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Enron highlights fair value accounting problems

by Mike Topping

Details of alleged sharp practice at Enron have highlighted the difficulties of preventing and detecting fraud in a mark-to-market environment, commentators said this week.

The observations follow testimony from law professor Frank Partnoy, who told a US Senate committee that the fallen energy giant had operated in a "regulatory black hole" and been brought down by an out of control derivatives operation so large it made Long Term Capital Management "look like a lemonade stand" (see *FP* 30 Jan).

Specifically, Partnoy alleged that losses were hidden by mis-marking forward rate curves and that valuation methodologies were rigged to create false profit and loss entries for the derivatives Enron traded.

Derivatives consultant Ira Kawaller told *FP*: "This is a very serious problem. The models depended on to provide estimates for fair value accounting are abstractions. This can lead to big differences of opinion as to what the executable price of a given instrument is."

Financial Accounting Standards Board Statement 133 (Fas 133) requires US companies to value their derivatives positions at market price. This mark-to-market, or fair value accounting, replaces the practice of valuing derivative instruments attheir historic cost, i.e. the original purchase price.

The problem, according to critics of the system, is that many instruments do not have a liquid market to use as a reference for calculating fair value. In such cases, complex modelling methodologies are used to generate estimates of fair value.

"Subjectivity comes into play here, and the devil is in the details," Kawaller said. "For instance there are real discrepancies in judgements on credit spreads."

The inherent capacity for differences in interpretation has the potential to mask deliberate miscalculation and manipulation of the figures, it has been suggested.

"The effects are huge where optionality is involved, because of the implicit assumptions about volatility," Kawaller said.

Such practises should not be entirely undetectable, according to Kawaller. "One thing to look for is inconsistency of methodology."

In most cases, a firm's exposure will change over time. Since a biased model would only work favourably in one direction, a systematic pattern of adopting differently biased models according to circumstance would emerge.

However, in cases where exposure remains predominantly in one direction, it may be possible to bias the valuation model consistently without arousing suspicion.

"This cuts both ways," another analyst pointed out. "Any ambiguity over how fair value is arrived at could leave legitimate firms open to allegations of sharp practice in the event of a bankruptcy investigation."

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