

COOKING THE BOOKS IS A CRIME: A LESSON LEARNED FROM THE ENRON CASE

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INTRODUCTION

The Enron debacle caused by the commission of alleged financial statement fraud is devastating for significant numbers of investors, creditors, employees, and pensioners. Recent reported financial statement frauds committed by high profile companies, such as Enron, World Com, Waste Management, Sunbeam, Lucent, Xerox, MicroStrategy, Aurora Foods, Cendant, Global Crossing, Quest, just to name a few, has raised the question of whether the financial reporting process and the related audit function can be trusted. The collapse of Enron and World Com, the two biggest corporate failures of recent times, has caused lawmakers (e.g., Congress), regulators (e.g., the Securities and Exchange Commission, SEC), and the accounting profession (e.g., the American Institute of Certified Public Accountants, AICPA) to address (1) the integrity, quality, and reliability of the financial reporting process; (2) adequacy and relevance of financial disclosures; (3) the effectiveness and efficacy of audit functions; and (4) the objectivity and appropriateness of the self-regulatory oversight of the accounting profession.

The highly publicized improper accounting practices of Enron are viewed by many, at best, as aggressive and, at worst, fraudulent. Enron dis-

closed that it had overstated earnings by more than half a billion dollars from 1997 to 2000 and established private partnerships that kept billions of dollars of debt off its books. Enron used sophisticated financing vehicles known as Special Purpose Entities (SPEs) and other derivative instruments to increase leverage without reporting debt on the balance sheet. The use of these aggressive accounting practices of “cooking the books” is a “CRIME” subject to harsh penalties by the SEC and lawsuits by damaged investors, creditors, employees, and pensioners. This article (1) presents a model consisting of five interactive factors which explain the occurrences of financial statement fraud; and (2) by using the Enron case, attempts to demonstrate that “cooking the books” causes financial statement fraud and results in a crime.

A MODEL OF FINANCIAL STATEMENT FRAUD

Financial statement fraud is material misstated financial statements issued by publicly traded companies to intentionally mislead users of financial statements, particularly investors and creditors. For the capital markets to function efficiently and effectively, market participants, including investors and creditors, must have confidence in financial information disseminated to

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