprise 44.1 % of Enron's assets (see Table 2). By 2000 this had changed dramatically, and only 17.9% of Enron's assets were invested in property, plant and equipment. This percentage change was not caused by a decrease in tangible fixed assets. Instead, it was the result of a sharp increase in both current and intangible assets because of Enron's derivatives trading activities. This increase in current and intangible assets was financed by increases to both current and long term liabilities. Shareholders' equity declined in relation to total liabilities, thereby causing a significant increase in Enron's total debt to equity ratio (2.49 in 1999 versus 4.71 in 2000)(see Table 2).

One additional reason that Enron's tangible fixed assets declined as a percentage of total assets was because Enron's management had begun transferring equity investments in independent power projects to unconsolidated affiliates, along with the debt on those projects. This was a conscious practice developed by Enron's Chief Financial Officer, Andrew Fastow, who was quoted as saying: "We transformed finance into a merchant organization. Essentially, we would buy and sell risk positions" (Strategic Management

TABLE 2

ENRON CORP. *Source: Enron Corp. Annual Reports*

Selected Financial Information (dollar amounts in millions)	**2000**	**1999**	**1998**	**1997**	**1996**
Summary Data for Unconsolidated Affiliates:					
Revenues	$ 15,903	$ 11,568	$ 8,508	$11,183	$11,676
Net Income	586	1,857	142	336	464
Current Assets	5,884	3,168	2,309	3,611	2,587
Total Assets	34,155	26,983	22,125	8,851	8,064
Current Liabilities	4,739	4,401	3,501	1,089	902
Total Liabilities	20,604	15,289	13,138	13,551	11,553
Owners' Equity	13,551	11,694	8,987	1,861	2,381
Equity in Earnings of Affiliates	87	309	97	216	215
Pro Forma Ratio Analysis- As if Consolidated:					
Current Assets/Current Liabilities	1.09	0.93	0.86	1.51	1.42
Total Liabilities/Stockholders' Equity	2.98	1.84	2.21	4.19	3.93
Net Profit Margin	0.84%	1.73%	1.77%	1.64%	1.97%
Asset Turnover	1.17	0.86	0.77	0.97	1.03
Return on Assets	0.98%	1.48%	1.37%	1. 60%	2.04%
Assets/Stockholders' Equity	3.98	2.84	3.21	4.32	3.96
Return on Stockholders' Equity	3.91%	4.20%	4.38%	6.89%	8.08%

Wharton, 2002). The idea was to move as many of Enron's assets and liabilities as possible off the balance sheet. The manner in which this was accomplished was by creating "Special Purpose Entities".

5. Enron's Use of Off-Balance-Sheet Financing

In a report prepared by Enron's Board of Directors shortly after the bankruptcy filing, Enron's financial statement footnote disclosures about transactions with off-balance-sheet financing entities were described as follows:

> *Obtuse, and did not convey the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships (Powers et al., 2002).*

US Senator Peter Fitzgerald, a member of the US Senate Commerce Committee, was more emphatic when he stated:

> *I quickly became convinced that there was no economic purpose for the partnerships other than to fictitiously pump up earnings.*

Senator Fitzgerald indicated that 72% of Enron's earnings from transactions with off-balance sheet, special purpose entities was fictitious (Cohn, 2002).

5.1 Accounting for SPEs

Special Purpose Entities (SPEs) are defined by the Financial Accounting Standards Board (FASB) as entities created for some specific purpose or activity (EITF, 1996). SPEs were initially used by banks and other financial institutions to facilitate off-balance sheet financing for mortgage loans and other types of loan receivables (Perny, 1993). The SPE structure permits a bank to increase the size of its loan portfolio without a corresponding increase to share capital. The credit rating agencies, such as Standard & Poors and Moody's Investors Services, treat asset securitization as financing vehicles and adjust leverage ratios accordingly for analysis purposes (Sprinzen, 2002). Apart from asset securitizations, SPEs have also been used to create synthetic leases (i.e. leases that are recorded as operating leases for accounting purposes, but treated as financing arrangements for tax purposes). The use of synthetic leases has become widespread in the real estate industry; many headquarters office buildings are off the balance sheet of the companies that occupy the buildings. An SPE can be structured as a partnership, limited liability company, trust or corporation. The funding for an SPE typically comes from debt provided by a bank, financial institution or pension plan. The primary purpose of creating an SPE is to remove specific assets and liabilities from the balance sheet of the sponsor. Thus, SPEs are a prime example of form over substance.

Under US GAAP the sponsor of an SPE does not have to consolidate the SPE into its financial statements it if the following criteria are met (EIFT, 1990, 1996, 2002; Jenkins, 2002):

1. A third-party, independent of the sponsor, makes an equity investment in the SPE;

2. The "at risk" portion of the investment is substantive (equal to at least 3 percent of the total investment);

3. The third-party has a controlling financial interest in the SPE (i.e. more than 50 percent); and

4. The third-party possesses the risks and rewards of ownership arising from its investment in the SPE (the owner's investment and potential return are "at risk" and not guaranteed by another party).

5.2 Enron's Use of SPEs

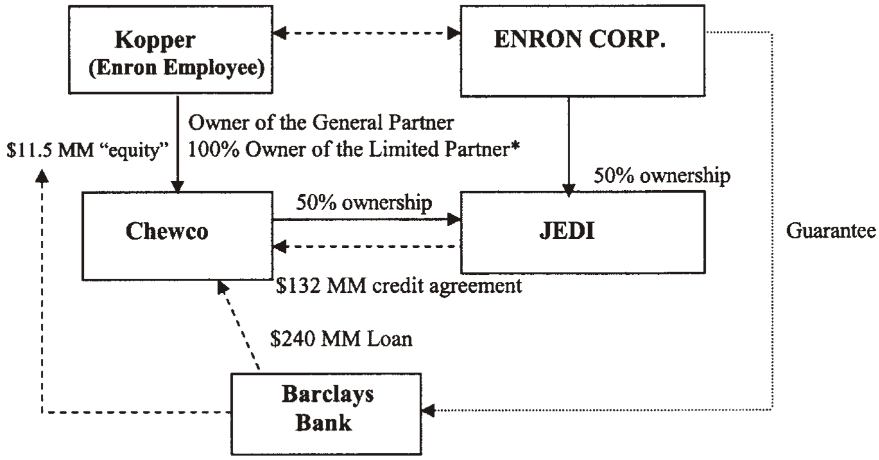
Between 1993 and 2001, Enron created over 3,000 SPEs. This section will examine only a few of the more notorious SPEs created by Enron, those which caused the overstatement of shareholders' equity by $1.2 billion. One of the first instances in which Enron created an SPE occurred in 1993 when Enron and the California Public Employees' Retirement System ("CalPERS") entered into a joint venture arrangement called Joint Energy Development Investment Limited Partnership ("JEDI"). Enron was the general partner, contributing $250 million of its common stock to the partnership. CalPERS was the limited partner and contributed $250 million in cash (Powers et al., 2002). Additional funds were borrowed from banks. The partnership invested in independent power projects. Since Enron held less than a majority voting interest in JEDI, it avoided consolidating the partnership. It was clear, however, that Enron controlled JEDI; as the largest public pension plan in the United States, CalPERS was a passive investor. If the concept of substance over form had been applied to the JEDI partnership, it should have been consolidated, but US GAAP allowed it to be off-balance sheet.

In November 1997, hoping that CalPERS would invest in a new, larger partnership, Enron bought out CalPERS' interest in JEDI for $383 million. This purchase posed a problem for Enron, because if its ownership interest in JEDI was not reduced to 50% or less, it would have to consolidate JEDI. For reasons that remain unclear, Enron was unable to locate another investor willing to purchase 50% of the JEDI partnership. In order to keep the partnership off Enron's books, a new entity called Chewco Investments LP ("Chewco") was created. Initially, Chewco was intended to be an investment opportunity for Enron employees. Enron's Chief Financial Officer, Andrew Fastow, assigned Michael J. Kopper, an Enron employee, to be the sole owner of the general partner of Chew Co. and also its sole limited partner.

Under the SPE rules summarized above, Enron could avoid consolidating JEDI if Chewco acquired a 50% interest in JEDI. The problem was that Chewco needed to raise $383 million to purchase the 50% interest in JEDI, of which 3%, or $11.5 million, would have to be "at risk". The question was, where would this money come from. To solve the problem, Fastow and Kopper created a new capital structure for Chewco which had three elements: a $240 million unsecured, subordinated loan to Chewco from Barclays Bank PLC, which Enron would guarantee; a $132 million advance from JEDI to Chewco under a revolving credit agreement; and $11.5 million in equity from Chewco's general and limited partners (Powers et al., 2002). Figure 1 diagrams this arrangement.

Fastow persuaded Kopper to invest $115,000 in the general partner of Chewco and $10,000 in the limited partner. This left $11.4 million in "at risk" equity to be raised. The money eventually came from Barclays Bank in the form of "equity loans" that were made

Figure 1



*Subsequently transferred to Dodson (domestic partner of Kopper).

to two companies called Big River and Little River. These companies in turn became the limited partners in Chewco. Big River and Little River were owned by William D. Dodson, a close personal friend and domestic partner of Kopper. The Barclays "equity loans" to Big River and Little River were documented by promissory notes and loan agreements, which were labeled "certificates" and "funding agreements". Instead of requiring Big River and Little River to pay interest to Barclays, the documents required them to pay "yield" at a specified percentage rate. The purpose of this documentation was to allow Barclays to record the transaction as a loan, while Enron and Chewco recorded the advances as "equity" contributions (Powers et al, 2002). The Power's Report states that the Chewco structure was approved by the Executive Committee of Enron's Board of Directors on November 4, 1997 (Powers et al. 2002). Furthermore, the transaction was reviewed and approved by Arthur Andersen prior to the closing of the Barclays loan in December 1997, and it was reviewed again during normal audit procedures in the years 1998 through 2000. In other words, the senior management and the external auditors of Enron Corp. agreed that this structure complied with US GAAP. To make matters worse, between 1997 and 2001, when the Chewco partnership was finally terminated, nearly $60 million in cash payments were made by JEDI to Enron and Chewco for various "services", including Enron's guarantee of the Barclay loan, Enron's management of the JEDI partnership, and Kopper's management of the Chewco partnership. Several million dollars found its way into the hands of Kopper and Dodson (Powers et al. 2002).

Despite the approval of the Chewco transactions by the Board of Directors of Enron and Arthur Andersen, in November 2001 Enron announced that it was restating its financial statements for the years 1997 through 2000 because of "accounting errors" related to Chewco and other SPEs. The announcement of these restatements occurred while Enron was in the midst of negotiations with Dynergy Inc. concerning a merger agreement which could have saved the company from bankruptcy (Emshwiller et al., 2001). The restatements reduced Enron's previously reported net income by $28 million in 1997 (out of

$105 million), $133 million in 1998 (out of $703 million), $248 million in 1999 (out of $893 million), and $99 million in 2000 (out of $979 million). The re statements also reduced shareholders' equity by $258 million in 1997, $391 million in 1998, $710 million in 1999, and by $754 million in 2000. Finally, the restatements increased reported debt by $711 million in 1997, $561 million in 1998, $685 million in 1999, and $628 million in 2000 (Powers et al., 2002). See Table 3 for a summary of these restatements. The restatements also revealed the lack of substance underlying the Chewco transactions and ultimately caused Dynergy to withdraw from its proposed merger with Enron. Less than one month after the restatements, Enron filed for bankruptcy.

TABLE 3
Effects of November 2001 Restatements
(Amounts in millions)

Year	1997		1998		1999		2000	
	As Reported	As Restated	As Reported	As Restated	As Reported	As Restated	As Reported	As Restated
Net Income	$105	$77 (-27%)	$703	$570 (-19%)	$893	$645 (-28%)	$979	$880 (- 10%)
Equity	$7,758	$7,500 (-3%)	$10,192	$9,801 (-4%)	$12,000	$11,290 (-6%)	$13,884	$13,130 (-6%)
LT Debt	$10,938	$11,649 (+7%)	$13,051	$13,612(+4%)	$14,622	$15,307 (+5%)	$23,213	$23,840 (+3%)

5.3 The Raptor SPEs

During fiscal year 2000, Enron created several SPEs named after birds of prey. The Powers Report refers to these SPEs as the Raptors transactions. The Raptors were capitalized by a transfer of Enron common stock to the SPEs in exchange for notes receivable. Simultaneously, LJM2, a partnership controlled by Andrew Fastow, temporarily invested $30 million in the Raptors, which was the amount necessarily to avoid consolidation of the Raptors into Enron's financial statements. The Raptors then entered into a "put" arrangement with Enron, whereby Enron paid the Raptors approximately $41 million to assume the risk of a significant decline in the value of Enron's common stock. This "put" arrangement was quickly terminated resulting in a profit for the Raptors. The Raptors distributed the $41 million in "earnings" on the "put" back to LJM2, thus guaranteeing that LJM2 got back its initial equity investment plus an attractive return in a matter of several months. Once these "earnings" were distributed, the Raptors entered into hedging transactions with Enron, whereby they agreed to pay Enron in the event of a decline in the value of certain assets held by Enron (i.e. shares of volatile e-commerce stocks) (Tauzin et al., 2002). Through this structure (see Figure 2), Enron was, in substance, entering into hedges with SPEs whose only assets had been contributed to them by Enron, and whose ability to pay was dependent on the value of Enron's common stock. The purpose of these transactions was to allow Enron to hedge against declines in the value of its portfolio of e-commerce stocks (Skilling, 2002).

By the end of 2000, the market value of Enron' s portfolio of e-commerce stocks had deteriorated significantly. Pursuant to the hedge agreement between Enron and the Raptors, this decline in value created liabilities for two of the Raptors that exceeded their assets. While Enron recorded the decline in value of the e-commerce stocks on its own books, it also recognized gains from the hedges with the Raptors - effectively neutralizing the impact of the decline in value of the e-commerce shares. The problem was that the value of Enron's own shares was falling, and since the receivable portion of the hedge with the Raptors was collateralized by Enron shares, these receivables needed to be reduced in value. To avoid reflecting this loss in value, in December 2000, Enron and Andersen agreed to a temporary 45-day "cross collateralization" of the four Raptor entities (Tauzin et al., 2002). This maneuver allowed the positive equity of two of the Raptors to offset the negative equity in the other two. However, by March 2001, the financial condition of the Raptors had continued to decline to the point where Enron needed to take a pre-tax charge of more than $500 million to reflect the decline in value of these partnerships. To avoid recording this impairment, Enron restructured the Raptor transactions by again transferring several hundred million dollars of Enron stock. In return, Enron received additional notes receivable from the SPEs (Powers et al., 2002).

Ultimately, the restructuring failed because of the continuing decline in value of both the e-commerce stocks and Enron's own shares. Enron terminated the Raptor SPEs in early autumn of 2001, recording a pre-tax charge of more than $700 million. On the same day that Enron disclosed this charge (October 16,2001) Enron also reported that it had overstated its shareholder equity by $1.2 billion because of "accounting errors" related to the recording of notes receivable from the Raptor SPEs. Carl Bass, a member of Andersen's Professional Standards Group wrote in an internal memo that the Raptor SPEs appeared to be a contrivance. He concluded that the: "*whole deal looks like there is no substance"* (Bass, 2000). Subsequently, the Board of Directors of Enron concluded that Enron's accounting treatments for the Chewco and Raptor transactions were incorrect and misleading (Powers et al., 2002). The Powers Report revealed that the:

> *Accounting treatment was wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in connection with the Raptor and Chewco transactions alone, above and beyond its regular audit fees* (Powers et al., 2002).

6. Enron's Use of Misleading Accounting Practices

This section discuss the way that Enron emphasized form over substance through misapplication of US GAAP in areas related to capital stock transactions, revenue recognition, and accounting disclosures.

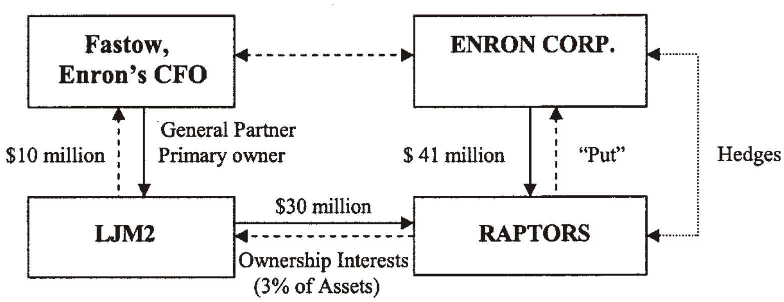
6.1 Capital Stock Transactions

As discussed above, starting in early 2000, Enron issued shares of its own common stock to the Raptor SPEs in exchange for notes receivable (see discussion above and Figure 2). Enronaccounted for these transactions by increasing notes receivable and stockholders' equity. This accounting treatment was later described as an "error" (Weil, 2001). Pursuant to US GAAP, when a company issues stock, the transaction cannot be recorded as an increase to stockholders' equity until a cash payment for the shares is received. The effect of this accounting treatment was that Enron's financial statements for year 2000 overstated notes receivable and shareholders' equity by $172 million. As of mid-2001, these overstatements reached $828 million, or a total of nearly $1 billion for the two years combined, which was 8.5% of Enron's shareholders' equity as of June 30, 2001. Lynn Turner, the former Chief Accountant of the SEC is quoted as saying with respect to this accounting treatment that:

> *It is basic accounting that you don't record equity until you get cash, and a note does not count as cash. The question that this raises is: How did both partners and the manager on the audit miss this simple Accounting 101 rule?* (Weil, 2001).

Enron often used shares of its own common stock to capitalize SPEs. The Raptor structure described above and shown in Figure 2 was typical of this type of transaction. As discussed previously, this structure was intended to hedge against the decline in value of the portfolio of e-commerce stocks that Enron owned. However, Enron was essentially hedging with itself through these contrivances (Powers et al. 2002). To satisfy US GAAP requirements that required the Raptors be separate from Enron, certain partnerships controlled by Andrew Fastow (LJMl and LJM2) had to invest just enough allow the SPEs not to be consolidated into Enron's financial statements, but when the prices of the e-commerce shares fell, along with the value Enron's own stock, the Raptors were not able to compensate Enron for the declines in stock value, so Enron had to transfer additional shares to the Raptors in a futile effort to support them. Recognizing that the Raptor structure was an effort to use form to conceal substance, Andersen's technical standards unit objected to Enron's decision in 2001 to combine the four Raptors together so that the losses in two of the Raptors could be offset by profits in the other two. As the Andersen Professional Services Group saw it, the Raptors transactions had *"no apparent purpose other than to achieve a financial reporting objective"* (Duncan 2001). In the end, however, the technical standards unit's opinion was overruled and the transactions were ultimately accounted for as described above.

Figure 2



6.2 Revenue Recognition

Financial statement re statements due to problems with revenue recognition comprise the single largest category of financial statement restatements (FASB, 2002). One reason for the large number of re statements for revenue recognition is the gap between the guidance provided in the FASB's Conceptual Framework and the guidance provided in pronouncements constituting US GAAP. Accounting pronouncements dealing with revenue recognition tend to focus on detailed issues in particular industries (e.g. long-term construction; real estate; software). Rules regarding revenue recognition have developed over many years and can be found in pronouncements with differing degrees of authority, including: Accounting Principles Board (APB) Opinions; FASB Statements; FASB Interpretations;

Emerging Issues Task Force (EITF) Consensus documents; Securities and Exchange Commission (SEC) Staff Accounting Bulletins; and AICPA Statements of Opinion.

The SEC tried to improve revenue recognition practices by issuing Staff Accounting Bulletin (SAB) No. 10 1. SAB 101 indicates that if a transaction falls within the scope of a specific revenue recognition pronouncement, that guidance should be followed, but in the absence of such guidance, the revenue recognition principles contained in FASB Concepts Statement No. 5 should be followed. FASB Concepts Statement No. 5 states that revenue should not be recognized until it is (a) *realized or realizable* and (b) *earned.* The *realized* criterion is not problematic if the meaning is restricted to receipt of cash, but the meaning of *realizable* becomes increasingly problematic when there is revenue recognition arising from a receivable that may or may not be collectible. The *earned* criterion raises additional concerns because it requires an entity to have "substantially accomplished" its obligations to the buyer prior to the recognition of revenue. For example, in a multiple element revenue arrangement when the customer has paid in advance, the question arises whether a company should partially recognize revenue when it has substantially accomplished only one of the elements of the contract and where it remains obligated to the customer for the remaining elements. Enron recognized revenue in a number of instances where form triumphed over substance. Perhaps most egregiously, Enron recognized revenue arising from an increase in the value of its own stock using the equity method of accounting. It also recognized revenue from long term contracts where the value of the contract was determined based on subjective mark-to-market models created by Enron's management.

6.3 Recognizing Revenue Due to Increases in Value of Enron's Common Stock

US GAAP required the use of the equity method when a company has the ability to exercise significant influence over an investee company. Usually this means an ownership interest of between 20% to 50% of the common stock of another company. The investment is recorded at cost and the investment is adjusted for changes in the book value of the stockholder's equity of the investee company (APB Opinion No. 18).

From the original creation of the JEDI partnership in 1993 through the first quarter of 2000, Enron recorded its share of JEDI's income or loss using the equity method. As discussed previously, JEDI held shares of Enron stock, which were carried at fair value. Consequently, Enron recognized income arising from the increase in value of its own stock when it reflected its share of the JEDI's income. Enron had a formula for computing how much income it was allowed to record from the appreciation of its own stock held by JEDI. Enron and Andersen apparently developed this formula in 1996, and modified it over time. Andersen's workpapers for the first quarter of 2000 indicated that Enron recorded $126 million arising from the appreciation in Enron's stock during that quarter (Powers et al., 2002). Although revenue was recognized, losses were not. In the first quarter of 2001, the Enron shares held by JEDI declined in value by approximately $94 million. Enron did not record its share of this loss (Powers et al., 2002).

6.4 Revenue Recognition and Mark-to-Market Accounting

"Mark-to-market" or "MTM" accounting refers to an accounting method whereby certain contracts (largely financial contracts) are reported at fair value in an entity's financial statements. MTM accounting has been used for many years by securities dealers. Pursuant to US GAAP, MTM accounting became mandatory for certain debt and equity securities in 1994 (FASB Statement No. 115), energy trading contracts in 1999 (EIFT Issue 98-10), and certain derivative instruments in 2000 (FASB, 2000). One problem with MTM accounting involves a determination of the fair value of a financial instrument when there is no active market for the instrument. US GAAP establishes procedures for determining fair value as follows:

- The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the market price (FASB Statement 107, paragraph 5).

- Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, options pricing models, or matrix pricing models (FASB Statement 107, paragraph 5).

This later provision allows companies wide discretion to forecast the future and to recognize movements in the "value" of long-term contracts as ordinary revenue. Depending on future developments, there may never be any realization of the revenue recognized under these contracts. The revenue recognized may be in form only with no substance underlying the transaction.

6.5 Examples of Enron's Use of Mark-to-Market Accounting

Enron used MTM in highly creative ways in a number of different circumstances. One of the first examples of Enron's use of MTM involved a long-term gas supply contract with Cuiaba, one of the primary power companies of Brazil. The Emerging Issues Task Force of the FASB issued a ruling (EIFT Issue 98-10) in 1998 which allowed companies to use MTM accounting with respect to long-term gas contracts. This ruling enabled Enron to record $34 million of MTM related income in the third quarter of 1999, and another $31 million in the fourth quarter of 1999. The problem with the EITF ruling was that while it might be acceptable to use MTM accounting when there is an active market for a financial instrument (e.g. publicly traded securities), where there is no active market, companies are able to create their own estimates regarding the fair value of long-term contracts. Since Enron controlled the natural gas market for the Cuiaba power project, it could use its own valuation estimates to manipulate the amount of revenue that it recognized.

Enron also recognized revenue on long-term energy contracts in circumstances where it actually paid out cash rather than receiving cash. Enron advanced $50 million to Eli Lilly's when it entered into a long-term contract to supply energy to Lilly. This arrangement was in substance a loan by Enron to its customer. The advance was to be repaid through future energy purchases. Because of the EITF's ruling, Enron was able to reflect $10 billion in revenue from long-term energy contracts. Even though these transactions were in substance loans, they were reflected in as sales (Barboza, 2002).

Enron Energy Services, a wholly owned subsidiary of Enron Corp., also used dubious accounting practices to recognize revenue. In fact, by forecasting that the price of electricity would decline in the future, Enron recorded an immediate profit on a long-term energy contract. As soon as it signed the contract, Enron Energy Services estimated what its profits would be over the full term of the contract, based on assumptions about future energy prices, energy use and the speed at which different states would deregulate their electric markets (Berenson, 2002). In the case of states which were not deregulated, Enron forecasted when the states would deregulate and then forecast what the prices would be in the nonexistent deregulated markets. Based on its projections, Enron calculated its total profit for the life of the contract. After discounting to account for the risk that its customers would default, and the fact that it would not receive payments for many years, Enron recorded the revenue from the contract (Noms, 2002).

In another transaction involving a joint venture with Blockbuster Inc., Enron recorded revenue even though the venture never attracted more than a few customers. In the Blockbuster deal, Enron created a pilot project involving the distribution of movies via cable to a few dozen apartments in Portland, Oregon. Enron created a partnership, Braveheart, which raised $115 million from a bank in exchange for a promise to pay most of the earnings from the venture to the bank. Enron reported this transaction on a MTM basis by applying a model that valued the transaction at more than $110 million. The bank that put up the money for the "sale" received a guarantee from Enron that it would not lose money. From the bank's point of view, the transaction was reflected as a loan, but Enron treated the transaction as a sale (Norris, 2002.)

6.6 Accounting Disclosures

One aspect of US GAAP is that it allows disclosures about transactions to be included in footnotes to financial statements instead of reflecting the substance of the transaction on the face of the financial statements. The following is a brief summary of the disclosure requirements relevant to Enron:

- A reporting entity is required to disclose the nature and amount of loss contingencies in its financial statements even though the possibility of loss may be remote (FASB Statement No. 5, "Accounting for Contingencies").

- A reporting entity is required to disclose indirect guarantees of the indebtedness of others (FASB Interpretation No. 34, "Capitalization of Interest Costs").

- A reporting entity is required to disclose certain unrecorded long-term obligations (FASB Statement No. 47, "Disclosure of Long-Term Obligations").

- A reporting entity is required to disclose the fair value of its financial instruments, including the fair value of any commitments, letters of credit, financial guarantees, or debt (FASB Statement No. 107, "Disclosures About Fair Value of Financial Instruments").

- A reporting entity that enters into certain derivatives or energy trading contracts is required to disclose the fair value of any obligation that arise from those contracts

(FASB Statement 133, "Accounting for Derivative Instruments and Hedging Activities").

- A reporting entity that sells financial assets is required to disclose information about what was sold (FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-A Replacement of FASB Statement No. 12").

In addition there are disclosures required for related parties transactions. Related parties are defined broadly to include:

- Affiliates of the enterprise, that is, entities in which the enterprise has investments that it accounts for using the equity method.
- Management of the enterprise (including members of the board of directors, the chief executive officer, chief operating officer, and chief financial officer).
- Other parties with whom the enterprise deals if one party controls or can significantly influence the management and operating policies of the other (FASB Statement No. 57).

6.7 Enron's Deficiencies in the Area of Financial Statement Footnote Disclosure

Because Enron's transactions with related parties were very complex, its accountants and lawyers relied heavily on the officers and employees of the Enron Global Finance subsidiary, who reported directly to Andrew Fastow. The Financial Reporting Group circulated drafts of related party disclosures internally, and both Arthur Andersen, and the company's legal advisor Vinson & Elkins commented on the disclosures. The Chief Accounting Officer of Enron, who was charged by the Board of Directors with approving the transactions with the LJM partnerships, made the final decisions on the related party footnote disclosures. Senior Management and the Board of Directors were both given opportunities to comment on proxy statement drafts. Members of the Board focused their attention on disclosures about themselves, and were not usually concerned with related- party disclosures. There was no systematic procedure in place for ensuring identification of all transactions with related parties that needed to be disclosed in the financial statements or proxy statements (Powers et al., 2002).

When there was disclosure of related party transactions in Enron' s financial statements, the disclosure was unclear. An example of this lack of clarity is the following disclosure of the Raptor transactions (see Figure 2) in a footnote to its December 31, 1999, SEC Form l0-K:

> *In June* 1999, *Enron entered into a series of transactions involving a third party, LJM Cayman, L.P. (LJM). LJM is a private investment company that primarily engages in acquiring or investing in energy and communications related investments. A senior officer of Enron is the managing member of LJM's general partner. The effect on the transactions was (i) Enron and the third-party amended certain forward contracts to purchase shares of Enron common stock resulting in Enron a having forward contract to purchase Enron common shares at the market price on that day, (ii) LJM received 6.8 million shares of Enron common stock subject to certain restrictions, and (iii) En-*

ron received a note receivable and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at the estimated fair value. In connection with the transactions, LJM agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. LJM repaid the note receivable in December 1999.

Enron offered a somewhat clearer footnote in its May 2000 proxy statement. LJMl and LJM2 were both described as being: "a private investment company that primarily engages in acquiring or investing in energy and communications related investments." Concerning LJM1, Enron disclosed that: "Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM1's general partner. The general partner of LJMl is entitled to receive a percentage of the profits of LJMl in excess of the general partner's proportion of the total capital contributed to LJM1, depending upon the performance of the investments made by LJMI." Essentially the same disclosure was repeated with respect to LJM2. The proxy statement did not disclose the amount of compensation Fastow received, or specify the compensation formula. The Powers Report admitted that "the disclosures were fundamentally inadequate" (Powers et al., 2002). An internal Andersen memo prepared by James A. Hecker, referring to Enron Vice-President, Sherron Watkins, stated:

Sherron seemed even more agitated at the transaction's accounting because she perceived that.. footnote disclosures in (Enron's) consolidated statements were difficult to understand and did not tell the 'whole story'... She asserted that the Enron financial statement disclosures related to the Fastow investment company relationships and transactions were (putting it kindly) hard to understand (Hecker, 2001).

The substance of the transactions was difficult to discern from the footnotes to the financial statements, and since only the form of the transactions was reflected on the face of the financial statements, it was hard for investors and creditors to obtain a clear view of the financial position and results of operations of Enron prior to the restatements that took place in November 2001.

7. Conclusion

This paper has examined the development of Enron Corp. from a regulated natural gas distribution company into a worldwide energy trading company and its ultimate demise into bankruptcy in December 2001. The bankruptcy of Enron Corp has led to assertions of fraud and illegal practices on the part Enron management and its external auditors. The paper has assessed these assertions and examined whether the Enron bankruptcy should be viewed as an accounting failure, with investors and creditors being misled by false financial statements, or whether it was a business failure that was obscured by accounting practices that strained the limits of credibility. It is the contention of this paper that astute financial analysis would have revealed the instability of Enron Corp., thereby alerting investors and creditors to the lack of creditworthiness of the company. At the same time, it is the contention of the paper that had there been an appropriate level of transparency in the financial statements, investors and creditors would have been provided with a more realistic view of the company's financial position and its results of operations, thereby facilitating their ability to assess the viability of the company and avoid their bankruptcy losses.

There have been laws enacted, and new accounting pronouncements issued, in response to the Enron bankruptcy. At this point, it is difficult to determine what the impact of these new laws and accounting pronouncements will be. Some have asserted that the Sarbanes-Oxley Act is the most far reaching change in accounting regulation since 1933 (Miller and Pashkoff, 2002). If this turns out to be the case, we may well see an increased level of transparency in financial statements, which hopefully will prevent a repetition Enron type problems. At the same time, there has not yet been a significant reassessment of accounting standards setting practices that would led us to conclude that greater transparency will soon be forthcoming. In essence, apart from a rigorous application of accounting standards by uncompromising auditors, a scandal like Enron could easily re-occur. It is in this way that Enron was an accounting failure, both from the perspective of Arthur Andersen who chose not to be an uncompromising auditor and from the perspective that accounting standards were not rigorously applied by the management of Enron; indeed they were misapplied. Moreover, there appears to be a fundamental flaw in US GAAP which essentially allows companies to reflect the form of accounting transactions above their economic substance. Until such time as the FASB decides to adopt a principles based approach to accounting standards setting, we may well see more Enron type accounting failures.

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