

## Should the Regulators, Specifically the Financial Accounting Standards Board, Be Blamed for the Enron Debacle?

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### Abstract

*Enron's use of Special Purpose Entities (SPEs) and Mark-to-Market (MTM) accounting methods to deceive investors resulted in tremendous public and regulatory scrutiny. Given the complexities that exist in the market place, the accounting guidance available is often limited and far too complicated for management to follow. In addition, some of the guidance clearly provided loopholes to allow Enron's schemes to go undetected until it was too late. Regulators' responses to innovative and creative accounting methods are often slow and politically motivated, placing the public at financial risk. This research paper examines the changes enacted by the regulators, specifically the Financial Accounting Standards Board (FASB), to determine if it contributed to Enron's demise. It focuses on Enron's use of the SPEs and the MTM accounting methods to disguise the transparency of its financial statements.*

Right after the horrifying terrorist attacks on the United States in 2001, the country was once again thrust into another crisis. One of the largest corporations in the U.S., Enron, announced that it was reviewing its financial statements for what it termed "accounting errors". Within weeks the company declared bankruptcy. Investors and creditors saw their shares in Enron disappear overnight. According to *The New York Times*, shareholder losses were estimated at \$60 billion (Editorial Desk, 2002). In addition, approximately 4,500 employees saw their retirement packages disappear and their careers ended. Enron had been named one of the top corporations in the United States and was often viewed as a model for others. Unknown to its investors and creditors, the company had achieved this status based on aggressive and sometimes deceptive accounting methods. In some cases, Enron's accounting methods were either approved by regulators or they were aware of its use by the

company. In other cases, Enron's accounting methods completely disregarded the Generally Accepted Accounting Principles (GAAP) set forth by the Financial Accounting Standards Board (FASB).

The corporate scandals of 2001 brought to light the corrupt accounting practices of some of the biggest firms in the United States. Most of the blame was placed on the auditors and accountants responsible for the financial statements. It is important for financial statements to be clear because both investors and creditors rely on them in order to make sound business decisions. In order for financial statements to be used as a tool of measure, they must be compiled using set guidelines provided by the regulators and adapted by companies in the same industry.

Enron's use of Special Purpose Entities (SPEs) and Mark-to-Market (MTM) accounting methods provided two avenues that cloaked the true financial status of the corporation by "use and abuse of accounting rules" (Van Neil, 2004, p. 14). MTM is an aggressive accounting method that allows companies to record revenues as earned before the services are provided. Accounting students are taught that the discipline relies on conservatism and that conservative accounting methods record revenue after services have been provided. However, conservatism appeared to be an unheard of principle by Enron, as its fraudulent activities portrayed.

Enron's accounting methods for its Special Purpose Entities (SPEs) were but one of the major factors that contributed to its demise. According to Bala G. Dharan (2002a), "SPEs are business entities formed for the purpose of conducting a well-specified activity, such as the construction of a gas pipeline, collection of a specific group of accounts receivables, etc." (p.3). Enron's use of SPEs, although perhaps legitimate at first, was used to "remove assets and liabilities from its balance sheet, to hide losses, and to create fictitious profits" (Duncan and Schmutte, 2005, p.1). Accounting for SPEs can be done in different forms. The FASB has worked injudiciously over a number of decades to come up with one set of accounting measures for these vehicles. Since Enron's debacle, SPEs and MTM accounting methods have been under scrutiny by both the public and governmental regulatory agencies.

The debacles of 2001-2002 forced the public to lose faith in the accounting process and the agencies responsible for regulating them. As a result, there have been many changes in both the public and private sector to regain the public's trust. Congress has enacted the Sarbanes Oxley Act of 2002 (the Act) which required major changes to the auditing and accounting profession. In addition the Act mandated that the FASB revise its guidance on SPEs. This research paper examines the

accounting methods enacted by the regulators, specifically the FASB, to determine if it was responsible for the Enron debacle. In order to understand the role the regulators have in the private sector an overview of the structure is presented first. Thereafter, the paper focuses on SPEs and the accounting dilemmas surrounding them. Subsequently, the MTM accounting method is discussed. Finally, the paper considers whether these changes (or lack of changes) by the FASB contributed to Enron's debacle.

### **The Regulators' Structure**

The regulators include the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), and Congress. While various regulatory bodies influence the accounting methods used in the private sectors, the FASB is the primary standard setter in the United States. The FASB was created by the SEC and works closely with it to release guidelines. J. Edward Ketz (2003) stated the "SEC was given the authority to create financial statements and accounting methods based on Section 19(a) of the Securities Act of 1933 and Section 13(b) of the Securities and Exchange Act of 1934" (p. 214). However, the SEC delegated this responsibility to the FASB but retained overall control of all final pronouncements. Since the SEC was created by Congress through the Securities and Exchange Commission Act of 1934, Congress also indirectly controls the FASB. This was evident most recently, as Roman L. Weil (2002) indicated, in 1990 when Congress used its power to make the FASB pull back on their proposals for expensing stock options.

The FASB has a unique approach before creating guidelines. It first issues exposure drafts to the public, requesting feedback. At best this can be described as a compilation of best practices in the field. As a result, it is often slow in responding to creative and innovative accounting methods. Bala G. Dharan (2004a) stated that the "standard setters were always a step or two behind (and were being reactive rather than proactive) in developing account rules to govern their proper use" (p. 119). Hence, many of the issues that exist in the market place are in use for a couple of years before the FASB addresses them. Al L. Hartgraves and George J. Bentson (2002) stated that the FASB took approximately 15 years before releasing any specific guidance on SPEs. Despite this evident lack of response, the FASB in its mission statement still claims to "consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard setting process" (Facts about the FASB). When pronouncements are eventually

published, they are released as Generally Accepted Accounting Principles (GAAP) and are followed by the private sector when preparing financial statements. A subsidiary of the FASB, Emerging Issues Task Force (EITF), is tasked with providing guidance on issues that the FASB has not addressed.

### **What are Special Purpose Entities?**

Special Purpose Entities became widely used in 1970-1980, but have been put under tremendous scrutiny because of Enron's misuse and abuse of them. They are set up by another company (sponsoring company) and can take any legal form such as a corporation, partnership and trust. The sponsoring company creates this entity for a specific activity. According to Hartgraves and Bentson (2002), the SPEs have a limited scope because their "activities," "life," and "purpose" are only to benefit the sponsoring company (p.1). Unfortunately, Enron's SPEs were used to benefit the management's personal goals more than those of the shareholders. "The term 'special purpose' comes from the limited scope of the charter of the SPE" (Dharan, 002a,p. 4). Once the purpose of the entity is fulfilled, it dissolves. J. Edward Ketz (2003) indicated that this type of entity allows the sponsoring company to borrow money, transfer or sell assets to it. SPEs, when used legitimately, provide investors and businesses with an effective tool. Investors' risk is limited to the activities of the SPEs, while the sponsoring company benefits by keeping the liabilities off its books, resulting in a positive debt to equity ratio. Although these entities have been around for a while, there had been no official guidance set for them by the FASB until 1990, when EITF 90-15 was issued to help companies account for these vehicles.

### **What are the Problems with Special Purpose Entities?**

"The SEC Staff grew concerned about accounting for SPEs around 1985" (Ketz, 2003, p. 215). This was 15 years after the vehicle had become widely used in the industry. According to Bala G. Dharan (2004a) one of the major issues with accounting for an SPE is whether it should be consolidated with that of the sponsoring company. A report by the Staff of the US Securities and Exchange Commission (2003) noted, "The term, off balance sheet, has sometimes carried the connotation of something underhanded or at least less than fully transparent" (p. 7). In Enron's case, most of the SPEs were used in this manner. They were able to deceive investors because they did not consolidate the financial statements of the sponsoring company with that of the various SPEs.

The accounting guideline, EITF 90-15, allowed a loophole for companies to not consolidate based on what has become the famous 3% ownership rule. In essence, the sponsoring company could own up to 97% of the SPE without consolidating it if 3% of the equity was owned by outside investors and was at risk. Bala G. Dharan (2004a) indicated that this 3% ownership rule "was a major departure" from the normal consolidation rules under GAAP (p. 119). GAAP requires that companies consolidate if they own 50% or more of equity interest in an entity. This loophole created by the FASB allowed Enron to not consolidate its debt. The result was that billions of dollars owed in liabilities was not included on the financial statements and was therefore unknown to the investors and creditors.

The FASB has since defended the 3% loophole by indicating that it was intended for certain types of lease transactions. However, when no guidance exists in the marketplace management will create and bend the rules to their advantage, often blatantly abusing loopholes. According to J. Edward (2003), the debt of the SPE also belongs to the sponsoring company since they own at least 97% of the company. Clearly this presents a conflict of interest for the parties involved. It is difficult to understand how the FASB could not have seen this conflict of interest that arose because of this arbitrary percentage ownership. Bala G. Dharan (2004a) explained the accounting problem that needs immediate attention is the issue of consolidation that arises with these types of entities. Unfortunately, three years after the Enron debacle, the FASB is still struggling with the rules to account for SPEs.

### **Mark-to-Market Accounting**

Mark-to-Market (MTM) is an accounting method that is used mainly by energy traders. This type of accounting method allows revenues to be recorded on the financial statements before services are provided. Bala G. Dharan (2004b) points out the two conditions that must be present before revenues can be recorded: services must be provided and there must be a reasonable certainty that cash will be collected. The problem with Enron's use of this method is not that revenues were recorded before services were provided, but the gross abuse of this method that resulted. C. William Thomas (2002) explained that MTM accounting methods rely on management to predict revenues for future periods. In some cases, judgments are made without a proper valuation based for the future market values of the product. The crooked management of Enron used this opportunity to greatly inflate its financial statements. In accounting, nothing should be left to the discretion of the

management because when decisions are left to be made by management, the results are often devastating to both creditors and investors, as Enron's demise has proven.

Enron's use of MTM accounting was approved by the SEC in 1992. Many companies soon followed suit because of the pressure to show earnings. If other companies had continued to use the conservative approach, their financial statements would not have stacked up against Enron.

Since management's discretion was needed for this type of accounting, Enron's management abused this method "on an unprecedented scale" to inflate its earnings (Thomas, 2002, p. 4). In testimony to the House Energy and Commerce Committee, Bala G. Dharan (2004a) stated that "without MTM [accounting], Enron would be required to recognize no revenue at the time the contract is signed and report revenues and related costs only in future years for actual amounts" (p. 121). However, when the tool to defraud is handed down by a regulator, in this instance the SEC, companies will not only abuse their privileges to the fullest extent, but will feel they are doing so lawfully.

### **Did the Changes or Lack of Changes by the FASB Contribute to Enron's Demise?**

The first official guidance published by the FASB and EITF in 1990 that dealt with the accounting methods for SPEs was EITF 90-15. This ruling was formalized by FAS 125 and eventually "replaced by FAS 140" (Bentson & Hartgraves, 2002). These pronouncements were limited in scope and did not fully account for the various scenarios that may exist in the complexities of different industries. While EITF 90-15 presented a loophole, two revisions by the FASB (FAS 125 and FAS 140) did not revise the 3% arbitrary guideline. Most professionals believe the standards were set too low. Specifically, the rulings allowed "firm[s] to own up to 97% of an SPE without reflecting either its assets or liabilities on the firm's balance sheet" (Crawford & Edward, 2003). This resulted in the sponsoring company having a great deal of control and influence on the SPE's activities. This loophole created by the FASB clearly allowed Enron to avoid consolidation of its SPEs, leading to its demise. Enron's eventual correction of the financial statements revealed that the SPEs' debt amounted to billions of dollars, which Enron was solely responsible for. When investors realized this they quickly sought to dump their stock, resulting in the company losing its value almost overnight.

In an attempt to comply with the Sarbanes Oxley Act of 2002, the FASB in 2003 revised the 3% guideline to 10% in its pronouncement FIN 46(R). Companies are now required to consolidate financial statements if they own at least 90% of the voting interest in the SPE. Edward J. Ketz (2003) suggested this ruling is still disappointing because it "creates three loopholes to allow business entities a way out" (p. 141). Unfortunately, the revised pronouncement still has loopholes to allow another Enron-type scandal.

Enron's use of MTM accounting methods was approved by the SEC. While this method has its legitimate use, it relies too much on management to forecast future revenues. Since judgment can be made without a substantial basis, it would be easy to pull numbers out of thin air. "In the end, the accounting standard-setters took the position that the increased benefit from reporting the market value information on the balance sheet justified the cost of decreased reliability of the income statement and earnings number" (Dharan, 2004a, p. 118). If the regulators will overlook the reliability of the financial statements, corporate America will only be too happy to follow their lead.

### Conclusion

While the debate about the true reason for Enron's collapse will probably be carried on into the next decade, and beyond, there are many established facts to ponder. Major among these is the role the regulators may have played, knowingly or unknowingly. The mere structure of the FASB can be seen as a contributing factor. It should not have to take 15 years for a regulatory agency to release guidance, as was the case with the SPEs. Being reactive and not proactive set the stage for gross abuse and outright fraud. Enron's endeavor to be a top US corporation was surely reason enough to take advantage of the MTM accounting and SPEs loopholes left in place by the FASB. These loopholes were just never abused to the levels that Enron took them.

To prevent this from happening again, the FASB should be strengthened and revamped. It has to be independent of the SEC and Congress. Both the SEC and Congress have invisible hands in the accounting rule making policies that quite often contradict the FASB aims. Dharan's (2002b) testimony to the House Energy Committee revealed the need for the FASB to be independent. An arm's length relationship with the SEC and Congress is necessary in order for the FASB to provide policies that are not politically motivated. Weil (2002) made it evident that Congress needs to "keep out of accounting rule making" (p. 5). More importantly, the FASB should close all loopholes

as fast as they are discovered. By doing so, another Enron-like disaster may be prevented.

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