

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

**01**

## **Rise of Enron**

Formation- Growth and Diversification- Valuation

**02**

## **Causes of Downfall**

Major reasons leading to sudden bankruptcy

**03**

## **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

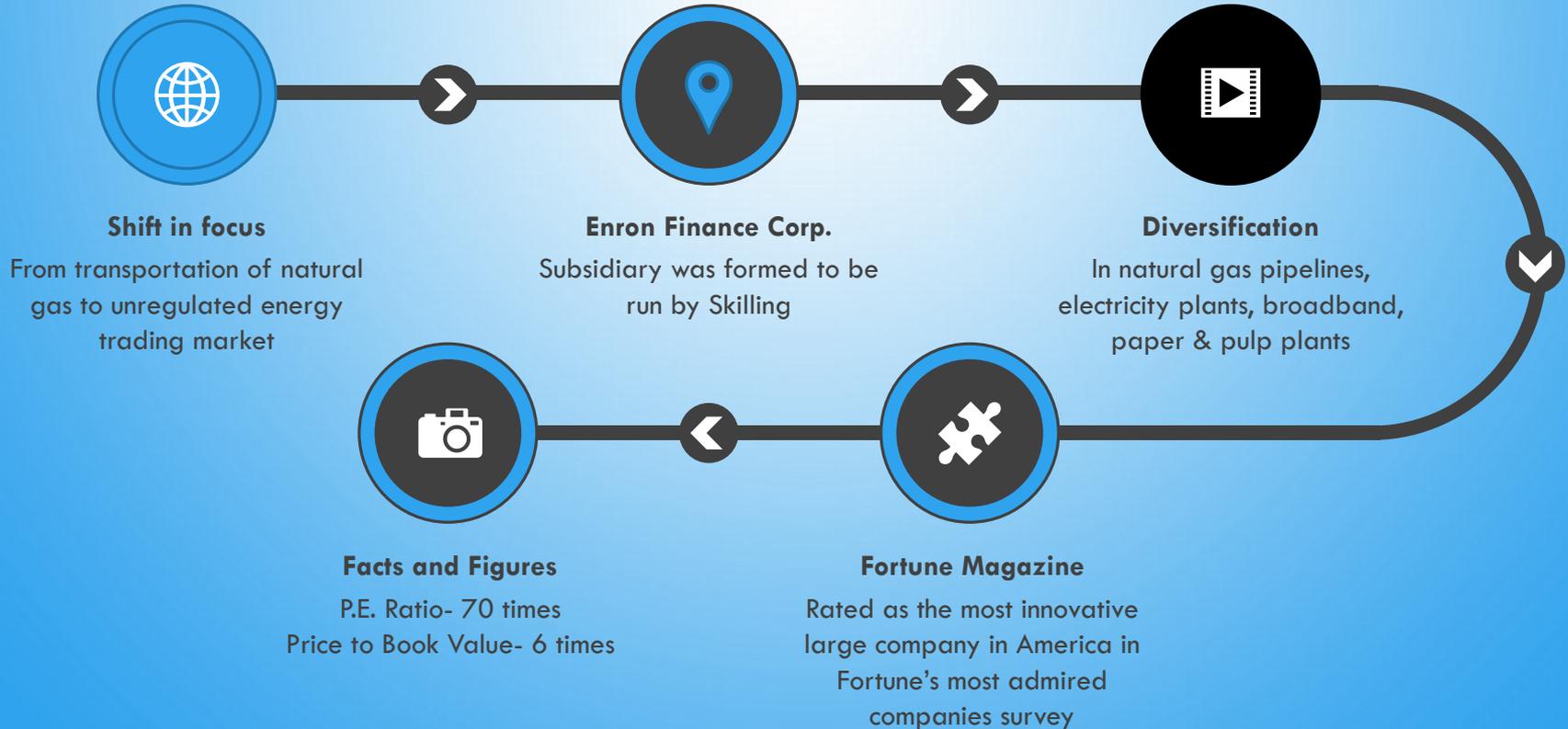
- **Valuation**

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

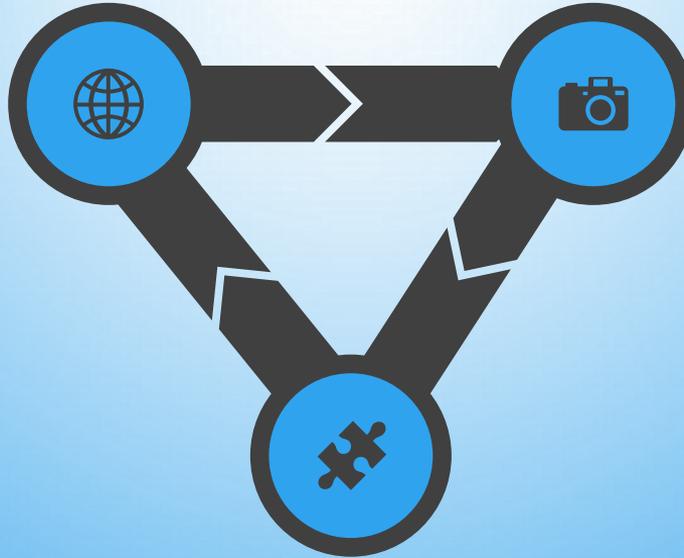
- **Risk Mis-management**

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.