Statement No. 176

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Statement of the Shadow Financial Regulatory Committee

on

Enron and Accounting Issues

February 25, 2002

The bankruptcy of the Enron Corp., perhaps the largest corporate bankruptcy ever, and the role and responsibility of its external auditor, Andersen, has occupied the nation as has no other public accounting issue. Hearings before several Congressional committees, stories in the press, and a report by a Special Committee of Enron's Board of Directors (the Powers Report) have given us some insights into what went wrong. At this point, we do not have a complete picture and we will not engage in comments about the responsibility and culpability of specific individuals or firms. However, in the light of some proposed and probably forthcoming legislation, we will put forth some general principles that should be useful in the legislative process.

The Causes of Enron's Failure

The particular causes of Enron's failure are complex. At one time Enron appears to have been a successful and innovative enterprise, principally engaged in trading and dealing in energy-related contracts. At some point it expanded by making substantial investments in a variety of large-scale projects. Although some of these were initially successful, others resulted in Enron incurring large economic losses. Then it appears to have embarked on covering up losses and manufacturing earnings. This succeeded for a time, but was ultimately unsustainable. These efforts allowed Enron to disguise the losses and not report debt for which it was contingently (and later actually) liable. They also apparently afforded certain Enron managers the opportunity of extracting personal gains at the expense of Enron's stockholders.

What Lessons Should and Should Not Be Drawn?

One lesson that should not be drawn is that firms should be prevented from taking risks or incurring failure. That is an essential part of any competitive economy. The fact that Enron failed is not, by itself, a matter of concern. The failure does impose losses on persons who dealt with Enron, including shareholders, creditors, counter-parties, and employees, with respect to both their jobs and as investors in Enron stock. The objective is not to eliminate such risks, but to make it possible for people to evaluate them better, and thus make informed decisions.

The first question is whether the accounting standards (including disclosure) and auditing procedures were so deficient and misleading that informed decisions could not be made effectively and the losses incurred were magnified. In particular, the treatment of transactions with Special Purpose Entities sponsored by Enron, which were thinly capitalized (3% of assets) and involved severe conflicts of interest, has been widely criticized. At present, we do not know enough to determine the extent to which the problem is one of inadequate accounting standards or deficient application of the standards by Andersen. This clearly should be a focus of continued investigation.

There also is a basic question as to the extent to which accountants can make, and others can rely on, estimates of the fair value of financial assets. The Financial Accounting Standards Board (FASB), in part at the insistence of the SEC, requires companies to state their financial assets at fair values. This measure should be distinguished from market values, which are based on prices revealed from purchases and sales in a market where the financial assets are regularly traded. An example is equity shares traded on the New York Stock Exchange. When market prices are not available, the FASB requires corporate managers to estimate the expected cash flows that might be obtained from a financial asset and discount these flows to determine their fair value. This procedure, which Enron used to value its energy contracts and merchant investments, is subject to a substantial degree of managerial discretion, such that the numbers reported in a financial statement can almost be whatever the managers want them to be. Such over-valuations appear to be responsible for a large part of Enron's subsequently discovered overstatement of reported net income and equity.

There is an ongoing debate about the potential benefits of greater frequency and depth of disclosure. It should be borne in mind, however, that the material disclosed would be useful only the extent that the information is reliable and, to the extent consistent with reliability, is economically relevant.

Another issue is whether and how the presumably independent auditors of corporations (CPAs) should be more effectively regulated. CPAs have been criticized for providing both consulting and other non-audit services. The critics assume fear of losing fees from non-audit services has discouraged or prevented CPAs from standing up to clients who want to misinform investors. We wonder why, if the loss of fee income has this detrimental effect on CPAs' integrity, larger fees for higher quality or more risky audit work would not be similarly detrimental? We also question whether, if CPAs were legally prohibited from offering non-audit services, the costs to shareholders of less efficient and higher cost audits would not exceed the benefits they might get from this legal change. In the end, we believe that the market should decide. Corporations should disclose in greater detail than is now required the nature of the non-auditing services obtained from their auditors.

A new administrative organization that would be charged with disciplining CPAs also has been proposed. This oversight body, termed a "Public Regulatory Organization" (PRO) in a bill introduced by Representatives Oxley and Baker, would have the authority and responsibility to discipline CPAs who sign the financial statements of publicly traded corporations. Presumably, it would do its job better than the SEC, the American Institute of Certified Public Accountants (AICPA), or state boards of accountancy that issue and can revoke CPA certificates, because at least two-thirds of the proposed PRO's members would not be CPAs. Errant CPAs, indeed, might need more effective discipline and ought to pay a greater price than at present for permitting clients to deceive investors. However, we observe that the SEC, which has had the power to discipline CPAs who attest statements of registrants for a very long time, presumably is an organization independent of CPAs. Hence, we question the value of a new administrative agency that would do what the SEC can do now.

Recommendations

The Oxley, Baker "Corporate and Auditing Accountability, Responsibility, and Transparency Act" proposes some legislative changes that might benefit investors, although we believe that it may well impose more costs than achieve benefits. It appears to us that the Securities Acts already give the SEC sufficient power to undertake to discipline the public accounting profession, if this were necessary and desirable. We urge the SEC and FASB to revisit its requirement for financial instruments to be stated at fair values when these values cannot be reliably determined. We also urge the Congress not to rush to enact legislation until more is known about the precise manner and extent to which inadequate accounting or auditing standards or incapable or even dishonest CPAs were the source of the losses to investors and employees of Enron and other publicly traded corporations.