**Accounting Fraud:**

**Enron Scandal**

**1.Description:**

(1) Main players: CEO Jeff Skilling and former CEO Kenneth Lay.

(2) Background: Enron was a Houston-based commodity, energy, and service corporation. Kenneth Lay founded it in 1985 through the merger of two natural gas pipeline companies. In an attempt to achieve further growth, Enron's business was quickly extended to become involved in natural gas trading. The minimal regulatory environment at that time allowed Enron to take advantage.

(3) What happened:

* Enron's stock price rose by 311% from the start of the 1990s until the year-end 1998. In 1992, Enron received the official SEC approval on transitioning its accounting method from the more conventional traditional historical cost accounting method to the mark-to-market accounting method. The change essentially laid the groundwork for much of the accounting abuse and fraud that would happen in the future.
* By century's end, Enron had become one of the most successful companies in the world. At Enron's peak in mid-2001, its shares were worth $90.75. Fortune Magazine named Enron "America's Most Innovative Company". However, its stock price fell to nearly zero within one year.
* In August 2001, the whistleblower Sherron Watkins wrote an anonymous letter to Kenneth Lay expressing concerns about the company's accounting.
* In October 2001, Enron surprised the market by announcing that the nonrecurring charges of $1.01 billion after-tax in the third quarter of 2001. Then the SEC started investigating the transactions between Enron and Fastow's special purpose entities (SPEs).
* On November 28, 2001, major credit rating agencies downgraded Enron's debt to junk bond status.
* On December 2, 2001, Enron declared bankruptcy in New York. At that time, its stock was trading at $0.26.

(4) After effects: Lay died before serving time. Skilling got 24 years in prison. The company filed for bankruptcy. Shareholders lost $74 billion, thousands of employees and investors lost their retirement accounts, and many employees lost their jobs. Arthur Andersen was found guilty of fudging Enron's accounts.

(5) Fun fact: Fortune Magazine named Enron "America's Most Innovative Company" 6 years in a row prior to the scandal.

**2. Causes of failure:**

(1) Accounting irregularities: Enron took full advantage of Mark-to-market accounting limitations. Its trading business involved complex long-term contracts and adopted mark-to-market accounting method. This method allowed the company to write unrealized future gains from contracts to the income statement and produce artificially significant earnings. Investors were given misleading information because of the deviation in the estimations.

(2) Conflicts of interest and lack of independent oversight of management: Enron used SPEs to hide its huge debts. By transferring the troubled operations of the company to SPEs, Enron made its losses look less severe than they really were. Enron had used hundreds of SPEs by 2001 and only provided only minimal disclosure on its relations with these SPEs.

**3. Summary:**

The Sarbanes-Oxley Act (2002) was passed in response to the Enron Scandal. It aims to help protect investors from fraudulent financial reporting by corporations. The act also mandated strict reforms to existing securities regulations and imposed tough new penalties on lawbreakers.