S12-4 Ethical Decision Making: A Real-Life Example

LO 12-1, 12-5

Enron

In a February 19, 2004, press release, the Securities and Exchange Commission described a number of fraudulent transactions that Enron executives concocted in an effort to meet the company's financial targets. One particularly well-known scheme is called the "Nigerian barge" transaction. According to court documents, Enron arranged to sell three electricity-generating power barges moored off the coast of Nigeria. The "buyer" was the investment banking firm of Merrill Lynch. Although Enron reported this transaction as a sale in its income statement, it turns out this was no ordinary sale. Merrill Lynch didn't really want the barges and had only agreed to buy them because Enron guaranteed, in a secret side-deal, that it would arrange for the barges to be bought back from Merrill Lynch within six months of the initial transaction. In addition, Enron promised to pay Merrill Lynch a hefty fee for doing the deal. In an interview on National Public Radio on August 17, 2002, Michigan Senator Carl Levin declared, the "case of the Nigerian barge transaction was, by any definition, a loan."

Required:

1. Discuss whether the Nigerian barge transaction should have been considered a loan rather than a sale. As part of your discussion, consider the following questions. Doesn't the Merrill Lynch payment to Enron at the time of the initial transaction automatically make it a sale, not a loan? What aspects of the transaction are similar to a loan? Which aspects suggest revenue has not been earned by Enron?
2. The income statement effect of recording the transaction as a sale rather than a loan is fairly clear: Enron was able to boost its revenues and net income. What is somewhat less obvious, but nearly as important, are the effects on the statement of cash flows. Describe how including the transaction with sales of other Enron products, rather than as a loan, would change the statement of cash flows.
3. How would the difference in the statement of cash flows (described in your response to requirement 2) affect financial statement users?

S12-5 Ethical Decision Making: A Mini-Case

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Assume you serve on the board of a local golf and country club. In preparation for renegotiating the club's bank loans, the president indicates that the club needs to increase its operating cash flows before the end of the current year. The club's treasurer reassures the president and other board members that he knows a couple of ways to boost the club's operating cash flows. First, he says, the club can sell some of its accounts receivable to a collections company that is willing to pay the club $97,000 up front for the right to collect $100,000 of the overdue accounts. That will immediately boost operating cash flows. Second, he indicates that the club paid about $200,000 last month to relocate the 18th fairway and green closer to the clubhouse. The treasurer indicates that although these costs have been reported as expenses in the club's own monthly financial statements, he feels an argument can be made for reporting them as part of land and land improvements (a long-lived asset) in the year-end financial statements that would be provided to the bank. He explains that, by recording these payments as an addition to a long-lived asset, they will not be shown as a reduction in operating cash flows.

Required:

1. Does the sale of accounts receivable, which generates immediate cash, harm or mislead anyone? Would you consider it an ethical business activity?
2. What category in the statement of cash flows is used when reporting cash spent on long-lived assets, such as land improvements? What category is used when cash is spent on expenses, such as costs for regular upkeep of the grounds?
3. What facts are relevant to deciding whether the costs of the 18th hole relocation should be reported as an asset or as an expense? Is it appropriate to make this decision based on the impact it could have on operating cash flows?
4. As a member of the board, how would you ensure that an ethical decision is made?