Failure of Measurement System? Some Lesson from Fall of Enron Corp

JIŘÍ STROUHAL
Department of Financial Accounting and Auditing
University of Economics Prague
W. Churchill Square 4, 130 67 Prague 3
CZECH REPUBLIC
strouhal@vse.cz

CARMEN BONACI
DUMITRU MATIS
RAZVAN MUSTATA
Department of Accounting
Babes-Bolyai University Cluj Napoca
Theodor Mihali 58-60, Cluj Napoca
ROMANIA

Abstract: - The current financial crisis makes us all remember both previous economic crisis that have marked our history and large bankruptcies, that were intensely debated through trade literature, all having similar elements with what we are nowadays experiencing. We trying to prove that we learn nothing from history would be pointless since we have repeatedly watched history repeating itself over and over again. This is even more obvious where capital markets are concerned, their tendency of relearning the same lesson seeming to be one of their most intriguing characteristics. We believe a short incursion into the past might help us look into the present with different eyes. This paper develops an analysis into the past, focusing on similarities with the current financial crisis and still believing in lessons that could and should be learnt.

Key-Words: - Financial Crisis, Accounting Scandals, Fair Value, Enron, Bankruptcy, Financial Instruments

1 Introduction

The current financial crisis reminds us about previous economic crises that have remained in history, as well as of large bankruptcies that were largely debated within trade literature, which themselves also comprise similarity elements with nowadays situation. We therefore couldn't agree more with George Bernard Shaw who used to say that *"We learn from history that we learn nothing from history"*. This hypothesis that would actually be pointless for us to try to validate, being demonstrated repeatedly over time, is even more obvious when it comes to financial markets that seem to have a tendency of learning the same lesson over and over again. This in fact we believe represents one of their most intriguing characteristic.

A brief incursion into the past will maybe help us look at the current situation from a different perspective. Even when looking at the declarations given by Sir David Tweedie, chairman of the International Accounting Standards Board, right after the fall of Enron, he was emphasizing accounting standard setting bodies', namely IASB's intention of learning from such a case:

> *… we plan to learn from this case and to make sure that international accounting standards do not have similar problems. … history is full of examples of those who said "it couldn't happen here" and came to regret it. I do not plan to repeat that mistake.*
>
> *Sir David Tweedie, chairman of IASB*

2 Literature Review

Information provided through financial reporting plays a crucial part on the arena of international financial sector. The current financial crisis makes us reconsider the entire decision making process in financial areas at different levels; financial instruments still having a "front seat" in the whole story. The foresights of the international referential have always been closely analyzed, considering their compatibility to national accounting systems in the context of existing differences. The challenges in endorsing IFRSs are now highlighted by a big question mark on their capacity of properly defending the vulnerabilities of the international financial system [26].

Numerous researches deal with information potential of measurement and accounting. Information systems are to assure enough information and transfer it according to a company's need, in relation to a company organization structure [29]. Knowledge is a fluid mix of framed experience, values, contextual information, expert insight and grounded intuition [20]. One portion supports day-to-day decision making; another part is used for tactical and strategically decision making [30].

Financial analysts remark a series of resemblances between the current financial crisis and other great crisis that have remained in history, such as the Great Crisis of the 30s', the 70s' stagflation and also the stagnation of the Japanese economy in the 90s. We are now dealing with a vicious circle within which confidence crisis and financial crisis sustain each other, reminding us about the banking crisis that manifested three generations before us. We have all heard about the "Black Thursday" (October 24, 1929) when the New York Stock Exchange recorded a significant crash, announcing the beginning of one of the biggest worldwide economic crisis. Stockholders within big American companies have lost until the end of the year up to 40 billion dollars, listed shares loosing 60% - 70% [17], considerably reducing industrial activity, while set rights took until 1933. Numbers that were left behind sound scary even today: industrial production was reduced by 46% in the US during the crisis, 24% in Great Britain, 41% in Germany and 32% in France. In 1933, the number of unemployed workers reached 30 million within the 32 developed countries, among which 14 millions just in the US [17].

For many economists the most relevant parallel is when comparing the current financial crisis with the 70s' stagflation that mixed economic stagnation and inflationist tensions. Back then, the central bank was promising to keep inflation under control but actually had to redirect its efforts on growth. For Peter Morici, economist at Maryland University, the recent American economic crisis looks much alike with the long stagnation that was also experienced by Japan after the long recession in 1989. Banks have nowadays created more and more complexes financial products in their attempt to raise profits, without also controlling for the involved risks, therefore generating a structural problem within the banking system, as it also happened in Japan. Other opinions are even more pessimistic on the current situation, since

> *Large amounts of money have been taken out of the regulated financial system and integrated within a "shadow banking network", made out of derivative products based on mortgage credits involving high risks, where authorities practically disappeared.*
>
> *Paul Krugman, Nobel Prize winner in 2008*

Before the current financial crisis that brought the bankruptcy of a significant number of financial institutions with international renown, three of the largest bankruptcies in the history of the US – WorldCom, Enron and Global Crossing –have taken place during the December 2001 and July 2002 period, having significant effects on investors' confidence. These had more in common than their timing and dimensions, all involving the use of the largely debated and little understood derivative financial instruments.

The lack of experience is felt not only in trading and handling of derivatives but also where accounting aspects are concerned. Even though, as shown in a previous study performed on formal harmonization of issues concerning financial instruments [24, 25], the accounting regulations have absorbed a great deal of the foresights of the international referential (referring here to IFRS), the actual accounting practices seem to show otherwise, seen through the lens of companies' financial statements. The low level of information provided for derivatives operations can turn derivative financial instruments into a potential source of private information and furthermore to abnormal returns, and not to forget inefficiency of the market since all the market participants do not have access to the information they need for their decision making processes.

The tricks of trade connected to derivatives refer to their ability to rapidly generate imaginary profits or virtual losses, which respects the foresights of legality and therefore can be shown in the income statement as the real thing, and in the same time they can be used to hide big investment losses.

Similar to current reactions, during the following periods trading derivatives was presented very often as representing a true abuse. The BBC reporter Emma Clark stating that *"if we are to analyze any financial scandal close enough; we usually discover a derivative or two to blame"*. The famous investor Warren Buffet also warned that derivatives bring a serious threat to the global financial system, stating the following within the annual report of Berkshire Hathaway for 2002:

> *We view them as time bombs; both for the parties that deal in them and the economic system … derivatives are financial weapons of*

mass destruction, carrying dangers that, while now latent, are potentially lethal

Warren Buffet, investor

Sir Julian Hodge emphasized how trading derivatives generates risk exposure even earlier, noting this idea within a memorandum that was addressed in November 1990 to the CEOs of the Julian Hodge bank in Cardiff, memorandum that was quoted in February 1995 by the Western Mail:

In no circumstances enter the derivatives trading market without first agreeing it in writing with me... at some time in the future it could bring the world's financial system to its knees

Sir Julian Hodge, banker

Unlike Warren Buffet, Sir Julian Hodge issued the apocalyptic warning four years before the first scandals were to take place around derivative, in cases such as Metallgesellschaft, Orange County, Sears Roebuck and Proctor & Gamble in 1994, and then Daiwa and Barings in 1995, still without any of them, individually being close to worst the global financial system. The closes to this performance, until recent events, was the hedge fund LTCM (Long-Term Capital Management), went bankrupt in September 1989, requiring massive intervention from other banks and investment funds. A more current case is that of Societe Generale in March 2008, also a victim of massive fraud that generated a 4.9 billion Euros loss.

A rational attitude when confronted with difficult situations would be to take the necessary time and look within the past from which, most certainly we will have something to learn. By doing so, we once again notice that the current financial crisis does not represent a first in blaming the fair value paradigm for the result of a series of aspects that were either neglected or manipulated, therefore generating results that are still remembered in history.

We consider that performing an analysis on what fair value really meant in the case of Enron would be helpful also when analyzing it within the context of the current financial crisis. Moreover, any information taken from the past always has its role in helping us perceive the present, and if this perception is inspired maybe, it will even help us anticipate elements within the future, as others before us used to consider:

The farther backward you can look the farther forward you can see

Winston Churchill

3 Enron Case

In our intention of closely analyzing the Enron case, we must start by admitting that there were actually many causes for the collapse, as well as mistakes made by the auditors, management' fraud, banks offering the possibility of inadequate financing, but also inappropriate valuation of financial instruments [11, 18, 24]. Generally, we could say that Enron is just one of the examples of entities believing that they can develop a product through simple use of the Internet for downloading information and movies for the users. Furthermore, they created a financial instrument that assumed revenues being generated through this service yet inexistent.

Enron, afterwards valuated this financial instrument with support from the auditors, based on the current value of future generated cash flows, all calculations, assumptions and valuations being based on level 3 inputs, assessed by the entity. Using these internal valuations, they were actually generating values that were recognized within the profit and loss account, based on the asset being recognized within the balance sheet, namely the derivative being recognized at fair value. Of course, those once the company started having problems these assets were proven not to worth a dime, the IT project not even being implemented.

After Enron's collapse, some observers of the accounting scene reached the conclusion that, one of the factors allowing the entity to “window dress” its financial statements, was the acceptance of some financial instruments being valued based only on internal estimations, made by the entity, without any external confrontation coming on behalf of the market. In order to stop this type of abuses from taking place in the future, FASB, together with SEC, instituted new regulations, meant to be less allowing.

The declared objective of the new regulations is one actually hard to be disputed. This would be to make sure that all fair values being recognized within entities' balance sheets are in fact derived from information provided by the market itself and not from assumptions made by the reporting entity thinking of its own interests. Categories of instruments such as those created by Enron would have for sure found a segment of the market being interested by that product, or at least willing to involve in creating a corresponding trading market for it [18].

The market for financial instruments developed quickly during the last ten years, the number of new instruments being developed through the financial ingeniosity of those passionate in this field actually being endless [26]. This made it even more obvious that a general standard was needed so that we could keep pace with these innovations, while also eliminating the image of fair value as an opportunity for creative accounting.

If WorldCom, Inc and Enron Corp. were top of the list with great bankruptcies, the current financial crisis unfortunately also changed this situation by bringing in 2008 Lehman Brothers Holdings Inc. and Washington Mutual Inc. on the top positions. At the time of Enron's bankruptcy (2001), the new paradigm of fair value accounting was gradually being incorporated within the American accounting referential with the purpose of serving together with the well-known historical cost accounting [28]. However, as nowadays, the disaster reached in the case of Enron involved abuses of both paradigms.

Back then, a reason was found in order to argue against the use of some model-based valuation. Moreover, some voices even rushed to conclude that the time for fair value accounting did not arrive yet [2]. Enron's management largely used level 3 and 2 inputs for both internal and external reporting purposes. Level 3 inputs were first used on energy contracts and afterwards for trading activities in general and different structured instruments among their investments. Fair values were also used in valuating and compensating employees having a certain history within the company.

As proven later, accountants within the entity (having Andersen's approval) have used a series of accounting settings in order to rather report trading cash flows and cover overvaluations and losses generated through fair values used on certain projects by managers whose payment was based on fair values [9].

Enron represents a largely debated topic, a series of analysis being performed within trade literature, with results not pointing fair value as a culprit. Moreover, it was documented that the lack of an appropriate, efficient and well projected internal control system was what created opportunities for abuse and manipulation of fair value accounting [2]. Even in this particular case, the obvious advantages regarding the relevance of information provided through fair analysts recognize value, but once again, the idea of developing a hybrid system is argued. This would involve using both historical cost accounting and fair value accounting which actually meanwhile produces a distortions within the coherence of the reporting system, opening the doors for income management and window dressing of financial statements, therefore cancelling the efficiency of the existent internal control systems [2].

Although a series of critiques are brought to the mix attribute [14, 23], the merits of fair value accounting are not yet cancelled through them. We even consider it actually enhances the need for a correct approach of fair value accounting, together with its fundaments, but also the importance of its adequate implementation in order for it to work as designed at conceptual level, this of course involving aspects related to control systems and audit standards.

Papers approaching Enron form a true reference point, regardless if we consider trade research literature or professional literature. Aspects related to elements that are comprised within financial statements and income measurement become extremely eloquent within the context of such a case study regarding the use of mark-to-market accounting, the subject being approached even nowadays and even reconsidered after so many years passed since Enron's collapse.

3.1 Brief History of the Legend

Some of the first reactions in the Enron case were pointed, when considering the accounting perspective, towards the company's excessive use of Special Purpose Entities (SPEs) in order to keep a significant part of its activities outside the balance sheet; towards aspects related to the use of these SPEs in supporting incomes that were recognized by Enron, through creating options that achieved would have protected the company assets' value; and towards the opportunity offered by SPEs and their connections with Enron, for personal enrichment of some employees at high levels within the company [22].

Afterwards, the perspective became more comprising and balanced as for where the true dimensions of accounting manipulations being done at Enron were concerned. Reports of those appointed by the court also contributed a lot in this sense [3, 4, 5, 6, 15]. Aspects referring to inadequate use of fair values did not escape analysis, being emphasized in papers such as those belonging to [1, 8, 19], but mostly [9], who performs a very analytical analysis.

We must also underline the contribution being brought by [16] who beside framing relevant aspects within the contextual and theoretical frame with a broader aim, also analyze, in a more detailed manner than any other previous study, the nature and qualitative level of proofs being used by Enron in order to support the recognized valuations. [16] focus mainly on materials comprised within the [15] report which received less attention in trade literature when compared with the [3, 4, 5, 6] reports. The objective is to find more details on how Enron reached those valuations being used, but also on the role third parties played both in generating these values, but also in supporting and raising the credibility of valuations being incorrectly, internal generated by the company.

Since the story of Enron and its collapse is today familiar to most of us, a detailed presentation won't be necessary, but only a synthesis of events, while focusing on those aspects related to financial instruments and fair value. Before its monumental bankruptcy, Enron was one of the corporations with the fastest ascension and highest success in the US. Established in 1985 through the merger of a number of companies, its core business was then the transportation of gas by pipeline, therefore creating the biggest distribution system in the US. By the end of the '80s and '90s, the company started to take advantage from the deregulation within the utilities industries, participating within and promoting markets for the supply of gas and oil, and therefore extending its activity at global level, in South America, UK, Europe and India. By the end of the '90s, the main generator of development and apparent profitability within the corporation was what they called in their financial statements as "wholesale services". This assumed not only purchasing and selling contracts for energy supply, but also developing strategic investments, either through the establishment of entities, either through acquisitions, in the energetic and technologic sector, or other connected to it. Incomes from wholesale services raised with 133% in the 1998 – 2000 period, reaching from 968 million dollars to 2260 million, while incomes from transportation of gas and supplying electricity, calculated cumulated have raised with 15 %, from 637 million to 732 million [16].

High competition on the futures market and the lack of success for many of the projects that were initiated overseas started to create tension on the company. Even if the quick appreciation of many of its „hi-tech" investments allowed Enron to hide the lack of success in other parts of the company, the consequences were also significant when the IT crisis burst. Enron's share value, that reached 90 dollars in august 2000, kept dropping because of the doubts on the quality of earnings being reported and of the balance sheet's credibility. Senior executives selling their stock only accentuated this downward trend in Enron's share value [16].

In August 2001, the CEO of Enron was resigning and in October 2001, the company reported a quarterly loss of 618 million dollars. Soon news came out that SEC was investigating possible conflicts of interests and in November 2001 an overstatement of profits with 600 million was recognized. Bad publicity associated with all these events affected the trading of its contracts. Therefore, having no cash available, Enron first tried to merge with its smaller competitor in Houston, Dynegy. Having no success in this direction, Enron declared bankruptcy in the US on December 2, 2001 [16]. A series of trials took place, ending with Enron's management being convicted. Among them were the CFO (Skilling) and the Chairman (Lay).

Activities developed by this corporation were the subject of many investigations done by a series of parties, including internal investigations initiated by Enron, comities of the US Senate, but also analysts of the bankruptcy. A significant number of papers were written, articles and research papers, analyzing different aspects of the collapse. The movie *„The Smartest Guys in the Room"* was also done on this highly debated subject, starting from [19].

3.2 Financial Instruments and Fair Value…Sounds Familiar?

A first reaction to the current financial crisis is once again to blame the fair value, which in its essence is just a simple messenger of the crisis, the causes being others. Indeed it is easy to say that at the basis of a fair value that would have had suffered an artificial increase of the real estate prices, some banks or financial institution would have offered furthermore more and more flexible mortgage credits, meanwhile others would have invested in toxic assets such as CDOs from the same considerate, the guarantee behind this being the same real estate assets extremely over valuated. It is hard to believe that within such a complex system, the incognizance can be as so great that there wouldn't exist responsible parts for the events that happened, other than the fair value, which, hard to believe, after so many decades of elaboration as a concept, could be the basis of the actual crisis [11].

Both when considering to give a mortgage credit, as well as when an investment is done in a derivative asset, today toxic, the bank, respectively the investor, have the responsibility to evaluate the risk inherent as better as possible, taking into consideration also a pessimistic scenario and its effects. In this situation, the question that is posed is until when is supposed the real estate price to reach in order to take into consideration the risk of decreasing? Unfortunately, it seems that…until the crisis. Even more, over the responsibility of the financial institutions and of the investors, that we put in the same place even though they differ, are found the agents' responsibilities of rating that have the role of improving the informational process between the one who sells the credits and the potential owners of the titles. It seems though, that all the participants on the market have forgotten a basic rule in the world of investment, which says that *"when you cannot valuate an element, don't buy it and don't sell it"* because lack of information can make you often *"voluntary victim"* within the process.

Coming back to details on Enron's accounting practices we believe it would be safe to say that the [15] report is the most detailed as in regards to its focus, offering a series of supplementary information regarding the manner in which some valuations have been done in order to sustain fair value accounting and market based values. Enron's bankruptcy was due to a series of causes, both direct causes (recognizing some significant false accounting information) and proximal caused (more complicated mechanisms among which we will further focus on those related to financial instruments). Still, there are sufficient proofs indicating the fact that using level 3 inputs in order to apply fair value accounting played a significant role in this said story [9], as it also did nowadays.

It seems like initially, these estimations were used without any intention of misleading investors, but rather to motivate and payback managers in correspondence to the economic benefits they were generating in favour of the stockholders. Trade literature assesses different degrees of quilt to the assembly of factors that generated Enron's collapse. For example [21] underlines the use of derivatives, [13] the inadequate behaviour of those who are supposed to be the gatekeepers of the accounting world – external auditors and even lawyers, but we will further focus on financial instruments and fair value accounting related aspects.

In 1990 Jeffrey Skilling, former Enron consultant, decided to enter the company, soon proving his innovative spirit through the development of a method that involved trading gas contracts called Gas Bank. Skilling becomes president and CEO of the new division, Enron Finance, with the purpose of implementing this new method, for which he was also going to be generously rewarded in "ghost" equity (he was rewarded in accordance to Enron's share value raising on the market). His innovation consisted in advance payments for gas producers, therefore making them sign contracts for supplying gas on long term. Skilling insisted on using a market based valuation (actually a fair value valuation since there was yet no market for those contracts) when accounting for the profit of his division. In 1991, Enron's management, the internal audit committee as well as the external auditor, Arthur Andersen, approved the use of these values.

Despite the US strongly arguing for some time in favour of historical cost accounting, SEC not even allowing revaluation when the value of tangibles grew [31], during the 90s mark-to-market accounting already became largely used, as a consequence of the direction taken through the conceptual framework. Enron, and especially Skilling, the one who in his quality of CEO was consider being the author of the masterpiece that was going to transform the company from a pipe and energy operator, militated for the right to use mark-to-market accounting in valuating energy contracts.

Therefore, on June 1, 1991, Enron was sending a letter to SEC announcing their intention regarding the use of mark-to-market accounting in its trading activity, together with a detailed memorandum that motivated the adequacies of this treatment, claiming that trading energy futures is similar to trading futures that involve securities, therefore requiring for the same accounting treatment. The memorandum also emphasized the development of some spot and forward markets for gas futures that were in their opinion capable of ensuring a market-based valuation. Letters from Arthur Andersen and Ernst & Young accompanied their memorandum.

Although the letter initially generated worries within SEC's staff, Skilling's change, or maybe after the events therefore generated it would be more appropriate to say bad luck, was that in January 1992 Walter Schuetze became Chief Accountant of SEC. Schuetze, a Texan with significant experience in auditing gas and oil companies, but most importantly, a convinced and passionate believer in fair value accounting, significantly contributed to the letter Enron was going to receive from SEC on January 30, 1992. The letter was saying SEC was not going to object on Enron's use of fair value accounting for its gas trading activities. Even if SEC's approval was initially received only for contracts that were initiated in 1992, Enron also applied the accepted accounting treatment for the 1991 financial statements that were not yet filled (once again without SEC objecting). This helped them report 242 million dollars profits [10]. From here on, Enron recorded earnings from signing contracts, based on estimations of gas prices projected a few years into the future (10 to 20 years).

Apparently, with no further consultation with the SEC, Enron extended mark-to-market accounting to other contracts in the field of electric power, coal, paper and pulp and even non-energy commodities in the 1999 – 2000 period. Even if in 1998 applying mark-to-market accounting for energy contracts was mostly "accepted" by accounting standard setting bodies, and assuming that necessary conditions were met by the entity applying it, this does not justify several of other cases. One of Enron's former employees expressed his opinion as follows:

> *When we marked to market, we were truly controlling our revenue. That was how your business model was set up . . . You could always meet [Wall Street's] expectations. [16]*

While Enron was using fair value accounting for shares within some new companies that were established by the company itself or in which the company invested, these shares were not traded or only recorded a few transactions, as also in energy contracts' case, fair values were not based on real market values since there were no markets to begin with. An example of income recognition related to trading a standard contract, but in, which Enron was actually participating on both parties, is the one related to supplying gas for the Cuiaba station in Brazil in the future. Meanwhile Enron owned 65% of Cuiaba.

In this particular situation, Enron avoided consolidation by selling 13% to LJM 1 (whose manager was Enron's CFO) once with the right to appoint one of the four directors (right that was obviously not used by LJM 1). This allowed Enron to argue that it did not have the right to appoint the majority of directors, therefore losing control over Cuiaba and avoiding consolidation. After avoiding consolidation, the shelled shares were re-bought at a price that generated a certain profit for LJM 1. This avoidance of consolidation allowed Enron to recognize, by using fair value in evaluating the contract, a 34 million dollars income within the third quarter of year 1999 and 31 million dollars for the fourth quarter, without mentioning the fact that the corresponding station and pipes necessary for providing gas were not finished.

In order to trade its derivatives that extended beyond the fuel of gas and energy to contracts with metals, paper and pulp, credits and other commodities, Enron developed a trading system with the help of internet called Enron On Line – EOL, that allowed it to dominate a series of markets. Enron was often the one establishing prices within these markets, prices that were afterwards used in establishing its transactions' fair values.

Analyzing the company's financial statements for 1989, 1999 and 2000, [21] concludes that trading derivatives was actually the only profit making activity that was developed by Enron, the rest of the activities generating loses or extremely low profits, and this despite of the overstated values being reported with the help of fair value accounting and other accounting mechanisms. Moreover, [21] concludes that profits reported from trading derivatives were not correctly determined either.

We must not forget that Enron's brokers were awarded based on the profit they obtained through the trading activity. Meanwhile, reported profits or losses were based on estimations brokers made in determining current (fair) values for the derivatives that often covered periods of several years. It is therefore obvious that brokers were tempted in manipulating the methods and estimations they used in the valuation process, so that they reached their own interests:

> *Because of the fact that brokers dealing with gas contracts were awarded based on the obtained profits, they were stimulated to hide losses by changing futures curves … in some cases brokers actually manually introduced such curves that were totally different from those generated by the market … when dealing with more complex transactions brokers adjusted the assumptions within the informatics model used in valuating transactions in order to make them look more valuable. [21]*

There were also situations when brokers under valuated profits or postponed their reporting using "prudential reserves". This practice allowed them to postpone profit towards future periods and was applied when brokers have already reached their maximum bonuses [9]. It is therefore pretty obvious that things have escaped any control when considering information being reported:

> *Real dimensions of those valuations within Enron's financial statements that were meant to mislead still remain unclear, although a series of brokers stated that inaccuracies went far beyond a billion dollars. [21]*

Implicitly, a real valuation of the degree to which Enron's brokers brought benefits for stockholders is not possible. [12] still concluded that during negotiations with Dynergy regarding a possible merger, an analysis was also performed on Enron by Dynergy, concluding that despite the values being generated through the EOL system Enron was still losing liquidities within its commercial activities.

[16] interestingly express the paradox of mark-to-market accounting, namely the fact that it is very probably that it would be more "precise" under circumstance that are less useful, such as the case of complete markets being so difficult to find in practice. Starting with 1979, [7] stated that the role of accounting information within incomplete markets that are characterized through uncertainty

are alike that of loud communication. The above-mentioned examples also suggest the fact that under certain circumstances, the “loud” party might weight more the informational content itself [16].

With all these in the background, analysis of Enron’s bankruptcy still do not bring criticisms to market values, but rather to the way, they were used in this particular case:

> *Actually, an adequate use of mark-to-market accounting for assets and debts that are frequently subjected to price fluctuations, and providing information concerning the involved risk, for sure offer more relevant and reliable data than historic costs. Moving beyond the abuses that were done within the valuation process, the real issue was not that of Enron using mark-to-market accounting, but rather that Enron used financial engineering in order to launch effects of mark-to-market accounting. [4]*

We must also not forget the finality of things, and that is that from users’ of financial information point of view, the result is the same. Providing inadequate information, which they used in grounding their investment decisions, was not going to be different regardless if it was the result of theoretical faults or failure in practice application [27, 28]. Enron personifies the case of failure in practice application, mostly determined through management’s role and also the problematic issue of using independent external agents in order to provide some valuations that are of great significance for mark-to-market accounting.

Therefore, through its great dimensions, the Enron case made us think about using level 3 inputs when reported information are not well grounded through relevant market prices ten years ago. These are issues raising the interest of standard setting bodies even nowadays. Once the corporation was allowed to use fair values for its energy contracts, it extended the treatment to a larger growing range of assets, both within external reporting and internal purposes of assessing employee’s performances and their corresponding rewards.

The result meant overestimating incomes and net profits, and creating complicated structured transactions that enhanced the inappropriate use of fair value. Establishing rewards based on fair values stimulated the employees to develop new projects that were afterwards overestimated, all these rather generating high exploitation expenses than successful projects. The losses therefore generated only made more space for accounting creativity until the corporation’s final collapse.

4 Conclusion

We end this journey into the past by thinking about Salvador Dali’s words advising us never to stop learning from the mistakes of the past, despite all these proofs showing us how history tends to repeat itself:

> *Mistakes are almost always of a sacred nature. Never try to correct them. On the contrary: rationalize them, understand them thoroughly. After that, it will be possible for you to sublimate them*
>
> *Salvador Dali, painter*

Standard setting bodies’ efforts in creating financial reporting standards that could guarantee high quality financial statements are fully justified and sustained. Introducing fair value within financial reporting naturally generated reactions on behalf o standard setting bodies wanting to get involved within the conceptualization process. This objective is quite a difficult one if we are to consider the complexity of economic realities trying to be captured. As a consequence, the process of finalizing the fair value concept and, most importantly, all necessary guidance related to its practical implementation under several demanding circumstances for a concept with high ambition is far from being closed.

We dear say that economic realities characterizing our every day compel us to undertake some measures trying to keep pace with these evolutions. In the particular case of fair value, we believe there is no magic solution able to simplify the anfractuous road we still have to cover in order to reach the proposed objectives. The financial system therefore seems to be repeatedly teaching us necessary lessons to be dealt with on this road. Despite the series of measures necessary to be taken under crisis circumstances, all debates surrounding fair value should at one time bring us closer to financial realism even if it is a difficult road having high prices to be paid.

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