
Andrew Holt

is a senior lecturer in the School of Accounting and Finance at Kingston University, UK. He co-wrote with Timothy Eccles earlier papers in the Journal of Corporate Real Estate and 'Accounting for investment properties in the UK: Problems of definition and implementation' in Briefings in Real Estate Finance. He is co-author of the forthcoming Property and Construction Accounting published by International Thompson Business Press.

Timothy Eccles

is a senior lecturer in the School of Surveying at Kingston University, UK. He co-wrote with Andrew Holt earlier papers in the Journal of Corporate Real Estate and 'Accounting for investment properties in the UK: Problems of definition and implementation' in Briefings in Real Estate Finance. He is also a co-author of the forthcoming Property and Construction Accounting and of the in-print Property and Construction Economics published by International Thomson Business Press. He is editor of the journal Environments by Design. He can be contacted by telephone on +1 (0)20 8547 7070 and by e-mail at t.eccles@kingston.ac.uk.

Keywords:

creative accounting, Enron, International Accounting Standards, off-balance sheet, revenue recognition

Andrew Holt
Senior Lecturer
School of Accounting and Finance
Kingston Business School
Kingston University
Kingston upon Thames, KT2 7LB, UK
Tel: +44 (0)20 8547 2000 ext 5204
Fax: +44 (0)20 8547 7026
E-mail: a.holt@kingston.ac.uk

Accounting practice in the post-Enron era: The implications for financial statements in the property industry

Andrew Holt and Timothy Eccles

Received (in revised form): 28th November, 2002

Abstract

The corporate failure of the Enron Corporation made world headlines for many reasons — greed, alleged malpractice and criminal behaviour, and the sheer size and speed of its collapse. A critical factor in Enron's demise was the use of creative and manipulative accounting practices to distort reported profitability and indebtedness. This paper uses the Enron case and similar financial events to highlight the accounting issues arising from recent corporate failures, and to examine the implications for the future. These include whether it could happen outside the USA, what lessons are being learned and the implications for those involved in real estate and property management. The case argued here is that all financial statements are simply artificially constructed realities attempting to describe the (financial) well being of a company within a framework of prescribed rules determined by socio-economic debates. The perceived laxness of US accounting regulations compared with UK and International Accounting Standards (IAS) adds weight to the calls for adoption of universal standards within the USA, since Europe claims — with some qualification — that 'it could not happen here'.

INTRODUCTION

This paper has no intention of offering definitive conclusions on the Enron and later cases, nor to actually offer guarantees on the security of British or international company reporting. However, it is timely to offer some commentary upon the speculation and reiterate a case that has been implied by the authors in earlier papers¹ concerning the security that is engendered by formal accounting regulations bedded into an (albeit not entirely clear) intellectual framework. The case of Enron has variously been regarded as a result of criminal activity,² negligent behaviour,³ collusion⁴ or downright laziness.⁵ However, there is clearly opportunity for some detailed commentary on these issues, with reference to UK practice and the role of International Accounting Standards (IAS) in preventing future debacles. The precise legal and political arguments surrounding the case are not discussed here, nor

can a paper of this type seek to offer current commentary upon the daily issues as they arise. The paper will also not comment upon the various wider issues of trust and fidelity that have been raised by the events. The mixture of hype, worry and fact concerning wrongdoing broadcast in the media are not central to the Enron case, although interesting in themselves.⁶

WHAT HAPPENED AT ENRON?

Throughout the late 1990s, Enron was universally hailed as one of the USA's most innovative companies. At its peak, Enron's market value reached \$70bn, with its shares trading at \$90 each.⁷ However, following the publication of its financial results in October 2001, Enron announced a \$638m loss on its income statement and highlighted \$1.2bn of debt that was previously excluded from its balance sheet. These revelations came as a complete shock to Wall Street and the rest of the financial world, but are not unsurprising if one conducts a detailed analysis of Enron's annual accounts from 1991–2001. From such an analysis it is clear that Enron was using at least two accounting policies to increase short-term profitability and reduce reported liabilities. These two issues will now be discussed in turn, starting with the income related issues.

Mark-to-market

In June 1991, Enron formally informed the US Securities and Exchange Commission (SEC), the US regulatory body and watchdog in charge of regulating corporate affairs, that it was to change its accounting policy on revenue recognition from the sale of natural gas contracts. Enron wanted to use 'mark-to-market' accounting⁸ to record natural gas trades. Using mark-to-market accounting meant that when Enron entered into a natural gas contract it would include in the income statement the present value of all future profits from that contract at the time the contract was signed. This aggressive mark-to-market accounting policy was in complete contrast to more traditional US accounting methods⁹ that required the recognition of revenue to be spread over the life of the underlying contract. In fact, Enron's changed policy on revenue recognition was openly criticised as early as 1993 by Mack¹⁰ who warned that if something happened to impair the value of contracts that Enron was marking-to-market, the company could be forced to book losses. Further public criticism of Enron's use of mark-to-market accounting was published in 1996 by Hurt¹¹ who cited former employees as suggesting that use of the accounting technique 'simultaneously inflates current earnings and creates a feeding frenzy as executives scramble to make new deals to prop up future profits'. If such criticisms of the mark-to-market model of accounting were not enough, it also suffers from an even more fundamental flaw of exactly how Enron could place an objective value on long-term contracts at the signing date. As the US Senate Committee on Governmental Affairs observed,¹² Enron used valuation models whose assumptions were 'in best case, necessarily subjective and, in the worst, subject to deliberate manipulation'. The sheer scale of the

Revenue recognition

impact of mark-to-market accounting on Enron's reported results was evident in 2000 when unrealised trading gains — ie those gains it expected to earn from trading in future years — represented over half the company's \$1.41bn originally reported pre-tax profits.

In order to illustrate the effects of mark-to-market accounting consider the following example of an owner of a commercial office block. Under mark-to-market accounting as soon as each long-term rental contract for an office was signed, the owner of the building would include an amount equal to the present value of all future rental contract payments in its profit and loss account. Any future deviations from this present value — ie default, rent rises — would then be charged to future profit and loss accounts. Therefore, a 25-year rental contract would be presented in the profit and loss account for the first year as the 25 years' rental payment, adjusted to present value. Such an accounting practice is clearly an 'aggressive accounting' policy for revenue since it assumes very favourable trading conditions. This policy would not be allowed under either UK or IAS generally accepted accounting principles (GAAP).

Special purpose entities

In addition to its aggressive use of mark-to-market accounting to increase short-term earnings, Enron had also disguised the 'true' reality of its balance sheet indebtedness by forming about 12 'special purpose entities' (SPES) or 'partnerships' with other companies it had itself created. These partnerships were used to borrow money and absorb debt liabilities for Enron Corporation, but were effectively excluded from Enron Group's consolidated accounts due to the manner in which legal ownership criteria could be abused in the US accounting rules for preparing consolidated accounts. Effectively, Enron Corporation 'engineered' 12 business entities to abuse US accounting rules and get its debt 'off-balance sheet'. Off-balance sheet financing is certainly not a new issue to UK accountants, as it was a major issue in the 1980s and resulted in changes to the accounting rules for both lease accounting¹³ and the rules relating to consolidated and group accounts. Indeed, Digby Jones, Director General of the CBI, referred specifically to this in defending UK business from any trace of 'Enronitis'. 'If you look at British business, we learnt our lessons from the Polly Pecks and the Maxwells and the BCCIs of the early nineties. British business put its house in order. A lot of it was transfer of best practice, a lot of it was self-governance.'¹⁴

Off-balance sheet financing

After Enron disclosed the economic reality behind its accounting numbers, its slide into the biggest bankruptcy in US history was irreversibly determined.¹⁵ It could be said that technical accounting issues ultimately led to Enron's downfall, but, alternatively, one could argue that 'creative' abuse of accounting rules helped to create the myth that was Enron's profitability growth. Irrespectively, it is clear that financial accounting played a key role in the Enron case. At the same time, it should be noted that Enron executives referred to 'a systematic problem in the economic system' rather than

deliberate criminal behaviour and maintained the belief that Enron could have survived.¹⁶ Even if this were so, it remains clear that despite the additional, and more glamorous, issues of criminal and congressional investigations, technical accounting issues offer a necessary rationale for the Enron collapse. What is also clear is that, whether a ‘politicised witch-hunt’ or not, the collapse has led to more thorough accounting-based investigations of other companies. For example, *Company Reporting*¹⁷ offered details on compliance issues for Pizza Express, Carlton Communications, Alders, Chrysallis Group and Lastminute.com to *Accountancy Age* on 14th February, 2002, the date of its first major piece on the scandal.

THE SPREADING VIRUS OF ENRONITIS

The term ‘Enronitis’ refers to ‘a simple enough virus. It starts with a diagnosis of opaque accounting or feeble corporate governance and ends in a share price collapse or, in fatal cases, bankruptcy’.¹⁸

Enronitis has affected, rightly or wrongly, the share price of many different companies across the globe. For the UK, only the term itself is new. In the 1980s a number of high profile creative accounting scandals in the UK led to corporate bankruptcies and calls for accounting reform. These scandals led directly to the creation of a new accounting standard setting body, the Accounting Standards Board (ASB), and the issuance of a whole plethora of new accounting standards aimed at eliminating deliberate accounting manipulation. In terms of the UK property industry, such reform largely eliminated some of the more widely used creative accounting techniques such as the lease accounting-based method of ‘off-balance sheet financing’. As a result of such changes in UK accounting, it was much less likely for a major corporate failure to arise from accounting manipulation.

While corporate failure is often characterised as a sign of an efficient market system, the sudden collapse of Enron once again raised concerns about deliberate accounting manipulation by corporate management. Since October 2001, further accounting-based scandals have rocked the financial markets, and made ‘creative accounting’ a primary issue on the agenda for governments, investors, employees, corporate management, accountants and investment analysts. Table 1 highlights a sample of the most prominent accounting issues recently under scrutiny by regulators and wary investors.

CREATIVE ACCOUNTING: IS IT ALWAYS BAD?

There is now a global fixation with ‘creative’ and manipulative accounting practices in the business world.¹⁹ Naser²⁰ attempts to provide a definition of creative accounting as:

‘(1) the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practice in them to transform financial

Creative accounting

Accounting Standards Board

Accounting manipulation

Table 1: Accounting issues under scrutiny

Corporation/Company	Accounting issues
Enron Corporation (USA)	<p>The US Senate Committee on Governmental Affairs report 'Financial Oversight of Enron' published in October 2002¹ provides a detailed description of the various accounting techniques used by Enron Corporation to deliberately inflate its reported earnings and reduce its reported liabilities. 'Off-balance sheet' financing techniques were used to disguise the amount of trading losses and accumulated debt. In addition, the inappropriate use of 'mark-to-market' accounting inflated short-term reported revenues.</p> <p>Further to the Senate investigation on Enron, in <i>SEC v Andrew S. Fastow</i>, Civil Action No. H-02-3666 (K.Hoyt) (SDTX) (2nd October, 2002),² the SEC charged Andrew Fastow, former Chief Financial Officer of Enron, with fraud. This charge involves allegations of violations of the anti-fraud, periodic reporting, books and records, and internal controls provisions of the federal securities laws.</p>
WorldCom (USA)	<p>In a first amended complaint for securities fraud (Civ. No. 02-CV-4963 (JSR)) brought before the US District Court SDNY on 5th November, 2002,³ the SEC outlined how WorldCom Inc. overstated the income reported in its financial statements by approximately \$9bn. Revenue-related expenses were inappropriately accounted for as capital expenditure (ie capitalised on the balance sheet). As a result, earnings were massively misreported in the profit and loss account.</p>
Vivendi Universal (France)	<p>The main accounting issue concerns Vivendi Universal's (VU) forced disposal of BskyB shares in order to secure European Commission approval for a further corporate acquisition. The accounting rules governing the treatment of such a transaction were specifically addressed under US GAAP principles but not clearly stated under French GAAP. This confusion has led directly to an investigation of VU's chosen accounting practices in the years 2000 and 2001. In a press release dated 4th November, 2002,⁴ VU announced their intention to cooperate fully with preliminary investigations by the French listings regulator, the Commission Des Operation de Bourse, the US Attorney's Office for the SDNY, and the SEC's Miami office.</p>
Xerox (USA)	<p>In a first amended complaint for securities fraud (Civil Action No. 02-272789 (DLC)) brought before the US District Court, Southern District of New York on 11th April, 2002, the SEC outlined how Xerox Corporation 'disguised its true operating performance by using undisclosed accounting manoeuvres'.⁵ These alleged accounting manoeuvres accelerated the recognition of equipment revenue by over \$3m and increased earnings by approximately \$1.5bn. Without admitting or denying the SEC allegations, Xerox consented to the entry of a final judgment of the complaint,⁶ with Xerox agreeing to pay a \$10m fine and restating its financial results for the period 1997–2000.</p>
Global Crossing (USA)	<p>At a hearing of the Subcommittee on Oversight and Investigations Committee on Financial Services entitled 'The Effects of the Global Crossing Bankruptcy on Investors, Markets, and Employees' on 21st March, 2002, an investigation was held into the reasons for Global Crossing ultimately filing for Chapter 11 Bankruptcy Protection. One reason highlighted was accounting policy choice, including the use of 'pro forma' accounting alongside an aggressive revenue recognition policy. The hearing found that Global Crossing used pro forma financial information to misinform investors and employees as to the profitability and performance of the company. Pro forma, in this context, refers to the presentation of financial results using non-GAAP methodologies. In an examination of Global Crossing's filings submitted in spring 2001 with the SEC, the company reported \$531m in earnings in its pro forma statement that were subsequently excluded from its US GAAP-compliant statement of earnings. This \$531m difference was due to the pro forma booking of revenue from capacity swap deals with competitors, known as Indefeasible Rights of Use (IRU). While these IRUs were entirely lawful, they rarely resulted in any positive monetary gain for the companies party to the transaction.</p> <p>Global Crossing has not yet faced formal legal proceedings from any SEC investigation for accounting irregularities. At the 21st March, hearing, Global Crossing's Chief Executive officer, John Legere, stressed that corporate accounting policies were derived from the applicable accounting literature and were practices common to the telecommunications industry.</p>
Tyco (Bermuda)	<p>In a first amended complaint for securities fraud (Jury Demand 02 Civ.) brought before the US District Court, SDNY on 11th September, 2002,⁷ the SEC outlined how L. Dennis Kozlowski (the former Chief Executive Officer of Tyco) and Mark H. Swartz (the former Chief Financial Officer of Tyco) misused corporate funds for their own benefit. As a result of such abuses, Tyco had to file false and misleading annual reports and proxy statements to the SEC according to the SEC.</p>
General Electric (USA)	<p>The latest financial reports and accounts include a \$14bn amount on the balance sheet entitled 'All other current costs and expenses accrued' with no explanatory footnote. This treatment is in no manner illegal. However, it does hinder accounting 'transparency', making it difficult for shareholders to assess corporate performance.</p>

¹ Report of the Staff (2002) Financial Oversight of Enron: The SEC and Private-Sector Watchdogs, Senate Committee on Governmental Affairs.

² <http://www.sec.gov/litigation/litreleases/lr17762.htm>.

³ <http://www.sec.gov/litigation/complaints/comp17829.htm>.

⁴ <http://finance.vivendiuniversal.com/finance/news/00001089.cfm>.

⁵ <http://www.sec.gov/litigation/complaints/comp17465.htm>.

⁶ Litigation Release No. 17465, <http://www.sec.gov/litigation/litreleases/lr17465.htm>.

⁷ <http://www.sec.gov/litigation/complaints/compl17722.htm>.

statements from what they should be, to what preparers would prefer to see reported; and (2) the process by which transactions are structured so as to produce the required accounting results rather than reporting transactions in a neutral and consistent way.'

While Naser's definition serves to highlight a number of crucial aspects about accounting rules and practice, it is itself flawed because it ignores the very ways that accounting rules and practice are developed. Despite his claims, accounts cannot become 'what they should be'. Reaching an objective consensus on the appropriate form of certain accounting practices can be impossible to achieve. For example, reaching agreement on a conceptually appropriate accounting valuation to place on an unfinished commercial property can be difficult under any circumstances and lead to differences of opinion between professionals. The situation becomes far more convoluted if the discussion involves accountants and valuers, both with differing professional gestalts, professional bodies and codes of working and very different perceptions on the concept of value and the use the concept is put to. Any attempt at a scientific and objectively neutral solution to such a question is problematic — at best. Equally, accounts cannot be expected to report all business transactions in a totally 'neutral' manner since they are created via agreement across all industries — smaller industries' perspectives will be lost in the argument to those more powerful.²¹ The vast majority of accounting principles and rules apply indiscriminately across all industrial sectors and types of company. Accounting rules may present a favourable 'picture' of the assets, liabilities and revenues of certain firms, and at the very same time portray an entirely negative view on the future prospects of other firms. As a result of such accusations, it is perhaps not surprising to observe corporate management indulging in 'creative' accounting to help show a more realistic view of the true economic reality of their business.

Constructed and contested reality

Although UK and US accounting rules do serve to lay down the foundations of generally accepted accounting practice, they can at best merely serve to provide a constructed and contested reality of corporate transactions. Accounting is not a science, and relies heavily on conflicting core concepts and rules. For example, it was shown in the authors' paper upon investment properties²² the very great differences in approach to the valuation of an investment property between accountants and surveyors, between accountants themselves, between surveyors and property investment companies, and between and within many other interested groups. Such disputes arise within every facet of accounting. Furthermore, accounting constructs reality as much as it merely pictures reality, as witnessed by the current UK pensions situation, for example, where many firms are now closing pension schemes (allegedly) on the basis of the accounting changes introduced in FRS 17. In effect, new forms of accounting may lead to economic consequences within both business

Economic consequences

and society and, as such, it can never be claimed as neutral and unbiased.

This suggests that accounting can never be scientific or 'perfect', and must reflect the established status quo within society. Creative accounting is universally hailed as a bad thing, but, to some degree, it is used during the preparation of each and every set of accounts. Accounting professionals apply general accounting rules and use their judgment when translating business transactions into accounting figures. Accounting 'creativity' is often needed to show the 'true and fair view' of corporate performance, but taken to extremes it can result in another Enron. No solution will ever be perfect, but with adequate general accounting principles, audit checks and accounting disclosures the extremes of creative accounting can be largely eliminated.

True and fair view

UK ACCOUNTING PRACTICE: COULD IT STOP A 'UK ENRON'?

In general, the opinion of UK accountants is that Enron could not happen here. As highlighted in an earlier paper²³ UK accounting relies on general principles rather than detailed prescriptive rules. In fact, the UK requirement to provide a 'true and fair view' of a company's performance can override the need to apply specific rules in certain situations. In contrast, US GAAP have emerged from a very different cultural environment where: 'with the advent of class-action lawsuits against companies whose share prices had tumbled, audit firms demanded detailed, prescriptive rules to help them in court. As a result accounting standards in America have multiplied into vast tomes.'²⁴

Generally accepted accounting principles

Plender²⁵ argues that 'it would have been impossible in the UK to pull off the debt vanishing trick'. Indeed, Plender is scathing in his views upon the US profession and procedures, pointing to the fact that UK adoption of 'true and fair' accounts is inherently safer and UK auditing processes more foolproof. However, there is little sign of complacency and UK bodies are examining the embers very carefully. Sir Howard Davies of the FSA is committed to examining whether lessons can be learned for UK practice²⁶ and the accounting profession's new watchdog, the Accountancy Foundation, has unveiled plans to 'ensure accountants operate in the public interest, including an examination of the Enron collapse from the 'anglo experience'.²⁷ Plender is less convinced, perceiving complacency as a problem in a system where 'non-accountants who carry out the review function are often businessmen whose instincts are not naturally hawkish when it comes to regulation. And corporate governance in the UK is shot through with conflicts of interest'.²⁸ Property professionals take note!

THE ROLE OF INTERNATIONAL ACCOUNTING STANDARDS (IAS)

As discussed in an earlier paper,²⁹ member countries of the European Union (EU) have agreed for IASs to become the accepted

method of accounting for stock exchange listed companies by 2005. The paper outlined the major differences between UK and IAS GAAP, but demonstrated that both sets of standards used a similar system of general principles rather than utilising the US model of detailed prescriptive accounting rules. As a consequence of this, Sir David Tweedie, head of the International Accounting Standards Board (IASB), has taken the opportunity of the Enron collapse to endorse IAS and push for their adoption within the USA³⁰ as well as in Europe. Perry points out that before the Enron collapse US GAAP was actually winning the battle against IAS to become the de facto internationally accepted reporting principles.³¹ Although the EU decision to adopt IAS made this unlikely in any event, there is no doubt that Enron and other US accounting scandals have furthered the cause of IAS and seriously damaged US GAAP.

Auditor independence

AUDITOR INDEPENDENCE: THE ROLE OF CONSULTANCY

A primary source of concern arising from both Enron and later cases has been the question of auditor independence. UK and US accounting firms have traditionally supplied both auditing and consulting services through different subsidiaries. However, the problem of independence and perceived conflicts of interest³² arises when the same accounting firm acts as both auditor and consultant to the same corporate client. Although this is not an area of direct concern here, it must be acknowledged as one of the characteristics of the Enron case and a topic of debate within the world of business. If Enron's auditors were acting in a neutral and independent manner then the SEC are clear that they should have reported the accounting manipulations and refused to accept the accounts. Enron's auditors, Andersen UK, defended themselves strongly against what Miller³³ terms the 'Enron fallout' and John Ormerod, managing partner, stated that clients were 'privately sympathetic and supportive'. His argument was that Andersen had done good work for clients in the past and would continue to do so in the future. The overall picture is less supportive, and calls for the rotation of auditors are growing in intensity.³⁴ This would not preclude consultancy, but would ensure a range of auditors would be engaged over a period of time, effectively policing each other's work. In a recent survey,³⁵ most accountants (71 per cent) accepted that auditors should not do non-audit work for their clients. However, in the same survey, 53 per cent believed that it was not the role of auditors to ensure there is no fraud with their clients.

Consultancy

At the same time, the more general question as to whether the profession itself has been brought into disrepute is less clear. *Accountancy Age* trumpets that 'among accountants at least the profession's reputation survives'³⁶ but this refers to prospective careers for the children of accountants, and not whether public views upon professional self-regulation have worsened. Wider public opinion is confused and unimpressed at both the behaviour and the lack of professional sanction upon the perceived culprits (and this

might yet turn out to be a longer term problem for the profession). For example, financial analysts, who also happened to be Enron consultants, were heavily criticised by Congress for talking up the value of Enron when it would appear that any competent analyst would have recognised the company's problems. The implication is that the role of financial analysts from the investment banks involved³⁷ was 'to puff up shares and flatter chief executives so that banks can earn huge fees for merger advice and underwriting'.³⁸ It is worth noting that the Institute of Chartered Accountants in England and Wales (ICAEW) has launched what is described as an 'Andersen probe'³⁹ and in a recent survey⁴⁰ most accountants favoured a media campaign by the ICAEW to counter the bad press and present a fairer case.

THE UK PROPERTY PROFESSION

The Carsberg Report

The recent publication of the Carsberg Report upon the accuracy of valuations suggests that the profession is aware of potential problems and seeking to regulate itself over the issue. As has been argued elsewhere at length,⁴¹ the role that valuers play in the field of accounting is limited in any event. In addition, the authors are in agreement with Brett⁴² when he states that 'the public in general and the financial world in particular have far too much faith in property valuations'. That said, there is no excuse for the profession. The fact that it does not educate the users of valuations on their limitations by more than simply a series of qualifications in the footnotes is probably a more important concern than the findings of the report in the authors' view. Carsberg, a report carried out under the auspices of the RICS, is heavily reliant upon an earlier University of Reading/Nottingham University output.⁴³ It does not consider the conceptual framework in which practices take place, but is simply an investigation of notions of accuracy and integrity. The latter is surely a wider issue within a purportedly professional institution where integrity is an ethical plank of the concept of professionalism, while the former lacks any conceptual framework. While the conceptual framework found within the accounting profession is qualified, there is little more than a bureaucratised Red Book procedure underpinning the 'theory' of valuation.⁴⁴ As has been shown earlier, the nature of such things is not value neutral, but exists in a continuum of competing interests and pressures. This is as true for valuation practice as for accounting.

The 'theory' of valuation

With reference to the particular case of Enron, property valuation per se was not an issue. However, *valuation* and *revenue recognition* criteria were vital concepts in the accounting controversy, and no property company can ignore them. Enron and the later accounting scandals have sent shock waves through the world's capital markets. The overall result of the affair is bound to lead to further discussion of many accounting issues, including those where the accounting profession has accepted the professional integrity of others such as that obtained within FRS 15 by chartered surveyors.⁴⁵ Table 2

Table 2: Property-related accounting issues under scrutiny

Accounting issue	Current UK rules	Creativity potential
Revenue recognition	No dedicated accounting standard. The ASB issued a discussion paper in July 2001 that raised issues for debate. Main guidance from: FRS 18 Accounting Policies ASB Statement of Principles	Extremely high potential for manipulation due to lack of detailed principles and rules. Auditor intervention cannot always be relied upon to stop it happening, eg Enron.
Valuation of tangible assets	FRS 15 Tangible Fixed Assets	Potential for abuse reduced significantly since the issuance of FRS 15, but still relies heavily on an 'independent valuer' appointed by the company itself.
Capitalisation of interest-related costs	FRS 15 Tangible Fixed Assets	Interest capitalisation is still optional which makes a consistent accounting approach across companies impossible.
Pre-contract costs associated with bidding for contracts	UITF Abstract 34 Pre-contract Costs; FRS 5	The UITF paper issued in May 2002 was needed due to the growth in PFI contract activity in the UK. Serves to introduce a more conservative attitude to such costs ie should be recognised as expenses as incurred except where the contract award is (a) virtually certain and (b) expected to result in future net cash inflows.
Lease accounting	FRS 5 Reporting the Substance of Transactions; SSAP 21 Leases and Hire Purchase Contracts	Together SSAP 21 and FRS 5 serve to eliminate the vast majority of off-balance sheet financing activities.

serves to highlight a number of property-related accounting issues where doubt remains as to best practice. The majority of these have been covered in earlier papers in more detail, but many are still serious issues that have the potential to be used for creative accounting purposes by companies.

Of the issues shown in Table 2, revenue recognition appears to be the most problematic in the UK. As was highlighted earlier in the paper, 'aggressive' revenue recognition was an often overlooked factor in the Enron case. While inappropriate revenue recognition should be outlawed by corporate auditors, it has the potential to produce misleading views of short-term profitability. The lack of a dedicated UK accounting standard on revenue recognition has directly led to a variety of inconsistent revenue recognition practices across industries and companies. There certainly appears to be a lack of consistency in respect of which companies provide revenue recognition disclosures. In a recent survey of revenue recognition practice across 600 UK companies,⁴⁶ 43 per cent do not even disclose any form of revenue recognition policy in their accounts. The ASB issued a discussion paper on revenue recognition in July 2001, but it failed to uncover any new insights that would aid

Table 3: Revenue recognition criteria adopted by UK construction firms

UK building company	Revenue recognition criteria
Bovis Homes	Turnover arises principally from the sale of residential properties and land, recognised upon legal completion. Profits in respect of house sales, land sales and land exchanges are taken at the time of legal completion of the sale. Legal completion basis
Barratt Developments	Turnover comprises the total proceeds of buildings and development on a legal completion basis. Sale proceeds of part exchange houses are not included in turnover. Legal completion basis
Wiggins	Now recognises turnover from commercial property sales that are legally completed. Previously, would recognise turnover at the date contracts were exchanged providing the group is reasonably assured of the receipt of the sales proceeds and that the earnings process is sufficiently complete. Switch to legal completion basis
Balfour Beatty	Turnover is recognised on property developments when they are subject to substantially unconditional contracts for sale. Middle ground basis
RMC	Disposals of properties are included as turnover when contracts have been exchanged before the end of the financial year and when completion is due to take place within six months of that date. Exchange of contracts basis
Westbury	Turnover from the sale of land is recognised where unconditional contracts have been exchanged. Exchange of contracts basis
Berkeley	Properties are treated as sold and profits are taken when contracts are exchanged and the buildings work is substantially complete, which is defined as being plastered and with the floor screed completed. Exchange of contracts basis

revenue recognition in the property and construction sector. Furthermore, many of the discussion paper's proposals relied heavily on a rigid definition of 'risk', which the paper itself did not provide.

One example of revenue recognition from the construction sector is Wiggins plc, a UK construction firm, which was forced by the UK Financial Reporting Review Panel in March 2001 to change its revenue recognition policy in respect of an airport it was building.⁴⁷ In this case, Wiggins recognised turnover raised by the sale of Manston Airport during the 1999 year-end accounts on the strength of non-binding heads of agreement, which did not become binding until 2000. Revenue was also recognised from a sale of additional land even though it was conditional on Wiggins obtaining planning permission for future work. A problematic revenue recognition issue concerns the sale of houses by housebuilders and one that has caused some to review traditional policy upon reporting post-Enron. Wilson Connolly when declaring its results to 31st June, 2001 announced plans to adopt a more conservative accounting policy for house sales, recognising revenue from a transaction on legal completion rather than on exchange of contracts. As can be seen in Table 3, this is not the only practice used by UK builders, but is a far more defensible policy against claims of both 'creative' and 'aggressive' accounting.

The same mixture of revenue recognition policies is also evident in the accounting treatment applied to long-term contracts. There appear to be two different approaches towards the recognition of revenue from long-term contracts although both are based on the concept of completion. Most popular is the recognition of turnover in line with the proportion of the total contract value executed during a year. Recognition in accordance with percentage of completion is the other principal method used, although this appears to be less widely used in the UK.

SCANDAL AND REAL ESTATE

What exactly do the current wave of accounting-based financial scandals mean for the property profession and the wider real estate industry? Although occurring in vastly different sectors, there is a lesson to be learnt. Creative accounting and manipulation can happen anywhere and at any time. Publications highlighted the problems of Enron's accounting years before the company collapsed. Examination of the accounting records could have unravelled at least part of the complex accounting web of distortion that Enron had built. Since Enron, the financial markets have heavily punished the share prices of companies even suspected of engaging in aggressive accounting practices.

Aggressive accounting

Questions are now being asked by all professionals, financial analysts and personal investors. Can auditors be trusted? Are accounts valid? While the answer is invariably, yes, it is also true that all accounts contain qualifications, and always have. Accounts must become owned by a wider group of professionals, investors and managers. In the case of Enron, while expressing some concerns, neither the relevant financial watchdog, in this case the USA's SEC, nor the supposedly independent auditor, Andersens, nor even prominent investment analysts, acted upon them and all allowed themselves to be persuaded into accepting the Enron practice. Thus it was up to the individual to access all the information about Enron. Property professionals need to become one of the actors in the examination, if not creation, of company accounts.⁴⁸ In particular, company directors, following Enron, are under a personal compunction to ensure that published financial statements are based upon clear and transparent accounting policies that are articulated fully in the accounts.

CONCLUSIONS

This paper sought to raise awareness of the accounting-based scandals that have hit 'Corporate America'. Because of its relatively weak conceptual foundation, modern accounting must never be viewed as a neutral and scientific process. Accounting produces a constructed reality of business transactions. When the accounting rules change, the old reality will disappear and be replaced by a new reality. Without accounting rules there would be no profit, assets or liabilities. Accounting serves to create such things and, in doing so,

A constructed reality of business transactions

it shapes perceptions, behaviour and expectations. As mentioned in previous papers, property professionals, with their established body of expertise, need to take a more active role in the formulation of accounting rules that may have economic consequences for their industrial sector. Post-Enron, it is even more advisable that these realities reflect the needs of property. However, it is equally important that property professionals are also aware of the wider implications of accounting practice in order to safeguard the truthfulness of financial statements. While UK GAAP and IAS are better protected from Enronitis, vigilance is always necessary.

Notes

- (1) Eccles, T. and Holt, A. (2001) 'Accounting for property in the UK', *The Legal and Professional Framework Journal of Corporate Real Estate*, 3(2): 132–149; (2001) 'Accounting for investment properties in the UK: Problems of definition and implementation', *Briefings in Real Estate Finance*, 2(1): 122–134; (2001) 'Accounting standards and the property manager', *Property Management*, 19(5): 417–432; Holt, A. and Eccles, T. (2001) 'Accounting for leasehold property in the UK: A triumph of substance over form?', *Journal of Corporate Real Estate*, 3(3): 232–247.
- (2) Michael Moore, as ever, offers a mixture of wry wit and incisive commentary on the issue at www.michaelmoore.com. The fact that Bush staff have 'worked' for Enron in some capacity has been a particular issue for Moore.
- (3) Plender, J. (2002) 'You can't legislate for integrity', *Estates Gazette*, 9th February: 54.
- (4) Miller, A. (2002) 'Inside Andersengate', *Accountancy Age*, 7th February: 4–5 offers an interesting dialogue upon the nature of US practice.
- (5) Miller, A. and Perry, M. (2002) 'Tweedie — not pulling any punches', *Accountancy Age*, 21st February: 6–7 inter alia point to Andersen's admitted error of judgment and shredding of papers as clearly some form of incompetence or criminality.
- (6) For example, note the discussions in similar areas, where little but hyperbole is realistically offered to support the stories. Clearly such issues are relevant, but are currently under such scrutiny simply due to the fallout from Enron. The key issue here is that financial markets, and accounting practice itself, is embedded within a social context. What people (investors, workers, politicians, analysts, the public etc) *think* to be true is often more important to their behaviour than what is in fact the truth, because high profile collapses and loss of confidence have created a ripple effect throughout the business world, perhaps with good reason or perhaps as pure paranoia. For example, every facet of Andersen's business post-Enron became major news, such as the speculation of failure of Andersen's insurer when asked to meet an obligation in an earlier settlement, quoted in Murray-West, R. (2002) 'Andersen insurer defaults', *The Daily Telegraph*, 1st April: 21. Equally, many assorted claims concerning business malpractice caused great damage, regardless of whether these cases were proved. For example, Hewlett Packard were accused of inducing a shareholding bank to vote with its board in return for major investment business with it, as reported in Lambeth, J. (2002) 'HP sued for "inducing" in \$19bn Compaq deal', *The Daily Telegraph*, 29th March: 40. No evidence was ever presented but, given the nature of the case, HP had difficulty in defending against the claim; cynics will simply point to the difficulties of proving such cases, with some justification of course! All financial transactions became major news items, such as that of a Croatian bank whose capitalisation is £85m, but appeared to have allowed a trader to run up debts of £70m, quoted in Amooore, T. and Todorovic, A. (2002) 'Croat trader puts bank in £70m crisis', *The Sunday Telegraph*, 24th March: 36.
- (7) Reynolds, B. (2002) 'Accounting crisis', *Accountancy*, August: 13.
- (8) The alternative terminology of 'fair-value' accounting is often used in the UK.
- (9) In 1991 the use of mark-to-market accounting was unusual for a company such as Enron or others outside of the financial industry. See Report of the Staff (2002) 'Financial Oversight of Enron: The SEC and Private-Sector Watchdogs' Senate Committee on Governmental Affairs.
- (10) Mack, T. (1993) 'Hidden risks', *Forbes*, May: 13–15.

- (11) Hurt, H. (1996) 'Power players', *Fortune*, August.
- (12) Report of the Staff, note 9 above, October: 43.
- (13) For a discussion of how UK lease accounting rules largely eliminate 'off-balance sheet' accounting abuses, see Holt and Eccles, 'Accounting for leasehold property in the UK', note 1 above.
- (14) Digby Jones is quoted from an interview given to the Internet site epolitix.com and the full interview can be found stored in their interview/articles database.
- (15) Enron Corporation filed for Chapter 11 bankruptcy on 2nd December, 2001.
- (16) Remarks taken from the testimony of Jeffrey Skilling, former Enron chief executive, and quoted in English, S. (2002) 'Skilling hits out at critics in Enron case', *The Daily Telegraph*, 27th February: 33.
- (17) Company Reporting is an independent research organisation and can be found at www.companyreporting.com.
- (18) The Times Editorial (2002) 'Enronitis', *The Times*, 5th June: 18.
- (19) The authors would like to offer thanks to an anonymous reviewer for helpful comments upon this paper. On their advice, reference to specific allegations within this paper to existing companies has been removed and only those 'proven' by some 'weighty' authority have been retained. Sadly, this undermines any ability to illustrate this point. However, a number of UK companies have been alleged to adopt (at best) creative or (at worst) illegal accounting practices, with serious repercussions to their 'bottom line' and as a deliberate policy to mislead users away from a 'true and fair view' of the accounts. These cases have either been settled 'without admission of guilt' or are currently being investigated and prosecuted.
- (20) Naser, K. (1993) *Creative Financial Accounting: Its Nature and Use*, Prentice Hall, London: 59.
- (21) Again, an issue that has been returned to in each of the authors' papers and one where it has been argued that property can be particularly poor at influencing decisions.
- (22) Eccles and Holt, 'Accounting for investment properties in the UK', note 1 above.
- (23) Eccles and Holt, 'Accounting for property in the UK', note 1 above.
- (24) The Economist (2002) 'Special report: Company accounts', *The Economist*, May, 363(8271): 83–85.
- (25) Plender, note 3 above.
- (26) Davies, H. (2002) 'It couldn't happen here', *Accountancy Age*, 14th February: 22–23.
- (27) Perry, M. (2002) 'Watchdog enters ring', *Accountancy Age*, 7th February: 2.
- (28) Plender, note 3 above.
- (29) Eccles, T. and Holt, A. (2001) 'International Accounting Standards: A Paradigm Shift for Corporate Real Estate?' *Journal of Corporate Real Estate*, 4(1): 66–82.
- (30) Miller and Perry, note 5 above.
- (31) *Ibid.*
- (32) Plender, note 3 above; Bill, P. (2002) 'If you value your credibility — split the tasks', *Estates Gazette*, 9th February: 35 presents an interesting argument for similar treatment of valuers and property consultants.
- (33) Miller, A. (2002) 'Ormerod: O is for optimism', *Accountancy Age*, 14th February: 4.
- (34) See for example *Accountancy Age* (2002) 'New balls please', *Accountancy Age*, 28th February: 6–7.
- (35) Zea, A. (2002) 'Institutes must restore faith', *Accountancy Age*, 21st March: 3.
- (36) *Accountancy Age* (2002) 'It's a good life really', *Accountancy Age*, 21st February: 12.
- (37) Again, on advice, the names of the banks involved have been removed, although these are a matter of record at the Congress hearings.
- (38) English, S. (2002) 'Congress blasts Enron experts', *Daily Telegraph*, 28th February: 33.
- (39) Perry, M. (2002) 'Institute launches Andersen probe', *Accountancy Age*, 21st March: 1.
- (40) Zea, note 35 above.
- (41) See titles by Eccles and Holt/Holt and Eccles in note 1 above.
- (42) Brett, M. (2002) 'Don't be too certain about valuations', *Estates Gazette*, 2nd February: 54.

- (43) University of Reading 'The influence of valuers and valuations on the workings of the commercial property investment market', University of Reading, UK.
- (44) This is an issue reflected upon in one particular case in the paper: Eccles and Holt, 'Accounting for investment properties in the UK', note 1 above.
- (45) Eccles and Holt, 'Accounting for property in the UK', see note 1 above.
- (46) Company Reporting (2002) 'Issue of the month: Revenue recognition', *Company Reporting*, April: 142.
- (47) Financial Reporting Review Panel (2001) 'Press notice 65': Wiggins plc, March.
- (48) Enron informed the SEC of its impending use of mark-to-market accounting. The auditors checked the accounts, but were not deliberately examining for 'fraud'. However, while the subject of a paper in itself, as a 'tip' offered without liability, the most noticeable means of 'smelling a rat' is to recognise that the warning signs are apparent far before the actual failure of the company. Cash and profit are essential factors to examine. If a profitable company is not generating a positive cash flow for more than two years that is suspicious. A company might be able to dupe investors about revenues in the short term, but cannot easily conceal the fact that corporate cash flow is negative.