Accounting lessons from Enron: fraud, aggressive accounting or the wrong conceptual framework?*

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Abstract

The paper argues that the lesson from Enron is that in capitalism ideology now subverts reality in accounting. That the underlying cause of Enron’s accounting was neither fraud nor aggressive accounting but the FASB’s ‘asset-liability accounting’ conceptual framework. The paper argues that this framework, rooted in the ideology of neo-classical economics, invites and encourages creative accounting. Part one contrasts the subjectivity of asset-liability accounting and its aim of decision-usefulness for the accounting issues raised by Enron - consolidated accounting, revenue recognition, fair value accounting and accounting for equity - with the objectivity of traditional accounting and its aim of holding management accountable for the stewardship of capital. Part two analyses Enron’s use of the subjectivity inherent in the asset liability framework to manipulate its accounts. It argues that Enron’s managers, accountants and auditors could and did use the ideas in the FASB’s asset-liability to justify its accounting. The paper concludes that the tight grip of the neo-classical ideology explains why the FASB’s proposed reforms of accounting for Special Purpose Entities (SPEs), central to Enron’s accounting manipulations and the fraudulent opportunities they provided, are unlikely to prevent future bouts of Enronitis.

“So far, Andersen has acknowledged its role in the [Enron] fiasco, while defending its accounting and auditing” (Edwards, 2002, p.8).

“The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities...at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates” (Enron Annual Report, 2000, p.36).

Commentators agree that Enron was the product of damnable but understandable human weakness when key individuals faced the wealth of avarice - the product of ‘greed’, ‘fraud’, the failure of ‘ethics’, or ‘aggressive accounting’ (the optimistic over-literal interpretation of accounting rules). The lessons they draw from Enron are tougher laws and more and better education and codes of conduct for management, accountants and others (e.g., Abdel-khalik, 2002; Demski, 2002, Lev, 2002, Benston and Hartgraves, 2002a, 2002b, Thomas, 2002).

The lesson drawn here is that the Enron experience reveals a problem at the heart of US accounting - with the FASB’s conceptual framework that encourages and legitimates creative accounting. At the centre of the Enron scandal are the US rules for consolidated accounting, but as these rules define what is and what is not an accounting entity - what is and what is not an ‘asset’ of the parent undertaking - they

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have profound effects on accounting for all transactions between undertakings. Enron used these rules to exploit ‘Special Purpose Entities’ (or Vehicles) (SPEs or SPVs) - businesses that it claimed it did not control and should not consolidate - to hide losses on its investments, to hide liabilities and to generate fictitious profits. On 16th October 2001 Enron announced its first losses for four years (Form-8K). Its accounts reported an unexpected non-recurring net of tax charge against earnings of $544 million. On the 17th October 2001 it announced the reversal of entries for assets and owners’ equity reducing both by $1.2 billion relating to transactions between Enron and its SPEs. This disclosure caught the attention of the Security Exchange Commission (SEC). On 22nd October 2001 Enron announced that the SEC was examining transactions between it and some partnerships owned by its Chief Financial Officer, Andrew Fastow, and fired him two days later. On 8th November 2001 Enron restated its accounts back to 1997, consolidating three previously omitted SPEs it had accounted for using the equity method and bringing additional losses of $591 million and liabilities of $628 million (Form 8-K, p.4) into its accounts. By the 28th November 2001 Enron’s shares had fallen to 26 cents a share. In February 2001 the market had valued Enron at $80 a share. In December 2001, Enron filed for bankruptcy, to date the biggest in world history. Enron did not go bust because it manipulated its accounts. Rather, as we shall see, Enron manipulated its accounts because it was going broke (Edwards, 2002).

What was the root cause of Enron’s accounting? We can rule out the ‘bubble story’ - that Enron’s accounting practices reflected the growth during the 1990s of ‘infectious greed’ - as there is no evidence that greed has increased. Thus, Enron’s accounting must have resulted from the failure of ‘gatekeepers’ - particularly accountants - to do the job the public expected (Coffee, 2002). The question, therefore, is how to explain the general decline in ‘earnings quality’ during the 1990s:

“[E]vidence suggests that something led to a general erosion in the quality of financial reporting during the late 1990s. During this period, earnings restatements, long a proxy for fraud, suddenly soared. To cite only the simplest quantitative measure, the number of earnings restatements by publicly held corporations averaged 49 per year from 1990 to 1997, then increased to 91 in 1998, and finally skyrocketed to 150 and 156, respectively, in 1999 and 2000” (Coffee, 2002, p.8).

Part of the explanation for this ‘spike’ of earnings restatements during the 1990s is the reduction in auditor liability for fraud resulting from various changes to the law; more relaxed regulation of accountants by the SEC; and the growth in executive stock options (Coffee, 2002). These factors may explain an increased desire of managers and accountants to reduce the quality of financial reporting. However, but the fundamental question is why US accounting principles and rules did not prevent it? The paper argues that Enron’s accounting shows just how deeply the capital markets view of value as economic value is embedded as the dominant ideology of US accounting. This idea underlies the conceptual framework of the FASB and its acolytes in the British Accounting Standards Board (ASB) and the International Accounting Standards Board (IASB). The paper argues that this ideology undermines accounting’s traditional stewardship or accountability role. The lesson drawn for accountants is the profound weakness of the FASB’s conceptual framework at the core
of which is its definition of an asset as an expected cash inflow. The paper argues that the ‘traditional’ definition of an asset as the recoverable cost of a controlled use-value would have prevented Enron’s accounting manipulations. However, the paper concludes that the Enronitis virus will never die. Evidence of its continued virulence is the FASB’s reforms in response to Enron’s accounting that, while they may prevent the specific practices used by Enron, will not prevent future outbreaks of Enronitis.

During the 1980s the FASB vigorously developed its asset-liability framework (completed in 1997) that became the official foundation of US GAAP (Zeff, 1999). The paper argues this framework underlies the deterioration of earnings quality in the 1990s and allowed Enron’s accountants “to bend the accounting rules to their advantage” (Benston and Hartgraves, 2002a, p.3). That it was because asset-liability accounting allows creativity that Enron’s accounting was “perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants” (Powers, Troubh and Winokur, 2002, p.31). That, within this framework, it is not “surprising that the accountants at Andersen, who should have brought a measure of objectivity and perspective to these transactions, did not do so” (Powers, Troubh and Winokur, 2002, p.31). We shall see that within the FASB’s conceptual framework Andersen could easily defend its accounting and auditing; could convince itself that Enron’s accounting was acceptable:

“Where were the auditors while all this was going on? The answer appears to be that they genuinely believed, or perhaps more accurately, succeeded in convincing themselves that Enron’s accounts met the requirements of US GAAP. …Evidence emerging from the various investigations of Enron shows that there was internal debate at Andersen about certain of the SPEs and that doubts were expressed about their accounting treatment” (Singleton, 2002, p.21).

The FASB’s conceptual framework could also explain “why a company with so many sophisticated executives believed they could get away with crassly deceptive practices” (Madrick, 2002, p.22). They believed they could because, consistent with explaining Enron’s accounting by a general cause,

“It seems that a great many others were doing the same thing. Why did Enron’s accountants and lawyers approve of these activities? Wall Street is now ridden with fears that other companies have overstated earnings because of similarly misleading accounting practices that were devised by the major accounting and law firms” (Madrick, 2002, p.23).

The paper argues that the cause of this outbreak of ‘Enronitis’ was the subjectivity inherent in the FASB’s conceptual framework. That Enron’s and other companies’ lawyers and accountants drew upon the ambiguity of asset-liability accounting to justify their overstatements of profits and understatements of risk.

Note that even if the authorities fully implemented traditional accounting the fundamental contradiction of capitalism between labour and capital would remain - i.e., ‘perfect’ accounting would not make capitalism work ‘perfectly’. The fundamental contradiction between economic value and labour value would still pervade the capitalist control relation (see: Bryer, 2002).
To draw the accounting lessons from Enron in part one the paper first contrasts the theoretical foundations of traditional and asset liability accounting. It then explains the traditional rules for consolidated accounts, revenue recognition, fair value accounting for financial instruments and accounting for equity, and contrasts these with the UK rules and US rules.\(^2\) In part two the paper first discusses the major problems with Enron’s SPE accounting and then analyses its accounting more generally (particularly revenue recognition and fair value accounting). It argues that although Enron’s accounting practices gave certain employees the opportunity to pursue apparently fraudulent ends,\(^3\) its accounting stemmed from and was ‘reasonable’ within the FASB’s asset-liability conceptual framework.

Benston and Hartgraves amongst others also “believe that US GAAP...are substantially responsible for the Enron accounting debacle” (2002a, p.16). However, they mean that Enron’s accounting was produced by the “highly specified US model” based on detailed rules and not its conceptual framework. They conclude that the US should adopt the approach of “UK GAAP, which requires auditors to report a ‘true and fair view’ of an enterprise’s financial condition is preferable” (Benston and Hartgraves, 2002a, p.16; see also, the FASB’s *Proposal: Principles-Based Approach to U.S. Standard Setting*, October 21, 2002). However, as the asset-liability framework also underlies UK GAAP on consolidated accounts and an increasing number of other areas of accounting, the paper argues it would not have prevented Enron’s accounting. As we shall see, in the UK as well as in the US the authorities have struggled with the subjectivity of the asset-liability framework to produce operational rules for consolidated accounting amongst many other issues. It is the difficulties the UK is having with this framework that underlies

> “The possible different interpretations of control and the difficulty of developing universal implementation guidelines [that has] led some to despair of control itself as the basis for consolidation because they believe it will never provide sufficient certainty about which entities should be included” (ASB, *Inside Track*, October 2001, Number 23, p.2).

Finally, a fundamental question is the likely impact of the Enron debacle on the rules of accounting. Whether the US authorities will drop its increasingly criticised asset-liability framework (see, for example, Storey and Storey, 1998; Zeff, 1999) and return to traditional accounting, or will engage in piecemeal reform with that framework? The FASB’s immediate response to Enron’s SPE accounting (FASB, 2002) suggests that the economics ideology is too strong for a revisionist revolution overthrowing the asset-liability framework. It concludes that the accounting lesson from Enron is that US accounting is a badly holed ship. That the only cure for Enronitis is traditional accounting. However, the manipulation of US accounts may be so big that coming clean could have unthinkable consequences for investor ‘confidence’.

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\(^2\) The FASB has been working on its ‘consolidations project’ for 20 or so years and the latest exposure draft proposes the UK approach (FASB, 1999).

\(^3\) To establish ‘fraud’ it is not enough to show that a person obtained something for nothing, or that a transaction was ‘unfair’ - for example, Fastow’s ‘management’ charges. The accuser must show that in obtaining the benefit the person broke the law, i.e., ultimately in this case, the rules of accounting.
Part One: Traditional versus asset-liability accounting

Financial reporting is the process of identifying, acquiring, processing and presenting financial information on the activities of businesses to investors and creditors - the providers of capital - to help them to pursue their economic interests. Accountants, regulators, and scholars agree that financial reporting should have a generally accepted ‘conceptual framework’ or ‘statement of principles’ - an agreed theory. This theory must accurately identify the economic interests of investors and creditors and tell us how to identify, acquire, process and present financial information on the performance and position of businesses. In short, we need a theory that tells us the objective or aim of financial reporting, and how to achieve that aim. If we know the objective of accounting we can devise appropriate methods of acquiring, processing and presenting financial information. As the Financial Accounting Standards Board (FASB) put it, “A conceptual framework is a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribe the nature, functions and limits of accounting and financial statements” (1976). However, while in 1894 Ernest Cooper said he knew the generally accepted meaning of the key “technical terms of his business”, today the theory of accounting is highly controversial. There are two completely different theories:

(i) The traditional theory. British judges and accountants developed this theory from the middle of the nineteenth century (Bryer, 1998). It underlies much generally accepted practice in the UK and around the world today. UK accountants call the traditional theory ‘accrual accounting’ or (incorrectly) ‘historical cost accounting’ (HCA). US accountants call it ‘revenue and expense’ accounting. In the late nineteenth century, Lawrence Dicksee, the first professor of accounting in England, called it ‘capital-revenue’ accounting (CRA).

(ii) The ‘asset and liability’ approach, derived from neo-classical economic theory, was developed in the USA in the 1960s by the American Institute of Certified Public Accountants (AICPA), and in the 1970s and 1980s by the FASB. The UK Accounting Standards Board (ASB) has adopted this approach. The ASB committed itself in its Statement of Aims to “Developing principles to guide it in establishing standards and to provide a framework within which others can exercise judgment in resolving accounting issues” (ASB, 1990). The ASB issued draft chapters of a Statement of Principles (SOP) in 1991, 1992 and 1993; published an exposure draft in 1995; issued a revised exposure draft in early 1999, and a final version in December 1999.

The traditional and asset-liability theories see different objectives for financial reporting. Traditional accounting comes from classical political economy. Its aim is

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4 Other groups or institutions may or do use financial accounts (e.g., government for taxes and statistics, labour for wage claims and employment prospects, customers for security of supply). However, other needs are subsidiary to those of investors and creditors, and are ignored here. Note that we use the terms ‘financial reporting’, ‘financial accounting’, and simply ‘accounting’ interchangeably to describe these activities.

5 In Cooper’s view, “it is not, I hope, presumptuous in a Chartered Accountant to claim an acquaintance with the technical terms of his business. If he does not know the meaning of such words as Capital, Revenue, Income, Loss and Profit, he is surely not qualified to practise a profession which deals so much with these terms” (Ernest Cooper, 1894, p.1037).
to report to investors and creditors on management’s stewardship of the capital invested in an enterprise. This means reporting on the sources and its uses of capital, its return, and its growth (profit) or its loss. The primary purpose is to hold management accountable to investors and creditors for the capital it controls by giving all providers of capital a factual and unbiased report. Investors and creditors give money or goods or services to companies, and they want to know that managers are accountable to them or their agents for the resources it controls. They want to know that managers devote their money or goods or services to the purposes of the business. Management must safeguard the assets and preserve their values. However, the providers of resources also (usually) want a return, usually cash dividends or interest payments. Shareholders and creditors therefore need financial information to tell them the surplus earned on their investments and to assess their security. To meet this need, as traditionalists have said in the UK since at least the middle of the nineteenth century, the aim of accounting is to give ‘a true and fair view’, a factual and unbiased report (Bryer, 1998).

Asset-liability accounting comes from neo-classical economic theory. According to its proponents, the purpose of financial reporting is to help individual investors and creditors make investment decisions. That is, to help them decide whether to buy, hold or sell financial securities, or to advance credit or loans and on what terms. In this view, investors and creditors need financial information to value businesses, to estimate what they are worth in the market. The aim of accounting is, therefore, to help investors and creditors predict the expected future net cash inflows to a business entity. Asset-liability accounting therefore defines ‘assets’ and ‘liabilities’ as actual and probable inflows and outflows of ‘future economic benefits’, future cash flows. All the other elements or parts of financial statements (for example, revenues and expenses, gains and losses) come from this fundamental definition of assets and liabilities.

The key idea in traditional accounting is stewardship or accountability. We therefore must be clear about what ‘accountability’ means, and what financial information is necessary to make management accountable to investors and creditors for the resources it controls. There are two meanings of the word ‘account’ of relevance to accounting. In the common modern sense it simply means ‘counting, calculation, reckoning’ - to ‘render an account’, to ‘narrate’, ‘to relate, recount, give an account of’ To be held accountable in this sense means the ‘accountant’ (i.e., management, on who the duty to prepare accounts is laid) must provide an objective calculation or reckoning - that is, provide ‘true and fair’ accounts. In another sense, to be accountable means the requirement ‘to explain, to answer for’ some behaviour, results, or state of affairs In this sense an accountant is ‘responsible’, held accountable, by being judged and then punished or rewarded. How does being accountable induce the manager to behave in investors’ and creditors’ interests, i.e., induce the manager to

7 ‘Objective’ measurement means reference to a material object or event, to a ‘thing’ external to the mind, as opposed to ‘subjective’ that refers to the mind of the subject. ‘Operational’ means that the measurer has specified the necessary measurement operations. We find both ideas in the broad idea of measurement accepted by scientists that is “defined as the assignment of numerals to objects or events according to rules” (Stevens, 1946, pp.677-78). These rules, of course, come from a theory or worldview (Kuhn, 1970). As it is not possible to ‘measure’ subjective states of mind, subjectivity implies non-operationality or vagueness.
control the business in their interests? How, in other words, does the duty to prepare accounts and be answerable for the results encourage managers to take the same decisions as the providers of capital would have? It does this simply because the manager expects investors and creditors to judge his or her behaviour and explanations. Thus, to satisfy investors and creditors and avoid punishment (e.g., loss of current and/or future income), managers must select behaviour it can justify to creditors and investors.

The traditional theory became the cornerstone of UK financial reporting from the middle of the nineteenth century when there was a rapid growth of joint stock companies with limited liability. For the first time on a large scale, the ownership of capital and its direct control was separated. Owners no longer ran their businesses, but began to invest in several different companies run by professional managers. This is why the key idea in traditional accounting is accountability for capital. ‘Capital’ was first in Ernest Cooper’s list of essential the ‘technical terms’ chartered accountants should understand. Dicksee called the theoretical chapter II of his book Advanced Accounting (1916) ‘capital and revenue’.8 The word ‘capital’ derives from the Latin capitalis, the substantive meaning of which was “head” or “chief”. In accounting, therefore, it means the “chief sum of money dealt with in a particular business” (Cannan, 1921, p.469). Capital is the most important money in a business because management must recover it before there is any surplus. The traditional objective of accounting is, therefore, to report on the movements of this money into, through, and out of the enterprise. Traditionalists such as UK GAAP call the movement of capital through these phases the enterprise’s ‘operating cycle.’

![Diagram of the enterprise operating cycle]

The operating cycle starts when investors and creditors provide money (M) or its equivalent.9 Management spend this money on the necessary means of production

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8 By ‘revenue’ Dicksee meant what today we would call ‘profit’.
9 Investors and creditors may also provide capital commodities, e.g., supply the means of production instead of money capital.
(mp) and labour (L), produce commodities or services (C′) and sell them to recover the money originally advanced with a profit (M′). The profit (after any interest) is M′ - M = m. Management distribute profit to investors or reinvest it in the enterprise.

If we stop the cycle and count what capital entered the business, what capital is in production, what exists as commodities ready for sale, and what is available for distribution or reinvestment, we will get a balance sheet and profit and loss account. To traditional accountants a balance sheet is a statement of the sources and uses of capital at a point in time, and a profit and loss account is a statement of the net change in capital for the period. Traditional accountants measure the change in capital for a period as ‘revenues’ minus ‘expenses’.

The Institute of Chartered Accountants in England and Wales (ICAEW) explained the traditional view to the Jenkins Committee on Company Law:

“[T]he primary purpose of the annual accounts of a business is to present information to the proprietors, showing how their funds have been utilised and the profits derived from such use. It has long been accepted in accounting practice that a balance sheet is prepared for the purpose of historical record and not a statement of current worth. Stated briefly its function is to show in monetary terms the capital, reserves and liabilities of a business at the date as at which it is prepared and the manner in which the total moneys representing them have been distributed over the several types of assets. Similarly a profit and loss account is an historical record. It shows as the profit or loss the difference between the revenue for the period covered by the account and the expenditure chargeable in that period, including charges for the amortisation of capital expenditure” (1962, p.130).

The ICAEW made clear this view of balance sheets and profit and loss accounts was fundamental to holding management accountable for the capital they controlled. It was necessary to “reduce…to a minimum the extent to which the accounts can be affected by the personal opinion of those responsible for them (ICAEW, 1962, p.130). A House of Commons Select Committee, the ‘Sandilands Committee’ made the same point in 1974. It was, it said, a “traditional tenet of accounting that the main objective of published financial statements is to enable the directors to give an account of their stewardship of the shareholders’ funds to the shareholders”. It did not refer to “the shareholder’s role as an investor” (1975, p.44). Both the ICAEW and the Sandilands Committee were sure, contrary to the asset-liability view, that the ‘current worth’ or economic value of the business was not a primary concern.

The traditional definitions of the elements of financial statements follow from its accountability objective. Investors and creditors can only hold management accountable for what it controls.10 If we stop the cycle of capital, some capital will be in use as:

(i) money or enforceable claims to money (e.g., cash, marketable securities, debtors), or as

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10 Either actually controls or potentially controls in the sense that the ability to control currently exists.
(ii) *the cost of the means of production* (e.g., stocks of raw materials, work-in-progress, fixed assets), that is, the cost of the ‘service-potentials’ or ‘use-values’ \(^{11}\) necessary to produce commodities or services for sale, and, for a manufacturing company,

(iii) *finished commodities awaiting sale* (finished stocks).

For the cycles of capital to continue, management must recover the claims to money, the cost of the means of production, and the cost of the finished stocks. Thus, traditional accountants recognise an ‘asset’ when management controls money, enforceable claims to money, or use-values (service-potentials) whose costs it has evidence it can recover. This definition yields objective and operational definitions of all other elements of financial statements - liabilities, revenues, expenses, gains and losses (Bryer, 1998). The paper explains the traditional approach to the issues raised by Enron’s accounting below. First, we must understand the FASB’s conceptual framework that the paper argues made it possible.

*Asset-liability accounting*

In developing its conceptual framework the FASB reviewed the US literature on the fundamental nature and purpose of accounting. It found two schools of thought. One, it dubbed asset-liability accounting, argued that income was an “increase or decrease in wealth or capital (net resources) of an enterprise during the period” (FASB, 1976c, p.37). The other school, based on traditional US practice, argued that profit was the difference between revenue and expenses for the period. To choose between these viewpoints the FASB turned to what it called the economic theory of “Business Enterprises in a Money Economy”. In this theory business corporations raise money from individuals who wish to “invest cash saved to bring in more cash in the future” (FASB, 1976, p.17). According to this theory the investment decisions of individuals and businesses are essentially the same - simply the investment of money to obtain more money. As the FASB put it,

> “although economic activities are more complex than investments and loans by investors and lenders, investment in earning activities and resources by a business enterprise is essentially the same as other investments” (1976, p.46).

Thus, the FASB concluded, financial accounting should ideally provide investors and creditors with economic valuations based on cash flow forecasts. As it said,

> “In the purest or ideal form of accrual accounting, sometimes called direct valuation, each noncash asset represents future cash receipts, each liability represents expected future cash outlays, and each revenue and expense represents a change in an asset or liability or a current cash receipt or outlay” (1976, p.54).

By ‘direct valuation’ the FASB meant calculating the present value of expected future cash receipts and using these values to calculate income. This is idea comes from neo-

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\(^{11}\) ‘Use-value’, or ‘service-potential’, or ‘services’, is whatever it is about an object or service that makes it useful to the enterprise. For example, the ‘use-value’ provided by an aeroplane is the number of hours flying time it will provide.
classical economics - for example the view that an individual’s income is “the maximum value which [a person] can consume during a week and still expect to be as well-off at the end of the week as he [sic] was at the beginning” (Hicks 1948, p.172). In this theory, we measure ‘well-offness’ as the present value of expected cash flows discounted at the risk-adjusted required return, and income as the difference between the present value at the beginning and the present value at the end of the period (after adjustment for capital injections and withdrawals).

Like the FASB, the ASB thinks that what investors primarily want from accounts is information useful in making economic decisions. That is, useful for predicting the size, timing, and risk of the future cash flows investors and creditors will receive from an enterprise. The ASB has accepted this as the primary purpose of accounting from the beginning of its quest for a conceptual framework. As it said in 1991, “The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation” (ASB, 1991, para.15). In other words, the primary role of accounting is to help investors and creditors predict an enterprise’s risk and return - so they can decide whether to hold, buy, or sell its securities. As the ASB put it in 1995,

“Information about the economic resources controlled by the enterprise and its capacity in the past to modify these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future” (para.16).

“Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future” (para.17).

Whereas traditional accounting reports past results, the ASB’s framework emphasises future results. It appeared to follow, as Page said, that the objective of “decision usefulness…conflicts with accountability and stewardship reporting” (1992, p.80). However, the possibility of a conflict was not considered by the ASB because, as Page said of the first exposure draft, although “The ASB mentions stewardship…[it] dismiss[es] it as part of economic decision making” (Page, 1992, p.80). While chapter 1 of the 1995 SOP was “revised to include a specific reference to the use of financial statements for assessing the stewardship of management” (ASB, 1995, p.9), the ASB still understood this to mean only usefulness for investment decision making. In the ASB’s view,

“Stewardship in this context is the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship of management do so in order to make economic decisions; for example, whether to hold or sell their investments in the enterprise or whether to reappoint or replace the management” (1995, para.1.1).

“The economic decisions that are taken by users of financial statements require an evaluation of the enterprise’s ability to generate cash and the timing and certainty of its generation…. Evaluation of the ability of an enterprise to generate cash is assisted by focusing on the enterprise’s financial position,
performance and cash flows and assessing financial adaptability” (1995, para.1.9).

Traditional accountants were not happy with this understanding of stewardship. Fearnley and Page saw it creating a “division between those who see the purpose of financial statements as taking economic decisions about the future, and those who see it as a basis for making management accountable” (1996, p.94). As they said, the ASB “attempts to adopt and economist’s measure of income as the increase in a company’s ‘well-offness over an accounting period” (Fearnley and Page, 1996, p.94). Or, as Paterson put it,

“By switching the focus to the future rather than the past, the company’s results are no longer to be reported as they unfold: instead, guesses about future results are impounded into today’s balance sheet, making the outcome more like a valuation model than a report on the outcome of an expired period” (1998b, p.90).

The ASB has nevertheless retained their decision-making interpretation of stewardship. In the ‘Technical Supplement’ to the March 1999 SOP the ASB comments that “At first sight these objectives - assessing stewardship and making economic decisions - might seem mutually exclusive” (1999b, p.12). However, in its view they are not mutually exclusive, i.e., inconsistent, they are the same. “Existing investors, for example, assess management’s stewardship in order to decide whether to seek a change in management or to change the level of their investment in the entity” (ASB, 1999b, p.12). Traditional accountants agree that stewardship is “not merely about the safekeeping and proper use of an entity’s resources but also about their efficient and profitable use” (ASB, 1999b, p.12). They disagree, however, about the meaning of profitability and the meaning of stewardship. In the final version this footnote is placed in the main text, and stewardship could be read as the primary objective.

“In its stewardship role, management is accountable for the safekeeping of the entity’s resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role. They are also interested in information that is useful in taking economic decisions about their investment or potential investment in the entity” (ASB, 1999d, para.1.3 (a)).

However, the ASB still claim that

“all the purposes involve taking informed economic decisions. Even present investors assessing the stewardship of the entity’s management do so in order to decide whether, amongst other things, to hold or sell their investment in the entity and to reappoint or replace the management” (ASB, 1999d, para.1.4).

Certainly, investors deciding whether or not to hold or sell their investments and to reappoint managers or not, is part of the process whereby managers are held accountable - part of the final process of punishment and reward. However, this does not mean that market discipline is sufficient for accountability. In traditional
accounting profitability is an objective report of the results of past transactions and events, and the purpose of assessing stewardship is to influence manager’s behaviour before reporting the profitability of the enterprise. Managers know they must report in the future on the results of their actions today. Thus, in the traditional view, the effectiveness of accounting in promoting stewardship is its impact on the behaviour of managers before reporting. Sacking managers for poor profitability represents a failure of the accountability process to achieve the desired results. By contrast, in the ASB’s framework sacking managers or selling shares is the essence of accountability. In the traditional framework, accountability starts from and depends upon objective measurement of desired outcomes.

Supporters of the ASB sometimes claim that managers would be just as accountable using its economic measure of profitability. That is, management would also choose appropriate actions in anticipation of future-oriented financial reports (see, for example, Lewis and Pendrill, 1996, p.4). However, the difference is that the ASB’s framework measures profitability as the change in current and future cash flows. Forecast future cash flows are subjective. It is not possible to hold management accountable for subjective expectations of the future, but only for objectively measurable outcomes of the past. As Fearnley and Page said,

“Accountability and the ASB’s decision usefulness are not compatible. Forward-looking decisions require forecasts of future cash flows, which in the economic model are what determines the value of assets. These values are too subjective to form the basis of accountability” (1996, p.94).

Only by being held accountable for the things it controlled in the past is management accountable for the things they control in the present, and only in this way does accounting influence the future. The ASB does not mention the traditional idea of accountability. The FASB, however, admits that in its vision of accounting financial reports cannot hold management accountable in the economic sense (1978, para.53). As it says, an enterprise’s economic value is the joint product of managements’ behaviour (decisions, actions, inactions) and the state of the environment (particularly, expectations of the future). It admits that it is impossible to distinguish management’s specific contribution to economic value. Certainly, we can contrast an entity’s share price performance with that of its sector, but this still leaves us with a forecast for the entity as such, not management’s contribution. Even if the market has specific expectations about management’s contribution we cannot hold it accountable for subjective expectations; only for its performance against the market’s requirements. Traditional accounting, by contrast, gives the market an objective record of an entity’s results it can use to identify management’s contribution to the realised return on capital by comparing one enterprise with other enterprises sharing the same environment. Other things being equal, the residual returns are attributable to management’s behaviour. Thus, insofar as the ASB’s SOP allows management subjective choice in accounting it will be to that extent less accountable for its performance.

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12 This may explain why share analysts compare companies with sector averages, and why comparability of accounts is the goal of the International Accounting Standards Committee (IASC, 1998, p.45).
In what follows the paper argues that the accounting issues raised by Enron illustrate how the subjectivity of asset-liability accounting undermines management’s accountability to investors. That whereas traditional accounting would have held Enron’s management accountable for the capital it controlled, the asset-liability approach allowed it the discretion that part two argues underlay Enron’s creative accounting.

**Accounting issues from Enron**

In part two the paper argues that Enron used five main practices to flatter its accounts:

(i) not consolidating controlled SPEs to hide losses and debt and reporting revenue by selling investments to controlled SPEs;
(ii) recognising current revenue on contracts for future services;
(iii) fair value accounting for commodity contracts as ‘financial instruments’;
(iv) accounting for loan notes as assets exchanged for Enron’s equity and accounting for debt as equity.

The general accounting issues raised by these practices are consolidated accounting, revenue recognition, fair value accounting for financial instruments and accounting for equity. In the remainder of part one the paper explains traditional accounting for each issue and contrasts it with asset-liability accounting. In part two the paper argues that Enron’s management and accountants could and did draw upon the asset-liability framework to justify its practices in each of these areas.

**Consolidated accounting**

A fundamental principle of traditional accounting is that management must account to investors for all the capital it controls. Control is essential to the traditional definition of an asset as money, enforceable claims to money, or the recoverable cost of controlled use-values. Management must account regardless of how it controls assets or the form the asset takes. The most common way management controls capital is by exercising the legal rights of ownership of an individual joint stock company, but management can control capital by various other forms of legal and informal agreements. Joint stock companies are legal entities with ownership rights that management, as the legally appointed agent, exercises in investors’ interests. If the management of one company buys the equity capital of another company it must account for the capital it controls through the investment like any other assets. Investments might be short-term to earn a return on temporarily surplus money or long-term to earn a return on the capital. Long-term investments range from passively held non-controlling stakes, through jointly controlled ventures, to actively-managed controlling interests.

Equity investments are assets in the investor company’s accounts if they provide management with controlled use-values (services) and there is objective evidence (e.g., market prices) that it can recover their cost. The primary use-value of an equity

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13 Although we will focus on inter-company equity investments, the same principles of accounting apply to “undertakings” of any legal form, for example, investments in partnerships or unincorporated associations.
investment is the enforceable claim it gives management over its entity’s share of the investee’s capital and profits. Equity investments also usually give rights to vote at board AGMs, board meetings, etc. If the investee undertaking makes profits and retains them and management has evidence – particularly the investment’s market price – it will recover these profits (through dividends or sale of all or part of the investment), their retention by the investee increases the cost of the investor’s investment as they are current dividends foregone. Management of the holding company must therefore account for dividends from the investee as a return of its investment and deduct them from its carrying value. Because this method measures the value of the investor’s share of the net assets - its share of the equity capital of the investee - accountants call it the equity method. If management can recover the capital it must account for all investments as assets in the holding company’s individual accounts using the equity method.14

However, if through holding the majority of voting rights (or by other means, e.g., legal agreements) the holding company’s management can control the investee entity itself, it must account for all the investee’s capital because now, in addition to the use-values of the investment, it also controls the entity’s operating and financial policies - its overall strategy, its financial targets and control systems; its dividend, investment and financing decisions; its marketing, production and personnel policies, etc. When the management of one entity (the ‘parent’) controls the capital of another company (the ‘subsidiary’) the parent company’s management must produce combined or ‘consolidated’ accounts for all the capital of both as though they were a single entity - the ‘group’. To hold the parent’s management accountable to investors for all the capital it controls it must prepare full (or ‘global’) consolidated accounts that combine the parent’s and all the subsidiary’s assets and liabilities and profits or losses even though it may not own them all.

If a parent’s management does not account for the capital of subsidiary entities it can engage in ‘off balance sheet finance’ (use ‘off balance sheet vehicles’). Using the equity method management can remove debt that should appear in the consolidated balance sheet by having the subsidiary borrow it, and report a lower gearing ratio and a higher rate of return on total capital by taking credit for the profits the subsidiary earns on the capital but not all the capital it controls. As Benston and Hartgraves say, “The company that can use the equity method, and avoids consolidation, is often able to improve its debt-to-equity ratios, as well as ratios for returns on assets and sales” (2002b, p.3). Furthermore, just as the management of one part of a company cannot make profits by trading with another part of the same company, so the management of a controlling entity cannot make profits by trading with a controlled entity. Management must cancel out all unrealised profits on internal trading transactions within a group at the balance sheet date. It follows that non-consolidation of controlled entities also allows management to generate false revenue and to hide losses by requiring controlled undertakings to purchase assets.15 As we shall see in part two,

14 Perhaps because it allows British management to inflate the profits it reports from selling its investments, UK rules require the cost method in the parent’s accounts. Under UK law only the parent pays dividends from its distributable reserves. Arguably, these regulations were elements of the wholesale loosening of the regulatory framework of accounting accompanying the major restructuring of UK industry during the 1970s and 1980s requiring many firms to pay dividends from capital (Bryer and Brignall, 1978, Bryer, 1997).

15 US rules require only proportional elimination when management use equity accounting.
management’s use of equity accounting for off balance sheet vehicles to hide controlled subsidiaries and generate spurious revenues and profits was at the heart of the Enron accounting scandal.

Under traditional accounting a subsidiary is an entity whose parent controls its operating and financial policies. The parent’s management is accountable for all the capital it controls whatever its ownership interest in the subsidiary and regardless of whether other economic benefits accrue to the parent from its control - e.g., from its investments, from sharing resources, eliminating duplication, giving access to markets, etc. Usually, ownership of more than 50% of votes gives control, but ownership is not necessary for control because the management of two entities can make formal or informal agreements giving one control of the operating and financial policies of the other. Traditional accountants do not insist on an equity interest to determine control. For example, the ICAEW’s memorandum to the Cohen Committee - whose recommendations introduced the UK’s first legal requirement to produce consolidated accounts in the Companies Act 1947 - proposed a definition of a holding company based on beneficial share ownership, but also included “power in relation to…any…company whether it holds shares in that other company or not” (Cohen Committee, 1944, p.392). In the ICAEW’s view “the factor of control is all important” (Cohen Committee, 1944, p.391). Just as the management of an individual company is the agent or trustee of its current and future investors without owning any significant amount of its capital, so the management of one entity can be the agent or trustee of another that has no ownership interest in that entity. In the same way that the trustee in a trusteeship has the power to deploy the trust’s resources whilst the beneficiaries benefit from their deployment, so the management of one company could contract to manage for a fee the capital of another company for the benefit of that entity’s investors.

The traditional idea of control underlies the UK Companies Act 1989. However, the ASB has used its Statement of Principles to implement the Companies Act (in FRS2: Accounting for subsidiary undertakings (1992) and FRS5, Reporting the substance of transactions) and has undermined the traditional view. As we shall see later, although the US authorities appear to believe the UK’s approach to financial reporting would prevent another Enron, Enron could have happened under UK rules.

**Asset-liability accounting for groups: lessons from the UK**

The aim traditional of accounting is management’s accountability for capital. The aim of asset-liability accounting is ‘decision-usefulness’ - helping investors make their investment decisions. It therefore defines assets as ‘control of probable future economic benefits’. This view has profound consequences for defining the accounting entity. Traditional accounting defines it solely in terms of control of operating and financial policies, but under asset-liability accounting “In principle ownership and control are alternative criteria for determining which enterprises are part of a group” (ASC, 1990, para.6). In other words, ownership and control are alternative ways of defining to whom management is accountable for future economic benefits. As the 1995 draft of the ASB’s Statement of Principles put it,

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16 The ICAEW limited the power to that directly or indirectly over 50% of the voting capital or to appoint the majority of directors.
“There are two opposing perspectives for accounting for subsidiaries: one perspective concentrates wholly on ownership (a proprietary view) and the other on the group as an entity, unified and encompassed by the parent’s control (an entity view”).

“A proprietary view regards ownership and the resulting access to benefit as of paramount interest to users and, therefore, as providing the basis of consolidated financial statements. Taking this view leads to proportional consolidation (the line-by-line consolidation of the investor’s share of each item). On a strict proprietary view, the investor’s influence over its investee is irrelevant to financial reporting….”.

“On an entity view, the parent’s ability to control its subsidiaries is all-important, regardless of the size of its ownership interest in the activities of the entity that it directs. The consolidated financial statements therefore consolidate in full the assets and liabilities of any entity that the parent controls” (ASB, 1995, para.7.18).

Within the asset-liability framework management is ‘accountable’ for the future economic benefits of the subsidiary. However, it gives us no basis for choosing the entity concept except management’s judgement about their ‘relevance’. It is, therefore, not surprising that “In accounting theory [i.e., the asset-liability framework] it has never been clear whether consolidated accounts should include assets controlled by the parent (the ‘entity’ approach) or only those from which the parent shareholders derive benefit (the ‘ownership’ approach)” (1990, p.88).

In contrast to the objectivity and operationality of the traditional criterion of control, attempting to hold management accountable for future economic benefits creates the problem of defining ‘control’ that the asset-liability framework poses but cannot resolve. The ASB’s Statement of Principles agrees with traditional accounting that

“the reporting entity is determined by the scope of its control…. [I]f the information provided by financial statements is to be useful, the entity that is the subject of the financial statements (the reporting entity) needs to be a cohesive economic unit. This assures accountability - the reporting entity is held to account for all the things it can control - and gives the reporting entity a determinable boundary - because activities and resources are either within its control or outside its control” (1999, chapter 2, Principles, para.2.3).

However, according to its Statement of Principles management must consolidate an undertaking only if is an ‘asset’ defined as ‘rights or other access to future economic benefits controlled by the entity as a result of past transactions or events” (ASB, 1999, para.4.6). This definition of an asset causes difficulties in defining control because the phrase ‘access to future economic benefits controlled’ is ambiguous. It could mean that management must control the ‘rights or other access’ to future economic benefits, or it could mean that it must control the future economic benefits themselves.17 As

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17 The ASB models its definition of an asset on the FASB’s definition - ‘probable future economic benefits obtained or controlled by a particular entity’ - and the same problem arises.
management cannot control the future, usually the ASB means controlling access to future economic benefits. It says that “Capacity to obtain future economic benefits is the essence of an asset” (ASB, 1999, para.4.13), and it often means by this what traditional accountants mean by control, control of use-values. For assets in general these include, for example, “the ability to use the item of property, to sell or exchange it or exploit its value by, for example, pledging it as security for borrowing” (1999, para.4.9); “the right to require others to make payments or render services and the right to use a patent or trade mark” (1999, para.4.11).

Sometimes, however, the ASB defines assets as control of the future economic benefits themselves. Although this looks similar to the traditional test that management must have objective evidence it will recover the cost of the asset, the ASB has a much wider notion of ‘future economic benefits’ that it defines as probable expected future cash flows. Within its framework, for example, advertising expenditures could be assets if they gave access to sufficiently probable future cash flows, whereas in traditional accounting they are never assets because management controls no use-values. The ASB applies the notion that an asset is a probable future cash flow to the problem of defining when one entity controls another. It says that

“An entity has direct control of an asset if it has the ability in its own right to obtain future benefits embodied in that asset and to restrict others’ access to those benefits” (1999, para.2.4, emphasis added).

The current ability to ‘obtain future economic benefits’ ‘embodied’ in an asset implies that management currently controls these future economic benefits. Thus, in the asset-liability framework

“Control has two aspects: the ability to deploy the economic resources involved and the ability to benefit (or to suffer) from their deployment. To have control, an entity must have both of these abilities” (ASB, 1999, para.2.8).

“An entity will have control of a second entity if it has the ability to direct the entity’s operating and financial policies with a view to gaining economic benefit from its activities” (ASB, 1999, para.2.11).18

By the ‘ability to deploy’ and ‘ability to direct’ the ASB means the traditional idea of control of the undertaking’s operating and financial policies. The ‘ability to benefit’, however, means the ‘ability to obtain future economic benefits’, i.e., ‘control’ of future economic benefits. The ASB therefore effectively requires consolidation when management thinks it ‘controls’ all of an undertaking’s future economic benefits. As the ASB put it in a previous draft of the Statement of Principles,

“A subsidiary operates as an extension of the activities of its parent and thus the parent has an interest in the whole of the economic benefits arising from the subsidiary’s activities” (1995, para.7.5, emphasis added).

18 IAS27: Consolidated Financial Statements and Accounting for Investments in Subsidiaries also defines control as “the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities” (IASC, 1994, para.6).
This is why, unlike under traditional accounting, the ASB distinguishes ‘control’ from management:

“Control needs to be distinguished from management. If an entity manages a second entity on its own behalf (ie it expects to benefit from the net assets of the second entity other than merely receiving a management fee) then it controls the second entity…. A fee structure that in substance amounts to an interest in the net assets of the entity is treated as an ability to benefit (or to suffer from the deployment of those net assets (sometimes referred to as an equity interest), whatever it is called” (ASB, 1999, para.2.19).

“On the other hand, if an entity manages the second entity on behalf of another party, it is not exposed to the benefits arising from, or risks inherent in, the activities of the second entity because the manager’s interest in the managed entity is normally limited to its fee…and therefore does not have control of the second entity” (ASB, 1999, para.2.20).

In traditional accounting management is a trustee or agent of investors having no necessarily direct interest in the economic benefits it generates. However, the ASB’s notion of control attempts to retain the idea of economic incentive associated with ownership. From the asset-liability perspective, as ED50 put it, “if there are no benefits, or if those benefits are very limited, there is no purpose to the exercise of control” (ASC, 1990, para.10 (a)). By contrast, in traditional accounting management’s purpose in exercising control is to make the maximum return on capital because its is for this that management is accountable to investors.

The ASB recognises that in practice management can never control future economic benefits, but only ‘influence’ them, albeit perhaps to a high enough degree to justify calling it ‘control’. In chapter 8 of its Statement of Principles it says that - unlike in traditional accounting where management either controls operating and financial policies or it does not - ‘control’ is just a high form of management’s ‘influence’ over future economic benefits, and that levels of ‘influence’ vary:

“Although an entity’s interest in a second entity may take different forms, the key factor in determining its effect on the first entity’s performance and financial position is the degree of influence it exerts over the operating and financial policies of the second entity involved.

The highest degree of influence that an entity can have over an investee is control. …[C]ontrol comprises the ability to deploy the economic resources and to benefit (or to suffer) by their deployment. Other degrees of influence have these same aspects; in effect, the ability to influence the activities of the investee with a view to gaining economic benefits from that influence. …[I]t is possible to classify the degree of influence that an entity has over its investee in an almost infinite number of ways” (ASB, 1999, paras.8.1, 8.2, 8.3, 8.4).

Under traditional accounting management either controls the operating and financial policies of another entity (albeit shared control) or it does not, and it consolidates the entity (fully or proportionally) or not, and in its individual accounts it accounts for all
investments using the equity method. By contrast, in the ASB’s framework management has “almost infinitely” varying degrees of influence over the future economic benefits (1999, para.8.4). The ASB therefore only requires equity accounting when the holding entity’s management has a ‘significant influence’ and only in the consolidated accounts. Unfortunately, the ASB leaves open how to objectively identify and measure ‘the highest degree of influence’ that it calls ‘control’ over an entity’s future economic benefits. It does not explain what, exactly, the ‘highest degree of influence’ is that tips the balance to ‘control’ from ‘significant influence’.

FRS2 anticipated the definition of control in the Statement of Principles. It defines control as “The ability of an undertaking to direct the financial and operating policies of another undertaking with a view to gaining economic benefits from its activities” (ASB, 1992, para.6), as had ED50 (ASC, 1990) and FRS5 (ASB, 1994). According to FRS2’s notion of ‘accounting control’ the tests in the Companies Act 1989 are not perfect (ASB, 1992, para.62) and it sets about interpreting them using the asset-liability framework. It reveals the subjectivity of the asset-liability notion of control when it applies this to the ‘actual exercise of a dominant influence’ and ‘unified management’ tests in the Companies Act, and to ‘quasi-subsidiaries’ in FRS5. As we shall see in part two, Enron’s SPE accounting fitted easily within these rules.

The Companies Act 1989 does not define the “actual exercise of a dominant influence” without a control contract, but it does not restrict it to a legal right. FRS2 defines it as effective control of the operating and financial policies of the undertaking and its exposure to economic risks and rewards:

“[the] exercise of an influence that achieves the result that the operating and financial policies of the undertaking influenced are set in accordance with the wishes of the holder of the influence and for the holder’s benefits whether or not those wishes are explicit. The actual exercise of dominant influence is identified by its effect in practice rather than the way it is exercised” (ASB, 1992, para.7).

Certainly, the main thrust of this definition is that it “focuses upon the influencer’s impact on the influencee’s operating and financial policies” (Simmonds, Mackenzie and Wild, 1992, p.8). That is, it focuses on the traditional definition of control as control of the operating and financial policies, or use-values of an undertaking. As Simmonds, Mackenzie and Wild say, “The first sentence implies a total ability to control what policies are set” (1992, p.9); that the influencee sets policies ‘in accordance with the wishes of the holder of influence’. However, the last bit of the first sentence, that the holder of influence ‘benefits whether or not those wishes are explicit, and

“the latter sentence makes judgement subjective since the assessment is of the behaviour of the influenced management, and why they have adopted particular operating policies” (Simmonds, Mackenzie and Wild, 1992, p.9).

If the holder of influence does not make his or her wishes known we must subjectively judge whether the management of the influencee behaved in the way it did to pursue
the economic ‘benefit’ of the influencor, or for other reasons. Identifying the actual exercise of a dominant influence by its ‘effect in practice rather than the way it is exercised’, that is, by the exposure of the influencor to the risks and rewards of ownership. Clearly, FRS2’s test for the actual exercise of a dominant influence is “inevitably a subjective test” (Chopping, Carroll and Skerratt, 2001, p.669). Not surprisingly, in the UK “The interpretation of the term ‘actual exercise of a dominant influence’ has proved to be most difficult in practice, principally because of the degree of judgement involved” (PricewaterhouseCoopers, 2000, p.21040). Long before Enron UK accountants worried that this subjectivity “might be seen as an opportunity…to manipulate profit or gearing” by including and excluding subsidiaries on the grounds that the parent did or did not actually exercise a dominant influence (PricewaterhouseCoopers, 2000, p.21042).

The Act does not define “managed on a unified basis”, but to traditional accountants it simply means management control. FRS2, however, defines it as where

“the whole of the operations of the undertakings are integrated and they are managed as a single unit. Unified management does not arise solely because one undertaking manages another because this may not fulfil the conditions that the undertakings are integrated” (ASB, 1992, para.12).

Traditional accounting consolidates managed companies based on objective evidence of control. By contrast, as PricewaterhouseCoopers said, “The application of an overall definition in practice will, as for dominant influence require considerable judgement” (2000, p.21044). In contrast to the traditional approach, the ASB thinks that because “Unlike a parent, a manager operates within guidelines or goals set by another, even if these are very general” (1995, para.7.15), management should not consolidate simply because it controls an undertaking’s operating and financial policies because it does not ‘control’ the future economic benefits of all of the net assets. This may be why the ASB seems to require ‘unified management’ at all levels - the full integration of all operating and financial policies so that management can justifiably claim to be exposed to the risks and rewards of ownership - of controlling all the entity’s future economic benefits. However, as Paterson said,

“This is a very narrow interpretation. There can be few arrangements where the whole of the operations of two undertakings are integrated, and it would therefore be easy for a company to escape this definition by keeping are part of two otherwise integrated businesses separate. As a result, this aspect of the definition is unlikely to be of any value as an anti-avoidance measure in relation to off balance sheet finance. However, this will make little difference. It can seldom be the case that two businesses are integrated yet dominant influence is absent” (1993, p.28).

However, as we have seen, applying the ASB’s ‘actual exercise of a dominant influence’ test is subjective.

Where one undertaking controls another but is not a parent under the rules of the UK Companies Act, FRS2 calls the controlled undertaking a ‘quasi-subsidiary’. The ASB discusses quasi-subsidiaries in FRS5: Reporting the economic substance of
transactions (1994). It defines them as those entities that are “directly or indirectly controlled by the reporting entity and gives rise to benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary” (ASB, 1994, para.7). These are the UK’s ‘rules’ for accounting for Enron-type SPEs.

SPEs are business entities formed for a specified activity such as the construction of a gas pipeline or the purchase of a specific bundle of debtors. Historically, SPEs began as joint ventures between a sponsoring company and a group of outside investors limited by their charters to specified, ‘special’ activities. These charters often required any cash flows from the SPE to go only to the investors and not to the sponsoring company for any other purpose. SPEs spread to the financial services industry during the 1970s and 1980s where they are now the most common use in the asset-based securities and synthetic lease markets (Dharan, 2002). After synthetic leases, the 1990s saw companies like Enron using SPEs for all types of ‘financial assets’ “such as long-term commitments to buy or sell energy (energy derivatives), broadband capacity, metals and mineral rights, etc.” (Dharan, 2002, p.9).

We discuss the US rules for SPEs that allowed Enron’s accounting below. Other than the provisions of FRS2 on the actual exercise of a dominant influence and those of FRS5 on quasi-subsidiaries, the UK has no rules specifically governing SPEs. The IASB issued Interpretation SIC - 12: Consolidation - Special Purpose Entities in June 1998. In SIC 12 the IASB defines SPEs:

“An entity may be created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitisation of financial assets). Such a special purpose entity (“SPE”) may take the form of a corporation, trust, partnership or unincorporated entity. SPEs are often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so-called “autopilot”)” (IASB, 1998, para.1).

“The sponsor (or enterprise on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains rights to use assets held by the SPE or performs services for the SPE, while other parties (‘capital providers’) may provide funding to the SPE. An enterprise that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE” (IASB, 1998, para.2).

Sponsoring companies form an SPE by investing in a business entity along with other investors and transferring assets to it. If the sponsoring company does not control the SPE it can book the transfer of assets to the SPE as a sale any debt raised by the SPE will stay off its balance sheet. In practice, in the US management has set up two interrelated SPEs to prevent creditors having access to the sponsoring company’s assets if the SPE becomes bankrupt:
The key accounting issue is whether the sponsoring company management controls the SPE. As SIC 12 says, “An SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise” (IASB, 1998, para.8). The IASB pays lip service to the asset-liability idea that control of operating and financial policies is insufficient without an exposure to the risks and rewards of ownership. However, it allows the traditional view that control is control of the SPE’s use-values to “indicate a relationship in which an enterprise controls an SPE and consequently should consolidate the SPE” (1998, para.10):

(a) in substance, the activities of the SPE are being conducted on behalf of the enterprise according to specific business needs so that the enterprise obtains benefits from the SPEs operation;

(b) in substance, the enterprise has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an ‘autopilot’ mechanism, the enterprise has delegated decision-making powers.

In short, as under traditional accounting, management should consolidate an SPE if it controls its usefulness to the sponsoring entity.

**Revenue Recognition**

Revenues are the lifeblood of business enterprises. With no revenues, there are no profits. With no profits there is no business enterprise. Traditional accountants define revenue as the increase in capital controlled by management over a period of time from transferring the use-values of goods and services to customers in exchange for cash or an enforceable claim to cash (or equivalent). Revenues arise at the end of the cycle of capital when, as traditional accountants say, they are ‘realised’.

Traditional accountants allocate the effects of incomplete transactions between reporting periods according to the realisation rule. They define realised revenue as the receipt of money or an enforceable claim to money (or its equivalent) arising from transferring the control of products or services (i.e., their use-values) to customers. This rule underlies the US requirement in APB Statement No.4 that “revenue is generally recognised when both of the following conditions are met: (1) the earning
process is complete or virtually complete, and (2) an exchange transaction has taken place” (APB, 1970, para.150). As UK GAAP put it,

“Under the historical cost system, revenues are the inflows of assets to an enterprise as a result of the transfer of products and services by the enterprise to its customers during a period of time, and are recorded at the cash amount received or expected to be received (or, in the case of non-monetary exchanges, at their cash equivalent) as a result of these exchange transactions” (1999, p.170).

The meaning of realisation

The only definition of realisation ever given in UK standards was part of SSAP2’s definition of ‘prudence’:19

“revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form of either cash or of other assets, the ultimate cash realisation of which can be assessed with reasonable certainty” (ASC, 1971, para.14 (d)).

In an influential paper on the meaning of realisation written for the ICAEW, Carsberg and Noke concluded that the main problem with SSAP2’s definition was its emphasis on the ‘ultimate cash realisation’ of ‘other assets’.20 In their view, this

“does not appear to accord with certain practices which, intuitively or by tradition, accountants might regard as giving rise to realised profits. Examples would include the exchange of investments or other assets for shares, or barter transactions such as the exchange of stocks for a fixed asset” (1989, p.5).

From Carsberg and Noke’s asset-liability perspective SSAP2’s definition of realised profits is “unclear”.

SSAP2’s definition is consistent with the traditional view. The acquisition of “other assets, the ultimate cash realisation of which can be assessed with reasonable certainty” means there is objective evidence of an enforceable claim to an asset - to cash, a claim for cash or its equivalent - as a result of transferring control of use-values to customers. The capital embodied in the ‘other assets’ received is ‘realised’ because management has objective evidence that it controls them and can recover the capital. Current market prices provide objective evidence of the recoverability of capital. Traditional accountants call these market prices ‘fair values’ (replacement costs for productive assets and finished stocks, and net realisable value for floating assets).

Carsberg and Noke are right that in traditional accounting there is “reliance on an exchange transaction for realisation”. For example, management usually exchange goods or services for money. However, in their view relying on transactions “seems to argue against accepted practices such as accruing interest receivable on bonds, interest

19 FRS18 has replaced SSAP2 and effectively downgraded the primacy of accruals and prudence.
20 Sir Bryan Carsberg worked for the FASB on their conceptual framework project and became chairman of the International Accounting Standards Committee.
which accrues as a result of ‘holding’” (Carsberg and Noke, 1989, p.7). They say there is no transaction for these items; that management merely holds an asset for a time. By contrast, traditional accountants accrue interest receivable on bonds as time passes because there is, in effect, a series of transactions. The debtor has the use-value of the loan capital for a period of time. Management transfers the use-value of the money to the debtor each period (i.e., management allows the debtor to continue to use the money or its equivalent) and an enforceable claim results.

Carsberg and Noke think realisation should mean “Represented by assets, the value of which can be measured with acceptable reliability” (1989, p.25). As they say,

“Under this approach, no exchange transaction would necessarily be needed. A realised profit could result from holding an asset while its price increased. The sole criterion would be ability to measure the asset with confidence - the asset measurement would have to be verifiable” (Carsberg and Noke, 1989, p.25).

Under their approach, for example,

“Revaluation of an asset such as a security, which, although measurable with reasonable certainty currently, may subsequently decline in price, would give rise to a realised profit if the criterion were ‘reasonable certainty’, but may not do so if it were ‘reasonable certainty of ultimate cash realisation’” (Carsberg and Noke, 1989, p.5).

By contrast, traditional accountants insist that realisation does not occur until management sells the security. Until then, it does control of capital equal to the current market price. By holding a security management controls the rights to participate in profits and vote and the right to sell it. The current market price of a security provides traditional accountants with evidence of recoverability; it does not provide them with evidence of control of money or an enforceable claim to money. Thus, the traditional answer to Carsberg and Noke’s question, “Can debtors, subject to a risk of default, be regarded as more worthy than a security with a stock market quotation” (1989, p.26), is yes.

Carsberg and Noke think traditional accountants are inconsistent. From their asset-liability perspective, one fluctuation in value is as good as another. Debtors can fall in value; securities can rise in value and, they say, accountants should impartially recognise both fluctuations. However, traditional accountants treat fluctuations in the value of debtors as realised profits and losses only because debtors are monetary assets, that is, enforceable claims to cash (or equivalent). A realised loss results from a fall in management’s enforceable claim for money from debtors and realised gains result from reversals of write-downs. By contrast, securities are not monetary assets, but are enforceable claims to use-values (voting rights and a share of profits and losses or interest). A security is non-monetary capital that management has lost if its recoverable amount or NRV falls below its cost, but it cannot gain capital if NRV exceeds cost because this is not evidence of an increase in the amount of capital that it controls. Thus, the different treatment of debtors and marketable securities does not reveal an inconsistency in traditional accounting.
A logical difficulty?

Carsberg and Noke think there is “logical difficulty in insisting that an exchange is needed”. They give the following example to make their point.

“At the start of the year Company A invests £1000 in security x and Company B invests £1000 in security y. Both securities increase in price (given by a stock market quotation) by 25 per cent during the year. At the end of the year, A sells security x and invests the proceeds in security y. If transactions costs are ignored, we have a situation in which A and B both start the year with £1000 and finish the year with identical holdings of security y. However, if an exchange transaction is regarded as necessary for realisation, A will report a profit of £250 while B reports no profit” (1989, pp.26-27).

Carsberg and Noke say there is no difference between these two companies. However, in traditional accounting the difference between these two companies is that whereas the managers of A gained control of £1,250 when they sold security x, those of B did not. Although Company A decided to reinvest the capital and the profit in security y, by selling x and buying y its management become accountable for capital of £1,250, the initial £1,000 and the realised profit under their control of £250. By contrast, the managers of B remain accountable only for the initial £1,000. The accounts of A report that management has realised its capital with a profit, and that management has reinvested this profit. Whether management should distribute this profit is a question of financial policy, not of accounting.

In the ASB’s framework we must first recognise assets and liabilities. We may then need to remeasure these elements and, finally, we may need to derecognise them. To be consistent with the ASB’s definition of assets and liabilities as potential cash flows, management should recognise all expected cash inflows and outflows arising from past events controlled by an enterprise and all changes in them. For example, the future economic benefits from past advertising expenditure should be assets. However, probably because this would introduce an unacceptable level of subjective judgment into accounting, the ASB cautions that “While only items that meet their definitions should be recognised, not every item that does so should necessarily be recognised” (para.4.2). In the 1995 SOP its view was that,

“An element should be recognised if:

(a) there is sufficient evidence that the change in assets or liabilities inherent in the element has occurred (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and
(b) it can be measured at a monetary amount with sufficient reliability”

(para.4.6, emphasis added).22

21 In other words, as we have seen, for the ASB definition and measurement are separate issues. Compare Edey’s view that before ‘profit’ and ‘value’ “can be conceived at all in any precise way they must be defined in such a manner that the definition contains within itself, or implies clearly, a method of calculation that could be followed in practice” (1971). The ASB definitions clearly do not do this.

22 Carsberg and Noke (1989) suggested this view to the ASB. We consider their arguments in below.
The ASB retained this view in the 1999 SOP (ASB, 1999d, Principles). The ASB applies identical criteria to remeasurement and derecognition. Traditional accounting agrees with the ASB that “Recognition is triggered where a past event gives rise to a measurable change in the assets or liabilities of the entity” (1995, para.4.11). However, it disagrees with the view that the critical event is ‘sufficient evidence’ of a change in probable future economic benefits measurable with ‘sufficient reliability’. Paterson “politely” describes this view as “utter gibberish” (1999a, p.7)! In traditional accounting the test for recognition is objective evidence of the transfer of control of use-values or money. For example, the view of UK GAAP, that “the trigger for revenue recognition should be based on the completion of performance by the reporting entity, and that this should dictate when the corresponding asset is recognised” (1994, p.134). By contrast, in the ASB’s view, “transactions [only] provide strong evidence of the amount of assets acquired” (1995, para.4.15). In other words, in the ASB’s view, management could recognise revenue before the completion of a transaction. The ASB openly admits that “‘sufficient evidence’ is a matter of judgement in each particular circumstance of each case: the evidence must be adequate, but need not be (and often cannot be) conclusive” (1999d, para.5.15). As we shall see in part two, Enron could use arguments like this to justify its revenue recognition practices. If it did its accounting literature search thoroughly, it would also have been glad at the opportunities an asset-liability view of revenue recognition opened up.

The ASB’s notion of transactions is broader than the traditional notion of performance. Transactions, it said in the 1995 SOP, “typically involve a series of events…includ[ing] (inter alia) agreement, sometimes involving a formal contract, between the entity and its supplier or customer, and performance (ie delivery of the goods or services or payment) by the respective parties” (para.4.16). While the ASB accepted that “When either party to a transaction has performed, the assets and liabilities arising from that performance should be recognised” (1995, para.4.19), it opened the possibility of basing recognition on the conclusion of agreements. As UK GAAP commented on the discussion draft, which also allowed this, “these principles…would radically alter conventional financial reporting practices if applied rigorously. In particular it becomes clear that the rules would require assets and liabilities under contracts for future performance to be recognised immediately unless it was possible to cancel the contract without incurring a significant penalty…. [T]he acceptance of a purchase order could be enough to trigger the recognition of the transaction, not simply its subsequent execution” (1994, p.89).

This remained the case under the 1995 SOP. As the ASB said, “In principle, a transaction gives rise to an asset at the time at which the entity has the right to require the other party to perform and a liability at the point when the entity can be compelled to perform by the other party” (1995, para.4.18). In other words, making a ‘firm commitment’ creates an asset and a liability. The ASB added “it is necessary for the right to be enforceable in practice, not merely a legal right that would not be enforced”. However, within traditional accounting even if the right’s enforcement was certain, such contracts would not create assets and liabilities until the transfer of control of use-values or money. Only then is there both a currently enforceable
obligation and a source of capital (either damages or the asset). For example, ‘take-or-pay’ contracts and ‘throughput agreements’:

“Under these contracts, the purchaser is obliged to pay a certain minimum amount even if, in the event, it does not take delivery of the goods or make use of the services it has contracted for. The accounting question which therefore arises is whether the purchaser has to account for a liability (its commitment under the contract) together with a corresponding asset (its right to use the facilities it has contracted for)” (UK GAAP, 1994, p.851).

As UK GAAP said, under the principles enunciated in FRS5: Reporting the Substance of Transactions (1993), based on the draft SOP,

“the rights and obligations under such contracts would seem to require to be recognised in the balance sheet, which would be a radical departure from present practice…. Indeed, a literal application of the principles might require all purchase obligations to be recognised on the balance sheet whenever a purchase order is accepted, rather than whether the contract is fulfilled, which would be an even more radical departure” (1994, p.851).

The IASC also accepts that these recognition criteria could significantly expand the range of assets and liabilities recognised compared with traditional accounting. For example, as it says,

“In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses” (1989, para.91).

From the asset and liability perspective a ‘firm commitment’ provides sufficient evidence of the existence of assets and liabilities, of ‘probable’ future cash flows. In the ASB’s view, “The existence of a firm commitment means there is sufficient evidence that a change in the assets or liabilities of the entity has already occurred”. From its perspective, “The persuasiveness of the evidence is of the same order as if performance had occurred,…hence these contracts call for recognition in the same way as do transactions” (ASB, 1992, para.35).

In the traditional view a purchase commitment does not create an asset because the use-values are not under the purchaser’s control and, until they are, there is no cost to recover. The obligation to pay also does not create a liability as, until the transfer of control of use-values there is no source of capital. As the ASB recognised, but did not accept, “A reason often given for non-recognition of contracts is that, as performance lies in the future, recognition of a contract merely anticipates the future activities of the business, which are best reflected in future years’ accounts” (1992, para.36).  

23 Note, however, that although in traditional accounting there is no liability and no asset, it may be appropriate to establish a provision from profits for any probable future losses.
the March 1999 SOP the ASB noted that “At present most types of unperformed non-derivative contracts are not recognised”. However, in its view, again confusing HCA with traditional accounting, “That is because the historical cost basis of measurement is being used and, on such a basis, the carrying amount will be the cost of entering the agreement, which is invariably nil”. It concludes that HCA does recognise unperformed contracts but “at nil” (1999c, p.70)! In the March 1999 SOP the ASB allowed management to report the net of any assets and liabilities according to its definitions arising from unperformed contracts (1999c, para.5.18), and the final version retains this (1999d, para.5.21). UK GAAP calls this “one particularly imprudent implication [of the ASB’s framework] concerning unperformed contracts”. As it explains,

“In brief, the problem is that the balance sheet recognition criteria...seem to require the recognition of a sale, and hence profit, where a contract has been agreed, but nothing else has happened. Certainly rights to future benefits exist at this point. …This difficulty is glossed over by the statement that the ‘right and obligation will be in balance’. However, assuming a profitable sale has been contracted, this cannot be the case” (1999, p.133).

The ASB accepted that “Initial recognition of assets and liabilities and subsequent remeasurement may also be triggered by events other than transactions”. For example, court damages and accidental damage to property. We saw earlier that for traditional accounting these are also assets or liabilities because management gains or loses control of use-values or money. However, the ASB goes further and allows that “Some of the events that trigger subsequent remeasurement involve the revaluation of the flow of benefits associated with an asset or liability” (emphasis added). In other words, as Enron might have been relieved to know, in principle the ASB’s approach allows ‘marking to market’ for all assets and liabilities for which ‘sufficient evidence’ is available:

“Examples are a change in the value of land or a freehold property…where the benefits of occupation are unchanged but the monetary value of those benefits is affected by market price changes. Transactions by other parties in similar assets and liabilities may provide sufficient evidence of a change in value.…. [S]uch a potential change in value is a candidate for recognition” (1995, para.4.24).

As we shall see in the following section, in the asset-liability framework, this logic applies perforce to ‘financial instruments’, including costless derivatives and certain commodity contracts.
The Recognition of Gains and Losses

Having established its general recognition criteria, the ASB applies them to the recognition of gains and losses. In the 1992 draft the ASB allowed only ‘realised’ gains and losses to pass through the profit and loss account. ‘Earned’ but not realised gains and losses had to pass through a ‘statement of total gains and losses’ (STRGL) introduced in FRS3 (para.27). As it said, “At any stage in the recognition process, where a change in assets is not offset by an equal change in liabilities a gain or loss will result” (1992, para.17). Hence it proposed that “gains should only be recognised in the profit and loss account when, in addition to the general recognition criteria being met, the following are satisfied:

(a) the gain is earned - that is there is no material transaction, contract or other event that must occur before the change in the assets or liabilities of the entity inherent in the gain will have occurred; and
(b) the gain is realised - that is one of the following is met:
   (i) a transaction whose value is measurable with sufficient reliability has occurred. In addition, for a transaction involving an exchange, the assets or liabilities exchanged must be dissimilar or monetary; or
   (ii) the gains results from a change in an asset or liability of a type not held for continuing use in the business, and the resultant asset or liability is readily convertible to known amounts of cash or cash equivalents (ASB, 1992, para.55).

The US standard also uses the words ‘earned’ and ‘realised’. The question, of course, is what they mean.

‘Earned’

Under traditional accounting, transferring control of use-values means there is no material transaction, contract, or other event remaining for realisation to occur - that the revenue is ‘earned’. Thus, for example, advance payments received for goods or services only becomes realised revenue when supply occurs. Until then advanced payments are accounted for as an asset (cash) and an equal liability, deferred revenue. The advance payment is a liability because it is a source of capital creating an enforceable obligation to transfer use-values or money. Traditional accounting agrees with the ASB that “The requirement that gains be earned ensures that revenue received in advance of performance does not give rise to the recognition of a gain, since until performance occurs the increase in assets resulting from the revenue will be matched by an increase in liabilities” (1992, para.56). However, from within the ASB’s framework not all of deferred revenue is a ‘liability’, an obligation to transfer economic benefits, as it includes the expected profit on the transaction. As UK GAAP says, the ASB’s treatment of advance payments “is not an entirely convincing

24 The asset and liability point of view limits the recognition of a realised gain to the exchange of ‘dissimilar’ assets. The reason is that exchanging similar assets “no material change will have occurred in the future benefits to which the entity has access” (UK GAAP, 1994, p.164). Traditionally, we measure the gain or loss on the exchange of assets by valuing both assets at their ‘fair value’, the RC of productive assets and the NRV of floating assets, regardless of whether they are ‘similar’ or not.
rationalisation, because it depends on the assumption that any liability for future performance should be measured at the selling price in the transaction, not at the cost of fulfilling the unperformed obligation” (1994, p.134). In other words, the ASB merely assumes the liability is the full advance payment, the selling price, and not the cost as it should be within their framework. If the ASB had strictly followed the logic of the asset and liability approach, the expected profit is ‘earned’ before transferring the goods or services if ‘sufficiently’ certain and measurable ‘sufficiently’ reliably.

An example of the difference between the traditional and asset liability views of earning is that in traditional accounting only the completion method of accounting for long-term contracts is acceptable. Management transfers the control of use-values only on completion. By contrast, in the ASB’s view, “Some gains are earned over a period of time as performance occurs. For example, profit on a long-term contract may be earned over several accounting periods as the contractor performs” (1992, para.57). While it may take several accounting periods to produce the use-values, traditional accounting recognises profits only when management transfers control to the customer and money or an enforceable claim results. The same rule applies “For shorter lived items that result in the entity’s revenue generating activities”. However, in the ASB’s view the “critical event” that marks the point at which an asset is earned could be any “point in the operating cycle where the most important decision is taken or the most critical act performed”. For example, for commodity stocks requiring no significant marketing or selling effort, mere “changes in market price” could constitute gains “being earned” (1992, para.57).

‘Realised’

Similarly, the ASB’s notion of realisation only “usually means that conversion into cash or cash equivalents must either have occurred or be reasonably assured”. In its view, “Changes in value may be caused by…the manufacture of goods, and possibly a change in market price of those goods…. but until evidenced by a transaction they are not normally recognised in the profit and loss account” (1992, para.58). In other words, although it would not be ‘normal’, recognising these events is possible. Thus requirement b(ii) above allows realised gains “where no transaction has taken place provided that certain strict criteria are met”. The ASB allowed either quoted prices from an “active market” or a contract, so long as there was “no significant uncertainty”.

“Under this requirement the attributable profit on a long-term contract may be realised (and hence recognised in the profit and loss account), as may be gains on commodity stocks for which there is an active market and gains arising from marking to market of readily marketable current asset investments” (1992, para.61).

The ASB believed the requirement for an active market would prohibit the recognition of gains on “most stocks”. It also thought the requirement that the asset or liability not be ‘held for continuing use’ would, for example, prohibit management from

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25 This is the case for the other examples given by the ASB of revenue being earned ‘over time’, i.e., royalties, rent and interest. For these items, the time in possession of the use-values of the entity’s resources measures the transfer of their control and the monetary claim of the entity.
recognising a gain from an increase in the market value of “most long-term investments” (1992, para.61). However, under their framework, where assets are future cash flows, and gains are future cash flows to equity, the possibility clearly exists. As UK GAAP concluded:

“despite the Chapter’s implication that a gain is not earned until performance has occurred, it is our view that the proposed rules for deciding whether or not a gain is earned start at the wrong end. Instead of basing the recognition of a gain on the performance of a transaction, the chapter proposes that recognition should take place when an increase in equity has taken place. This means that completion of performance becomes the effect of an increase in equity, rather than the cause of the recognition of the gain. In our view, the trigger for revenue recognition should be based on completion of performance by the reporting entity, and that this should dictate when the corresponding asset is recognised - not the other way around” (1994, p.134).

The ASB proposed that “Where earned but not realised... [gains] should be included in the statement of total recognised gains and losses; an example is an unrealised holding gain on the revaluation of property” (1992, para.63). As UK GAAP said, the division of the traditional concept of realisation into ‘earned’ and ‘realised’ implies

“that the statement of total recognised gains and losses represents a form of alternative profit and loss account for items which do not fully meet... [both] criteria. For example, a gain which is earned but not yet realised will be dealt with in the statement of total recognised gains and losses, and even when it is subsequently realised it will not feature in the profit and loss account because it has already been reported in the other statement. Overall, therefore, the effect of this approach is that balance sheet recognition and measurement criteria will dictate what increases in equity are to be recorded, and the choice between the two statements in which they are recorded is then to be determined by the... [two] criteria... While th[is] approach deserves to be fully considered, it should be realised that it is far removed from the implicit rules on recognition which are currently applied” (1994, pp.89-90).

Apparently in response to these and other criticisms, in the 1995 SOP the ASB abandoned realisation as the basis for inclusion in the profit and loss account, relegating disclosure of ‘realised’ profit to a footnote (1995, para.6.24).

**Traditional realisation abandoned**

As the ASB admitted, from their point of view, “The concept of realisation is difficult to define precisely” (1995, para.6.22). It accepted that tilting realisation towards the receipt of cash, or towards an enforceable claim, the traditional definition, was “helpful” two ways. First, in recognising “profits that require a selling effort”, i.e., traditional matching. And, second, in distinguishing these profits from “gains that arise simply as a result of price changes” (ASB, 1995, para.6.23), i.e., traditional

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26 In traditional accounting the revaluation of a property does not create a ‘holding gain’, but a ‘capital maintenance adjustment’.
capital maintenance adjustments (see below). However, ASB thought this idea was outdated.

“As markets develop...conversion into cash diminishes greatly in relevance, particularly for those items that are not held for continuing use in the business and may therefore be readily sold at any time. Where sufficiently reliable current values for assets and liabilities are available, relevance requires that changes are recognised, irrespective of whether the gain or loss is realised” (ASB, 1995, para.6.23).

In other words, for assets that ‘may readily be sold at any time’ - e.g., commodity stocks, marketable securities, finished goods - where there are ‘active’ markets with sufficiently reliable prices, the ASB’s framework requires treating changes in their market prices as though they were traditional realised gains and losses. This, as we shall see in part two, was music in the ears of Enron’s accountants.

Ironically, the ASB wanted to dump traditional realisation because it thought that it gives management unwarranted discretion in recognising gains and losses.

“For example, if we define realisation as shipment, management can delay or advance this. If we defined it as customer acceptance, management can seek or discourage them. From the asset and liability point of view this kind of behaviour has ‘little economic significance’ because management has merely ‘smoothed’ reported profits. However, from the traditional point of view, by manipulating the timing of realisations management have not smoothed the profits on paper, but have smoothed them in fact. Traditional accounts report exactly what management did. If smoothing the pattern of realisation is dysfunctional for investors - if this produces a lower return than investors require - they can hold management accountable.

In the final 1999 SOP the ASB breaks the recognition process into three stages:

(a) initial recognition, which is where an item is depicted in the primary financial statements for the first time;
(b) subsequent remeasurement, which involves changing the amount at which an already recognised asset or liability is stated in the primary financial statements; and
(c) derecognition, which is where the item that was until then recognised ceases to be recognised (1999d, para.5.1).

As UK GAAP comments,
“The introduction of ‘subsequent remeasurement’ in the recognition process provides the first hint of the ASB’s balance sheet-focused approach to current value income recognition…. Thus, whilst existing accounting practice is to record gains and losses that occur as a result of transactions and other events (such as adverse court judgement or damage to property as a result of fire), it is now clear that the ASB envisages that changes in the fair value of assets and liabilities will also be recorded as gains and losses in the profit and loss account” (1999, p.182).

Matching abandoned?

Instead of the objectivity of traditional realisation, in the March 1999 SOP the ASB only offered investors and creditors “a reasonable degree of confidence as to the item’s existence and the amount at which it should be stated” (1999b, p.25). In response to criticism that it was abandoning the matching concept, the ASB stressed “it is envisaged that matching will continue to play an important role in the revenue recognition process” (1999a, p.10). Traditional accounting matches realised revenue with the cost of use-values transferred to customers. The ASB redefines “Revenue/expenditure matching…[as] the recognition of expenditure directly associated with the generation of specific gains as a loss in the same period as the gains are recognised, rather than in the period when the expenditure is incurred” (1999d, para.5.28 (b)). This definition could allow management to defer recognition of, say, advertising expenditure, because the economic benefit followed some time after the expenditure was made and the advertisements appear. The ASB accepts that

“Almost any expenditure is undertaken with a view to acquiring some form of benefit in exchange. Consequently, if [its notion of] matching were used in an unrestricted way, it would be possible to delay the recognition in the performance statement of most items of expenditure insofar as the hoped-for benefits still lay in the future” (1999d, para.5.29).

In other words, the ASB’s definition would open the door to deferring almost any expenditure as an asset. The ASB claims its SOP “imposes a degree of discipline on this process because only items that meet the definition of, and relevant recognition criteria for, assets, liabilities or ownership interest are recognised in the balance sheet” (ASB, 1999d, para.5.29). This effectively abolishes the traditional idea of matching according to the “relationship…established or justifiably assumed”, as SSAP2 put it, between realised revenues and the associated expenses. The ASB accepts that its asset-liability framework “means that the Statement does not use the notion of matching as the main driver of the matching process” (1999d, para.5.30). Furthermore, in FRS18 (ASB, 2000) “Matching, which was at the heart of the SSAP2 definition of accruals, has been abolished as an accounting concept” (Chopping, Carroll and Skerratt, 2001, p.60). Given the ASB’s definition of an asset as access to future economic benefits its constraints on recognition may not prove very restrictive.

27 The ASB claims that the “realisation notion originally came into use in order to protect creditors from the uncertainties that arise in accruals accounting, and its purpose was to try to ensure that profits were not overstated and there was sufficient cash available to distribute those profits without the company becoming insolvent” (1999b, p.28). This view apparently comes from Yamey (1962), although the evidence does not support it (Bryer, 1998).
For example, if management could provide ‘sufficient evidence’, it could justifiably defer expenditure on research within its framework, whereas in traditional accounting it could not because unless management patent the results, research and development expenditure does not give it controlled use-values.

Finally, the ASB continues with its view that, while for many types of transactions the “critical event” in the operating cycle that triggers recognition “is synonymous with full performance”, unlike traditional accounting “there could be more than one critical event in the cycle” (ASB, 1999d, para.5.35). It gives the example of a long-term building contract. It says, “the gain that is expected to be earned on the contract as a whole will need to be allocated among the critical events” (ASB, 1999d, para.5.36 (c)). How we might do this objectively the ASB does not explain, as the essence of a long-term contract compared to a series of short-term contracts is that the ‘critical event’ comes when the contract is completed. In traditional accounting there is always only one ‘critical’ event - whether or not revenue is realised, i.e., whether or not an enforceable claim exists as a result of transferring use-values to customers. As UKGAAP comments,

“We find it somewhat surprising that the ASB believes that the application of the percentage-of-completion method of profit recognition in the case of long-term construction contracts is an example of the critical events approach…[T]his is clearly an application of the accretion approach, and the ASB’s confusion on this matter seems to illustrate further its inability to devise a theoretically coherent conceptual framework” (1999, p.177).

There are several inconsistencies between the ASB’s SOP and company law (ASB, 1999d, Appendix 1). However, “probably the most significant is the one relating to the recognition of gains: the Act requires that only profits realised at the balance sheet date are to be recognised in the profit and loss account, whilst the draft Statement adopts an alternative approach not based on the notion of realisation” (ASB, 1999b, p.42). The same point is noted in the final 1999 SOP (Appendix 1, para.7). While the ASB have supported Carsberg and Noke’s criterion, UK accountants generally do not accept its Statement of Principles and, with some exceptions, dominant current practice in revenue recognition suggests they are unlikely to welcome a change in this direction. Nevertheless, the ASB’s recent discussion paper on revenue recognition (July 2001), makes proposals for a standard based on its SOP. If implemented, the ASB’s asset-liability approach would mean radical change to current practice because, as we have seen, “the ASB views the realisation principle as ‘irrelevant’, with the result that all gains and losses will be recognised in a performance statement without any distinction being made between realised profits and unrealised profits” (UKGAAP, 1999, p.169). By requiring fair value accounting for all financial instruments, the US and other authorities have taken a large stride to this end.

**Fair value accounting for financial instruments**

Whereas the circuit of non-monetary capital is C-M-C, from use-value to money to use-value, that of monetary capital is from money to more (or less) money, M-M′. Expenditures on non-monetary assets give management control of physical use-values, but investment in monetary (or financial) assets either give it control of money or
enforceable claims to money. In short, unlike non-monetary assets, with monetary assets management do not control use-values whose replacement cost it must recover. Rather, management controls money or claims to money, money capital that it must recover. Thus, under traditional accounting whereas management values non-monetary assets at replacement cost, it must value monetary assets at their historical cost.

Monetary assets can be either productive capital or capital of circulation. A productive monetary asset is an enforceable claim to money held for the return it offers. Examples are a loan and a lessor’s long-term debtor. These investments are monetary assets because they are claims for determined amounts of money, and are productive because management holds them for their financial return and not for sale on the market. As with all productive assets, management accounts for productive monetary assets at their historical cost, or recoverable amount if lower. Similarly, for monetary capital in the sphere of circulation the rule is the lower of cost and net realisable value - for example, debtors. As management can sell its debtors management must account for them using the lower of cost or market rule.28

It follows from the above that equity investments are not monetary assets. Shares are assets that management hold for their use-values, for the expected return and for the rights they give the owner to influence or control an enterprise. Shares are not enforceable claims to pre-determined amounts of money. Although the holding company can sell the shares at the current market price, this possibility does not give it an enforceable claim to cash. Until the sale takes place the cash value is uncertain. In traditional accounting, therefore, equity investments are non-monetary assets.29 They are capital circulating outside the holding company’s circuit of capital whose use-values are not consumed and are, therefore, not replaced. Thus, management accounts for them using the equity method. That is, management accounts for the cost of the investor’s share of the net assets of the investee at the date of acquisition plus the profits retained since then measured after maintaining the investee’s non-monetary productive capital and capital of circulation at replacement cost, less losses and dividends.

‘Derivative’ financial instruments such as forward foreign currency contracts, futures, swaps and options are not money assets or liabilities because to be money capital management must either control money or invest in enforceable claims to money. Derivative contracts are usually costless at their inception.30 For example, although forward contracts to buy and sell foreign currency are for determined amounts of money, as they do not require management to invest capital they are executory contracts - mere promises for promises - that traditional accountants do not recognise. As IAS39 says,

28 Like other elements of capital of circulation, debtors should be written down to their recoverable amount if this is less than their historical cost - the amount for which they could be sold to a debt factor plus the factor’s profit.
29 See, for example, SSAP20: Foreign currency translation (ASC, 1983).
30 And they are not money capital simply because there is a cost. For example, options have a cost, but while this is an asset it is not a monetary asset. They give management a non-monetary use-value - the right to buy or sell - not a claim to a determined amount of money.
“assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are not recognised under present accounting practice until at least one of the parties has performed under the agreement such that it is either entitled to receive an asset or is obligated to disburse an asset. For example, an enterprise that receives a firm order does not recognise an asset (and the enterprise that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered, or rendered” (IASB, 2000, para.29 (b)).

Only if a purchaser pays in advance or a seller transfers goods does management recognise the transaction because then does the purchaser or seller have capital that it controls - an enforceable claim to commodities or services and money for an advanced payment, and a right to recover the debt and the goods or services for a credit sale.

In contrast to the objectivity and operationality of traditional accounting for money capital, the world’s accounting authorities have vigorously promoted the subjective and non-operational asset-liability definition of money assets based on the idea that ‘financial instruments’ are contracts for expected future cash flows. From this viewpoint,

“in the light of the recent growth of derivatives, the trend for companies to actively manage risk on a portfolio basis and the ease with which gains and losses on financial instruments can be realised, all financial instruments have to be measured at current values with all gains and losses recognised as they occur” (ASB, 1996, Summary, para.26).

In what follows we explain asset-liability accounting for financial instruments and contrast its subjectivity with the objectivity of traditional accounting.

Asset-liability accounting for ‘financial instruments’


“A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. A financial asset is any asset that is:

(a) cash;
(b) a contractual right to receive cash or another financial asset from another entity;
(c) a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
(d) an equity instrument of another entity.

A financial liability is any liability that is a contractual obligation:
(a) to deliver cash or another financial asset to another entity; or
(b) to exchange financial instruments with another entity under conditions that are potentially unfavourable.

An equity interest is any contract that evidences an ownership interest in an entity, i.e. a residual interest in the assets of the entity after deducting all of its liabilities” (para. 8).

The essence of the above definition, as the ASB’s discussion paper, *Derivatives and other financial instruments* put it, is that financial instruments are “contracts for cash flows (i.e. monetary assets and liabilities) and equity instruments” (1996, Summary, para. 8). As the ASB says, underlying the definition is the view that

“Financial instruments can be distinguished from non-financial assets and liabilities in terms of their nearness to cash. Financial assets generate cash directly whereas non-financial assets generate cash only indirectly, by being used with other inputs to produce goods and services” (1996, para. 1.2.3).

In other words, financial ‘assets’ and ‘liabilities’ are expected future cash flows that differ from non-monetary assets and liabilities only in their ‘nearness’ to cash. However, ‘near’ and ‘far’, ‘direct’ and ‘indirect’ are relative terms, incapable of precise definition. Thus, whereas in traditional accounting the absence or presence of controlled use-values strictly distinguishes between money and non-money capital, the best we can say from within the asset-liability framework is that with a financial instrument

“the amount of cash generally does not vary depending on what entity holds the instrument or how it is used. By contrast, the cash generated by a non-financial asset will vary from entity to entity depending on how the asset is used” (ASB, 1996, para.1.2.3, emphasis added).

In saying that the cash generated from a non-financial asset depends on how ‘the asset is used’, how management uses its use-values, the ASB appears to recognise the traditional distinction. As in asset-liability accounting the distinction between non-monetary and monetary assets is the nearness or directness of the route to cash, the amount of cash should never depend on who holds the contract. However, as the amount of cash realised from an equity investment clearly could depend on who holds it, and the ASB wants to include equity as a financial asset, it can only say it ‘generally’ does not vary. To include equity investments as financial assets it relies instead on its core definition of ‘nearness’ to cash, the idea that selling them at the current market value could provide a direct route to cash independent of the owner’s exercise of their use-values (votes, etc). As we have seen, by contrast in traditional accounting the distinction between non-monetary and monetary capital is between whether management controls a use-value other than money or an enforceable claim to money. Equity investments give management control of use-values, not claims to money. Thus, as we shall see, whereas in asset-liability accounting management should mark equity investments and all other financial instruments including costless derivatives, to market prices (or to model) and take any ‘gains’ or ‘losses’ to the profit
and loss account, in traditional accounting there is no question of management valuing these investments at market values unless they falls below cost.
Recognition

Traditional accounting’s solution to the “main concern...that derivatives can speedily transform the position, performance and risk profile of a company in a way that is not made readily apparent within the present framework” (ASB, 1996, Summary, para.7) is disclosure and accountability for realised results, not recognition of executory contracts. By contrast, as IAS39 says, from the asset-liability viewpoint, the answer is that

“a forward contract...is recognised as an asset or liability on the commencement date, rather than waiting until the closing date on which the exchange actually takes place. When an entity becomes party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero, and only any net fair value of the right and obligation is recognised as an asset or liability. However, each party is exposed to the price risk that is the subject of the contract from that date” (IASB, 2000, para.29 (c)).

In asset-liability accounting, exposure to risks and rewards is the essence of an asset, but this is true for all purchase commitments. To justify recognition of financial instruments the IASB relies on the asset-liability definition of a financial instrument as its ‘nearness’ to cash. Then it can say that the difference between purchase commitments and financial instruments is the latter’s marketability and therefore nearness to cash. Not surprisingly, therefore, when the IASB and others apply this test to tradable contracts to supply commodities they conclude that these executory commodity contracts are also ‘financial instruments’.

In traditional accounting no question arises of accounting for commodity contracts as money capital as they are mere promises to deliver commodities at a future date in return for payment. By contrast, in asset-liability accounting

“There are some powerful arguments for addressing commodity contracts along with financial instruments. The distinction between them and cash-settled financial instruments for which the settlement is indexed to commodity prices is arbitrary and has little, if any, economic significance. Furthermore, in certain commodity markets, few participants hold commodity contracts to maturity and take delivery of the physical commodity” (ASB, 1996, para.1.3.2).

Apparently not wishing to require current value accounting for all stocks - and hence current value accounting for production - the ASB draws upon the fuzzy distinction in asset-liability accounting between monetary and non-monetary assets to favour requiring mark-to-market accounting “those commodity contracts where it is usual market practice to close out the contract before maturity rather than take physical delivery” (ASB, 1996, para.1.3.2). Following this logic, management must apply IAS39 to “commodity-based contracts that give either party the right to settle in cash or some other financial instrument” (IASB, 2000, para.6). “If an enterprise follows a pattern of entering into offsetting contracts that effectively accomplish settlement on a net basis, those contracts are not entered into to meet the enterprise’s expected
purchase, sale, or usage requirements” (IASB, 2000, para.7), and under IAS39 it must, just as Enron did, account for them as financial instruments and mark them to market or to ‘model’.

**Measurement**

In traditional accounting management measures financial instruments including derivatives at cost. From the asset-liability view this is merely conventional. The reason is that like non-monetary assets, at the moment of purchase the cost of a monetary asset also equals its expected exit value, current exit value, current cost, and present value at historical and current interest rates (FASB, 1976c, p.211). Thus, in asset-liability accounting all of these options exist for the valuation of all financial assets including costless derivatives. Asset-liability accounting applies the same approach to marketable equity securities for which current value equals current exit value and present value at the current rate of interest. In asset-liability accounting market values “provides the most useful measure of the economic resources currently available to the enterprise and identifies changes in the value of marketable securities with the periods in which those changes take place” (FASB, 1976c, p.226). If our aim is reporting economic value

“Current values are the best measure of performance and stewardship as they reflect all economic events occurring in the year but not those of other years. …Current values are the best measure of financial position at the year-end. …They also overcome the problem that, because many derivatives have zero cost, they are not recorded in the balance sheet at all in a historical cost system” (ASB, 1996, para.2.3.4).

Under traditional accounting management accounts only for the capital outlay on financial instruments including derivatives - for example, the cost of an option. This was the dominant practice: “[O]nly the initial outlay on the instrument is recorded in the accounts until such time as the instrument is realised by sale or payment of a cash flow. Unrealised gains and losses resulting from changes in value in the interim are ignored” (ASB, 1996, Summary, para.11). By contrast, in asset-liability accounting “cost…is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability) for it”, where fair value of consideration “is determinable by reference to transaction prices or other market prices” (IASB, 2000, para.67). In the case of a forward contract to sell foreign currency management expects from a debtor, for example, IAS39 requires it to account for the ‘asset’ and ‘liability’ arising from the forward contract at their ‘nominal’ amount, reporting the net asset or liability and subsequent changes as gains and losses.

Carrying the asset-liability definition of ‘cost’ to its logical conclusion, under IAS39 “If…market prices are not reliably determined, the fair value of the consideration is estimated as the sum of all future cash payments, or receipts, discounted…using the prevailing market rate(s) of interest for a similar instrument…of an issuer with a similar credit rating” (IASB, 2000, para.67).

“After initial recognition, an enterprise should measure financial assets, including derivatives that are assets, at their fair values” (para.69).
“There is a presumption that fair value can be reliably determined for most financial assets classified as available for sale or held for trading” (para.70).

“Situations in which fair value is reliably measured include (a) a financial instrument for which there is a published price quotation in an active public securities market for that instrument, (b) a debt instrument that has been rated by an independent rating agency and whose cash flows can be reasonably estimated, and (c) a financial instrument for which there is an appropriate valuation model and for which data inputs to that model can be measured reliably because the data come form active markets” (para.96).

Enron was probably pleased to read in IAS39 that marking to model was fine, and that one of the “Techniques that are well-established in financial markets include…discounted cash flow analysis” (IASB, 2000, para.100). IAS39 allows management this option on the ground that “An enterprise is unlikely to purchase a financial instrument for which it does not expect to be able to obtain a reliable measure of fair value after acquisition” (IASB, 2000, para.102). Enron shows that this was wishful thinking.

The only ‘disadvantage’ the ASB can think of for using current values for financial instruments is that to be comparable all companies should use current values for all assets and liabilities (1996, para.2.3.14).

Reporting ‘gains’ and ‘losses’

Whereas traditional accounting recognises only realised gains, if the aim is to report economic value,

“Supporters of current value believe that unrealised gains are as important as realised ones. Both have occurred and both leave the entity better or worse off. Thus, both should be reported in the same way. …In addition, some believe that realisation is not a suitable trigger for reporting gains and losses on financial instruments. Such gains and losses are easily realised, often with no more than a telephone call. Hence, realisation, at least in the sense of conversion into cash, is not an economically significant event” (AS, 1996, paras.2.2.9-2.2.10).

Thus, IAS39 requires

“A recognised gain or loss arising from a change in the fair value of a financial asset or liability that is not part of a hedging relationship…should be reported as follows:

(a) a gain or loss on a financial asset or liability held for trading should be included in the net profit or loss for the period in which it arises…;
(b) a gain or loss on an available-for-sale financial asset should either:

(i) included in net profit or loss for the period in which it arises; or
(ii) recognised directly in equity, through the statement of changes in equity…until the financial asset is sold, collected or otherwise disposed of, or until the financial asset is determined to be impaired…, at which time the cumulative gain or loss previously recognised in equity should be included in the net profit and loss for the period” (IASC, 2000, para.103).

Supporters of asset-liability often argue that marking to market would eliminate management’s discretion over the timing of sales to allow it to control reported earnings. That “using cost does allow entities to control the volatility of reported profits by choosing when to realise (and thereby report) gains and losses: using current values removes this possibility” (ASB, 1996, para.2.2.8). That “basing profit recognition on realisation allows companies to manage reported profits by ‘cherry-picking’ which gains and losses to realise” (ASB, 1996, para.2.2.11). That is, by choosing to sell particular items of (for example) stock with particular costs management can, within limits, choose the profit they report. In the ASB’s view, “This is a particular problem for financial instruments since gains and losses on them are easily realised” (1996, Summary, para.11 (a)), but from the asset-liability view the cherry-picking problem is endemic. As Whittington says of physical inventories, “if the stock items are truly homogeneous”, that is, if they have the same economic value, under traditional accounting profit will depend on which item is selected for sale “despite the fact that the economic state of the enterprise is unaffected by which items of stock are selected” (1999, p.11). This problem only arises in the asset-liability framework. First, if management follows traditional accounting and values physical inventories at current replacement cost, identification or cost flow assumptions are unnecessary. Second, for monetary assets functioning as capital of circulation such as a portfolio of marketable securities valued at historical cost, although an enterprise’s economic value may be unaffected by cherry-picking, the same is not true of its accountability. Management can choose which gains or losses to realise, but in traditional accounting they are accountable for those choices, accountable for their impact on the rate of return on capital. If accounting is objective, cherry-picking is no problem. The capital markets require management to go cherry-picking all year round. Management must always choose the timing of asset acquisitions and disposals to generate at least the required rate of return on capital in every period.

While market values measure the economic value potentially available, management does not control this value until it sells the securities or receivables, while decreases below cost are either losses of circulating capital or falls in the recoverable amount of a productive, long-term security.

The final major accounting issue raised by Enron’s practices is accounting for ownership interest, or equity. As the ASB said in its 1995 SOP, “The distinction between liabilities and ownership interest is highly significant” (para.3.39).31 For example, many people believe the ratio of debt to equity (ownership interest) provides information about an entity’s financial risk.32 Unfortunately, the distinction between

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31 As, therefore, is the distinction between provisions and liabilities.
32 The ASB could not use the normal term ‘equity’ as FRS4 defines some sources of share or ‘equity’ capital as ‘non-equity’, as we shall see.
debt and equity is hazy within the asset-liability framework. We shall see in part two that Enron used this haziness to creatively account for equity.

Ownership Interest (Equity) Accounting

In traditional accounting, the difference between equity and liabilities is clear. Whereas equity is a source of capital (contributed or retained) remunerated only from profit, liabilities are sources of capital creating obligations that have to be paid regardless of profits. As UK GAAP said,

“The traditional distinction between shares and debt is clear. The issue of shares creates an ownership interest in a company, remunerated by dividends, which are accounted for as a distribution of profits, not a charge made in arriving at it. Loan finance, on the other hand, is remunerated by interest, which is charged in the profit and loss account as an expense (1994, p.739).

The ASB’s 1995 SOP recognises the traditional distinction. As it said,

“Although owners invest in an entity in the hope of return..., owners - unlike creditors - do not have the ability to insist that any transfer is made. This is generally reflected in the law, which forbids the transfer of assets to owners unless the entity will have sufficient assets after the transfer...to meet the demands of its creditors” (para.3.39).

Nevertheless, the ASB defines ownership interest, as “the residual amount found by deducting all of the entity’s liabilities from all of the entity’s assets”. This makes the definition of equity depend on the ASB’s definitions of assets and liabilities. The ASB uses identical wording in the 1999 SOP (ASB, 1999d, para.4.37). FRS4: Capital instruments (ASB, 1993), which uses the ASB’s definition of a liability, reveals some of the difficulties of using this approach. Thus, FRS4 says

“Capital instruments...should be classified as liabilities if they contain an obligation to transfer economic benefits (including a contingent obligation to transfer economic benefits). Capital instruments that do not contain an obligation to transfer economic benefits should be reported within shareholders’ funds” (para.24).

For example, as convertible debentures carry an enforceable obligation to repay the loan until conversion takes place, FRS4 requires classification as debt - as they would be under traditional accounting because they receive interest until conversion. Here traditional accounting and the ASB come to the same conclusion, but for different reasons. However, a difficulty with the ASB’s definition is that, as FRS4 says, “Certain kinds of shares have features which make them economically similar to debt” (para.83, emphasis added). For example, under the ASB’s definition it is clear that as in traditional accounting non-redeemable preference shares are not liabilities. This is so even though these shares have ‘rights’ (e.g., to a fixed dividend; to the accumulation of unpaid dividends; to restrictions on dividends to others; to additional voting powers). As the ASB says, “None of such rights includes the right to insist on a transfer of economic benefits, and such shares are therefore not liabilities, but rather
form part of the ownership interest in the company” (1995, para.3.43). However, the ASB’s classification of redeemable preference shares is not clear. With redeemable shares there is an obligation to transfer economic benefits, and they would seem to be liabilities in the ASB’s framework. The SOP does not discuss redeemable preference shares. FRS4 reluctantly classifies them as “non-equity shares” (para.87) because Company Law does not allow reporting redeemable preference shares as debt. As FRS4 says, although in its view “Certain kinds of shares have features which make them economically similar to debt”,

“Nonetheless, the requirement to classify capital instruments as debt if they contain an obligation to transfer economic benefits does not apply to shares. The legal status of shares is well established and understood…. In addition the balance sheet formats prescribed by company legislation requires called up share capital to be separately stated from liabilities” (para.83).

As UK GAAP said, while applying the approach in the SOP “might be expected to result in redeemable preference shares being shown as debt…, the standard does not go this far…[because] to classify them as liabilities would be in breach of the format requirements of the Companies Act” (1994, p.743). Unfortunately, this contradicts the ASB’s definition of ownership interest as the ‘residual interest’. As FRS4 says, “Shares that the issuer may or will be required to redeem are classed as non-equity shares, since they do not form part of the residual interest in the company” (para.87). In other words, these share are not part of ownership interest, and therefore according to the ASB’s framework should be liabilities!

Part Two: Enron’s accounting

In this part the paper argues that Enron’s management and accountants could have used the asset-liability framework to justify all of its now condemned accounting methods, and provide evidence consistent with the hypothesis that it did. At the heart of Enron’s manipulations was consolidated accounting and the paper therefore considers this first. It then turns to Enron’s revenue recognition practices, its fair value accounting for ‘financial instruments’ and, finally, its equity accounting. The paper then draws general accounting lessons from Enron.

(i) SPE accounting

Enron had from 3,500 to 4,300 SPEs (Singleton, 2002, p.20). It used many to ‘legitimately’ shelter foreign income from US taxes, but it used some substantial SPEs to conduct domestic business (Benston and Hartgraves, 2002, p.3). Enron’s Special Investigations Committee described its growing use of SPEs.

“From the early 1990s through 2001…Enron used SPEs in many aspects of its business. We have been told these included: synthetic lease transactions, which involved the sale to an SPE of an asset and lease back of that asset (such as Enron’s headquarters building in Houston); sales to SPEs of ‘financial assets’ (a debt or equity instrument owned by Enron); sales to merchant ‘hedging’ SPEs of Enron stock and contracts to receive Enron stock; and
transfers of other assets to entities that have limited outside equity” (Powers, Troubh and Winokur, 2002, p.37).

As we shall see, it was Enron’s use of sales of its shares and forward contracts on its shares to merchant ‘hedging’ SPEs (called by Enron management, ‘Chewco’, ‘LJM1’, ‘LJM2’, ‘The Raptors’) that in practice failed to provide an effective economic hedge exposing Enron’s accounting manipulations and bringing it down. Enron’s SPE accounting is, therefore, the initial focus, and the first question - who controlled Enron’s SPEs according to US rules? - is the most important. The rules were conceived, were born and lived and breathed in an environment saturated by the asset-liability framework. We argue that this framework explains why it was that

“After more than 20 years since SPEs appeared on the business scene, there remains a confusing, if not convoluted, set of guidelines regarding the consolidation of SPEs” (Benston and Hartgraves, 2002b, p.8).

The confusions and convolutions in the US rules on SPE accounting are inherent in the asset-liability framework.

**The development of US consolidated and SPE accounting**

After five years deliberating its ‘consolidation project’, in 1987 the FASB signalled in Statement No.94, its aim of shifting from the ownership rules of ARB51 (AICPA, 1959). In the Background Information the FASB said it had “tentatively concluded that the [reporting entity] concept should be based primarily on control rather than on ownership of a majority voting interest, which is the most common but not the only means of controlling a subsidiary” (FASB, 1987, para.20). This meant it was wedded to the definition of an asset as management’s ‘control’ of future economic benefits. It was in this context that the US Emerging Issues Task Force began to issue guidance for SPE accounting.

FASB Statement Nos.76 and 77 (FASB, 1983a, 1983b) dealt with debt factoring and, although they talked some of the language of the asset-liability framework, required traditional accounting as a sale of debtors “so long as there are assets placed in trust outside of the debtor’s control sufficient to satisfy the obligation” (Benston and Hartgraves, 2002, p.4). In 1996 FASB Statement No.125 overthrew this lingering hold of traditional accounting - softened up by EITF Issue No.84-30 (FASB, 1984), EITF Topic D-14 and Nonconsolidation of SPEs (FASB, 1989) and EITF Issue No.90-15 (FASB, 1990) - by abolishing Statement Nos.76 and 77.

In 1989 the SEC pointedly offered an asset-liability test for not consolidating SPEs during discussions on EITF Topic D-14 and issued EITF 90-15.

“Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals)” (Topic D-14 quoted in Dharan, 2002, p.20).
EITF 90-15 includes a series of questions and answers intended to clarify the application of its criteria. The most critical question asks

“What is meant...by the term expected substantive residual risks? What amount qualifies as a substantive residual equity capital investment?” (quoted in Munter, 2002, p.87).

In traditional accounting a subsidiary is an entity whose parent controls the undertaking’s operating and financial policies and has evidence it will recover the cost of the investment. In contrast, at the heart of Enron’s consolidated accounting, the now infamous 3% rule in the US for SPE non-consolidation, is the economists’ subjective notion of control, exposure to the risks and rewards of ownership. The three per cent rule said that a sponsoring company need not consolidate an SPE if at least three percent of its assets are owned by outside equity holders who bear ownership risk (Dharan, 2002, p.19). Although formalised as the 3% rule, the EITF’s test is essentially subjective. It says that to be acceptable as the basis for non-consolidation, “the initial substantive residual equity should be comparable to that expected for a substantive business involved in similar transactions with similar risks and rewards” (Munter, 2002, p.87). The FASB included the 3% rule in Statement No.125, issued in June 1996 and in Statement No.140 that replaced it in September 2000.

Statement No. 125 introduced the asset-liability notion of control to debt factoring and rules only requiring consolidation of specific financial SPEs, leaving the way clear for the asset-liability view underlying EITF Issue No.90-15, that management need only consolidate SPEs where it retains ‘substantially all the risks and rewards of ownership’.

“Consequently, it was possible for an SPE to qualify for nonconsolidation under Statement No.125, even though the SPE satisfied the consolidation provisions of Issue No.90-15” (Benston and Hartgraves, 2002, pp.5-6).

The FASB issued Statement No.140 replacing No.125 governing QSPEs created for certain financial asset transfers and securitizations.

“The EITF criteria for nonconsolidation center on requiring control of the SPE by one or more independent third parties who have substantial at-risk equity investments in the SPE, interpreted to mean a minimum of 3 per cent of the total assets of the SPE” (Benston and Hartgraves, 2002, p.6).

“a primary objective of the FASB in the consolidation project is to expand the control notion from an approach based solely on ‘legal’ control, as evidenced by stock ownership, to one based on ‘effective’ control. …[The 1999]…exposure draft gave the impression that the same ‘effective’ control criterion apply to SPEs as to other types of equity investments” (Benston and Hartgraves, 2002, p.7).
“The problem at Enron, as it expanded the role of SPEs, was that even though its SPEs were thinly capitalized and held assets that imposed considerable risks, Enron took the limited authoritative pronouncements literally, allowing them to not consolidate the SPEs, even in situations where Enron took virtually all of the risks” (Benston and Hartgraves, 2002b, p.8).

Benston and Hartgraves do not show that Enron took the rules ‘literally’ as its personnel and its auditors and legal advisors interpreted them within the vagaries of the asset-liability framework. This, we argue, explains why “Enron and its outside counsel and auditor felt comfortable in following the specified accounting requirements for consolidation of SPEs” (Benston and Hartgraves, 2002a, p.15). In short, the evidence is consistent with Enron using the asset-liability framework to justify its accounting for SPEs allowing it to hide losses on its investments, to hide liabilities and to generate fictitious profits.

Who controlled Enron’s SPEs?

Not surprisingly, given all this confusion and convolution, the Special Investigative Committee of the Board of Directors of Enron Corp. (The ‘Powers Report’) concluded that

“the independent owner must exercise control over the SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature on partnership control rights for guidance in making this evaluation” (Powers, Troubh and Winokur, 2002, p.39).

“The assessment of control under applicable accounting literature was, and continues to be, subjective” (Powers, Troubh and Winokur, 2002, p.48).

As the general partner has unlimited liability there is a rebuttable presumption that he or she is fully exposed to the risks of ownership. However, within US rules rebutting this presumption was not difficult:

“In general, there is a rebuttable presumption that a general partner exercises control over a partnership. The presumption can be overcome if the substance of the partnership provides that the general partner is not in control of major operating and financial policies” (Powers, Troubh and Winokur, 2002, p.48).

“Both LMJ1 and LMJ2 present substantial questions about whether Fastow was in effective control. Fastow was the effective general partner of both partnerships, and had management authority over them. On the other hand, both partnership agreements limited the general partner’s investment authority, and required approval of certain investment decisions by the limited partners. Moreover, the LMJ2 partnership agreement provided for removal of the general partner, without cause, by a recommendation of an Advisory Committee and a vote of the limited partners (initially limited partners with 75% in interest, later reduced to two-thirds). Given the role of the limited
partners..., arguments could be made both for and against consolidation based on Fastow’s control of the partnerships. ...We have reviewed these issues in detail, and have concluded that there are no clear answers under relevant accounting standards” (Powers, Troubh and Winokur, 2002, p.76).

The Special Investigative Committee recognised that Fastow, the Chief Financial Officer of Enron, “had management authority”. The fact that Fastow exercised his authority within constraints - e.g., requiring approval for certain investments - and could be removed by the other partners, does not mean he did not control the operating and financial policies of LJM1 and LJM2 for Enron. For example, debt covenants often require management to seek the approval of banks for major investments. Most observers conclude that “Enron’s SPEs...in substance...were merely an extension of Enron” (Singleton, 2002, p.21). That “In reality, Enron and the partnerships were usually, in fact, one and the same. Truly independent partnerships would not have made investments on terms so favourable to Enron” (Madrick, 2002, p.22, see also Ketz, 2002, p.7). Benston and Hartgraves say “There is no doubt that Andersen knew that the SPEs were managed by a senior partner officer of Enron”, but contradict their view that Enron stuck literally to the rules by giving us the traditional rule: “On this basis, alone, it seems [sic] that Andersens should have required Enron to consolidate the Fastow SPEs with its financial statements and eliminate the effects of transactions between those entities and Enron” (2002a, p.14). However, the US rules, as we have seen, do not require consolidation simply because management controls the operating and financial policies, but that management has ‘economic control’ - is exposed to the risks and rewards of ownership. This is why

“neither Issue No.90-15, nor other pronouncements involving SPEs, restrict[ed] the sponsor of the SPE from guaranteeing loans to the SPE. Consequently, although the sponsor cannot directly protect equity investors in unconsolidated SPEs from risk, the sponsor can indirectly reduce that risk by guaranteeing the SPE’s debt” (Benston and Hartgraves, 2002b, p.5).

Debt guarantees can reduce the risk to equity, but who is to say whether it remains exposed to ‘substantially all’ the risks and rewards of ownership? And who is to say when a dividend based on fee-income of the SPE is a return of the original capital or a high return on that capital? This mattered in the Enron case because under US rules “the sponsors were not explicitly prohibited from engaging in Enron’s practice of bailing out the equity investors by almost immediately transferring funds to SPEs in the form of fees that, in turn, were paid to the investors” (Benston and Hartgraves, 2002b, p.5). Although the “evidence...indicates that Enron in fact bore most of the risk” (Benston and Hartgraves, 2002, p.14) the test for consolidation was “substantially all the risks and rewards of ownership”. The traditional test for control eliminates these subjective judgements.

‘Hedge’ accounting with SPEs

Enron made 20 transactions with two SPEs - LJM1 and LJM2 - that “had a significant effect on Enron’s financial statements” (Powers, Troubh and Winokur, 2002, p.68):
“Each transaction theoretically involved a transfer of risk. The LJM partnerships rarely lost money on a transaction with Enron…, even when they purchased assets that apparently decline in value after the sale. …Taken together, they resulted in substantial recognition of income, and the avoidance of substantial recognition of loss” (Powers, Troubh and Winokur, 2002, p.68).

Enron formed LJM Cayman, L.P., (LJM1) in June 1999 to ‘hedge’ its investments in Rhythms NetConnections’ (Rhythms) stock and engage in other transactions with Enron. As is typical in the US, LJM1 wrote the hedge through another SPE it established, LJM Swap Sub, funded by LJM1 with cash of $3.75m plus 1.6 million shares of restricted Enron stock with an unrestricted current value of $205m discounted by 39% and therefore valued at $80m, giving it total capital of $83.75m. Enron paid for a put option on 5.4 million shares of its Rhythms’ stock valued at $104m by a transfer to LJM1 of $168m of restricted Enron stock. In return, LJM1 gave Enron a note for $64m. LJM1 therefore received net assets of $104m ($168m - $64m) from Enron, for which Swap Sub gave Enron a put option on its Rhythms stock:

Using the restricted value on Enron’s restricted stock, LJM Swap Sub patently had negative equity - $83.75m assets less the liability for the put option of $104m. Viewed in this way, LJM Swap Sub patently did not meet the 3% rule. However, Enron persuaded Andersens to use the unrestricted value of $205m (Powers, Troubh and Winokur, 2002, p. ). In giving evidence to the US Congress, Andersen’s CEO said that the “error” arose because of “some complex issues concerning the valuation of various assets and liabilities” (Powers, Troubh and Winokur, 2002, p.84). Andersens did not explain the ‘error’ but the Power’s Committee review of some of Andersen’s workpapers “indicates that at least some of the analyses were performed using the unrestricted value, rather than the discounted value, of the Enron stock in Swap Sub” (Powers, Troubh and Winokur, 2002, p.84). Benston and Hartgraves and others also call this choice of valuation an “error” (2002, p.5). The same choice arose when Enron unwound the transaction:

“Because of the decline in Rhythms stock, the Rhythms options were substantially in the money to Enron when the structure was unwound. Enron calculated the options as having a value of $207 million. In exchange for terminating these options (and receiving approximately $27 million cash), Swap Sub returned Enron’s shares having an unrestricted market value of $204 million. Enron’s accounting personnel determined that this exchange was fair, using the unrestricted value of the shares…[even though] the value that Enron gave up (the $207 million in Rhythms options plus $27 million in cash) exceed the value Enron received ($161 million in restricted Enron shares) by more than $70 million. … The Enron shares, however, were not unrestricted. They carried a four-year contractual restriction. …It is difficult to understand why Enron’s accounting personnel did not use the discounted value of the restricted stock.33

33 Enron’s ‘restricted stock’ was mainly forward contracts to buy its shares from an investment bank that it could not exercise for four years. Enron originally made these contracts to hedge the dilution resulting from its employee stock option programmes (Powers, Troubh and Winokur, 2002, p.78). As the Powers Report put it, “Enron was…looking for a way to take advantage of an increase in the value” (Powers, Troubh and Winokur, 2002, p.78) of these contracts as the current value of its shares considerably exceeded the exercise price (Benston and Hartgraves, 2002, fn.9).
shares to assess the fairness of the exchange” (Powers, Troubh and Winokur, 2002, p.90).

The holder of Enron’s forward contracts could not sell them for four years. “Because of the restriction, at closing on June 30, 1999, those shares were given a valuation discount of 38%” (Powers, Troubh and Winokur, 2002, p.90). This was not a market valuation. The PwC fairness opinion at the initial transaction said a restriction discount of “20% to 40% was reasonable” and the Powers Report say that Enron should have amortised it in its accounts (Powers, Troubh and Winokur, 2002, p.90). Faced with choosing between the current market value of Enron’s shares and the book value of the forward contracts Andersen’s ‘error’ is wholly unsurprising as choosing the current market value is more consistent with the definition of an asset as an expected future cash flow than amortised book value. “The apparent accounting success was hard won after several months of negotiations with the external auditors” (Dharan, 2002, p.23).
During 1999 and 2000 Rhythms stock fell in value and Enron took ‘gains’ on its put option to offset the losses on Rhythms stock. However, Enron’s stock was also falling in value and with it the value of LJM Swap Sub’s principal asset so that it also made losses. On the 8th of November 2001 Enron consolidated LJM1 reducing its reported profit by $95m for 1999 and $8m for 2000 (Powers, Troubh and Winokur, 2002, p.84).

To fully exploit the ‘hedging’ opportunities of its forward contracts in its own shares Enron created four SPEs known as the ‘Raptors’ that it capitalised with either its own common stock at a discount to market price or contingent forward contracts to buy Enron stock at a discount.34

“Expanding on the concepts underlying the Rhythms transaction…, Enron sought to use the ‘embedded’ value of its own equity to counteract declines in the value of certain of its merchant investments. Enron used the extremely complex Raptor structured finance vehicles to avoid reflecting losses in the value of some merchant investments in its income statement. Enron did this by entering into derivative transactions with the Raptors that functioned as ‘accounting hedges’. If the value of the merchant investment declined, the value of the corresponding hedge would increase by an equal amount. Consequently, the decline - which was recorded each quarter on Enron’s income statement - would be offset by an increase in income from the hedge” (Powers, Troubh and Winokur, 2002, p.97).

The Powers Report concluded that

“As with the Rhythms hedge, these transactions were not true economic hedges. …Enron still bore virtually all of the economic risk. In effect, Enron was hedging with itself” (Powers, Troubh and Winokur, 2002, p.97).

Benston and Hartgraves agree: “All along…Enron really was hedging with itself - which, of course, is of no economic value to Enron’s stockholders” (2002, p.5). However, as Dharan says,

“If Enron’s stock price had continued to go up, as apparently assumed by the creators of the Raptors, the so-called hedges might have remained viable for some time, buying some needed time during which the merchant investments were expected to recover from their losses in value. However, the market price of Enron’s stock collapsed along with those of the merchant investment, thereby destroying the SPE’s ability to cover Enron’s losses. This led to the unwinding of the Raptors in October 2001 and the reporting of the huge loss” (2002, p.24).

A ‘true’ economic hedge is where the returns on two assets are perfectly negatively correlated. Enron’s returns and those on its merchant investments turned out to be positively correlated ex-post, but may well have been ‘sufficiently’ negatively correlated ex-ante to justify Enron’s accounting under the asset-liability framework. As the Powers Committee itself said,

34 In some cases Enron agreed to transfer further Enron shares to ensure the SPEs investors earned their required return if Enron’s share price fell below specified levels.
“This ‘accounting hedge’ would work, and the Raptors would be able to ‘pay’ Enron on the hedge, as long as Enron’s stock price remained strong, and especially if it increased. Thus, the Raptors were designed to make use of forecasted future growth of Enron’s stock price to shield Enron’s income statement from reflecting losses incurred on merchant investments” (Powers, Troubh and Winokur, 2002, pp.97-98).

The real problem was not the economic effectiveness of the hedge, but that mark-to-market hedge accounting allowed Enron to recognise ‘gains’ on its own shares as current income.\(^{35}\) The Powers Report concluded that this “runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement” (Powers, Troubh and Winokur, 2002, p.98). In fact, Enron’s hedge accounting reveals a deep confusion in the minds of its accountants, evident in the Powers Report that could even contemplate increases in the value of a company’s own shares as ‘gains’. In traditional accounting there are no circumstances in which management can recognise increases in the value of its own shares because, whether realised or not, these increases are not ‘gains’, i.e., distributable profits, but increases in the capital for which management is accountable.

From the traditional viewpoint, when Enron made forward contracts to buy its shares from an investment bank at a fixed price it effectively planned to re-issue these shares at a premium. Thus, any excess Enron might realise by buying the shares and selling them at a higher price is a share premium and should be accounted for as such at the time. That Enron’s accountants (and the Powers Report) could even contemplate accounting for share premiums as ‘gains’ reveals the fundamental confusion between capital and profit endemic in the asset-liability framework in which ‘gains’ are any increases in economic value. Although the Powers report questions this aspect of Enron’s accounting, it does not question its use of mark-to-market accounting that is also a product of the asset-liability framework. We discuss this so-called ‘fair value accounting’ later.

Leaving aside that Enron should have consolidated the Raptors and their losses because it controlled their operating and financial policies, it could have hidden these losses using mark-to-market accounting without using ‘gains’ on its own shares by ‘hedging’ with forward contracts on other companies’ shares. By contrast, using traditional accounting Enron’s management should have written its merchant investments and the derivatives down to the lower of cost or market thereby not delaying disclosure of the after-tax loss of $544 million ($710 million pre-tax) until 16th October 2002 in its initial third quarter earnings release and the $1.2 billion reduction of stockholders’ equity (discussed later).

Asset-liability notions also infused all other aspects of Enron’s accounting, particularly its revenue recognition.

\((ii)\) Revenue recognition

\(^{35}\) We discuss Enron’s extensive use of mark-to-market accounting later.
Enron recorded management fees for future services at their present value. Benston and Hartgraves say that “this accounting appears to be [sic] a violation of GAAP” (2002, p.7). However, as the contract called the fees “required payments” Enron could argue from within the asset-liability framework that, to use the terminology from the ASB’s *Statement of Principles*, it had ‘sufficient evidence’ that was ‘sufficiently reliable’ for it to recognise this revenue. In Concepts Statement No. 5 the FASB gives the general asset-liability view that management recognises revenue when (a) ‘realised or realisable’, and (b) ‘earned’. In asset-liability accounting revenues are ‘realised or realisable’ and ‘earned’ when there are “inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities” (FASB, 1985, para.78). This definition is as vague as the asset-liability framework’s definition of an asset. As Storey and Storey conclude, Statement No. 5 “provides little or no conceptual basis for analyzing and attempting to resolve the controversial issues of recognition and measurement about which accountants have disagreed for years” (1998, p.158). In this context it is wrong to describe the following types of deals ‘sham revenue transactions’:

“Additional sham revenue transactions appear to have been recorded when Enron sold forward gas commodity contracts to Mahonia Ltd., a Channel Island company connected with Chase Bank, and simultaneously purchased a comparable and offsetting forward gas commodity contract from another Channel Island company, Stoneville Aegean Ltd., also connected with both Mahonia and Chase. Enron collected immediately the discounted present value of the sales contract (which was apparently recorded as sales revenue), but did not recognise the purchase contract as an offsetting expense, since it did not have to be paid until the contract delivery date. Mahonia simultaneously sold its forward contracts to Chase, thereby obtaining the funds to pay Enron. In at least one such contract, the difference between the discounted sales contract and the undiscounted purchase contract was roughly equivalent to the interest on a 7% loan” (Benston and Hartgraves, 2002, p.7).

According to the asset-liability framework Enron could argue that cash movements gave it sufficient evidence of sufficient reliability of a change in economic value. Thus, it could book the cash payment to it for the forward contracts as sales revenue since this was ‘realisable’ - an ‘asset’ had increased - but could defer recognising the purchase on the ground there was insufficient evidence that Enron’s assets and liabilities had increased as it could choose to sell these contracts to buy gas before the due date. Under traditional accounting the contract to supply gas becomes a sale only when Enron delivers the gas, and it should not recognise the purchase until the gas is delivered and the supplier has an enforceable claim.
(iii) Mark-to-market accounting and sales of investments to SPEs

The finest product of the asset-liability framework is fair value accounting for financial instruments. As it developed and promulgated the asset-liability framework the FASB naturally expanded the role of fair value accounting throughout US GAAP. It usually requires marking to market prices determined by arm’s length transactions involving “the same or similar assets”. However, FAS133 allows “the ‘values’ of derivatives to be determined by marking to model”, and Benston and Hartgraves say that “EITF Issue 98-10 requires energy-trading contracts to be stated at fair values that may be determined by estimated net present value” (2002a, p.8).

“This calculation involves managers in estimating future net cash flows and applying a discount rate to obtain present (fair) values. Such procedures allow managers who want to manipulate net income the opportunity to make ‘reasonable’ assumptions that would give them the gains they want to record. Such appears to be what Enron did” (Benston and Hartgraves, 2002a, p.8).

EITF Issue no.98-10 allowed Enron to structure contracts to supply energy, call them ‘financial instruments’, and immediately recognise revenue and profit on them by
‘marking to model’, i.e., projecting energy prices for the term of the deal (that often ran for 10 years or more); calculating the projected annual profits and discounting them to present value and booking the result as an immediate ‘profit’ (Benston and Hartgraves, 2002b, pp.8-9).

In contrast to Benston and Hartgraves view that EITF Issue 98-10 ‘requires’ mark-to-market accounting for energy contracts, Dharan says

“Enron sought and obtained exemptions from regulators to allow it [to] report these types of long-term supply contracts as ‘merchant investments’ rather than regulated contracts, and obtained permission from accounting standard-setters to value them using MTM [mark-to-market] accounting. Without MTM Enron would be required to report revenues and related costs only in future years for actual amounts of [for example] electricity supplied in each year. However, MTM accounting permits Enron to estimate the net present value…and report this amount as income in the year the contract is signed. The idea for such an accounting treatment seems to be based on the notion that the financial contract could have been sold to someone else immediately at the estimated market value, and hence investors would benefit from knowing this amount in the balance sheet and correspondingly in the income statement” (Statement to the Committee on Energy and Commerce, February 6, 2002, p.84).

In 2000 Enron marked to market “Assets from price risk management activities” of $12.018 billion classified in its consolidated balance sheet as current assets and $8,988 billion classified as “Investments and Other Assets”, and current liabilities and other liabilities under the same heading of $10.495 billion and $9.423 billion respectively. Enron massively increased its assets and liabilities for ‘price risk management’ and marked them to market and to model. Total assets under this heading increased from $5.134 billion in 1999 to $21.006 billion in 2000 and total liabilities increased from $3.991 billion to $19.918 billion. The notes to the accounts report that most of these assets and liabilities were various types of contracts to sell and buy natural gas and electricity (p.38). They say

“Under the mark-to-market method of accounting forwards, swaps, options, energy transportation contracts utilized for trading activities and other instruments with third parties are reflected at fair value and are shown as ‘Assets and Liabilities from Price Risk Management Activities in the Consolidated Balance Sheet. These activities also include the commodity risk management component embedded in energy outsourcing contracts” (p.36).

Furthermore, under US GAAP permits fair value accounting for normal ‘merchant investments’ - shares in power production companies, etc - managed as a portfolio of financial assets allowing Enron’s managers to also value many of its these investments as reliable market prices did not exist “which gave Enron the opportunity of assigning values that permitted it to record earned revenue” (Benston and Hartgraves, 2002b, p.9).

How important was mark-to-market accounting to Enron’s reported results? Benston and Hartgraves confuse the issue by reporting what in Enron’s cash flow statement is
described as the “Realized gains on sales…[of] Merchant assets and investments”. Benston and Hartgraves call it “Pre-tax gains from sales and revaluations”. Benston and Hartgraves ignore the other reversals in Enron’s cash flow statement that also arise from mark-to-market accounting, the reversals of $763 million in 2000 for “Net assets from price risk management” and “Additions to and unrealized gains [on]…Merchant assets and investments” in 2000 of $1.295 billion. Thomas notes that “unrealized gains accounted for slightly more than half of the company’s $1.41 billion reported pre-tax profit for 2000 and about one-third of its reported pre-tax profit for 1999” (2000, p.4). He includes only the “Net assets from price risk management” of $763 million and $395 million in 2000 and 1999 respectively. Enron continues the summary of its accounting policies for ‘price risk management’:

“Unrealized gains and losses from newly originated contracts, contract restructurings and the impact of price movements are recognised as ‘Other Revenues’. Changes in the assets and liabilities from price risk management activities result primarily from changes in the valuation of the portfolio of contracts, newly originated transactions and the timing of settlement relative to the receipt of cash for certain contracts. The market prices used to value these transactions reflect management’s best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments” (p.36).

Enron deducted the following non-cash items from its reported net income after tax in its cash flow statements relating to ‘price risk management’ contracts and ‘merchant assets and liabilities’:

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<td>(in millions)</td>
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<td>)</td>
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<tr>
<td>Net income</td>
<td>979</td>
<td>893</td>
<td>703</td>
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<tr>
<td>Net assets from price risk management (NAFPRM)</td>
<td>(763)</td>
<td>(395)</td>
<td>350</td>
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<tr>
<td>Merchant assets and investments:</td>
<td></td>
<td></td>
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<tr>
<td>Realized gains on sales</td>
<td>(104)</td>
<td>(756)</td>
<td>(628)</td>
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<tr>
<td>Additions and unrealized gains (AUG)</td>
<td>(1,295)</td>
<td>(827)</td>
<td>(721)</td>
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Both NAFPRM and AUG on ‘merchant assets’ include the present value of new contracts.36 NAFPRM includes changes in ‘the valuation’ of the existing portfolio of contracts, including changes in their present value, whereas “unrealized gains” on ‘merchant assets and investments’ includes changes in values arising from ‘contract restructurings and the impact of price movements’. In short, both categories report unrealised gains. Enron provides no breakdown of these figures. It is therefore

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36 As Dharan says, “Enron used the term ‘merchant investments’ to report a variety of financial instruments, such as equity investments in other companies, and financial contracts, such as energy derivatives and energy supply contracts. There was very little disclosure in Enron’s financial reports to help evaluate the mix and performance of these investments” (2002, p.23, fn.15).
unclear how much of the mark-to-market ‘revenues’ arose from appraisals and cash flow forecasts, and how much came from management using market prices. However, what is clear is that without Enron’s mark-to-market ‘gains’ it would have reported an operating loss in 2000 and reduced income in 1999 and 1998:

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<tr>
<td>Net assets from price risk management (NAFPRM)</td>
<td>(763)</td>
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<td>Merchant assets and investments:</td>
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<tr>
<td>Additions and unrealized gains (AUG)</td>
<td>(1,295)</td>
<td>(827)</td>
<td>(721)</td>
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<tr>
<td>Other revenues from mark to market gains</td>
<td></td>
<td></td>
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<tr>
<td>Report operating income</td>
<td>2,058</td>
<td>1,222</td>
<td>371</td>
</tr>
<tr>
<td>Operating income (loss) without mark to market gains</td>
<td>(105)</td>
<td>420</td>
<td>1,007</td>
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Mark-to-market accounting is perfectly ridiculous from the traditional viewpoint, but all perfectly reasonable under asset-liability accounting. Scholars regularly argue “there are strong conceptual reasons to support MTM accounting” (Dharan, 2002, p.84). However, as UK GAAP concludes,

“The arguments for fair value accounting seem cogent, and they have been assembled very persuasively…. [but it does] not sit well with widespread perceptions of the role and meaning of accounts” (2001, p.876).

Enron used prices it set in sales of its investments to SPEs to mark to market other investments. Some of its realised gains on merchant investments were “‘sales’ made to and through controlled SPEs that were guaranteed by Enron or on which Enron actually accepted the risk of non-payment” (Benston and Hartgraves, 2000a, p.8). For example, Enron could have used asset-liability accounting to justify booking its sale of (dark) fibre-optic connections to LJM2:
Benston and Hartgraves say that “according to the income recognition requirements of GAAP, this was not really a sale, unless it was improbable that Enron would have to assume its guarantee” (2002, a, p.9). Assuming Enron did not control the SPE it formed to buy the fiber, Enron’s management could easily argue that paying up on the guarantee was ‘improbable’. In traditional accounting the transfer of the excess capacity for $100m is not a sale to LJM2 as Enron controlled LJM2 through Fastow, and the profit of $67 million it booked (when dark-fibre prices were plunging) is bogus. However, the sale of the excess capacity to the external buyer is a sale as LJM2 and hence Enron transferred the excess capacity to the buyer and has an enforceable claim. Assessing the probability Enron would have to pay its guarantee of $61 million of the buyer’s obligation is irrelevant to the question of income recognition, merely introducing another layer of subjectivity. Enron should have either eliminated the sale on consolidation if it controlled the SPE or noted a contingent liability or made a provision.

Finally, consider the ‘Braveheart’ transaction that broke the traditional rule of revenue recognition based on ‘execution’ (Dharan, 2002, p.28) but conformed to the asset-liability framework. Enron formed a joint venture with Blockbuster Inc to deliver videos at home on demand. It formed an SPE called Braveheart and raised guaranteed funding of $116 million from CIBC of Canada, and about $9 million from two apparently independent entities (that were related to the project and Enron) to satisfy
the 3% rule. Enron then sold the Blockbuster joint venture to Braveheart for $126 million based on an internal appraisal of the present value of the expected cash flows, allowing it to report a profit of $111 million spread over the fourth quarter of 2000 and the first of 2001, even though the venture did not have a single paying customer. Presumably Enron’s management felt it had ‘sufficient evidence’ that an asset had changed in ‘value’.

**(iv) Accounting for Equity**

JEDI owned 12 million Enron shares which it marked to market through its income statement. Enron equity accounted for JEDI from 1993 to 2000 taking its share of the ‘profit’. When the value of the Enron stock fell by $94 million in 2001 Enron did not take its share of the loss, and Andersen concurred (Benston and Hartgraves, 2002b, p.10). Perhaps Enron argued it no longer exerted a ‘significant influence’?

In the third quarter of 2001 Enron purchased LJIM2’s equity interests in the Raptors for $35 million. As part of the capitalisation of the Raptors Enron issued equity of $1.2 billion for notes receivable that it accounted for as assets contrary to US GAAP (EITF 85-1 and Rule 5-02.30 of SEC Regulation S-X) that requires loan notes to be offset against the equity capital “based on the reasonable concern that the note may not be paid” (Benston and Hartgraves, 2002a, p.10). This is too simplistic. Although in contravention of black letter US GAAP, under asset-liability accounting the note was an expected future cash flow and therefore was an ‘asset’. Thomas says that Enron’s accounting “appears [sic] to violate generally accepted accounting principles” (2002, p.5). In traditional accounting the note is an asset if management has an enforceable obligation and evidence it can recover the debt and it should make a provision to cover the possibility it may not. Enron removed these assets and reduced equity by $1 billion in the third quarter of 2001 to correct this “error” (Benston and Hartgraves, 2002a, p.10), and reduced equity by a further $200 million for the excess of the fair value of the contracts deliverable by Enron over the fair value of the notes receivable (Form 8-K, November 8, 2001, p.7).

As we saw in part one, asset-liability accounting makes no clear distinction between equity and debt. Enron used this ambiguity to justify not consolidating Chewco:

“In order to qualify for non-consolidation, Chewco...had to have a minimum of 3% outside equity at risk. ...There had been efforts to obtain outside equity...but those efforts were unsuccessful. ...Instead, to obtain the remaining $11.4 million [of equity], Enron and Kopper reached agreement with Barclays Bank to obtain what were called ‘equity loans’ to Big River (Chewco’s limited partner) and Little River (Big River’s sole member). ...The Barclays’ loans to Big River and Little River were reflected in documents that resembled promissory notes and loan agreements, but were labelled ‘certificates’ and ‘funding agreements’. Instead of requiring Big River and Little River to pay interest to Barclays, the documentation required them to pay ‘yield’ at a specified percentage rate. The documentation was intended to allow Barclays to characterize the advances as loans (for business and regulatory reasons), while allowing Enron and Chewco simultaneously to characterize them as equity contributions (for accounting reasons). During this
time period, that was not an unusual practice for SPE financing” (Powers, Troubh and Winokur, 2002, pp.49-50).

Pretending that debt was equity was usual. What was unusual and fatal to Enron’s pretence was that Enron provided cash collateral to guarantee a substantial element of the ‘loan’:

“Even assuming that the Barclays’ funding could properly have been considered ‘equity’ for purposes of the 3% requirement, equity was not at risk for the portion that was secured…in cash collateral” (Powers, Troubh and Winokur, 2002, p.52).

Leaving aside the cash collateral (that Andersen denied knowing about), did Enron and Andersen (who reviewed the Chewcon transactions) use the asset-liability framework to justify the conclusion that Chewco passed the 3% equity test? Evidence consistent with this are “Documents from 1997 indicat[ing] that Glisan [one of Enron’s accountants working on Chewco] was actively monitoring the accounting literature and guidance on the substantive outside equity requirements for non-consolidated SPEs” (Powers, Troubh and Winokur, 2002, p.53).

FASB reform of SPE accounting or refudge?

The evidence presented above is consistent with Enron exploiting the creativity inherent in the asset-liability framework in many areas of accounting. However, so far the FASB’s response to the Enron debacle is limited to a proposed reform of SPE accounting. As this merely attempts to elaborate the existing asset-liability view of SPE accounting, it appears that the FASB will not abandon its framework and engage in wholesale revisionist reform of US accounting.

In April 2002 the FASB voted to “tighten up the rules on consolidations - potentially adding billions of dollars of debt to companies’ books” (Accountancy, April 2002, p.9).

“FASB decided that an SPE should be consolidated by its primary beneficiary when the SPE ‘lacks sufficient independent economic substance’. An SPE is an entity that supports the primary beneficiary’s activities. A primary beneficiary retains or obtains principal economic benefits and risks that arise from SPE activities.

It was ruled that an SPE has sufficient independent economic substance if, at all times during its life, it is able to fund or finance its operation without the assistance from, or reliance on, the primary beneficiary.

The new rule would require independent outside investors to provide cash amounting to at least 10% (vs 3%) of the SPE’s capital for it to avoid the requirement for consolidation. The ruling will apply to existing partnerships” (Accountancy, April 2002, p.9).

Tim Lucas, FASB’s research director:
“We want to re-look at the rules that govern when one of these SPEs needs to be included in the financial statements. It’s a hard question. Is it really a substantive entity? Does it have its own risks and rewards? As a backstop we have said that the outside investors must have at least a 10% interest” (*Accountancy*, April 2002, p.9).

In August the FASB issued a proposed interpretation of ARB No. 51, *Consolidation of Certain Special-Purpose Entities* (August, 2002). As it said,

“Transactions involving SPEs have become increasingly common, and the existing literature related to SPEs is fragmented and incomplete. Current accounting standards require an enterprise to include subsidiaries in which it has a controlling financial interest in its consolidated financial statements. That requirement usually has been applied to subsidiaries in which an enterprise has a majority voting interest, but in many circumstances, the enterprise’s consolidated financial statements do not include SPEs with which it has fundamentally similar relationships” (FASB, 2002, p.i).

“Some enterprises appear to have used SPEs to avoid reporting assets and liabilities for which they are responsible, to defer the reporting of losses that have already been incurred, or to report gains that are illusory” (FASB, 2002, p.13).

In filling this gap in US rules the FASB draws directly on its asset-liability framework and immediately introduces ambiguity and subjectivity by declaring that

“The relationship between an SPE and its primary beneficiary results in control by the primary beneficiary of future benefits from the assets of the SPE even though the primary beneficiary may not have the direct ability to make decisions about the uses of the assets” (FASB, 2002, p.iii).

Although management may control access to whatever future economic benefits the asset may bring, it cannot ‘control…future benefits from the assets’. This definition, therefore, leads the FASB to propose a test for consolidating SPEs that remains inherently subjective. It proposes requiring any enterprise that provides an SPE with either the majority or the significantly largest amount of financial support in the form of what the FASB call a ‘variable financial interest’ - effectively as equity capital. For example, “financial instruments, service contracts, nonvoting ownership interests, or other arrangements” (FASB, 2002, p.i). Although it may usually be true that those who provide variable financial interests take care to control the operating and financial policies of an SPE, the FASB simply assumes this is the case:

“Economically, the holders of variable interests would not be willing to provide an SPE with the type of support normally provided by equity investors without an expected return commensurate with the risk of an equity investment. The variable interest holders also will protect their interests (manage their risks) either by establishing predetermined limits on the SPE’s activities or by
wielding decision-making authority in some form other than voting interest” (2002, para.B14).

“The Board reasoned that providers of financial support to an SPE would be expected to have risks and opportunities to benefit (risks and rewards) that are of the same character as those of an equity investor. At the same time, they arrange to protect their investment through means other than ownership of voting shares” (2002, para.B15).

If the FASB is right and variable interest holders control SPEs in their economic interests it should have no objection to using the traditional criterion that management controls the SPEs operating and financial policies. The FASB’s proposal might stop many of Enron’s SPEs because “in many cases a guaranty or other form of credit support was required from Enron” (Powers, Troubh and Winokur, 2002, p.37). However, first, in “Enron’s SPE transactions, it was at least debatable whether risk was shifted to the on the hedged assets owned by Enron” (Schwarcz, 2002, p.7). Second, the traditional rule would also catch schemes where a management actually controls an SPE but it does not have the majority or largest variable interest - those that distribute risk ‘evenly’ that under the FASB’s test the management of the sponsoring entity would not consolidate.

The same subjectivity infects the FASB’s proposals for ‘Consolidations Based on Voting Interests’. Although it has raised the lower limit on outside equity to 10% of the SPEs capital, its test is subjective:

“The amount of equity investment is sufficient to allow the SPE to finance its activities without relying on support from other variable interest holders. That is, the investment is large enough to enable the SPE to conduct its activities or finance its activities without direct or indirect assistance from holders of variable interests. Generally, that means that the equity investment should be greater or equal to the expected future losses of the SPE at all times during the SPEs existence.” (FASB, 2002, para.9 (b)).

The FASB notes that “Expected future losses refers to a probability-weighted estimate of losses without considering possible gains”, i.e., it is a subjective forecast open to manipulation.

**Conclusion: learning lessons from Enron?**

Benston and Hartgraves conclude:

“Andersen appears, at best, to have accepted as sufficient Enron’s conformance with minimum specified requirements of codified GAAP. They do not appear to have been concerned that the substance of GAAP was violated, particularly with respect to the independence of the SPEs that permitted their activities to be excluded from Enron’s financial statements and the recording of mark-to-market-based gains on assets and sales that could not be supported with trustworthy numbers (because these did not exist). They either did not examine or were not concerned that the put obligations from the SPEs that presumably
offset declines in Enron’s investments (e.g., Rhythms) were of no or little economic value” (2002a, p.13).

Benston and Hartgraves do not explain what they think constitutes the ‘substance of GAAP’. As we have seen, Enron’s accounting was not ‘fraudulent’, but the product of accounting regulation drenched in the ideas of neo-classical economics. Enron’s managers and accountants and Andersen and others could use this framework to justify most if not all of Enron’s accounting practices as reasonable. Yet from the traditional viewpoint (and in its consequences) most of Enron’s accounting was highly unreasonable. If Enron had used traditional accounting the opportunities for fraudulent appropriation of personal wealth by Fastow and others would not have existed.

The real lesson from Enron for accounting regulators is that the FASB’s asset-liability framework is fundamentally flawed. Enron could be the tip of an accountability iceberg. Many other companies have Enronitis. To name a few: Global Crossing, World.com, Reliant Services, Elan, General Electric, Tyco. The Levey Forecasting Centre “believes that profits nation-wide may be overstated on average by 20 percent” (Madrick, 2002, p.23). Many companies have taken advantage of the amnesty to restate accounts before management sign up to individual legal responsibility for them under the Sarbaine-Oxley Act.

Despite the many problems that beset them, there is no sign that the world’s accounting regulators will abandon the asset-liability framework. More likely, they will patch it with either yet more rules or circular exhortations to indefinable ‘principles’. This raises the question, why does the asset-liability framework retain its grip on western regulators? I have argued at length elsewhere that the labour theory of value underlies traditional accounting (Bryer, 1998, 1999a, 1999b, 2002). This could explain the aversion of academics and accountants, nurtured on a diet of neo-classical economics, to traditional accounting ideas. If so, there will never be a generally accepted theory of accounting. However, so long as the asset-liability framework rules the minds of the world’s accountants Enronitis remains a threat to confidence in capitalism.

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