Enron vs. General Electric:
Is Earnings Management Worth the Risk?

2010

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Accounting Major

Submitted in Partial Fulfillment of the
Requirements for the Degree of Bachelor of Science
In the Honors Program at
Coastal Carolina University

May 2010

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Introduction

The majority of people understand the severity that fraud can have on stakeholders and the economy, but few understand the meaning or potential impact that earnings management can have. Its growing popularity over the past two decades within companies has resulted in numerous bankruptcies, loss of shareholders' dollars, loss of jobs, and loss of transparency in financial statements. So what is earnings management? Kin Lo (2008) states that, "Earnings management occurs when managers or executives decide to alter financial reports through various methods, to mislead stockholders and investors about the true economic performance of the company, to meet their expectations so stockholders feel confident and investors invest." In other words, managers are "cooking the books" to make the company look good. At the end of each quarter managers are under a lot of pressure to report expected earnings and as a result look for ways around ideal accounting principles to come up with these numbers if the company isn't doing well (Chiou and Tsai 2009). However, the problem with this is that many times companies start off small and then fall into a trap. Once one quarter is altered, then the succeeding quarters will need more managing. Eventually, after many years or even maybe only a few, a company will not be able to hide its true economic performance anymore. They will be exposed, resulting in millions and sometimes billions of lost dollars.

The main objective of this paper is to provide a review on why companies use earnings management and the benefits and consequences as a result. There is a large grey area between aggressive accounting and outright fraud and this paper focuses on narrowing down that area so companies know when to stop. General Electric is an example of a company that used earnings management to its advantage because they used it cautiously. However, there is the other side where earnings management started off small and ended up spiraling out of control like with Enron. This paper will examine both how Enron crossed the line into fraud which resulted in the largest U.S. bankruptcy at the time, as well as General Electric's rather favorable experience with earnings management (Magrath and Weld 2002).

In almost all of the articles on earnings management, it is interesting to take notice of the different discernments that various stakeholders have on the subject. For the most part, when people hear earnings management, they consider it as misleading material and thus a fraudulent activity. However, articles on earnings management were very informative on how earnings management today is a responsibility and requirement of businesses. They don't point out that managers should overdo earnings management for their own personal benefits, but instead that it is a part of their job. Then there is the Securities and Exchange Commission's (SEC) viewpoint that even though earnings management may follow all of the accounting standards and laws, they may go against what those laws were originally trying to establish (Rafik 2002).

Importance of Earnings Management and Why it is Used

It is important to understand why earnings management is so crucial in today's society. Financial reports are made to convey managers' information on their firms' performance and as a result it is up to them to exercise judgment in financial reporting. The managers' backgrounds in their businesses enable them to choose the best reporting methods, estimates, and disclosures that match the firms' business economics. However, because they have this responsibility, they also have the opportunity for earnings management, which is selecting reporting methods that do not accurately reflect their firms' underlying economics (Chiou and Tsai 2009). The problem with this is the credibility of financial reporting as a whole. A lot of businesses, investors, and stockholders rely on financial reports, so when they lose their validity, a disaster is waiting to happen in the near future. Unfortunately, if earnings management continues to grow, it could ruin American capital markets by ruining this transparency and reliability of financial statements that investors' confidence rely on (Rowland 2002). The best example of how it has already negatively impacted the economy occurred between the years 1998 and 2001. Over 66 billion dollars were lost when firms made earnings restatements. Besides Enron, three other companies - Lucent, Cendant, and MicroStrategy - also abused earnings management and ended up costing the stock market more than 34 billion dollars in three days (Magrath and Weld 2002).

Use of earnings management is a result of the opportunity that managers have. One article addresses this issue and three other factors that play a part in the commitment of fraud. An exposure draft that was released by the Auditing Standards Board (ASB) for public comment in February 2002 described three conditions generally present when fraud occurs, known as, "The Fraud Triangle." These three components are incentive/pressure, opportunity, and attitude/rationalization. However, in David T. Wolfe's article, he adds a new component of capability to make a "Fraud Diamond." This additional element focuses on the individual's personal traits and abilities playing a major role in the commitment of fraud. The reason for the fourth component is that many frauds, especially the large multi-billion ones, would most likely not have occurred if there was another person with different capabilities in place. The article goes on to explain how the four parts of the diamond relate. First, opportunity creates the possibility for fraud, and then the incentive and rationalization will draw the individual toward it. Finally, if the person is capable of recognizing the opportunity and taking advantage of it, fraud is most likely to occur. The article gives a good explanation of the thought process a person considering to commit fraud might have:

- Incentive: I want to, or have a need to, commit fraud.
- Opportunity: There is a weakness in the system that the right person could exploit. Fraud is possible.
- Rationalization: I have convinced myself that this fraudulent behavior is worth the risks.
- Capability: I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.

(Hermanson and Wolfe 2004)

After understanding what goes into committing fraud, it is easier to understand how companies get wrapped up in the troubles of earnings management. Every company has the priority to show that their company is doing well, even if that takes some extra actions. In fact, some managers believe it is necessary to use earnings management. They mention the capital market's unwillingness to forgive companies that miss their earnings estimates (Lo 2008). So, in order to keep the stockholders happy, they're going to do everything they can to make their numbers look good. Kin Lo (2008) states in his article how users of financial statements today actually anticipate earnings management, thus, managers report inflated earnings because inflated earnings are expected of them.

Another motivation is personal gain. Over the past two decades, companies have begun to have a new obsession with short-term results, stimulated for the most part by a rise in the use of stock-based executive pay in the 1990's. Wall Street's high demand for growing profits persuaded many companies to switch compensation to their executives with stock and stock options. This instantly created a problem because now high up managers' pay are highly dependant on the value of their company's stock. So, like the average person, these people wanted to earn more money, which in turn meant that company management focused less on the long-term ability to generate cash. Instead, now they only worried about how to increase the stock price every quarter in order to earn more. The primary reason behind this new switch of paying out in stock was the idea that it would make executives more inclined to do a better job. However, the problem was, they ruled out the possibility that executives might find schemes to manipulate earnings. The future consequences of manipulating earnings were an afterthought of managers, as long as the short-term was looking prosperous (Fowler 2006).

Sometimes managers are promised a bonus or their income is based on the earnings of the company, so they have their own reasons to manipulate the financial statements (Ciaou and Tsai 2009). Loomis (1999) states in his article that a lot of times employees don't start out doing it to be dishonest, but instead to ignore a few rules. However, this minor action will end up growing and there will be no way out. Instead of stopping, the employees get scared and just keep on committing fraud (Loomis 1999).

As a result of the increase in fraudulent activities such as earnings management, the SEC has been increasingly more cautious over the past decade by keeping a watchful eye. Ever since Arthur Levitt was Chairman of the SEC, the SEC has worked to keep companies in check and prevent overuse of earnings management or fraud accounting. Rowland's (2002) article states how under then-Chairman Levitt, the SEC adopted several rules that were created from recommendations made by a blue ribbon committee that was formed to specialize in studying the increased problem of fraud. These rules included designs that improved the system by which important accounting decisions at the corporate level are made, such as strengthening the role of the audit committee. The audit committee consists of members of the board of directors who act as independent, vigilant, and knowledgeable overseers of the financial reporting process of its company (Rowland 2002). However, even with increased regulation, earning management continued to flourish.

It wasn't until the collapse of Enron and other corporate scandals that the most influential bill addressing fraud was implemented by the SEC. This bill was called the Sarbanes-Oxley Act (SOX), which was passed in 2002. It set new or enhanced standards for all U.S. public company boards, management, and public accounting firms (Li, Pincus, and Rego 2008). The act contains eleven titles that range from the adoption of new responsibilities, tough provisions to deter and punish corporate accounting fraud, and a new quasi-public agency called the Public Company Accounting Oversight Board (PCAOB). The PCAOB is responsible for overseeing, regulating, inspecting, and disciplining accounting firms in their roles as auditors of public companies. As a result of all the increased set of laws, the SEC threatens companies suspicious of using earnings management with the possibility of intervention and investigations, as well as sentencing executives caught practicing fraud to jail (Coates 2007).

As the SEC focuses on controlling and disciplining the use of earnings management, stockholders and investors are looking for better methods to detect earnings management for their own reasons. Recent studies have shown that there are two sides of how investors view earnings management. Some believe that investors are victims of earnings management because it is important for them to have trust in the company in which they are invested or planning to invest (Lo 350). When financial statements are being excessively manipulated, it is almost impossible for investors to evaluate the true financial and operating position of a company. As a result, the investors are often negatively affected and can lose a lot of money because of the company's actions. Studies supporting this opinion pointed out that investments in firms with high earnings management tended to perform poorly in future periods (Ciaou and Tsai 2009).

Conversely, the other opinion stated by Rafik Elias (2002) is that "…current shareholders actually have a positive demand for earnings management in order to maximize the value of the stock at the expense of future shareholders…" However, the empirical evidence supporting this argument is important to observe. The study focused on managerial actions that benefited the company and ones that solely benefited the manager. Then the study looked at the financial statement users' reactions to these events. The results showed that shareholders, for the most part, considered the actions ethical when they benefited the company (Elias 35). As mentioned earlier, firms' primary objective is maximizing shareholders' wealth. Therefore, if managers have this responsibility, Parfet (2000) says that managers should choose among all legal options that will help realize this objective.

Methods of Earnings Management

After understanding what earnings management is and the different people involved or affected by it, it is important to understand methods of earnings management and how it is detected. There are several different ways of manipulating earnings, but unfortunately, it is very difficult to trace, especially some methods such as "cookie jar reserves." Fortunately, it seems that the SEC is doing a better job controlling correct accounting practices in firms.

There are many approaches to using earnings management; and original methods, or alterations to previous ones, are continuously being invented. There are two broad categories of earnings management: real earnings management (i.e. affecting cash flow) and accruals management, which use accounting policies or a change in estimates (Lo 353). One of the most popular methods of accounting accruals is when companies account for earnings before the cash is actually received. This action, called improper revenue recognition, increases earnings for a period and as a result makes the company look better. The primary reason this is a popular method is because it is difficult to be detected, less costly, and easy for managers to manipulate (Ciaou and Tsai 2009). Loomis (1999) gives an example how some businesses would hold their books open at the end of quarters in order to have enough sales to meet their target earnings. Other companies have been caught creating false invoices to book sales, or a "bill and hold" scam, which is when the sale of goods is recorded but the goods are held in the company's warehouse (Loomis 1999).

Other methods include "big bath" restructuring charges, cookie jar reserves, creative acquisition accounting, and immaterial misapplications of accounting principles. "Big bath" restructuring charges is a popular method. Under the Generally Accepted Accounting Principals (GAAP), a company might decide to close a factory in the near future. It must then estimate the costs that will eventually be incurred by the closing of the factory and charge them off, even though these expenses might not be paid off until future years. These charges are recorded as a liability called a reserve and that first year's profit will be dramatically decreased because of the recognition of costs, but leaves the future clear for good results. Analysts and investors, however, are aware of this and ignore these write-offs and focus on operating earnings. This understanding by the investors that the company is supposed to do poorly that one year creates an opportunity for earnings management. Essentially, the company uses this restructuring cost as a way to purge all kinds of costs that should be affecting that year's earnings or future ones. Then the next few years, as a result, all have higher profits than they should (Loomis 1999).

Acquisition accounting is a bit similar to the previous method, in that companies will expense more than they are supposed to in order to make future years look better. An example is when tech companies merge together. When this happens, the buyer must assign values to all the assets that it acquired from the bought out company and capitalize these assets. However, in tech companies there is an asset called in-process research and development (IPR&D), and this asset is assigned a value and then expensed immediately. IPR&D assets are defined as those "to be used" in R&D, like possible technology instead of already proven technology. So basically, since value is based on judgment, companies will try to maximize the value of IPR&D so they can get rid of other costs. Motorola is an example of a company that was caught using this type of earnings management. After restating their statements, it was found that they tried to write-off $99 million of IPR&D costs all at once in 1998 (Loomis 1999).

Another popular method is the use of cookie jar reserves. In general, it is when companies hold back earnings that should have been recognized during that period and instead keep them for a period of poor earnings. It doesn't matter if companies are just anticipating a bad year or trying to smooth earnings, GAAP states that reserves for "contingencies" are not allowed because such costs cannot be estimated, but instead should hit income statements when they actually arrive. The problem with cookie jar reserves is that they are impossible to detect by investors and even the board of directors are rarely aware that managers are hiding them. As a result, it makes these companies difficult to fairly value, since the reserves can smooth out bumps of when business is both good and bad (Loomis 1999).

All of these methods were specifically addressed by Arthur Levitt of the SEC and can be very risky to carry out; but can both create a temporary fix and are difficult to detect (Loomis 1999). It is evident that almost all companies use earnings management to a certain degree. Some go to the extent of using the methods mentioned above or worse, while some only use mild ways of managing earnings. Unfortunately, the problem companies run into is if it is actually worth it in the long run. They don't realize how often just a small quick fix through manipulating earnings could result in a continuous downhill spiral until the company is in such bad shape that no kind of earnings management will do the trick anymore. But how can companies stand clear of falling into the trap in which so many others have been pressured?

Purpose

This paper will address this issue by looking at two well-known companies: Enron, a company that was doing extremely well but fell into the earnings management trap; and General Electric, who seems to have used earnings management successfully, or better than most. In one article, Parfet (2000) came up with the idea that there are two types of earnings management, "good" and "bad." "Good" earnings management occurs when managers create stable financial performance by acceptable, voluntary business decisions. “Bad” earnings management occurs when managers create artificial accounting entries or stretch estimates beyond reasonable limits (Parfet 2000). This idea focuses on the point that companies can and should use earnings management to their advantage, but must be wary of how far they should go. This paper will look at why, when and where GE and Enron used “good” and “bad” earnings management and the effects it had on each company. Through this comparison, a better understanding of the differentiating line between “good” and “bad” will be sought after, and whether the risk of possibly crossing into the “bad” side is really worth it.

General Electric, Enron, and Earnings Management

Earnings management tends to have a bad connotation attached to it, but really it is hardly an uncommon practice and not always illegal. If there is a business, there is earnings management. So why hasn’t it been such a big problem until recently? Business in the United States and internationally has been present for quite some time, yet never has there been as many fraud scandals as there are today. Maybe the increased reliance on computers has opened up new opportunities to pursue earnings management, or lack of core morals in new generations. Management compensation contracts are often a leading cause, as well as companies’ obsession with short-term results in order to meet Wall Street’s high demand for growing profits. Future earnings became an afterthought of managers, as long as the company was looking prosperous at the present time. Powerhouse companies, General Electric and Enron, were no different, and got caught up in the mania like the rest of them (Fowler 2006).

General Electric: Brief History

One of the most recognized, and successful companies in the world was no different and used earnings management like the rest of them. That company is General Electric, who has dominated business for a long time and has become one of the most familiar brand names in the entire world. It all began with Thomas Edison in the late 18^{th} century. Edison, in 1890, brought all of his business interests together to form one corporation called Edison General Electric. Soon after, a top rival at the time, Thomson-Houston Company, and Edison General Electric decided to merge in 1892 to create the General Electric that exists today. GE's website describes their company as "a strong set of global businesses in infrastructure, finance and media aligned to meet today's needs, including the demand for global infrastructure; growing and changing demographics that need access to healthcare, finance, and information and entertainment; and environmental technologies." (General Electric 2010)

Since its establishment in 1892, General Electric has become a top company that offers many products and services. In 2009 it was ranked as the largest company in the world by Forbes with over 300,000 employees. But not everything is perfect with GE. Benner (2008) states that GE's strength and curse is that it is so similar to the American economy. A common misconception of the average person is that GE is mainly an industrial company. Although GE has become a distinguished manufacturing business in products such as jet engines, locomotives, appliances, and light bulbs, its real business, like America, is in services. Over the past few decades, the manufacturing side of GE has diminished substantially, and therefore services have become the most important part of GE. The most profitable of these services that GE offers are financial. In fact, Fortune 500 classifies GE in the diversified financials industry. Not only is it classified as a financial company, it actually is the largest company in the industry by a hefty margin (Benner 2008). Clearly, as demonstrated above, GE has quite a resume. So why would a company that has had so much success involve itself in the risky business of earnings management and what were the outcomes?

Earnings Management Success

It is quite possible that GE used earnings management throughout its existence, but it isn't until the past two decades that it has become so significant. In fact, during the 1990's, GE was publically known of practicing earnings management and actually had its methods published in the Wall Street Journal in 1994. The article listed different ways that GE smoothed earnings, such as the careful timing of capital gains and the use of restructuring charges and resources (Magrath and Weld 2002). GE's methods seemed to be working back then, and even to this day they are one of the most successful companies in the world. But in the 1990's there was a lack of strict regulations and SEC interference, so they were able to get away with it (Rowland 2002). In fact, it was stated that since 1995 through 2004, GE met or exceeded analysts' final consensus expectations regarding earnings per share every quarter (Hogan 2009).

The fact that GE was able to meet expectations every year for the amount of time is unbelievable. But that is what makes General Electric such a unique company. Not only has it been able to constantly expand to new markets and move out of less profitable markets, but it also has moved up the value chain by using its accumulated cash and knowledge to its maximum potential. Through these strong strategies and others, GE's stock has become one of the most popular and safest to invest in. However, with this reputation of being a "safe and reliable growth company" as President of GE Jeff Immelt has described them, comes a lot of pressure (Pearlstein 2008).

Under former President Jack Welch, GE's reputation eventually turned into a dangerous guarantee that GE would deliver double-digit earnings growth every quarter. This kind of promise created a major problem for GE, because sooner or later they would have a poor year and the earnings management they were utilizing at the time would not be enough. So in order to meet those expectations, GE had to turn to more aggressive methods. In the SEC's point of view, however, GE's amazing ability to book revenue and expenses and timing asset sales to meet earnings estimates with precision and consistency became increasingly more suspicious (Pearlstein 2008). Eventually, though, GE failed to meet its quarterly number even after President Immelt promised it would. This apparently raised a red flag with the SEC, which decided to investigate GE's internal controls and accounting practices (Hogan 2009). However, the fact that it took so long for the SEC to get to that point must speak about how well GE was able to rationalize their success.

General Electric's use of GE Capital

Before talking about what the SEC found in its investigation, there is a very important part of General Electric's success, as well as use of earnings management, that explains why it failed to meet expectations in 2008. This goes back to GE's major involvement with financial services. This has to do with a 100%-owned affiliate called GE Capital, which deals with these financial services and actually files its own reports with the SEC. GE Capital provides almost any kind of financial service out there, from making car loans to investing in commercial real estate. Even credit cards that are offered from Wal-Mart or Lowe's are actually from GE Capital. But, not only does GE Capital provide about half of GE's exceptional profits, it helps the manufacturing department with sales as well. Basically, GE Capital helps finance customers that are buying GE products by offering low interest rates that competitors fail to match (Benner 2008).

General Electric Capital has had a lot of success over the years through their services, while fulfilling one crucial role. That role is managing earnings. The trick is that financial assets owned by GE Capital are far more liquid than tangible assets owned by the industrial side. As a result, when they need to report earnings, GE can buy or sell these financial assets in the final days of a quarter to give a smooth rise to reported earnings. This is exactly what investors are looking for because companies with unpredictable profits are risky, so GE's stock was very valuable. In fact Benner (2008) quotes Michael Lewitt, the president of the hedge fund Harch Capital Management, who stated GE Capital "has become such a necessary part of GE's legendary earnings results that General Electric could not perform as well or consistently if anything happened to it."

Fortunately for GE, nothing seemed to even threaten GE Capital, especially between the years 2002 and 2006. GE Capital was able to aggressively globalize the business while growing rapidly. Their assets seemed to all be appreciating, interest rates were low, and new opportunities were everywhere. In fact, during those years GE Capital raised its ratio of debt to equity from 6.6 to 8.1 and quadrupled profits to almost $11 billion. GE Capital had no trouble selling or purchasing financial assets to make a perfectly smooth rise on General Electric's earnings per quarter. Things couldn't have been going better for GE (Benner 2008).

Exposure

Unfortunately for GE, most things never last, especially when dealing with earnings management. GE has always been well known for anticipating changes and would respond quickly, creating a competitive advantage. However, in 2007, GE and GE Capital were making some poor decisions, resulting in unnecessary losses. GE Capital, for example, took a 1.2 billion dollar loss in 2007 after selling a rotten business it had purchased earlier. But even with all these problems materializing one after another, President Immelt remained confident. He even promised investors in 2008 that GE was right on track and there was nothing to worry about. In reality though, Immelt knew things were going poorly, but that was ok. He still had GE Capital to fall back on (Benner 2008).

In April 2008, GE announced that first-quarter profits had missed Wall Street's expectations by 700 million dollars. According to GE's standards, to miss expectations by that amount was detrimental and would go down in history as one of their worst quarters. The problem that year was that the credit markets nationwide had frozen up. Therefore, GE Capital wasn't able to help bail the company out at the last minute, resulting in the poor financial report. Afterwards, Immelt proclaimed that this event would never happen again, but the damage was already done. Investors now had a better understanding how GE was always so consistent and no longer had the same trust they previously had. They were betrayed by the lack of transparency of the financial statements due to earnings management and hoped to make better decisions in the future (Benner 2008).

Over a year later, after the SEC had been investigating GE's accounting practices, GE was charged with fraud and multiple violations of the federal securities laws on August 4, 2009. GE agreed to settle the charge by paying a 50 million dollar penalty without admitting or denying the allegations, thus ending the SEC's investigation. The SEC alleged that GE used improper accounting methods to increase revenues and earnings and avoided the need to report negative financial results on four occasions in 2002 and 2003, thereby misleading investors (Hogan 2009). The rule bending was said to have increased GE's earnings by more than 780 million dollars and its revenues by 370 million (Economist 2009). This might sound like a lot of money, but GE's methods of manipulating earnings were innocent-like compared to that of Enron.

Enron

One of the largest and infamous accounting scandals in American history is that of Enron Corporation. In the beginning of the 1990s until 1998, Enron was growing at a respectable rate shown by a 311 percent increase in its stock. After 1999, however, is when things started to become suspicious. Enron's stock increased by 56 percent in 1999 and by a further 87 percent in 2000, compared to a struggling economy for those same years. Enron continued to grow and by December 31, 2000, its market capitalization exceeded 60 billion dollars, indicating to investors high expectations for the future. In fact, *Fortune* magazine did a survey of Most Admired Companies and Enron was rated as the most innovative large company in America. Nevertheless, by the end of 2001, Enron's image and reputation were destroyed. Its stock price plummeted from a peak of

$90.75 in the summer of 2000 to nearly zero in November of 2001, wiping out shareholder's equity by almost 11 billion dollars. On December 2, Enron filed for bankruptcy in New York, becoming the largest bankruptcy in American history at that time (Bratton 2002). There were many things going wrong in Enron, such as poor corporate governance and incentives, but one of the most significant was earnings management. According to Elkind and McLean (2004) in their book, *The Smartest Guys in the Room*, "The Enron scandal grew out of steady accumulation of habits and values and actions that began years before and finally spiraled out of control."

Enron: Brief History

In 1985, Enron was founded by Kenneth Lay by means of a merger between Houston Natural Gas and Internorth, which were two natural gas pipeline companies. During the early 1980's, most contracts between natural gas producers and pipelines were long-term contracts, assuring stability in supply and prices of natural gas. However, by the mid-1980s, changes in the regulation of the natural gas market occurred, allowing more flexible arrangements between producers and pipelines. Enron, as a result, profited from the increased flexibility resulting from the changes because of its ownership of the largest interstate network of pipelines. Taking advantage of its recent success, Enron decided to grow by expanding outside its pipeline business and into natural gas trading. Over time, Enron continued to expand further by becoming a financial trader and market maker in electric power, coal, steel, paper, and water. By 2001, Enron had become a multinational corporation that owned and operated gas pipelines, electricity plants, paper plants, water plants and traded generally in financial markets for the same products and services (Healy and Palepu 2002).

Focusing on the deregulation on the natural gas market that Enron took advantage of, is what allowed the company to become so successful. The increased freedom in the market introduced more volatility in gas prices and suppliers were allowed to interrupt the supply of gas without being legally penalized in a standard contract. Jeffrey Skilling, who would eventually become CEO, had the idea to create a natural "gas bank" to manage these risks facing suppliers and buyers effectively. Basically, it would intermediate between suppliers and buyers of natural gas like a financial banking institution would with money (Healy and Palepu 2002). This strategy created a comparative advantage over rivals from the financial sector, because Enron could forecast regional shocks earlier because of its superior knowledge of the industry (Deakin and Konzelmann 2003).

Enron Begins Manipulating Earnings

Eventually Enron began offering utilities long-term fixed price contracts for natural gas; and to reduce exposure to fluctuating prices, it would enter into long-term fixed price arrangements with producers. To help finance many of these transactions, Enron began using off-balance sheet financing vehicles called special purpose entities. By 1992, the gas trading business became Enron's second largest contributor to net income and the largest merchant of natural gas in North America. In November of 1999, Enron introduced an on-line trading model called EnronOnline, which further enabled the firm to extend its abilities to negotiate and manage their financial contracts (Healy and Palepu 2002). Things seemed to be going well for Enron on the outside, but in reality, because of its complex organizational structure that stretched the limits of accounting, many ghosts in the closet were just waiting to get out. These accounting limitations gave

Enron the opportunity to manage earnings to create attractive financial statements (Healy and Palepu 2002).

Mark-to-Market Accounting

Enron had two main schemes of managing earnings that were found after the scandal. The first method of earnings management being used that would eventually transform into a major problem was Enron's aggressive accounting practices with its long-term contracts. Instead of accounting for actual costs of supplying a product and actual revenues received from selling it when it occurred, Enron used a complex method called mark-to-market accounting, or fair value accounting. According to GAAP, this method requires that once a long-term contract has been signed, the seller must estimate income as the present value of net future cash flows (Healy and Palepu 2002). However, if used effectively, this accounting rule and other revenue boosting methods could create the illusion that a company is extensively larger than it really is (Bufkins and Dharan 2004). This is the case because the bias that goes into estimating the present value of net future cash flows is what opens the door for earnings management. Despite this, the SEC approved the accounting method on January 30, 1992. The ruling only applied to the trading of natural gas contracts, but Enron would use it in other areas of the company in order to meet expectations (Elkind and McLean 2004). An example is when Enron signed a 20 year agreement with Blockbuster Video to introduce entertainment on demand to multiple U.S. cities. Pilot projects in a few cities were created to stream movies to a few dozen apartments from servers set up in the basement. Even though there were still doubts about market demand and technical feasibility with this agreement, based on the pilot projects, Enron decided to recognize estimated profits of more then

110 million dollars. Eventually, Blockbuster pulled out of the agreement because of its failure, but Enron, on the other hand, continued to recognize future profits (Hays 2005).

Special Purpose Entities

The second main method involved in the scandal was Enron's use of special purpose entities (SPE). SPE's are defined as a legal entities created to fulfill specific or temporary objectives (Healy and Palepu 2002). A company will create an SPE, but an outside investor will come in to supply external capital and share the risk (Deakin and Konzelmann 2003). In this way, companies can finance a large project that they want achieved without putting the entire firm at risk. In Enron's case, SPE's were used to fund or manage risks associated with assets such as the acquisition of gas reserves from producers. For financial reporting purposes, there are a series of rules that state whether an SPE is a separate entity from the sponsor (Healy and Palepu 2002). These rules made by GAAP again leave room for opportunities to create misleading financial reports because the rules state that the assets and liabilities of an SPE do not need to appear on the balance sheet of the sponsor (Deakin and Konzelmann 2003).

Enron took full advantage of these rules and as a result set up hundreds of SPE's whose accounts did not need to be consolidated with its own. This enabled Enron to maximize its benefits of using SPE's. Enron was able to replace potential liabilities with assets such as promissory notes issued to Enron by its own SPE's, and increase earnings through income generated by the SPE (Deakin and Konzelmann 2003). Surprisingly none of these actions were illegal since they adhered to GAAP. However, Enron crossed the line into fraud by entering into a series of transactions with an SPE that had no outside investor called Chewco (Deakin and Konzelmann 2003). In the annual reports, Enron did disclose the existence of these transactions as required, but in a blurred manner. By violating accounting standards with the creation of Chewco and other false SPE's which were revealed in October of 2001, Enron was able to understate its liabilities and overstate its equity and earnings (Healy and Palepu 2002).

Collapse and Exposure

It is evident that towards the end of Enron's reign on top from 1997 until its collapse in 2001, its primary motivations for accounting and financial operations seem to have been to keep reported income and cash flow up, asset values inflated, and liabilities off the books (Bodurtha 2002). But Enron's phenomenal four-year growth from 13.3 to 100.8 billion dollars was tainted with the use of a variety of deceptive, perplexing, and fraudulent accounting practices. Enron awed everyone, including Wall Street, with its continuous growth, even in down energy and utility industries. But it was all a scam and the best analysts during that time were tricked with the rest (Bufkins and Dharan 2004).

The discouraging truth is that some in Congress claim that Wall Street analysts should have seen red flags as early as two years before Enron's implosion. Instead, analysts rated Enron stock as a strong buy the same day that Enron acknowledged it had overstated profits by almost $600 million (Cohan 2002). Even though Enron's financial statements were described as opaque and impenetrable, there were still signs of suspicious activities. For example, Enron's return on equity and profit margins showed that it wasn't profitability that drove its stock prices up, because they ranked at the bottom of the largest energy companies. This would suggest a major weakness in the company's financial foundations regardless of how much debt was hidden in special purpose entities and concealed from the public. When it seems like a company is too good to be true, it probably is. Bufkins' and Dharan's (2008) numbers point out that Enron's growth of over 65 percent per year is unprecedented in any industry, let alone an industry like the energy one which considers a two or three percent a year growth decent. If Enron would have continued to grow at the pace it was at, it would have surpassed Wal-Mart as the world's largest company (Bufkins and Dharan 2008).

Towards the fall of Enron, executive Sherron Watkins noticed these questionable actions and informed CEO Ken Lay of them, but he seemed to just not comprehend the seriousness of the situation. In fact, the optimism of Mr. Lay continued even after explicitly being warned that several years of improper accounting practices threatened to bring down the company (Cohan 2002). It is possible that Mr. Lay acted obliviously because of the fear of the public finding out about his involvement. According to Bufklins and Dharan (2004), it is very probable that the linkage of revenues with executive compensation is a leading factor in Enron's focus on boosting its total revenue figures. Some evidence provided in Enron's annual proxy statements showed that the level of compensation of its key executives was linked to reported revenues under the description of compensation plans. For example, Hewitt Associates executive compensation survey which is generally used to compare competitive pay levels related to revenue size, reveals that CEO Ken Lay was paid a lot of money compared to the average. In 2000, his total compensation was 40.8 million dollars which is 62 percent higher than the 25 million dollars for a 100 billion dollar company (Bufkins and Dharan 2004). Clearly, the numbers point out that Lay was involved and well aware of the illegal activities going on within the company.

Conclusion

General Electric and Enron were both involved with earnings management. One is still around today, while the other is not. This is what makes earnings management such a risky business with which to become involved. It has the potential to give the impression that a company is impervious to a bad year, which in return creates an attraction to investors. But it also has the power to undermine an entire company in a matter of months. There is undoubtedly a large gray area when it comes to the legality of earnings management and fraud because of the difficulty in detecting violations of accounting standards. However, there is a distinction between earnings management that will destroy a company and methods that will smooth a company's reported earnings, whether that being neither too high nor too low.

After examining Enron and GE's actions, Enron evidently stands out more when it comes to fraudulent activities, ending in its economic failure. Besides Enron, there are many other companies that went under over the past decade, and often earnings management was exposed as a central cause. Going back to Parfet's idea about "good" and "bad" earnings management, it appears that there is a correlation between "bad" earnings management and the failure of companies. Enron might have begun with aggressive accounting practices through the use of mark-to-market accounting and special purpose entities with no intention to take it a step further. Their actions at the time adhered to GAAP, even though they were a bit questionable. Eventually though, they crossed the line from "good" to "bad" when they created false special purpose entities and exaggerated future revenues through the mark-to-market method.

General Electric, on the other hand, began using earnings management just like Enron, but never blatantly crossed the line. For the most part, they created a financially stable company that continued to meet analysts' expectations without violating accounting standards. Using General Electric Capital as a means to smooth earnings could be considered deceitful to stakeholders, but it wasn't unlawful. In 2009, when GE was charged with multiple violations of the federal securities laws for using improper accounting methods to increase revenues, GE settled the dispute by paying the penalty. The company didn't fall a part like Enron. It was just a minor setback that slightly hurt its image, but nothing more. GE was still financially stable because they didn't use earnings management to create false revenues in order to be the most profitable company, but as a way to meet expectations.

Companies like Enron who used earnings management to fallaciously create revenues or hide liabilities always end up being caught, but they still do it anyway. These companies rationalize their decisions by stating that it is in the best interest of the company. They believe that they will be able to fix it later on, and convince themselves as well as others that this is true. The unfortunate thing is that when a company creates artificial entries, there is no turning back. The company might look really good on the exterior, when in actuality there is nothing to back it up.

Therefore, the important question a company should ask itself is whether earnings management is really worth the risk. If Enron was exclusively the basis for a decision, earnings management would be considered absurd as a means to become successful. Therefore, "bad" earnings management is certainly not worth the risk, unless a company is looking to be on top of the world for a few years while being aware that a long fall that is impossible to recover from most likely awaits them in the future. But what about "good" earnings management that every now and then crosses into "bad" territory? General Electric would probably fit this strategy the best, and is a great example for others to see whether it is advantageous or not. For a while GE was meeting expectations every year, but that success brought accountability and pressure to match those results in the future. Consequently, that same pressure compelled GE to take the risk of inflating revenues to the next level in order to meet expectations. Eventually their poor decisions were detected and they had to face the consequences. Fortunately for GE, they didn't overuse "bad" earnings management and recognized their mistake. Ever since their financial troubles in spring of 2008, GE has been coming around and expects growth in the near future (Layne 2010).

In conclusion, the level of use of earnings management is and will almost always be up to the discretion of executives. If those executives are smart, they will stick exclusively to "good" earnings management, but with caution. "Good" earnings management is always the stepping stone to "bad" earnings management because of the temptation to build that reputation of flawlessness like GE did. Besides, once a company stretches revenues beyond reasonable limits or hides expenses, it is nearly impossible to get back on track. It is best for a company to just allow itself to have a bad year and move on. GE had to learn it the hard way and is still recovering from the damage, while Enron never even got a second chance. Hopefully, companies today and in the future will recognize these risks imposed by earnings management and the SEC will continue to prosecute those who don't follow the law. Otherwise, the economy could be in serious jeopardy.

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