

E-RESOURCES

AUDITING & CORPORATE GOVERNANCE

SEMESTER-VI

SECTION D & F

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TOPICS COVERED:

1. THE ENRON SCANDAL

2. THE SARBANES-OXLEY ACT, 2002

THE ENRON SCANDAL

OUTLINE

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Rise of Enron

Formation- Growth and Diversification- Valuation

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Causes of Downfall

Major reasons leading to sudden bankruptcy

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Corporate Governance Failure

Flaws in Corporate Governance and Failure of Financial Audit

04

Aftermath of Enron Scandal

Consequences of the downfall

RISE OF ENRON

(JOURNEY TO BECOME LARGEST NATURAL GAS SELLER IN NORTH AMERICA BY 1992)

- **Formation**

Merger of Houston Natural Gas and Inter North in 1985 by Kenneth Lay (CEO)

- **Growth & Diversification**

Revenue increased due to deregulation in 1990s allowing sale of natural gas at higher price

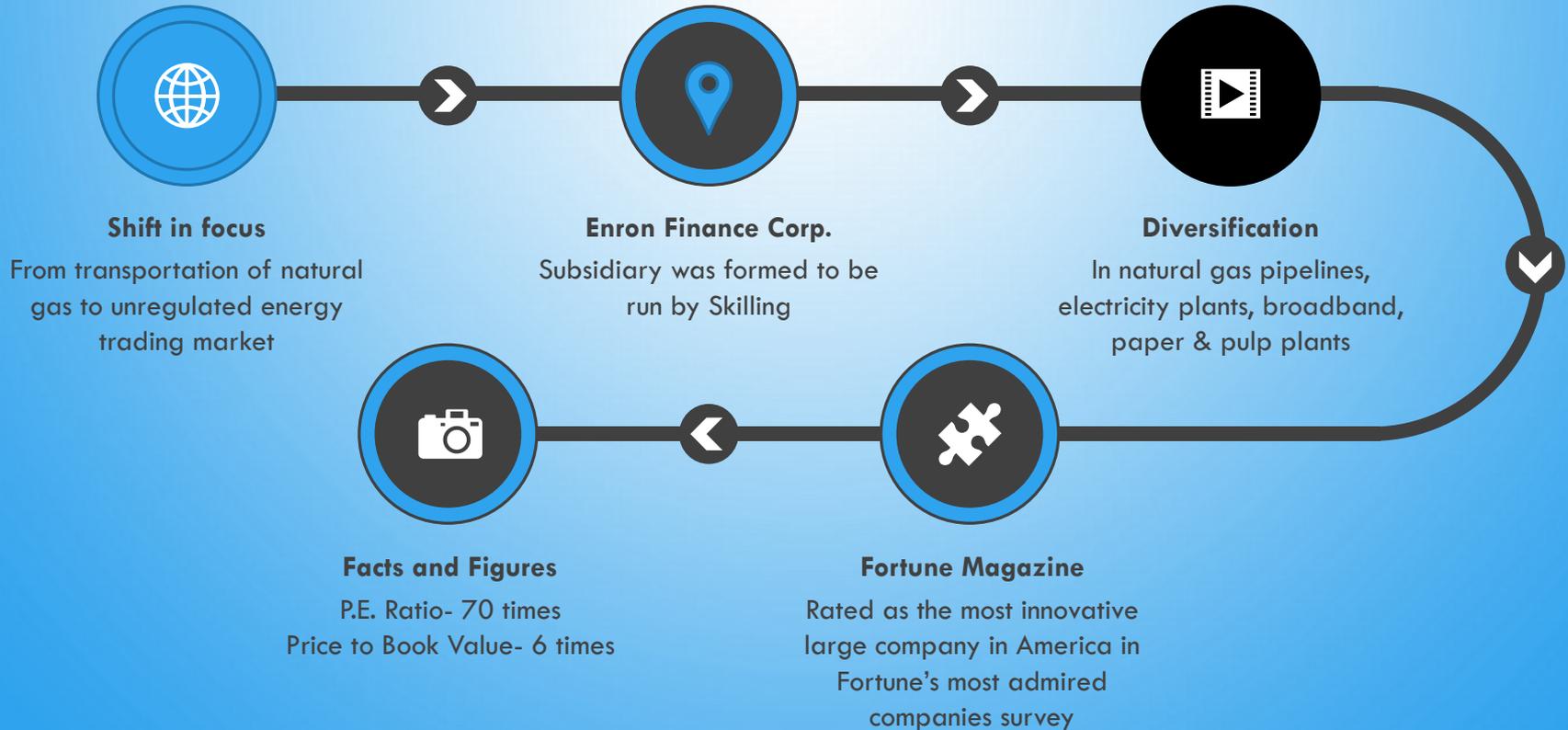
- **Valuation**

Stock priced at \$83.13 with market cap of \$60-70 billion by the end of 2000

Rated as the most innovative large company in America in Fortune's Most Admired Companies Survey

DIVERSIFICATION

(STRATEGY THAT BUILT THE FRAMEWORK FOR SCANDAL)



CAUSES OF DOWNFALL

- **Faulty Revenue Recognition Model**

Adoption of 'Merchant Model' against 'Agent Model'

- **Mark-to-Market Accounting**

Led to false reports as it accounted for complex long-term contracts

- **Special Purpose Entities**

To 'window-dress' the finances and to hide the debt of parent company

- **Excessive Executive Compensation**

Focused only on short-term earnings so as to maximize bonus and stock options

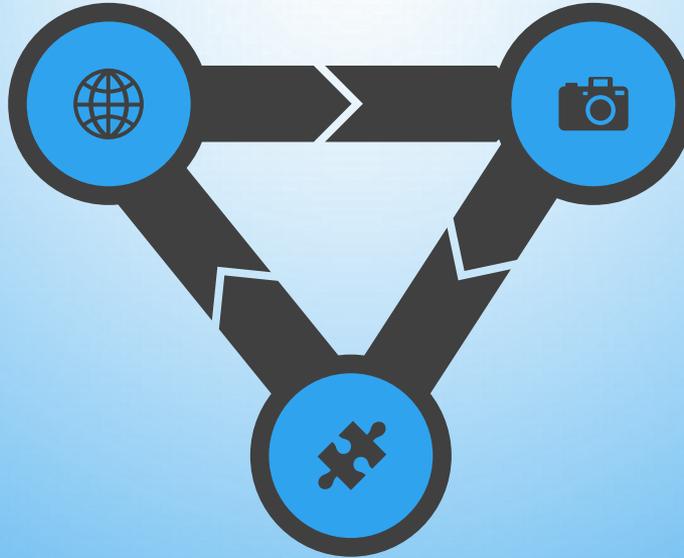
- **Risk Mis-management**

Hedging of risk with self-owned special purpose entities, retained the risks

WHERE WERE THE REGULATORS?

Arthur Anderson & Co

- Received \$ 1 million weekly fees
- Was engaged in accounting and consultancy also
 - Conflict of interest



Credit Rating Agencies

Enron paid Moody's, S&P, Fitch/IBC hefty sums to disillusion the employees

SEC

Positive reports by auditors and credit agencies did not ring the bell

FLAWS IN CORPORATE GOVERNANCE

Audit failure

External auditor, Arthur Anderson failed in its professional duty

Stakeholders

Remained silent spectators until the scandal became too evident

Breach of Fiduciary duty by Board

- In oversight responsibilities w.r.t. executives and related party transactions

Unethical business practices

Employees and senior executives indulged in self-dealings

Whistle Blower Policy

Lack of it did not allow the scandal to come to notice

AFTERMATH OF THE ENRON SCANDAL

- Shattered investors' confidence
- Banks cancelled credit facilities extended
- Rating agencies downgraded the ratings
- Failed acquisition deal with rival Dynegy
- Filed for Bankruptcy

AFTERMATH OF THE ENRON SCANDAL

- **Shareholders:** Estimated total losses amounted to \$ 74 bn to shareholders before the company's bankruptcy.
- **Employees:** Employees and shareholders received limited returns in lawsuits, despite losing billions in pensions and stock prices.
- Executives including Kenneth lay, Jeffrey Skilling and CFO, Andrew Fastow were indicted for a variety of charges and were imprisoned.
- Enron's Auditor, Arthur Anderson was found guilty and the firm was closed down.
- **New Laws and Legislation:** Sarbanes-Oxley act was enacted in the US to increase the accuracy of financial reporting and to expand accountability of auditing firms.

UNFOLDING OF EVENTS

THE GREAT COLLAPSE

August 14, 2001

Skilling resigns and Lay became CEO again

October 12, 2001

Arthur Anderson legal counsel tells auditors to destroy all Enron files except basic documents



2000

Enron's shares skyrocketed to all time high of \$ 90.56

August, 2001

Sherron Watkins, a V.P., warns Lay that the company could “implode into a wave of accounting scandals”

October 16, 2001

Enron announces third-quarter loss of \$ 618 mn and accepted overstatement dating back to 1997

UNFOLDING OF EVENTS

THE GREAT COLLAPSE

November 9, 2001

Enron confirms being taken over by rival Dynergy for \$ 9 bn

December 2, 2001

Enron's stock closes at 26 cents. Enron files for Chapter 11 bankruptcy protection

October 31, 2001

The company discloses that it is under formal investigation by the SEC

November 28, 2001

Dynergy announces that it has terminated merger talks with Enron

January 9, 2002

The US Department of Justice opens a criminal investigation



UNFOLDING OF EVENTS

THE GREAT COLLAPSE

January 15, 2002

NYSE suspends trading of
Enron shares

January 23, 2002

Lay resigns as CEO and
later from Board of
Directors



January 10, 2002

Arthur Anderson discloses
that its employees had
destroyed company
documents

January 17, 2002

Enron ends its partnership
with Arthur Anderson

February 19, 2004

Skilling is charged with
fraud and insider trading

UNFOLDING OF EVENTS

THE GREAT COLLAPSE

May 25, 2006

Skilling and Lay are convicted of conspiracy and fraud

June 21 ,2013

Federal judge reduces Skilling sentence in return of \$ 42 bn to be distributed to victims



July 7, 2004

Lay is charged with conspiracy, securities fraud, wire fraud, bank fraud, making false statements



September 8, 2008

Class action suit filed by shareholders and investors is settled for \$ 7.2 bn



December 8, 2015

SEC permanently debarred Skilling from serving as an officer or director of a publicly held company



THE SARBANES-OXLEY ACT, 2002

THE SARBANES-OXLEY ACT OF 2002

- Introduced after collapse of Enron & WorldCom
- The US government introduced the Sarbanes-Oxley act of 2002 drafted by the US senator Paul Sarbanes and US congressman Michael Oxley.
- Considered to be one of the most dynamic securities legislation
- Apply to all the companies that have registered equity or debt securities with the SEC. Companies whether incorporated in the USA or outside that have registered public offerings in the USA have to follow the provisions of Sarbanes-Oxley Act.

MAJOR ELEMENTS

1) **Public Company Accounting Oversight Board (PCAOB)**

- Oversees audit of public companies
- Has the power to establish and amend rules and standards, enforce compliance and penalize them in case of non-compliance. It also review company disclosures and financial statements

2) **Auditor Independence**

- Gives a list of non-audit services that cannot be taken up for the client by the auditor
- Audit committee must preapprove all non-audit services provided by auditor

3) Corporate Responsibility

- Establish minimum independence standards for audit committee
- Establish procedures for addressing complaints
- CEO's and CFO's must certify the truthfulness and accurateness of the financial reports

4) Enhanced Financial Disclosures

- Disclosure of all the off-balance-sheet transactions that may affect financial status
- Pro-forma figures and stock transactions of corporate officers
- Assuring accuracy of financial reports and disclosures
- Timely reporting of material changes in financial condition
- Annual report must contain a report which states that management is responsible for establishing internal control and its effectiveness

5) Analyst Conflicts Of Interest

Includes measures designed to help restore investor confidence in the reporting of securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of conflicts of interest

6) Corporate And Criminal Fraud Accountability

Manipulating, destroying, concealing or falsifying records or documents with the intention of obstructing federal investigation invites fine and imprisonment up to 20 years. Working papers must be retained by the auditor for at least 5 years. The act provides protection of whistle blowers.