Sell-side security analysts: Re-reporting of Enron corporation fraudulent financial data

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Abstract

Listed companies that successfully deceive investing public and issue false financial reports have been observed in the financial markets around the world. The consequences of this practice are devastating on the investing community as well as on the society as a whole. Sell-side security analysts, among other gatekeepers in the financial markets, have been criticized. They should examine financial data issued by listed companies to assure investing public about the reliability of published data. So, to understand how listed companies have succeeded in issuing fraudulent financial reports in the presence of gatekeepers such as sell-side analysts, a well-known fraud case was chosen, i.e. Enron Company. During Enron’s fraud period, 1997-2001, the research paper examined how sell-side security analysts processed Enron’s misleading financial statements. The research method adopted to analyze analysts’ reports was qualitative content analysis guided by Strauss and Corbin (1990, 1998) version of grounded theory Re-reporting was one of the main results generated through the analysis process. It is meant by re-reporting is that analysts were re-reporting what had been reported by Enron without due analysis or scepticism. Additionally, based on the findings of the analysis and relevant literature, two propositions have been developed for further research.

Keywords: Fraudulent financial reporting, sell-side security analysts, Enron; re-reporting, propositions.

1. Introduction

The latest accounting scandals at the turn of the 21st century, particularly scandals in the U.S. markets, have battered global financial markets. The scandals started with Enron Corp. in 2001, a prominent and influential case, which was then followed by other companies up to the present day (Kieso, Weygand, & Warfield, 2007; McClelland & Stanton, 2004; Palazzo & Rethel, 2008; Ribstein, 2002; Thapa & Brown, 2007; Zahn, Singh, & Singh, 2008), WorldCom Inc. (2002), Global Crossing Ltd. (2002), HealthSouth (2003), Refco Inc. (2005), Bernard L. Madoff Investment Securities, LLC (2008), Lehman Brothers Holdings Inc. (2008) Satyam Computer Services Limited (2009) are some examples, (Benson, 2009; Bullock, Guerrera, Jenkins, & Sender, 2010; Giroux, 2008; Rockness & Rockness, 2005; Solomon, Mollenkamp, McKay, & Weil, 2005; Thakurta, 2009), with many of those companies ending up in bankruptcy status.

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The accounting information of these companies, which covered multiple periods of time and was externally audited, showed a healthy financial position and impressive performance. Then weeks or months later, these companies collapsed, or in some cases, needed to restate their financial statements. Thus, the fair and true financial picture had not been portrayed in the issued financial reports. Also, the word scandal is used here because many related parties, such as the Securities and Exchange Commission (SEC), external auditors and security analysts, who are concerned with financial reporting process and outcomes, had not raised their voices and warned the public in advance to take timely and appropriate actions before the revelations of manipulation surfaced and emerged.

2. Sell-Side Security Analysts

As one of the gatekeepers, sell-side security analysts play this role. Sell-side security analysts normally utilize data from different sources to evaluate the company they follow before issuing investment recommendations to buy, hold, or sell its shares and formulate projections such as earnings per share and target price. Those sources include financial and nonfinancial issued by companies, its employees, trade publications, customers, suppliers, and general macroeconomic data level (Lorenzo, 2006; Sirri, 2004).

Further, Sell-side analysts are typically employed by brokerage firms, and most of these brokerage firms are investment banks (Newsome, 2005; Scianni, 2003). In contrast to buy-side analysts who are typically employed by money management firms as mutual and hedge funds, and prepare research reports for their employers solely, sell-side analysts provide their research reports to their employers and their clients (Fogarty & Rogers, 2005). Therefore, sell-side analysts should exert every effort to provide independent, professional, and honest opinion to their clients and to public who entrusted them. In other words they should act as their agent (Goshen & Parchomovsky, 2005).

Hence, when fraud cases erupted, analysts among others have been severely criticized and blamed as the cases of Enron and WorldCom (Healy & Palepu, 2003; Ribstein, 2002; Sirri, 2004). Even in many cases, sell-side analysts or their employers have been accused of intentionally, and contrary to their personal opinions, of hyping and touting intentionally stocks to land lucrative investing deals for their investing banking divisions and penalized hundreds of millions of dollars. In 2003, and based upon what so called the Global Settlement Agreement, ten major investment banking firms, as Leman Brothers, in the U.S. agreed to pay around $1.4 billion dollars of penalties and making structural reforms because of issuance of unreliable and incredible research reports by their analyst (Fuchita & Litan, 2006). In 2003, Jack Grubman, who was working a well-known telecommunication analyst at Citigroup, agreed to pay a penalty of $15 million and barred permanently form working in the securities industry because he issued deceptive recommendations (McGeehan, 2003; Scianni, 2003).

3. Research Issue

Fraudulent financial reporting is unethical and has serious and damaging consequences on the financial markets. Shareholders lose their investments in terms of millions of dollars when stock prices fall down because of the revelations concerning those fraud companies, confidence of investors in financial markets is also lost and thus seek alternative investments other than financial markets, and potential job losses (Braddock, 2006; Crest, 2002; Nicholson, 2007; Perino, 2002; Thapa & Brown, 2007). Further, whatever actions are taken to punish those violate security laws by issuing misleading financial data is conceived too late as to the victims of the fraudulent reporting game.

So, there is a need to investigate thoroughly the fraudulent financial reporting phenomenon from different angles. One of these angles is to find out how sell-side security analysts process fraudulent financial reports and cope with fraud companies before the revelation of such sham practices. In other words, sell-side analysts as experts and information traders in the financial markets and who process financial and nonfinancial data to provide investment advice are linked to the financial numbers game, and thus it is warranty to study the fraudulent reporting from this side and find out how this group of gatekeepers digest fraudulent data during the fraud periods when evaluating such fraud companies.
4. Literature Review

Many studies in various periods have shown steadily that security analysts are utilizing accounting data in their reports, though the extent by which analysts used such data is different from study to study. Govindarajan (1980), Rogers and Grant (1997), and Abdolmohammadi et al. (2006) are examples of studies that have showed this utilization. Generally, those studies highlighted the utilization in terms of quantitative sense. For example, what percentage of financial statements as a source of data being found in the analysts’ reports to the total sources of data used in those reports. Therefore, it can be inferred that sell-side security analysts are by and large utilizing accounting data issued by the companies they cover.

Concerning sell-side analysts and fraudulent financial reporting, some studies have shown that although analysts may signal implicitly that there are fraudulent reporting practices, yet they have not clearly stated that selected fraud companies are producing fraudulent financial reports. Other studies have shown that analysts failed to indicate that there are financial misstatements. For example, Dechow et al. (1996) and Cotter and Young (2004) have shown that the number of analysts who dropped coverage of fraud companies before the revelation of such practices may indicate that they might discover such practices but withhold to reveal them in clear terms and expressions. While, Griffin (2003) found that analysts have failed to uncover the misleading accounting data before it is become a public news.

5. Research Method

Since that there is a need to understand thoroughly how sell-side security analyst process and utilize fraudulent financial reports issued by fraud companies, qualitative content analysis guided by grounded theory approach, Strauss and Corbin (1990, 1998) version have been employed by this study. This approach implies that major categories (high level theoretical abstractions) are not predetermined and derived from data collected through down-top mechanism of analysis. Down-top style implies that analysis and conceptualization starts from the raw data level to identify low level abstraction of concepts, then uplifting the conceptualization abstraction process from those initial concepts derived to arrive at major categories that reflect the data collected pertinent to the phenomenon under investigation (Gurd, 2008; Kelle, 2007). Further, data collection and analysis are performed concurrently and directed by what so called “theoretical sampling”. Theoretical sampling dictates that next data to be collected should be based on the outcomes of the analysis process, therefore theory evolves through interplay of data collection and data analysis (Mansourian, 2006; Parker & Roffey, 1997; Strauss & Corbin, 1998; Suddaby, 2006).

According to Strauss and Corbin (1990, 1998), there are three types of coding; open, axial, and selective coding. Thus, by utilizing these coding types the researcher ends up with a theoretical model that can explain the phenomenon under investigation. However, In axial coding, there is a hot debate regarding the usage of what so called “Paradigm Model”, and many researchers who have adopted Strauss and Corbin approach dropped the usage of this model (Kanning, 2008; Legree, 2008; Mehmetoglu & Altinay, 2006; Perry, 2006). This model consists of several components. These are mainly causal conditions, phenomenon, context, intervening conditions, strategies, and consequences. The major criticism to this paradigm is that grounded theory researcher should not force concepts or categories during the coding process to fit into a priori predetermined scheme thus significant concepts might be lost (Kelle, 2007).

6. Fraud Case: Enron Corporation

Enron Corporation has been chosen for this study as a case study since it has committed fraudulent financial reporting as evidenced by the Securities and Exchange Commission (SEC) Accounting and Auditing
Enforcement Releases (AAERs). According to those AAERs, The fraud period of Enron is 1997-2001 (AAER No. 1617, August 21, 2002; AAER No. 1820, July 28, 2003; AAER No. 2056, July 13, 2004)†.

On December 2, 2001, Enron filed for Chapter 11 of the U.S. Bankruptcy Code, and this filing was considered as the largest bankruptcy case in U.S. history up to that time and shocked the financial markets in the U.S. (Bealing & Baker, 2006; Grumet, 2002). This shock, in addition to other fraud cases as WorldCom, has led to the enacting of a new law called Sarbanes-Oxley Act in July 2002 (Perino, 2002; Thapa & Brown, 2007).

So, Enron as a fraud case was considered as a prominent and influential fraud case, and that is why it has been chosen for this research. Moreover, data available for this case is rich and comprehensive. As a result, intense theoretical model can be developed to explain how did sell- side security analysts process misleading accounting data issued by Enron during that long fraud period, i.e. 1997-2001.

7. Data Collection

The main source of data for this study was sell-side security analysts’ reports issued during the fraud period of Enron, i.e. 1997-2001. Those reports were downloaded from a database called Investext Plus. Additionally, financial media as Wall Street Journal have been utilized to enrich and support the coding outcomes of those analysts’ reports.

From Investext Plus database, it has been downloaded a total of 355 reports. 80 reports were excluded from the analysis, since they were credit rating reports, equity reports related to Enron subsidiaries as Enron Oil and Gas (EOG) in which their financial results have been consolidated in the parents’ financial statements, and other types of reports as interviews transcripts with some of the Enron senior officers. This implies that a total of 255 sell-side equity reports were left for analysis. The details these 255 reports are shown in table 1.

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† Those AAERs can be accessed through the SEC web site: http://search.sec.gov/secgov/index.jsp#queryResultsTop
8. Coding results: Re-Reporting

One of the major categories developed through the analysis process was Re-reporting. The implication of this major category is that analysts were getting data, accounting as well as other types of data, and, largely just reiterating what has been said or written without due analysis or discussion. More specifically, they presented their analysis based upon the data provided by Enron without questioning or examining the data itself. Therefore, to some extent, the analysts covering Enron were working as journalists.

This behaviour indicates that analysts failed to show fraudulent reporting of Enron, in the sense that if analysts had recognised and disclosed Enron’s deceptive practices in their reports, they would not reiterate what have been written or presented by Enron.

This major category is supported by three subcategories, which are behaviours or actions that have supported or led to the generation of this major category. These subcategories are reporting results, various channels of contacts, and reliance of management. See figure 1 below.

![Diagram of subcategories](image)

Figure 1: Subcategories of “Re-Reporting” Major Category

8.1 Reporting Results

During the analysis process, it was noticed that analysts utilised reported accounting information issued by Enron without questioning the reliability of such data itself. However, analysts publicly and widely acknowledged the fact that Enron lacked transparent accounting practices.

Paine Webber, July 13, 1999, re-reported, “Enron Corp today reported second quarter recurring diluted earnings per share of $0.54, up 29% from the $0.42 it earned in the second quarter of 1998” (p. 1).

A.G. Edwards, January 30, 2001, re-reported “ENE reported strong fourth-quarter earnings, led by dramatic increases in the company’s wholesale energy segment” (p. 1).
Furthermore, during the period when Enron’s financial stability deteriorated, which started after the resignation of Jeffrey Skilling on August 14, 2001, and included surprise results in October and financial media articles discussing the wrongdoings of Enron, analysts re-reported results issued by Enron without any indication that Enron might have committed fraudulent financial reporting or any other types of accounting manipulations, such as income smoothing.

Salomon Smith Barney, on October 16, 2001, re-reported, “Enron reported 3Q recurring operating EPS of $0.43 vs. $0.34, $0.01 above our estimate” (p. 1).

UBS Warburg, October 17, 2001, re-reported, “Enron yesterday reported a 26% increase in recurring third quarter diluted EPS, to $0.43 from $0.34 in 3Q00” (p. 1).

Even after Enron had filed 8-K form to restate its financial statements from 1997 until the third quarter of 2001 on November 11, 2001, analysts have re-reported this new data as if those new figures are acceptable and reliable. They have re-reported items as areas of restatements. An example of this is from Credit Suisse First Boston, who on November 16, 2001, re-reported:

On November 8th, Enron filed an 8-K that provides information on certain related party transactions and a restatement of its annual financial statements for the four-year period covering 1997 through 2000 and also for the first nine months of 2001. (p. 3)

CIBC World Markets, on November 21, 2001, re-reported:

The key disclosures in the 8K (filed prior the recent 10Q filing) were related to consolidation of three off-balance sheet transactions, which required restatement of financial reports from 1997 to 2001. Further, the filing also elaborated on the $1.2 reduction in shareholders equity that was announced during the 3rd quarter conference call. (p. 3)

Interestingly, in Commerzbank’s report of November 12, 2001, it was indicated that the impact of these restatements were inflating Enron’s earnings and other liabilities might surface, “We believe that failing to consolidate these vehicles inflated Enron’s reported earnings... However, we are concerned that there may be additional liabilities related to these and other Enron financing vehicles that have not been identified” (p. 6). Yet, as can be seen, this conclusion emerged very late, since it surfaced after Enron filled form 8-K to restate its financial statements and not before. Additionally, in the same report their recommendation was “Accordingly, we are downgrading Enron to Hold from Accumulate” (p. 6), which shows Commerzbank had made no dramatic change of recommendation.

Therefore, it can be said that during Enron’s fraudulent period, 1997 – 2001, analysts practiced a process of re-reporting Enron-issued statements, without due care or scepticism, which means that not only did analysts build their analysis on accounting numbers issued by Enron, a company with weak transparency, they have not questioned or examined the numbers themselves.

8.2 Various Channels of Contacts

Analysts have received different types of data from Enron, financial and non-financial. They have received data as management’s estimates and targets, overviews, strategy, and evaluation. The data were obtained via various types of channels other than financial statements prepared and issued by Enron. Analysts’ annual meetings, conferences, and holding personnel meeting with management were identified as channels of contacts from analysts’ reports.

It can be said that generally analysts were observed as re-reporting, and to a great extent, re-affirming what had been said in those meetings and gatherings. This supports this subcategory being cited within this major category, re-reporting.

In what reads like a marketing document, Donaldson, Lufkin & Jenrette, in January 28, 1997, re-reported:
Enron held its annual analysts’ meeting on Thursday and Friday, January 23 and 24. The well attended two-day session provided specifics on Enron’s plans and its goals for achieving high growth that will enable the company to lead the group and market. (p. 1)

Paine Webber, on January 22, 1999, re-reported:

After attending the full day analyst conference that included a complete review of the company’s strategic direction and tours of its world headquarters, it would be hard to disagree with Enron’s suggestion that it has evolved into the Blue Chip Energy Company. (p. 2)

Dain Rauscher Wessels, on January 26, 2001, stated:

The conference outlined several initiatives that should allow continued growth. At the beginning of the conference, management boosted its EPS guidance for 2001 to $1.70-$1.75 per share. We had already increased our 2001 EPS estimate to $1.75 after the earnings report last week. (p. 1)

A.G. Edwards, on October 25, 2001, and after the release of Enron’s third quarter adverse results on October 16, 2001, seemingly quoted and supported Enron’s position when it stated:

The company hosted a conference call with analysts on October 23 to discuss “general investor concerns”. Management mainly discussed the issues relating to the LJM transactions and other partnerships in which ENE has similar interests. The company also attempted to assure investors that no further charges were coming and that no other hidden transactions exist. (p. 4)

In the above report, and after recommending investors to continue to hold Enron’s shares (p. 4), A.G. Edwards analysts stated, “While we believe the market is most likely overreacting to the news of the last few days, we have concerns that the company may face additional write-offs” (p. 4). This implied that there might be accounting information manipulations in previous periods. However, analysts have presented the above conclusion in a mild manner, given the context of the situation then, and no elaboration or further details were given regarding the issue they have raised. Furthermore, analysts have raised their “concerns” after the issue of Enron’s suspicious financial reporting was discerned by well known financial media, such as the Wall Street Journal (mentioned in the same report of A.G. Edwards, (p. 5)), and as a result of the SEC inquiry into Enron’s financial affairs including financial reporting (mentioned in the report as well, (p. 5)). However, in the same report, analysts re-reported the third quarter results within a favourable context, since Enron’s results were in line with their estimates, “On October 16, Enron reported third quarter earnings of $0.43 per share, in line with our estimate and company guidance” (p. 4). In that third quarter, Enron has changed it earnings by $1.01 billion, which led to reported losses of $618 million and a reduction of stockholders’ equity by $1.2 billion. Therefore, in their analysis, analysts focused and evaluated Enron on recurring earnings, not bottom line earnings that included those nonrecurring items.

Hence, analysts who authored the above reports can be viewed, because of the surrounding circumstances and public debates regarding Enron’s suspicious behaviour, as re-reporting the already emerged and public issues and not uncovering hidden issues.

8.3 Reliance on Management

Analysts’ approach to handling comments and projections made by Enron’s management was with and manner of general acceptance and they re-reported accordingly.

The critical point here is not the argument of whether it was correct or otherwise to re-report, but rather that analysts practiced this reporting with general approval. Based on this view, this subcategory was classified as part of the major category, re-reporting.

Expressions such as “management believes”, “according to management” and the alike were familiar in many analysts’ reports. An example is Prudential Securities Incorporated, who on April 15, 1997, re-reported an Enron management statement, “While management continues to state that the company is on track to achieve its goal of 10-15% reported earnings growth, our expectations are at the low end of this range” (p. 2).

Credit Suisse First Boston, on October 8, 1999, stated, “Management has clearly articulated to investors that growth in non-regulated energy markets and growth in so-called network revenue and income must drive higher returns on invested capital” (p. 3).
CIBC World Markets, on January 21, 2000, stated, “Management now believes that “market opportunities created by retail deregulation could dwarf what Enron has experienced in the wholesale gas & power markets” (p. 3). A.G. Edwards, on January 30, 2001, seemingly approved with Enron’s definition when it re-reported:

Management stressed that it is a logistics company and not a trading company... For example, ENE might meet a sharp increase in the demand for electricity in Chicago by 1) buying wholesale electricity, 2) firing up a gas-fired peaking plant and taking gas out of storage, 3) exchanging coal for electricity, and 4) turning off a manufacturing operations for a Retail Energy customer. (p. 5)

9. Discussion of the Results and Formulation of Propositions

Security analysts are not reporters, in a sense that the reporter describes by and large what is happening. The analyst dives into a company, collects and analyses relevant data, quantitative or qualitative, public or non-public information, and comes out with a reliable opinion and recommendation, otherwise, users of analyst’s reports can evaluate stocks by themselves. Hence, the role that analyst should play is the “analyst role” and not the “reporter role” of the information issued by Enron, either financial or nonfinancial data.

However, analysts in Enron’s case just re-reported the accounting information released by Enron. They selected some financial items, such as EPS, from Enron’ financial reports or management releases and presented these numbers in their reports. Further, analysts performed financial analysis based upon that data without paying attention as to the extent of credibility of the accounting information they were utilising.

It was noticed that financial analysis utilised in the analysts’ reports focused on ratios, such as earnings per share (diluted and basic), price/earnings ratio, book value per share, price/book value per share, cash flow per share, price/cash flow per share, debt to capitalization. Also, analysts made some comparisons either with previous periods, analysts’ estimates, competitors, and the market. No analysis was done based on other arguments, such as the impact of rapid growth and debt to capitalization ratio on the quality of the reported accounting information.

The lack of analysis suggests that when analysts utilised or re-reported the financial data issued by Enron in their reports, either by pure presentation or financial analysis, it meant that they considered the data to be reliable, otherwise they should have given the financial data a different treatment in their reports.

If the information base, from which analysts perform financial analysis and calculate ratios is misleading, then it is natural to expect outcomes to be inaccurate and misleading. The impact of conducting analysis on inaccurate or misleading data is not only that the analysis and findings are useless, but it may also cause serious harm to recipients of such reports. In particular, in this situation the investing public can be affected more than institutional investors. Institutional investors have their own analysts called “buy-side analysts” to assist them in making investment decisions. In addition, they may have their own sources of data regarding the companies that are covered by sell–side analysts (Fogarty & Rogers, 2005; Mikhail, Walther, & Willis, 2007).

Even credit rating agencies, such as S&P and Moody, have fallen into the process of utilising misleading financial statements that leads to false or inaccurate ratings. Credit rating agencies kept Enron’s rating as “investment grade” from 1995 – 2001, based mainly on financial statements issued by Enron. Such financial statements were used to compute ratios pertinent to areas such as liquidity, leverage, and profitability to rate Enron’s creditworthiness (Haldeman Jr., 2006).

Nevertheless, this does not mean the analysts were victims of using manipulated accounting information when they performed financial analysis. Many researchers found that it was possible to detect Enron’s manipulation of its financial data as was early as 2000 (Baker & Hayes, 2005; Higson, 2001; Kastantin, 2005; Reinstein & McMillan, 2004; Reinstein & Weirich, 2002). Moreover, many models have been developed by researchers to detect potential manipulation of accounting information and could have been utilised by sell-side security analysts to examine the status of financial statements issued by Enron or any other company they follow (Beneish, 1999; Lee, Ingram, & Howard, 1999; Persons, 1995). It could even be suggested that due to conflicts of interest, such models were deliberately not utilised.
Therefore, sell-side analysts should exert sufficient attention or even scepticism as to the reliability of accounting information of Enron before conducting financial analysis and come out with opinions which partially relied on such analysis (King, 2002). According to Fogarty and Rogers (2005, p. 341) “If analysts perform a duly diligent investigation, they should produce a solid mass of data separate from that controlled by management.”

Maybe that was why analysts, as experts and providers of investment recommendations, had been exposed to harsh criticisms and to new regulations since they utilised fraudulent accounting information, an extreme form of earnings management by Enron, for a long period, 1997 – 2001. The criticisms occurred because the analysts re-reported fraudulent financial data issued by Enron without due diligence and reasonable care.

So trusting in Enron’s financial data, some analysts re-reported the assertions by Enron’s management in, for example, annual analysts’ conferences held by Enron. For example, Prudential Securities Incorporated, January 25, 2000, stated, “Enron left analysts and investors ‘giddy’ after recent conference, highlighting telecommunications and wholesale energy” (p. 1). This information released by Enron’s management was received by many analysts without any scepticism or question.

However, this research did find some cases where analysts had formulated an evaluation different to those presented in Enron-led analyst conferences and shown a different point of view in the evaluation, against the general trend of analysts. This implies that some contrarian analysts, who challenged the dominant analyst attitudes, were observed during the analysis process. For example, after attending a conference, held on January 23, 2001 by Enron, two analysts’ reports issued by two security firms depicted two different perceptions concerning that conference. Credit Suisse First Boston, stated, January 26, 2001, “At Enron’s recent analyst meeting, management showcased compelling growth and rising return platforms across all business units. We are increasing our 2001 earnings estimate from $1.65 to $1.80 per share and introducing a 2002 estimate of $2.20” (p. 1). While A.G. Edwards, January 30, 2001, stated in relation to the same conference:

This year’s analyst conference was void of any blockbuster announcements. The company instead chose to focus on past successes and its unique position to expand market share going forward. Despite much higher estimates from the company, our internal models indicate a fair price for the stock in the low $70/latest trading price according to that report was $78.50] per share area. (p. 1)

Thus, the second report showed that their “internal models” produced different evaluations of what has been presented in that conference. Yet, the dominant view regarding that conference was to accept Enron’s claims.

In general the majority of analysts not only re-reported what Enron was stating, but also, they developed their opinions upon those statements. As such, their opinions were lacking critical analysis and a sceptical attitude of the information mentioned in those meetings and conferences.

Also, in some major events, analysts repeated what Enron’s management said about such events. For example, when chief executive officer (CEO) Jeffrey Skilling resigned on August 14, 2001 and claimed that his resignation was due to personal reasons, analysts repeated this justification in their reports. They just mentioned the event without further investigation. Below are examples of repetition of Enron’s justification of that major event.

Management was adamant that there are no hidden or undisclosed issues at Enron (such as other shoes to drop) that led to Mr. Skilling’s departure. It reaffirmed that the move is purely a personal one and maintained its recent earnings guidance (UBS Warburg, August 15, 2001, p. 1).

In the same report, UBS Warburg stated,

Mr. Skilling was a core force in the evolution of Enron (and open markets) over the past decade and the recent turn of events can not all be placed on his watch. We wish him well and hope he enjoys the time and money he has worked hard to create (p. 1).

It seems that analysts, with their array of resources and corporate management connections, did not investigate this event and concurred with Enron’s version. They left investigation and uncovering the truth to the financial press, in this case the Wall Street Journal, as the story regarding the third quarter results released by Enron on
October 16, 2001, was initially reported by the Wall Street Journal, and not through analysts. In that quarter, shareholder equity was reduced by $1.2 billion and Enron recorded its first time losses of $618 million in four years.

Sanders Morris Harris, stated on October 23, 2001:

Current Events: Welcome To A Media Storm

ENE’s otherwise fine third quarter has been all but ignored in light of the media storm created by Wall Street Journal revelations about ENE’s sponsorship of the LJMI and LJM2 (Cayman) partnerships. (p. 2)

In the same context, A.G. Edwards stated on October 25, 2001, “On October 18, the WSJ [Wall Street Journal] ran an article disclosing that ENE had written down $1.2 billion in equity as the company decided to repurchase 62 million of its shares from a subsidiary” (p. 5). These articles written by two journalists, Rebecca Smith and John Emshwiller, contained quotes by A.G. Edwards. In their articles of October 17 and 18, 2001, the reporters shed light on Enron’s partnership affairs that led to the equity reduction of $1.2 billion as released by Enron in the previous date, that is, third quarter results of October 16 (Bost, 2006; Marken, 2003; Sherman, 2002).

Enron’s manipulations were discovered first by a hedge manager called James Chanos in year 2000 (Sherman, 2002). When Chanos analysed the financial statements of Enron, and found in particular “related party” transactions and their links to senior officers of Enron were suspicious, this was a red flag warning. He then dug into this issue deeper, and accordingly, he, being a fund manager, decided to sell Enron’s stock in November 2000.

Thus, sell-side analysts apparently have failed to act as analysts, and acted as reporters who did not bother to check facts. Therefore, it is not surprisingly that they failed to show fraudulent financial reporting committed by Enron in the prolonged fraud period, 1997-2001. Therefore, based on the findings of this research and relevant literature, the following propositions are presented:

**P1**: It is likely that sell-side security analysts, who failed to show fraudulent financial reporting, to re-report selectively from the filed financial data of the fraudulent company without questioning the financial data itself.

**P2**: It is likely that sell-side security analysts, who failed to show fraudulent financial reporting, to re-report corporate management releases of fraudulent financial information from media and conferences, without questioning the released information itself

10. Conclusions

Analysts failed to show that Enron issued misleading financial data since they re-reported what Enron had reported without due care and scepticism. This might raise ethical questions about their performance whether it was independent and objective or otherwise. Analysts’ failure to show fraudulent reporting of Enron could be attributed to conflict of interests argument. However, this needs further research.

Sell-side analysts’ role, as one of the gatekeepers in the financial markets, should be improved by adopting many measures. For example, analysts might be held liable for their opinions regarding companies they follow, thus they will be more careful when formulate and issue their reports. Analysts might be exposed to standards to guide their performance as the case with external auditors.

11. Limitations and Further Research

The above coding results generated from sell-side analysts’ reports were pertinent to Enron’s fraud period of 1997-2001, and for that reason, those results are confined to those reports of the Enron case. Nevertheless, they can be considered as the first step to code more analysts’ reports of other fraud companies, make comparisons and develop a more refined grounded theory regarding the process of how sell-side analysts utilise fraudulent accounting information.
The theoretical propositions developed in section ten, which offer tentative explanations regarding relationships between the failure to show fraudulent financial reporting of Enron and the re-reporting practice of sell-side analysts can also be the subject of further research and empirical testing.

References


