Enron: what happened and what we can learn from it

George J. Benston*, Al L. Hartgraves

Goizueta Business School, Emory University, 1300 Clifton Road, Atlanta, GA 30322-2710, USA

Abstract

Enron’s accounting for its non-consolidated special-purpose entities (SPEs), sales of its own stock and other assets to the SPEs, and mark-ups of investments to fair value substantially inflated its reported revenue, net income, and stockholders’ equity, and possibly understated its liabilities. We delineate six accounting and auditing issues, for which we describe, analyze, and indicate the effect on Enron’s financial statements of their complicated structures and transactions. We next consider the role of Enron’s board of directors, audit committee, and outside attorneys and auditors. From the foregoing, we evaluate the extent to which Enron and Andersen followed the requirements of GAAP and GAAS, from which we draw lessons and conclusions.

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1. Introduction

On October 16, 2001, Enron Corporation of Houston, Texas, one of the largest corporations in the world, announced it was reducing its after-tax net income by $544 million and its shareholders’ equity by $1.2 billion. On November 8, it announced that, because of accounting errors, it was restating its previously reported net income for the years 1997–2000. These restatements reduced previously reported net income as follows: 1997, $28 million (27% of...
previously reported $105 million); 1998, $133 million (19% of previously reported $703 million); 1999, $248 million (28% of previously reported $893 million); and 2000, $99 million (10% of previously reported $979 million). These changes reduced its stockholders’ equity by $508 million. Thus, within a month, Enron’s stockholders’ equity was lower by $1.7 billion (18% of previously reported $9.6 billion at September 30, 2001). On December 2, 2001, Enron filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. With assets of $63.4 billion, it is the largest US corporate bankruptcy.²

The price of Enron’s stock, which had increased spectacularly over the 1990s from a low of about $7 to a high of $90 a share in mid-2000, declined to under $1 by year-end 2001. Many Enron employees who had invested their tax-deferred 401(k) retirement plans in Enron stock saw their assets go from hundreds of thousands and even millions of dollars to almost nothing. This situation generated an enormous number of stories in the popular and financial press and television news programs, hearings before several congressional committees, and investigations by the SEC and other statutory bodies. Following a three-month investigation, a Special Investigating Committee of the Board of Directors of Enron Corp., chaired by Dean William C. Powers, Jr. of the University of Texas School of Law, submitted its Report on February 1, 2002.³ This narrative is based largely on that document (hereafter the “Powers Report”) and on cited press reports.

Enron's bankruptcy is of particular interest to accountants, because its longtime auditor, Arthur Andersen, LLP (Andersen), is (or was) one of the Big 5 CPA firms. It has been charged with gross dereliction of duty and even fraud by the press and members of the US Congress (amongst others), and is being sued in many lawsuits for very substantial damages.⁴ The Chairman of the Securities and Exchange Commission (SEC), Harvey Pitt, has called for the creation of a new oversight body to regulate and discipline CPAs. The SEC, the Financial Accounting Standards Board (FASB), and the American Institute of CPAs (AICPA) have been severely criticized for not having clarified the GAAP rules relating to special-purpose entities (SPEs, thinly capitalized and presumably independently owned and managed enterprises created to serve the business interests of their sponsor), the vehicle associated with Enron’s accounting restatements of its financial statements. Critics have emphasized that,

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² Texaco, Inc., which went bankrupt in April 1997 with assets of $35.9 billion, was the next largest.
³ Powers was not previously a member of the Enron board of directors. One committee member, Herbert S. Winokur, Jr., was a member during the period in question, and the third member, Raymond S. Troubh, a New-York-based financial consultant, was not a member of the board. Powers and Troubh were added to Enron’s board.
⁴ Andersen’s initial settlement offer for those claims was reported to be in the range of $700 million to $800 million. This offer was subsequently reduced by as much as fifty percent.
in 2000, Andersen was paid $25 million in audit fees and $27 million for non-audit consulting. This observation has given new impetus to demands that CPAs be prohibited from offering non-audit services (other than tax preparation and advice), on the assertion that these fees corrupt the independence of CPAs. Indeed, in response to this criticism, all of the Big 5 CPA firms announced that they would no longer offer certain consulting services to their auditing clients. At this writing, it is unclear whether or not these consulting opportunities include such non-audit services as tax preparation and non-financial systems analysis and design.

As of the end of May 2002, there is much yet to learn about the full extent to which Enron’s financial statements were incomplete or misleading, the effect of these shortcomings on the dramatic decline in the price of Enron’s stock, Andersen’s role in and responsibility for incorrect numbers presented in Enron’s financial statements, and the extent to which it is responsible for Enron’s failure or losses incurred by employees and investors. Nevertheless, we cannot wait until the record is complete, because what is now known is affecting how public accounting and accountants are regulated. We proceed as follows. We delineate six important accounting issues in Section 2, and describe and analyze Enron’s accounting procedures related to them and the financial-reporting consequences thereof. In Section 3, we consider issues of governance—the role of the gatekeepers in the Enron debacle (directors, audit committee, outside attorneys and auditors). From the foregoing, in Section 4 we draw lessons from the debacle. Section 5 summarizes and draws general conclusions.

2. The accounting issues

The transactions involving SPEs at Enron, and the related accounting issues are, indeed, very complex. This section summarizes some of the key transactions and their related accounting effects. The Powers Report, a 218-page document, provides in great detail a discussion of a selected group of Enron SPEs that have been the central focus of the Enron investigations. While very much less detailed than the Powers Report, the discussion in the following section (which may seem laborious at times), supplemented with additional material that became available after publication of the Report, should provide the reader with insight into how Enron sought to bend the accounting rules to their advantage. However, even a cursory review of this section will give the reader a sense of the complex financing structures that Enron used in an attempt to create various financing, tax, and accounting advantages.

Six accounting and auditing issues are of primary importance, since they were used extensively by Enron to manipulate its reported figures: (1) The accounting policy of not consolidating SPEs that appear to have permitted Enron to hide losses and debt from investors. (2) The accounting treatment of sales of Enron’s merchant investments to unconsolidated (though actually controlled) SPEs as if these were arm’s length transactions. (3) Enron’s income recognition practice of recording as current income fees for services rendered in future periods and recording revenue from sales of forward contracts, which were, in effect, disguised loans. (4) Fair-value accounting resulting in restatements of merchant investments that were not based on trustworthy numbers. (5) Enron’s accounting for its stock that was issued to and held by SPEs. (6) Inadequate disclosure of related party transactions and conflicts of interest, and their costs to stockholders.

2.1. Accounting for investments in subsidiaries and special-purpose entities

Enron sponsored hundreds (if not thousands) of SPEs with which it did business. Many of these were used to shelter foreign-derived income from US taxes. Some very substantial SPEs, though, were sponsored to conduct business with Enron domestically. Under GAAP rules in place at the time, Enron was not required to consolidate these SPEs with its financial statements if independent third parties had a controlling and “substantial” equity interest in the SPE, where “substantial” was defined as at least 3% of the SPEs’ assets. In several cases, as is usual with SPEs, Enron guaranteed their bank debt. As is not usual, the SPEs’ principal asset was restricted Enron stock. When the market price of Enron’s stock declined, the SPEs’ assets were insufficient to cover its debt. As a result, Enron had to assume the debt. This is the source, we believe, of the criticism that Enron understated and, hence, hid its real debt from investors. However, the actual situation is much more complicated, as the following explication and analysis of the principal Enron SPEs shows, even though it is a simplified summary of what Enron did.

2.1.1. JEDI and Chewco

In 1993, Enron joined with the State of California’s pension system, CalPERS, in a joint venture, JEDI, that invested in energy-related projects. Enron was the general partner with a 50% capital investment, with the other 50% contributed by CalPERS, a limited partner. In 1997, Enron decided to buy out CalPERS, so that CalPERS could invest in a larger partnership. In November and December of 1997, Enron sponsored an SPE, Chewco, to take over Cal-
PERS’s $383 million limited partnership interest in JEDI. Chewco was financed with a $240 million Barclay’s Bank loan that Enron guaranteed, a $132 million advance from JEDI, and $11.5 million in equity (3% of total assets) from presumably independent outside investors solicited by Andrew S. Fastow, then Enron’s Executive Vice President and Chief Financial Officer. Fastow proposed that he act as the manager, but Enron’s in-house and longstanding outside counsel, Vinson & Elkins (‘‘V&E’’), advised that, because Fastow was a senior officer of Enron, his participation in Chewco would have to be disclosed in Enron’s proxy statement. To avoid disclosure, Michael J. Kopper, who reported to Fastow but was not a senior officer of Enron (and, hence, may have technically not been subject to related-party regulations), was made manager. Through a complex series of reserve accounts and guarantees by Enron to Barclay’s, the bank loaned Kopper almost all but $125,000 of his equity investment in Chewco. 7 Thus, Enron guaranteed almost all of Chewco’s financing. Nevertheless, Enron did not consolidate Chewco or JEDI with its financial statements, and, presumably, reported as income gains from sales by Enron of assets to Chewco and JEDI. The Powers Report indicates that Enron accounted for its investment in JEDI under the equity method, presumably eliminating only half of the gains from the asset sales to Chewco; whereas, under full consolidation, all the gains would have been eliminated. 8

Andersen claims that it was unaware of Enron’s guarantee of the loan to Kopper, and that it believed that the 3% outside-ownership rule was met. Consequently, Chewco was not consolidated until late 2001, when Andersen said it realized that the 3% rule was not met. Andersen also recognized that JEDI also was in violation of the 3% rule, because Chewco was not an independent owner of JEDI, but a subsidiary of Enron. The result was the re-statement of Enron’s financial statements outlined in the first paragraph of this paper. From the description given in the Powers Report, and recognizing that Andersen has not as yet explained its reasoning, we find it difficult to understand why Andersen did not determine that Chewco (and, hence, JEDI) failed the 3% at-risk equity requirement, since Enron was at risk for almost all of the debt and the so-called equity of the SPE from day one.

2.1.2. LJM1 and LJM2

Two other SPEs, LJM Cayman, L.P. (LJM1) and LJM2 Co-Investment, L.P., established and controlled by Fastow, were involved in 20 distinct

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7 Kopper’s domestic partner, William D. Dodson, also owned a small portion of the equity.
8 Enron’s 8-K filing on November 8, 2001 states: “JEDI is currently a wholly owned subsidiary of Enron.” Footnote 9 of Enron’s 2000 and earlier financial statements list JEDI as an unconsolidated subsidiary with a 50% net ownership interest.
transactions with Enron. LJM1 was formed in June 1999. It was established to hedge Enron’s position in Rhythms NetConnections (Rhythms) stock. Because Fastow was both the general partner of the SPEs and a senior officer of Enron, Enron could be viewed as having control over the SPEs. But, the partnership agreements limited his authority and allowed for his removal as general partner by a 75% (later 67%) vote of the limited partners. Hence, the Powers Report states [p. 76]: “We have reviewed these issues [that contractual limitations on Fastow’s authority were sufficient for Enron to determine that he did not control the SPE] in detail, and have concluded that there are no clear answers under relevant accounting standards”.

LJM1 actually wrote the hedge through an SPE it established, LJM Swap Sub. This SPE was funded by LJM1 with cash of $3.75 million plus 1.6 million shares of restricted (hence, discounted by 39%) Enron stock valued at $80 million, for a total capitalization of $83.75 million.9 LJM Swap Sub gave Enron a put option on 5.4 million shares of Rhythms stock valued at $104 million, which was paid for by a transfer to LJM1 of $168 million in restricted Enron stock. LJM1 simultaneously gave Enron a $64 million note. Thus, LJM1 received net assets of $104 million ($168 less $64) from Enron, for which LJM Swap Sub gave Enron a put option on its Rhythms stock.

As initially structured, LJM Swap Sub had negative equity—assets of $83.75 million and an obligation valued at $104 million; hence, it could not meet the 3% rule. In November 2001, Andersen recognized this error, consolidated the SPE into Enron’s statements, thereby reducing Enron’s 1999 net income by $95 million and its 2000 net income by $8 million. The reason for these losses is that the market value of Rhythms stock declined substantially, as did the principal asset held by LJM Swap Sub, Enron stock. All along, though, Enron really was hedging itself with itself—which, of course, is of no economic value to Enron’s stockholders. Nevertheless, until it was reversed, it served to keep the decline in value of Rhythms stock off Enron’s financial statements.

2.1.3. Raptors (LJM2)

In 2000, Enron sponsored four SPEs (called Raptor I–IV) that, through their sponsorship of other SPEs, had the effect of keeping losses on its merchant investment portfolio from appearing on its financial statements. These

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9 Some of this was in the form of embedded value of Enron stock in forward contracts Enron was holding to buy its stock from an investment bank at a deep discount to current market value. These contracts had been originally written to hedge the dilution resulting from Enron’s employee stock option programs, but had become much more valuable due to increases in the market value of Enron stock.
SPEs sold Enron put options on several of its investments. These allowed Enron to avoid showing losses when the investments declined in value, because the losses were offset by the put-option obligations of the SPEs. However, Enron provided almost all of the funds for the SPEs that, presumably, were available to pay Enron should the investments decline in value. Consequently, Enron’s shareholders could not avoid absorbing losses on the investments, but Enron could avoid showing those losses.

Raptor I created the Talon SPE; LJM2 was the “outside” owner. Fastow, Enron’s CFO, was LJM2’s general partner. LJM2 contributed $30 million of Talon’s assets (7%, thus over the 3% requirement) and Enron contributed $400 million in the form of a promissory note and restricted Enron stock. However, Talon was contractually obligated to pay LJM2 at least $41 million within six months (a sure gain of $11 million to Fastow and his interests). The source of this payment was a $41 million fee for a six-month put-option on Enron stock paid by Enron to Talon; if the fee was not forthcoming, Enron was required to purchase LJM2’s interest in Talon. Thus, LJM2’s investment in Raptor I was never at risk—indeed, it never really existed, since Enron provided it through a complicated and convoluted process.

Following the return of LJM2’s investment in the form of the $41 million, Talon executed derivative transactions on Enron’s merchant investments with a notional value of $734 million that would give Talon claims or responsibility for future gains or losses. One of these transactions was on Avici stock. Apparently, the documents were backdated to August 3, 2000 so that Enron could avoid showing the $75 million loss on this stock that had occurred after that date. As the market values of both the merchant investments and Enron’ stock declined, Enron gave Talon a “costless collar” that obligated Enron to pay Talon for losses on Enron stock so that Talon would be able to meet its obligations on the aforementioned derivatives due to Enron. Thus, when Talon no longer had sufficient resources to pay its obligation to Enron because the market price of Enron stock had declined, Enron was obligated to provide the necessary resources. The purpose of this maneuver was to keep Enron from having to record losses on its presumably protected merchant investments, at least as long as Enron’s stock price was sufficient to cover Talon’s obligation. In actuality, though, Enron’s stockholders were not protected, as Talon’s assets were Enron’s stock and a note due from Enron. If the market price of Enron’s stock declined (in part, at least, as a consequence of the decline in the value of its merchant investments), that loss could not be covered. If the value of Enron’s stock had increased sufficiently to cover Talon’s obligation, the loss on its merchant investments would be hidden, but shareholders would have borne the cost in the form of stock issued at less than its market price. If the value of Enron’s stock did not increase, Enron’s investment in Talon would decline in value to reflect the amount paid by Talon to Enron.
2.1.4. Timberwolf and Bobcat

In September 2000 Enron sponsored two additional SPEs, Timberwolf (sponsored by Raptor II), and Bobcat (sponsored by Raptor IV), using a procedure similar to that used for Talon. LJM2 also contributed $30 million, which it received back in short order from Enron’s put-option fees. A fourth SPE, Raptor III, which in turn created another SPE, Porcupine, was structured differently. It was created to write a put-option on the stock of The New Power Company (TNPC), a residential and commercial power delivery company that Enron created as a separate entity. Enron had sold warrants on some of its holdings in TNPC to another SPE that it formed with an outside investor, Hawaii 125-0. Enron contributed 24 million shares of TNPC to Porcupine. The stock was valued at $10.75 a share, in exchange for which Porcupine gave Enron a note for $259 million. LJM2 also contributed $30 million. When the TNPC stock was offered for sale one week later, its price closed at $27 a share after one day. Enron immediately executed a total return swap on 18 million shares of TNPC at $21 a share, and LJM2 received a dividend of $39.5 million.

Based on the put-option from Porcupine, Enron also recorded a gain of $350 million. However, in subsequent trading TNPC’s share price fell rapidly to under $10. This diminished Porcupine’s capacity to fulfill its put obligation on TNPC shares, on which Enron’s recording revenue of $350 million depended. To avoid having to reduce this amount, in December 2000 Enron executed a 45-day cross-guarantee agreement that essentially merged the credit capacity of all four Raptors.

2.1.5. Subsequent actions and accounting changes as Enron’s stock prices declined

By November 2000, Enron had entered into derivative contracts with the Raptors I, II, and III with a notional value of $1.5 billion on which it had a gain of $500 million. However, the Raptors’ principal asset from which it could pay this amount consisted of Enron stock or obligations, or TNPC stock. By late March 2001, as the price of Enron’s shares declined, the Raptors’ credit capacity also declined. To avoid having to report a $500 million pre-tax charge against earnings, Enron executed a cross-collateralization among the Raptors, “invested” additional Enron stock contracts, and engaged in a series of complex and questionable hedges and swaps with the Raptors. Based on these moves (which Andersen apparently approved), it was determined that a loss of only $36.6 million had to be recorded for the first quarter of 2001.

In September 2001 Enron terminated the Raptors by buying out LJM2 for approximately $35 million, even though they estimated that their combined assets were approximately $2.5 billion and combined liabilities $3.2 billion. This resulted in a charge of approximately $710 million after taxes on Enron’s third quarter 2001 financial statements. In all, Enron’s not consolidating these SPEs increased its reported earnings as follows ($millions):

Thus, at a very considerable cost to shareholders, Enron’s managers temporarily were able to hide substantial losses.

2.2. Sales of merchant investments to unconsolidated (though actually controlled) SPEs as if these were arm’s length transactions (only a few of several examples are described here)

Enron had entered into forward contracts with an investment bank to purchase Enron’s stock at a fixed price. In June 1999 the strike price was considerably below the market. Under GAAP, the increase in value cannot be recorded as income, because the gain was due to an increase in value of Enron’s own stock. Enron used the gain on these contracts to fund its investment in several of the SPEs it sponsored, as detailed above.

In September 1999, Enron sold to LJM1 for $11.3 million a 13% interest in a company building a power plant in Cuiaba, Brazil. This sale supported Enron’s recording a mark-to-market gain of $65 million in 1999 due to alterations in Enron’s accounting treatment of a related gas supply contract. In August 2001 it repurchased that interest for $14.4 million, even though the project had encountered serious technical and environmental problems. The $65 million recorded gain does not appear to have been reversed.

Also in September 1999, Enron sold to LJM1 13 percentage points of its 65% ownership of another Brazilian company, Empresa Productora de Energia Ltda (EPE), along with some redeemable preference shares and control rights. Based on this sale, the Powers Report [pp. 135–6] states: “Enron took the position that, as a result of the decrease in its ownership interest, it no longer controlled EPE and was not required to consolidate EPE in its balance sheet.” Considering that 65% less 13% equals 52%, it is not clear why Andersen did not make Enron consolidate EPE and allowed it to record an additional gain of $65 million by marking to market a portion of a gas supply contract with EPE.

In December 1999, Enron sold to LJ M2 a 75% interest in a company that owned a power plant under construction in Poland for $30 million, part of it in

<table>
<thead>
<tr>
<th>Financial report</th>
<th>Reported earnings (loss)</th>
<th>Earnings (loss) without Raptors</th>
<th>Decrease in reported earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>3rd quarter 2000</td>
<td>364</td>
<td>295</td>
<td>69</td>
</tr>
<tr>
<td>4th quarter 2000</td>
<td>286</td>
<td>(176)</td>
<td>462</td>
</tr>
<tr>
<td>1st quarter 2001</td>
<td>536</td>
<td>281</td>
<td>255</td>
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<tr>
<td>2nd quarter 2001</td>
<td>530</td>
<td>490</td>
<td>40</td>
</tr>
<tr>
<td>3rd quarter 2001</td>
<td>(210)</td>
<td>(461)</td>
<td>251</td>
</tr>
<tr>
<td>Total</td>
<td>1506</td>
<td>429</td>
<td>1077</td>
</tr>
</tbody>
</table>
the form of a loan and part an equity investment. Enron recorded a gain of about $16 million on the sale.

2.3. Recording as current income fees for services rendered in future periods

Several of the SPE’s paid Enron fees for guarantees on loans made by the SPEs. In accordance with the matching concept of income determination, the revenue should have been recognized over the period of the guarantees. However, Enron recorded as income in December 1997 a $10 million up-front payment from Chewco for a guarantee that was outstanding for the next 12 months. The JEDI partnership contracted to pay Enron an annual “management fee”. After contractually converting 80% of the fee to a “required payment”, in March 1998 Enron recorded its present value through June 2003 (net of a reserve) of $25.7 million as income. Because this accounting appears to be a violation of GAAP, it is unclear why Andersen accepted it.

Additional sham revenue transactions appear to have been recorded when Enron sold forward gas commodity contracts to Mahonia Ltd., a Channel Islands company connected with Chase Bank, and simultaneously purchased a comparable and offsetting forward gas commodity contract from another Channel Islands company, Stoneville Aegean Ltd., also connected with both Mahonia and Chase.\[10\] Enron collected immediately the discounted present value of the sales contract (which was apparently recorded as sales revenue), but did not recognize the purchase contract as an offsetting expense, since it did not have to be paid until the contract delivery date. Mahonia simultaneously sold its forward contract to Chase, thereby obtaining the funds to pay Enron. In at least one such contract, the difference between the discounted sales contract and the undiscounted purchase contract was roughly equivalent to the interest on a 7% loan. Surety companies which wrote surety bonds for the delivery of the commodity product are now refusing to pay the bonds on the grounds that there was never any intent by Enron to deliver the commodity and that Enron (and Chase) were conspiring to disguise loans, which under New York law cannot be insured by commodity surety companies as commodity contracts. This dispute between the bank and the surety companies is in litigation.

2.4. Fair value restatements of merchant investments that were not based on trustworthy (reliable) numbers

The FASB has gradually expanded fair value accounting under GAAP over the past several years. Although fair values should be based on market prices derived from arm’s length transactions involving the same or similar assets,
FASB 133 permits the “values” of derivatives to be determined by marking to model. Such models depend significantly on alternative model input assumptions, the application of which can result in substantially varying estimates. EITF Issue 98-10 requires energy-trading contracts to be stated at fair values that may be determined by estimated net present values. This calculation involves managers in estimating future net cash flows and applying a discount rate to obtain the present (fair) values. Such procedures allow managers who want to manipulate net income the opportunity to make “reasonable” assumptions that would give them the gains they want to record. Such appears to have been what Enron did. Enron employees interviewed by National Public Radio claimed that Enron’s policy was to reward section heads who met their revenue targets (generally a 15% growth rate) and dismissed or effectively demoted those who did not. It rarely is possible for anyone to maintain a rate of this magnitude quarter after quarter and year after year. However, they could give this appearance, at least for a while, by marking assets to “market” and recording the presumed gains.

In its 1999 and 2000 annual reports filed on form 10-K with the SEC, Enron reported that its merchant investments and energy assets are recorded at fair value, based on “market values of publicly traded securities, independent appraisals and cash flow analyses (Footnote 7).” No breakdown is provided on the extent to which each of these methods was employed. The pre-tax gains from sales of merchant assets and revaluations of investments reported, the amount of Enron’s total pre-tax net income, and the percentage increase to total net income of the gains are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>$millions</th>
<th>Pre-tax gains from sales and revaluations</th>
<th>Pre-tax reported net income</th>
<th>Percentage increase in reported net income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>104</td>
<td>979</td>
<td>10.6</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>756</td>
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<td>628</td>
<td>703</td>
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<tr>
<td>1997</td>
<td>136</td>
<td>105</td>
<td>129.5</td>
<td></td>
</tr>
</tbody>
</table>

We cannot determine how much of these gains were the result of fair-value estimates. Some were the result of “sales” made to and through controlled SPEs that were guaranteed by Enron or on which Enron actually accepted the risk of non-payment. Some insight might be obtained from a newspaper report of how Enron reported the fair value of some of its merchant investments.
2.4.1. Broadband and blockbuster inc. partnership, braveheart 11

In January 2000, as reported in the Washington Post, Enron’s former CEO, Jeffrey K. Skilling “told stock market analysts (in December 2001) that Enron was about to create a market for trading space on the high-speed fiber optic networks that form the backbone for Internet traffic”. He said it “would eventually add $40 billion to Enron’s stock value”. Enron invested more than $1 billion on broadband. In 2000, Enron reported revenue of $408 million and had a net loss of $64 million. The unit was closed down in mid-year 2001, after having produced just $16 million in additional revenue.

The 2000 revenue was generated by a sale of excess unused (dark) fiber-optic connections to LJM2, the SPE discussed earlier that was run by Fastow, Enron’s CFO. As noted above, Enron effectively controlled the SPE both through Fastow and because LJM2’s principal asset was Enron stock. “Enron valued the sale at $100 million, one-quarter of the $408 million in revenue Enron said it made from broadband sales last year (2001). At the time of the sale, Enron received $30 million in cash and a $70 million note from LJM2. On that one deal, Enron also recorded a profit of $67 million, at a time when dark-fiber prices were plunging. It also received a $20 million fee from LJM2 for marketing and managing the dark-fiber assets, according to an SEC filing”. LJM2 “repaid” the $70 million note with proceeds from sales of dark fiber, sales that occurred because Enron guaranteed payment on the sales, assuming $61 million of the buyers’ obligations. Thus, according to the income recognition requirements of GAAP, this was not really a sale, unless it was improbable that Enron would have to assume its guarantee.

Another aspect of Enron’s broadband venture was a mid-2000, 20-year partnership with Blockbuster Inc., Project Braveheart, to develop a company that would allow consumers access to Blockbuster-controlled films through Enron’s fiber-optic lines. Although the Braveheart venture was incorporated on December 28, 2000, Rebecca Smith of the Wall Street Journal reports that “Enron assigned the partnership a value of $124.8 million based on its projections of the revenue and earnings potential of the Blockbuster venture, according to company documents”. For the fourth quarter of 2000, “Enron claimed its ownership of Braveheart resulted in a $53 million profit, even though the Blockbuster venture was only two weeks into its pilot program and not generating any profit at all . . . In the following quarter, the first of 2001, Enron claimed an additional $57.9 million in revenue from Braveheart”. This revenue limited Enron’s Broadband losses to $67 million during the two quarters. Blockbuster Inc. did not record any profits for the same two periods. On March 12, 2001, Blockbuster Inc. dissolved the partnership. In October 2001, Enron had to reverse the $110.9 million in profit it had claimed earlier.

2.4.2. Energy contracts

Enron was required to mark-to-market the value of its contracts to supply energy, in accordance with the EITF Issue no. 98-10. As described in the New York Times: “When its energy services unit signed a power-supply contract with a company, it would structure the deal to bring it under those accounting rules. It would then project electricity and natural gas prices for the full term of the deal, which could last as long as 10 years, according to former Enron officials... Then, based on its projections, Enron would calculate its total profit over the life of the contract. After discounting that figure to account for the risk the customer would default and the fact that it would not receive most payments for years, Enron would book the profit immediately”. At this time, we do not know how much in total of Enron’s reported net profits were the result of these kinds of calculations.

2.4.3. Enron’s merchant investments

Enron carried many of its investments in its merchant investment portfolio as financial assets. It also monetized contracts to deliver services, turning them into financial assets. Enron’s merchant investments portfolio was apparently organized as an investment fund; therefore, under GAAP it could—indeed, must—revalue such assets to fair values. Reliable market prices were not available for many of these financial assets, which gave Enron the opportunity of assigning values that permitted it to record earned revenue. At present, we do not have a detailed analysis of the extent to which this means of manipulating reported net income was employed.

2.5. Accounting for Enron stock issued to and held by SPEs

Quite sensibly, GAAP does not permit a corporation to record as income increases in the value of its own stock. Nevertheless, Enron did this. JEDI owned 12 million shares of Enron stock, which it recorded at market and recognized income for the amount of the increased market value. As stated earlier, Enron accounted for its investment in JEDI with the equity method in 1993 through the first quarter of 2000. Hence, in recording increases in the accounting basis of its investment in JEDI, Enron recorded in its income increases in the appreciation of the market value of its own stock. In 2000 Andersen decided that this was incorrect, although it does not appear that a correction was made. When Enron’s stock held by JEDI declined by $94 million in the first quarter of 2001, Enron did not record its share of the loss, and Andersen apparently concurred with this treatment.

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GAAP (as stated in EITF 85-1 and Rule 5-02.30 of SEC Regulation S-X) also does not permit a corporation to record exchanges of its stock for a note receivable as an increase in equity, based on the reasonable concern that the note may not be paid. Rather, the amount of the receivable must be deducted from equity, which offsets the increase in stock outstanding, resulting in no change in total owners’ equity. Enron, though, recorded the “sale” of its shares and embedded rights in futures contracts to purchase shares at a discount to the Raptor SPEs in exchange for promissory notes by recording an asset, notes receivable, and an increase in stockholders equity. These incorrect entries increased Enron’s stockholders’ equity by $172 million in the first quarter 2000 and by $828 million in the first quarter of 2001. The $1 billion error was corrected in the third quarter of 2001.

2.6. Disclosure of conflicts of interest and its costs to stockholders

SEC Regulation S-X, item 404 requires disclosure of transactions exceeding $60,000 in which an executive officer of a corporation has a material interest, including the person’s name and relationship to the registrant, the nature of the relationship, the amount of the transaction, and the amount of the person’s interest in the transaction. FAS 57 also requires disclosure of material related-party transactions.

Enron’s proxy statements in 2000 and 2001 disclose that “Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM1’s general partner. The general partner is entitled to receive a percentage of the profits of LJM1 in excess of the general partner’s proportion of total capital contributed to LJM1, depending upon the performance of the investments made by LJM1”. A similar statement is made with respect to LJM2. The amounts Fastow received and a more complete description of the reasons for his compensation were not disclosed. However, Enron’s 1999 10-K asserted: “the terms of the transactions with related parties were reasonable and are representative of terms that would be negotiated with unrelated third parties”. Enron’s 2000 10-K changed the language somewhat to read: “the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties”.

Enron’s transactions with the SPE’s discussed above, though, do not appear to have been made at arm’s length. Andrew Fastow, Enron’s Executive Vice President and CFO, and employees who reported to him (Michael Kopper and others) were on both sides of the transactions from which they benefited. They benefited personally from Enron’s dealings with the SPEs in which they were general and limited partners. Yet, they presumably represented Enron’s shareholders when they arranged for the prices paid for investments and services transferred from and provided by Enron to those SPEs. The Powers Report details the transactions and states that Fastow obtained more than $30
million personally from his management of SPEs that did business with Enron. Kopper (and his partner, Dodson) received approximately $11.1 million.

Enron’s issuance of its stock to Fastow- and Kopper-controlled SPEs for notes receivable (described above) represent large transfers from Enron’s stockholders to these related parties. In effect, Enron gave these parties and investors in the SPEs they controlled valuable options on Enron stock. If the stock went up in value, they could pay for it at the original price and pocket the gain. If the stock went down, they could abandon the SPE (as described above, Enron guaranteed and gave them a rapid return of their original investments). In addition, sale of the stock was restricted, so they were obligated to pay only about 61% of its market price when it was issued. Presumably acting for Enron, Fastow also apparently could (and in some instances, did) release the SPEs from the restriction.

In March 2001 Enron repurchased Chewco’s limited partnership interest in JEDI and consolidated JEDI into its financial statements. For their $125,000 investment, Enron (represented by Fastow) paid Kopper (and Dodson) $3.0 million in cash at closing, plus approximately $7.5 million (net) in cash during the term of their investment, and $1.6 million in management fees for Kopper’s “work” with Chewco. In September Enron (at the insistence of Fastow) paid Chewco an additional $2.6 million to cover its tax liabilities related to the buyout, even though Enron’s in-house counsel and its outside counsel, Vinson and Elkins concluded that the payment was not required.

When Enron unwound LJM Swap Sub in 2000, the SPE gave Enron the shares in Enron that it had received from LJM1, and received in return $16.7 million and termination of its obligation for the put options it wrote on Rhythms (on which Enron estimated it was owed $207 million). The result was, as the Powers Report puts it, “a huge windfall (more than $70 million) to Swap Sub and LJM1”, and, therefore, to Fastow and his limited partners. His Enron group, which negotiated the payment, failed to take into account that the stock was restricted (and hence, subject to a large discount), and did not obtain an independent fairness opinion. The consequence of this conflict of interest was not revealed in Enron’s financial statements.

Enron’s sponsoring of the Talon SPEs in 2000 resulted in additional funds transferred to Fastow and his interests, the general and limited partners. Enron purchased a six-month put-option on 7.2 million shares of its own stock from Talon for $41 million. If Enron’s stock declined in value, Talon would owe Enron a maximum of $82.8 million. However, its assets consisted of restricted Enron stock, a promissory note from Enron, and $30 million in cash from LJM2, an SPE of which Fastow was general partner. The $30 million was contributed by LJM2. As it happened, the Enron stock increased in value, the put was cancelled early, Talon returned $4 million of the premium, and paid $41 million to LJM2, thus enriching Fastow (the general partner) and his limited partners.
In 1999 Enron sold several investments to LJM1 and LJM2, SPEs of which Fastow was general partner, at what appears to be inflated profits. The Enron employees who negotiated the terms of the deal reported to Fastow. In the Ciaba, Brazil power plant deal, LJM1 paid $11.3 million for Enron's interest on September 30, 1999 and sold it back to Enron on August 15, 2001 for $14.4 million, despite the serious problems experienced by the plant in the interim. As stated earlier, on December 21, 1999, LJM2 purchased an Enron interest in a Polish power plant for $30 million and resold it to Enron on March 29, 2000 for $31.9 million.

3. Governance – role of the gatekeepers: Enron’s board of directors, its audit committee, outside attorneys, independent public accountants (CPAs), and the SEC

3.1. Board of directors and audit committee of the board

In 1999, in response to the SEC’s concerns about financial reporting quality, as emphasized by its then chair, Arthur Levitt (Levitt, 1998), a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon Committee, 1999) recommended that audit committee members have accounting and/or related financial expertise. In response, the SEC registered exchanges (New York and American stock exchanges and Nasdaq) required financial literacy for all audit committee members and financial expertise for at least one member.

Enron’s Audit and Compliance Committee appears to exceed this requirement substantially. At least four of the six members had expertise that was particularly relevant to Enron’s activities. Robert K. Jaedicke (board member since 1985) chaired the Audit Committee. He had been a distinguished Professor of Accounting and Dean of Stanford University Business School. Wendy L. Gramm (board member since 1993) has a Ph.D. in economics and had been Chair of the Commodity Futures Trading Commission. She is Director of Mercatus Center at George Mason University (which may have received support from Enron). Lord John Wakeham (board member since 1994) was the British Secretary of State for Energy and leader of the Houses of Lords and Commons and is Chairman of Press Complaints Commission in Britain. (In addition to his board-member compensation, he was paid $72,000 in 2001 as a consultant to Enron’s European operations.) Paulo Ferraz Pereira (board member since 1999) was the president of the State Bank of Rio de Janeiro and is Executive VP of Group Bozano (a Brazilian investment bank). Two other members of Enron’s audit committee appear to be at least financially literate. Ronnie C. Chan (board member since 1996) is Chairman, Hang Lung Group (which is involved in property development and investments in China). John
Mendelsohn (board member since 1996) is President, University of Texas M.D. Anderson Cancer Center (Enron donated more than $600,000 to the cancer center).

According to the Powers Report [p. 148], Enron’s Board of Directors reviewed and approved creation of the SPEs and “assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the review only in a cursory way”. The Powers Report goes into substantial detail about the Board and the Audit and Compliance Committee’s failure to adequately understand, review, approve, and monitor the Fastow-created SPEs and Enron’s accounting and reporting practices. The complexity of the material discussed in the Powers Report prevents us from condensing and summarizing it adequately here. A partial summary may be gleaned from the following conclusionary statement in the Report [p. 162]:

The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships. The Board had agreed to permit Enron to take on the risk of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron’s transactions with the LJM partnerships. These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda . . . lasting ten to fifteen minutes.

Furthermore, after detailing serious incomplete and potentially misleading aspects of Enron’s financial statements (including footnotes), the Powers Report states [p. 182]: “The Audit and Compliance Committee reviewed drafts of the financial statements footnotes and discussed them with Causey (Enron’s Chief Accounting Officer)”. At this writing, we do not know why Enron’s very well qualified audit committee accepted the inadequate disclosures therein.

3.2. Outside attorneys

The Powers Report, testimony before committees of the US Congress, and press reports severely criticize Enron’s outside attorneys (and, much more severely, its CPAs). As of the date of this writing (Mid-March, 2002), neither firm has provided publicly its explanation of what they are accused of doing and not doing. We base the following conclusions on our understanding of the available public record.

Vinson and Elkins were Enron’s outside attorneys. They reviewed and approved the partnerships managed by Fastow, the other SPEs, and many, if not all, of the misleading and, to shareholders, costly actions reviewed above. On
August 14, 2001, an Enron vice president, Sherron Watkins (who also is a CPA and had been an auditor with Andersen for eight years) sent a letter to Enron Chairman Kenneth Lay that outlined and complained of many of the misleading accounting devices discussed above. Among other things, she wrote (Watkins, 2002): “I realize that we have had a lot of smart people looking at this and a lot of accountants including AA & Co. (Andersen) have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day”. She later met with Lay. He sent a copy of the letter to Enron’s General Counsel, James V. Derrick, Jr., who engaged V&E to investigate Watkins’ charges. The Powers Report states [p. 176]: “V&E concluded that the facts revealed in its preliminary investigation did not warrant a ‘further widespread investigation by independent counsel or auditors’, although they did note that the ‘bad cosmetics’ of the Raptor related-party transactions, coupled with the poor performance of the assets placed in the Raptor vehicles, created a ‘serious risk of adverse publicity and litigation’.”

3.3. Independent public accountants (CPAs)

The highly respected firm of Arthur Andersen audited and unqualifiedly signed Enron’s financial statements since 1985. According to the Powers Report, Andersen was consulted on and participated with Fastow in setting up the SPEs described above. Together, they crafted the SPEs to conform to the letter of the GAAP requirement that the ownership of outside, presumably independent, investors must be at least 3% of the SPE assets. At this time, it is very difficult to understand why they determined that Fastow was an independent investor. Kopper’s independence also is questionable, because he worked for Fastow. In any event, Andersen appears, at best, to have accepted as sufficient Enron’s conformance with the minimum specified requirements of codified GAAP. They do not appear to have realized or been concerned that the substance of GAAP was violated, particularly with respect to the independence of the SPEs that permitted their activities to be excluded from Enron’s financial statements and the recording of mark-to-market-based gains on assets and sales that could not be supported with trustworthy numbers (because these did not exist). They either did not examine or were not concerned that the put obligations from the SPEs that presumably offset declines in Enron’s investments (e.g., Rhythms) were of no or little economic value. Nor did they require Enron to record as a liability or reveal as a contingent liability its guarantees made by or through SPEs. Andersen also violated the letter of GAAP and GAAS by allowing Enron to record issuance of its stock for other than cash as an increase in equity. Andersen also did not have Enron adequately report, as required, related-party dealings with Fastow, an executive officer of Enron, and the consequences to stockholders of his conflict of interest.
3.4. The SEC

The SEC has the power to discipline CPAs who willfully or recklessly attest to financial statements filed with it that significantly violate the provisions of GAAP or GAAS (assuming the deviations there from are not disclosed). Rule 201.102 (e) provides that

\[\ldots\text{the Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to a person who is found by the Commission after notice and opportunity for hearing in the matter \ldots to have engage in unethical or improper professional conduct; or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder. (iv) With respect to persons licensed to practice as accountants, “improper professional conduct” under §201.102(e) (1)(ii) means:}\]

(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
(B) Either of the following two types of negligent conduct:
   1. A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
   2. Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

As best we could learn, the SEC has rarely even attempted to suspend independent CPAs or their firms who have not fulfilled their professional responsibilities, despite the negative externalities that result from situations such as Enron. Granted, it is difficult to prove that an auditor “willfully” or “knowingly” violated professional standards, but a showing of “unreasonable conduct \ldots resulting in a violation of applicable professional standards,” could be demonstrated, if that is what occurred.

4. Lessons from the Enron debacle

Public, press, and legislative shock over the Enron bankruptcy and the apparent failure of its independent public accountants to reveal the problems earlier or even to have participated with Enron managers in producing and attesting financial statements that were materially misleading has led to strong
criticism against public accountants generally and calls for reform. The critics would be demanding creation of a government agency to regulate financial statement disclosure and CPAs, except that the United States already has such an agency, the Securities and Exchange Commission. It has the authority to establish generally accepted accounting and auditing standards, review and disapprove as inadequate the financial statements registered with it by all but very small publicly traded corporations. The SEC also can discipline CPAs who sign such statements, either by refusing to accept statements they sign, or by suspending or barring them from SEC practice. The SEC can conduct investigations and recommend civil or criminal actions to the Department of Justice.

Nevertheless, additional regulatory actions have been proposed. These include forbidding CPA firms that audit financial statements from offering to their clients other financial services, such as tax preparation, internal auditing, systems analysis, litigation support, and financial planning. Individual CPAs might be subject to a new disciplinary body dominated by non-accountants that might recommend or impose additional sanction against them. Before these suggestions are taken seriously, though, what has been learned from the Enron debacle should be specified.

4.1. GAAP

We believe that two important shortcomings have been revealed. First, the US model of specifying rules that must be followed appears to have allowed or required Andersen to accept procedures that accord with the letter of the rules, even though they violate the basic objectives of GAAP accounting. Whereas most of the SPEs in question appeared to have the minimum-required 3%-of-assets of independent ownership, the evidence outlined above indicates that Enron in fact bore most of the risk. In several important situations, Enron very quickly transferred funds in the form of fees that permitted the 3% independent owners to retrieve their investments, and Enron guaranteed the SPEs’ liabilities. Second, the fair-value requirement for financial instruments adopted by the FASB permitted Enron to increase its reported assets and net income and, thereby, to hide losses. Andersen appears to have accepted these valuations (which, rather quickly, proved to be substantially incorrect), because Enron was following the specific GAAP rules.

Andersen, though, appears to have violated some important GAAP and GAAS requirements. There is no doubt that Andersen knew that the SPEs were managed by a senior officer of Enron, Fastow, and that he profited from his management and partial ownership of the SPEs he structured. On this basis, alone, it seems that Andersen should have required Enron to consolidate the Fastow SPEs with its financial statements and eliminate the effect of transactions between those entities and Enron. Furthermore, it seems clear that the SPEs established by Fastow were unlikely to be able to fulfill their osten-
sible role of closing put options written to offset losses in Enron’s merchant investments. If this were the purpose, the options should and would have been purchased from an existing institution that could meet its obligations.

Andersen also seems to have allowed Enron to violate the requirement specified in FASB Statement 5 that guarantees of indebtedness and other loss contingencies that in substance have the same characteristics, should be disclosed even if the possibility of loss is remote. The disclosure shall include the nature and the amount of the guarantee. Even if Andersen were correct in following the letter, if not the spirit of GAAP in allowing Enron to not consolidate those SPEs in which independent parties held equity equal to at least 3% of assets, Enron’s contingent liabilities resulting from its loan guarantees should have been disclosed and described.

In any event, Andersen does not appear to have applied the GAAP requirement to recognize asset impairment (FAS 121). From our reading of the Powers Report, the put-options written by the SPEs that, presumably, offset Enron’s losses on its merchant investment, were not collectible, because the SPEs did not have sufficient net assets. (Details on the SPEs’ financial situations should have been available to Andersen.) GAAP (FAS 5) also requires a liability to be recorded when it is probable that an obligation has been incurred and the amount of the related loss can reasonably be estimated. The information presently available indicates that Enron’s guarantees on the SPEs and Kopper’s debt had become liabilities to Enron. It does not appear that they were reported as such.

GAAP (FAS 57) specifies that relationships with related parties “cannot be presumed to be carried out on an arm’s-length basis, as the requisite conditions of competitive, free-market dealings may not exist”. As Executive Vice President and CFO, Fastow clearly was a “related party”. SEC Regulation S-K (Reg. §229.404. Item 404) requires disclosure of details of transactions with management, including the amount and remuneration of the managers from the transactions. Andersen does not appear to have required Enron to meet this obligation. Perhaps more importantly, Andersen did not reveal the extent to which Fastow profited at the expense of Enron’s shareholders, who could only have obtained this information if Andersen had insisted on its inclusion in Enron’s financial statements.

4.2. GAAS

SAS 85 warns auditors not to rely on management representations about asset values, liabilities, and related-party transactions, among other important items. Appendix B to SAS 85 illustrates the information that should be obtained by the auditor to review how management determined the fair values of significant assets that do not have readily determined market values. We do not have access to Andersen’s working papers to examine whether or not they
followed this GAAS requirement. In the light of the Wall Street Journal report presented above of Enron’s recording a fair value for the Braveheart project with Blockbuster Inc., though, we find it difficult to believe that Andersen followed the spirit and possibly not even the letter of this GAAS requirement.

SAS 45 and AICPA, Professional Standards, vol. 1, AU sec. 334 specify audit requirements and disclosures for transactions with related parties. As indicated above, this requirement does not appear to have been followed.

An additional lesson that should be derived from the Enron debacle is that auditors should be aware of the ability of opportunistic managers to use financial engineering methods to get around the requirements of GAAP. For example, derivatives used as hedges can be structured to have gains on one side recorded at market or fair values while offsetting losses are not recorded, because they do not qualify for restatement to fair-value. Another example is a loan disguised as a sale of a corporation’s stock with guaranteed repurchase from the buyer at a higher price. If this subterfuge were not discovered, liabilities and interest expense would be understated. Thus, as auditors have learned to become familiar with computer systems, they must become aware of the means by which modern finance techniques can be used to subvert GAAP.

5. Summary and conclusions

We believe that US GAAP, as structured and administered by the SEC, the FASB, and the AICPA, are substantially responsible for the Enron accounting debacle. Enron and its outside counsel and auditor felt comfortable in following the specified accounting requirements for consolidation of SPEs. The SEC had the responsibility and opportunity to change these rules to reflect the known fact that corporations were using this vehicle to keep liabilities off their balance sheets, although the sponsoring corporations were substantially (often almost entirely) liable for the SPEs’ obligations.

We also believe that the UK GAAP, which requires auditors to report a “true and fair view” of an enterprises’ financial condition is preferable to the highly specified US model. The US model allows—even encourages—corporate officers to view accounting requirements as if they were specified in a tax-code. For taxes, avoidance of a tax liability by any legally permissible means not only is acceptable, but is an obligation of corporations acting in the interests of their shareholders. Enron appears to have taken the same approach to accounting (except that what was done was detrimental to its shareholders). The gatekeepers (Vinson & Elkins and Andersen) seem to have gone along and possibly even participated in this approach to accounting.

The most important lesson with respect to GAAS is that Andersen’s partners and staff do not appear to have exercised the requisite skepticism that auditors should adopt. Rather, they appear to have accepted too readily
management’s valuations and determinations with respect to valuations and related-party transactions. It is possible that this presumed lack of skepticism and distance is simply a failing of the particular auditors-in-charge. Or, it may be a consequence of auditors having been associated with Enron for many years. (Familiarity may breed over-involvement with and empathy for management’s worldview, rather than contempt.) Or, the auditors in charge of the Enron audit may have overlooked or supported their client’s overly “aggressive” accounting, misleading, and possibly fraudulent accounting practices in order to protect their very salaries and bonuses.13 Or, as many critics have charged, the gatekeepers may have been corrupted by the sizeable audit and possibly the non-audit fees paid by Enron.

Andersen’s audit personnel also might have been incapable of understanding the complex financial entities and instruments structured by Enron’s chief financial officer, Andrew Fastow. These auditors dealt with Enron when it was an oil and gas producer and distributor. In recent years, it became primarily a dealer in financial instruments and a developer of new ventures. For reasons that have yet to be explained, Andersen did not replace these auditors or (apparently) provide them with the requisite expertise. Another lesson, then, is that CPA firms should ascertain that their personnel are capable of dealing with the presently existing activities of their clients.

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13 David Duncan, the Andersen partner in charge of the Enron account, was reported by The Times (London) as having an estimated $1 million per year salary [January 19, 2002].