

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

CASE 1.3 ENRON CORPORATION

27

accountants to adopt the public service ideal that had long served as the underlying premise of the more mature professions such as law and medicine. He also lobbied for the adoption of a mandatory continuing professional education (CPE) requirement. Andersen realized that CPAs needed CPE to stay abreast of developments in the business world that had significant implications for accounting and financial reporting practices. In fact, Arthur Andersen & Co. made CPE mandatory for its employees long before state boards of accountancy adopted such a requirement.

By the mid-1940s, Arthur Andersen & Co. had offices scattered across the eastern one-half of the United States and employed more than 1,000 accountants. When Arthur Andersen died in 1947, many business leaders expected that the firm would disband without its founder, who had single-handedly managed its operations over the previous four decades. But, after several months of internal turmoil and dissension, the firm's remaining partners chose Andersen's most trusted associate and protégé to replace him.

Like his predecessor and close friend who had personally hired him in 1928, Leonard Spacek soon earned a reputation as a no-nonsense professional—an auditor's auditor. He passionately believed that the primary role of independent auditors was to ensure that their clients reported fully and honestly regarding their financial affairs to the investing and lending public. Spacek continued Arthur Andersen's campaign to improve accounting and auditing practices in the United States during his long tenure as his firm's chief executive. "Spacek openly criticized the profession for tolerating what he considered a sloppy patchwork of accounting standards that left the investing public no way to compare the financial performance of different companies."² Such criticism compelled the accounting profession to develop a more formal and rigorous rule-making process. In the late 1950s, the profession created the Accounting Principles Board (APB) to study contentious accounting issues and develop appropriate new standards. The APB was replaced in 1973 by the Financial Accounting Standards Board (FASB). Another legacy of Arthur Andersen that Leonard Spacek sustained was requiring the firm's professional employees to continue their education throughout their careers. During Spacek's tenure, Arthur Andersen & Co. established the world's largest private university, the Arthur Andersen & Co. Center for Professional Education, located in St. Charles, Illinois, not far from Arthur Andersen's birthplace.

Leonard Spacek's strong leadership and business skills transformed Arthur Andersen & Co. into a major international accounting firm. When Spacek retired in 1973, Arthur Andersen & Co. was arguably the most respected accounting firm not only in the United States, but worldwide as well. Three decades later, shortly after the dawn of the new millennium, Arthur Andersen & Co. employed more than 80,000 professionals, had practice offices in more than 80 countries, and had annual revenues approaching \$10 billion. However, in late 2001, the firm, which by that time had adopted the one-word name "Andersen," faced the most significant crisis in its history since the death of its founder. Ironically, that crisis stemmed from Andersen's audits of an energy company, a company founded in 1930 that, like many of Arthur Andersen's clients, had struggled to survive the Depression.

The World's Greatest Company

Northern Natural Gas Company was founded in Omaha, Nebraska, in 1930. The principal investors in the new venture included a Texas-based company, Lone Star Gas Corporation. During its first few years of existence, Northern wrestled with the problem

2. *Ibid.*

Username: Oleksandra Lemeshko**Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

of persuading consumers to use natural gas to heat their homes. Concern produced by several unfortunate and widely publicized home “explosions” caused by natural gas leaks drove away many of Northern’s potential customers. But, as the Depression wore on, the relatively cheap cost of natural gas convinced increasing numbers of cold-stricken and shallow-pocketed consumers to become Northern customers.

The availability of a virtually unlimited source of cheap manual labor during the 1930s allowed Northern to develop an extensive pipeline network to deliver natural gas to the residential and industrial markets that it served in the Great Plains states. As the company’s revenues and profits grew, Northern’s management launched a campaign to acquire dozens of its smaller competitors. This campaign was prompted by management’s goal of making Northern the largest natural gas supplier in the United States. In 1947, the company, which was still relatively unknown outside of its geographical market, reached a major milestone when its stock was listed on the New York Stock Exchange. That listing provided the company with greater access to the nation’s capital markets and the financing needed to continue its growth-through-acquisition strategy over the following two decades.

During the 1970s, Northern became a principal investor in the development of the Alaskan pipeline. When completed, that pipeline allowed Northern to tap vast natural gas reserves it had acquired in Canada. In 1980, Northern changed its name to InterNorth, Inc. Over the next few years, company management extended the scope of the company’s operations by investing in ventures outside of the natural gas industry, including oil exploration, chemicals, coal mining, and fuel-trading operations. But the company’s principal focus remained the natural gas industry. In 1985, InterNorth purchased Houston Natural Gas Company for \$2.3 billion. That acquisition resulted in InterNorth controlling a 40,000-mile network of natural gas pipelines and allowed it to achieve its long-sought goal of becoming the largest natural gas company in the United States.

In 1986, InterNorth changed its name to Enron. Kenneth Lay, the former chairman of Houston Natural Gas, emerged as the top executive of the newly created firm that chose Houston, Texas, as its corporate headquarters. Lay quickly adopted the aggressive growth strategy that had long dominated the management policies of InterNorth and its predecessor. Lay hired Jeffrey Skilling to serve as one of his top subordinates. During the 1990s, Skilling developed and implemented a plan to transform Enron from a conventional natural gas supplier into an energy-trading company that served as an intermediary between producers of energy products, principally natural gas and electricity, and end users of those commodities. In early 2001, Skilling assumed Lay’s position as Enron’s chief executive officer (CEO), although Lay retained the title of chairman of the board. In the management letter to shareholders included in Enron’s 2000 annual report, Lay and Skilling explained the metamorphosis that Enron had undergone over the previous 15 years:

Enron hardly resembles the company we were in the early days. During our 15-year history, we have stretched ourselves beyond our own expectations. We have metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.

Enron’s 2000 annual report discussed the company’s four principal lines of business. Energy Wholesale Services ranked as the company’s largest revenue producer. That division’s 60 percent increase in transaction volume during 2000 was fueled by the rapid development of EnronOnline, a B2B (business-to-business) electronic marketplace for the energy industries created in late 1999 by Enron. During fiscal 2000

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Revenues	\$100,789	\$40,112	\$31,260	\$20,273	\$13,289
Net Income:					
Operating Results	1,266	957	698	515	493
Items Impacting Comparability	(287)	(64)	5	(410)	91
Total	<u>979</u>	<u>893</u>	<u>703</u>	<u>105</u>	<u>584</u>
Earnings Per Share:					
Operating Results	1.47	1.18	1.00	.87	.91
Items Impacting Comparability	(.35)	(.08)	.01	(.71)	.17
Total	<u>1.12</u>	<u>1.10</u>	<u>1.01</u>	<u>.16</u>	<u>1.08</u>
Dividends Per Share:	.50	.50	.48	.46	.43
Total Assets:	65,503	33,381	29,350	22,552	16,137
Cash from Operating Activities:	3,010	2,228	1,873	276	742
Capital Expenditures and Equity Investments:	3,314	3,085	3,564	2,092	1,483
NYSE Price Range:					
High	90.56	44.88	29.38	22.56	23.75
Low	41.38	28.75	19.06	17.50	17.31
Close, December 31	83.12	44.38	28.53	20.78	21.56

EXHIBIT 1

ENRON CORPORATION
2000 ANNUAL REPORT FINANCIAL HIGHLIGHTS TABLE (IN MILLIONS EXCEPT FOR PER SHARE AMOUNTS)

alone, EnronOnline processed more than \$335 billion of transactions, easily making Enron the largest e-commerce company in the world. Enron's three other principal lines of business included Enron Energy Services, the company's retail operating unit; Enron Transportation Services, which was responsible for the company's pipeline operations; and Enron Broadband Services, a new operating unit intended to be an intermediary between users and suppliers of broadband (Internet access) services. Exhibit 1 presents the five-year financial highlights table included in Enron's 2000 annual report.

The New Economy business model that Enron pioneered for the previously staid energy industries caused Kenneth Lay, Jeffrey Skilling, and their top subordinates to be recognized as skillful entrepreneurs and to gain superstar status in the business world. Lay's position as the chief executive of the nation's seventh-largest firm gave him direct access to key political and governmental officials. In 2001, Lay served on the "transition team" responsible for helping usher in the administration of President-elect George W. Bush. In June 2001, Skilling was singled out as "the No. 1 CEO in the entire country," while Enron was hailed as "America's most innovative company."³

3. K. Eichenwald and D. B. Henriques, "Web of Details Did Enron In as Warnings Went Unheeded," *The New York Times* (online), 10 February 2002.

Username: Oleksandra Lemeshko**Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

Enron's chief financial officer (CFO) Andrew Fastow was recognized for creating the financial infrastructure for one of the nation's largest and most complex companies. In 1999, *CFO Magazine* presented Fastow the Excellence Award for Capital Structure Management for his "pioneering work on unique financing techniques."⁴

Throughout their tenure with Enron, Kenneth Lay and Jeffrey Skilling continually focused on enhancing their company's operating results. In the letter to shareholders in Enron's 2000 annual report, Lay and Skilling noted that "Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance." Another important goal of Enron's top executives was to increase their company's stature in the business world. During a speech in January 2001, Lay revealed that his ultimate goal was for Enron to become "the world's greatest company."⁵

As Enron's revenues and profits swelled, its top executives were often guilty of a certain degree of chutzpah. In particular, Skilling became known for making brassy, if not tacky, comments concerning his firm's competitors and critics. During the crisis that gripped California's electric utility industry during 2001, numerous elected officials and corporate executives criticized Enron for allegedly profiteering by selling electricity at inflated prices to the Golden State. Skilling brushed aside such criticism. During a speech at a major business convention, Skilling asked the crowd if they knew the difference between the state of California and the Titanic. After an appropriate pause, Skilling provided the punch line: "At least when the Titanic went down, the lights were on."⁶

Unfortunately for Lay, Skilling, Fastow, and thousands of Enron employees and stockholders, Lay failed to achieve his goal of creating the world's greatest company. In a matter of months during 2001, Enron quickly unraveled. Enron's sudden collapse panicked investors nationwide, leading to what one *Newsweek* columnist described as the "the biggest crisis investors have had since 1929."⁷ Enron's dire financial problems were triggered by public revelations of questionable accounting and financial reporting decisions made by the company's accountants. Those decisions had been reviewed, analyzed, and apparently approved by Andersen, the company's independent audit firm.

Debits, Credits, and Enron

Throughout 2001, Enron's stock price drifted lower. Publicly, Enron executives blamed the company's slumping stock price on falling natural gas prices, concerns regarding the long-range potential of electronic marketplaces such as EnronOnline, and overall weakness in the national economy. By mid-October, the stock price had fallen into the mid-\$30s from a high in the lower \$80s earlier in the year. On October 16, 2001, Enron issued its quarterly earnings report for the third quarter of 2001. That report revealed that the firm had suffered a huge loss during the quarter. Even more problematic to many financial analysts was a mysterious \$1.2 billion reduction in Enron's owners' equity and assets that was disclosed seemingly as an afterthought in the earnings press release. This write-down resulted from the reversal of previously recorded transactions involving the swap of Enron stock for notes receivable. Enron had acquired the notes receivable from related third parties who had invested in limited partnerships organized and sponsored by the company. After studying those transactions in more depth, Enron's accounting staff and its Andersen auditors concluded

4. E. Thomas, "Every Man for Himself," *Newsweek*, 18 February 2002, 25.

5. Eichenwald and Henriques, "Web of Details."

6. *Ibid.*

7. N. Byrnes, "Paying for the Sins of Enron," *Newsweek*, 11 February 2002, 35.

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

CASE 1.3 ENRON CORPORATION

31

that the notes receivable should not have been reported in the assets section of the company's balance sheet but rather as a reduction to owners' equity.

The October 16, 2001, press release sent Enron's stock price into a free fall. Three weeks later on November 8, Enron restated its reported earnings for the previous five years, wiping out approximately \$600 million of profits the company had reported over that time frame. That restatement proved to be the death knell for Enron. On December 2, 2001, intense pressure from creditors, pending and threatened litigation against the company and its officers, and investigations initiated by law enforcement authorities forced Enron to file for bankruptcy. Instead of becoming the nation's greatest company, Enron laid claim to being the largest corporate bankruptcy in U.S. history, imposing more than \$60 billion of losses on its stockholders alone. Enron's "claim to fame" would be eclipsed the following year by the more than \$100 billion of losses produced when another Andersen client, WorldCom, filed for bankruptcy.

The massive and understandable public outcry over Enron's implosion during the fall of 2001 spawned a mad frenzy on the part of the print and electronic media to determine how the nation's seventh-largest public company, a company that had posted impressive and steadily rising profits over the previous few years, could crumple into insolvency in a matter of months. From the early days of this public drama, skeptics in the financial community charged that Enron's balance sheet and earnings restatements in the fall of 2001 demonstrated that the company's exceptional financial performance during the late 1990s and 2000 had been a charade, a hoax orchestrated by the company's management with the help of a squad of creative accountants. Any doubt regarding the validity of that theory was wiped away—at least in the minds of most members of the press and the general public—when a letter that an Enron accountant had sent to Kenneth Lay in August 2001 was discovered. The contents of that letter were posted on numerous websites and lengthy quotes taken from it appeared in virtually every major newspaper in the nation.

Exhibit 2 contains key excerpts from the letter that Sherron Watkins wrote to Kenneth Lay in August 2001. Watkins' job title was vice president of corporate development, but she was an accountant by training, having worked previously with Andersen, Enron's audit firm. The sudden and unexpected resignation of Jeffrey Skilling as Enron's CEO after serving in that capacity for only six months had prompted Watkins to write the letter to Lay. Before communicating her concerns to Lay, Watkins had attempted to discuss those issues with one of Lay's senior subordinates. When Watkins offered to show that individual a document that identified significant problems in accounting decisions made previously by Enron, Watkins reported that he rebuffed her. "He said he'd rather not see it."⁸

Watkins was intimately familiar with aggressive accounting decisions made for a series of large and complex transactions involving Enron and dozens of limited partnerships created by the company. These partnerships were so-called SPEs or special purpose entities that Enron executives had tagged with a variety of creative names, including Braveheart, Rawhide, Raptor, Condor, and Talon. Andrew Fastow, Enron's CFO who was involved in the creation and operation of several of the SPEs, named a series of them after his three children.

SPEs—sometimes referred to as SPVs (special purpose vehicles)—can take several legal forms but are commonly organized as limited partnerships. During the 1990s, hundreds of large corporations began establishing SPEs. In most cases, SPEs

8. T. Hamburger, "Watkins Tells of 'Arrogant' Culture; Enron Stifled Staff Whistle-Blowing," *The Wall Street Journal* (online), 14 February 2002.

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

EXHIBIT 2

SELECTED EXCERPTS
FROM SHERRON
WATKINS' AUGUST
2001 LETTER TO
KENNETH LAY

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting—most notably the Raptor transactions and the Condor vehicle. . . .

We have recognized over \$550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly. . . . The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for "personal reasons" but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting gurus can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem—we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in 1 year and trying to pay it back 2 years later. . . .

I realize that we have had a lot of smart people looking at this and a lot of accountants including AA & Co. have blessed the accounting treatment. None of this will protect Enron if these transactions are ever disclosed in the bright light of day. . . .

The overriding basic principle of accounting is that if you explain the "accounting treatment" to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts?

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. . . .

The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring [sic] over that footnote disclosure right now? I can just hear the discussions—"It looks like they booked a \$500 million gain from this related party company and I think, from all the undecipherable 1/2 page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." . . . "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA & Co. wouldn't let them get away with that?"

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

were used to finance the acquisition of an asset or fund a construction project or related activity. Regardless, the underlying motivation for creating an SPE was nearly always “debt avoidance.” That is, SPEs provided large companies with a mechanism to raise needed financing for various purposes without being required to report the debt in their balance sheets. *Fortune* magazine charged that corporate CFOs were using SPEs as scalpels “to perform cosmetic surgery on their balance sheets.”⁹ During the early 1990s, the Securities and Exchange Commission (SEC) and the FASB had wrestled with the contentious accounting and financial reporting issues posed by SPEs. Despite intense debate and discussions, the SEC and the FASB provided little in the way of formal guidance for companies to follow in accounting and reporting for SPEs.

The most important guideline that the authoritative bodies implemented for SPEs, the so-called 3 percent rule, proved to be extremely controversial. This rule allowed a company to omit an SPE's assets and liabilities from its consolidated financial statements as long as parties independent of the company provided a minimum of 3 percent of the SPE's capital. Almost immediately, the 3 percent threshold became both a technical minimum and a practical maximum. That is, large companies using the SPE structure arranged for external parties to provide exactly 3 percent of an SPE's total capital. The remaining 97 percent of an SPE's capital was typically contributed by loans from external lenders, loans arranged and generally collateralized by the company that created the SPE.

Many critics charged that the 3 percent rule undercut the fundamental principle within the accounting profession that consolidated financial statements should be prepared for entities controlled by a common ownership group. “There is a presumption that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.”¹⁰ *Business Week* chided the SEC and FASB for effectively endorsing the 3 percent rule.

*Because of a gaping loophole in accounting practice, companies can create arcane legal structures, often called special-purpose entities (SPEs). Then, the parent can bankroll up to 97 percent of the initial investment in an SPE without having to consolidate it. . . . The controversial exception that outsiders need invest only 3 percent of an SPE's capital for it to be independent and off the balance sheet came about through fumbles by the Securities and Exchange Commission and the Financial Accounting Standards Board.*¹¹

Throughout the 1990s, many companies took advantage of the minimal legal and accounting guidelines for SPEs to divert huge amounts of their liabilities to off-balance sheet entities. Among the most aggressive and innovative users of the SPE structure was Enron, which created hundreds of SPEs. Unlike most companies, Enron did not limit its SPEs to financing activities. In many cases, Enron used SPEs for the sole purpose of downloading underperforming assets from its financial statements to the financial statements of related but unconsolidated entities. For example, Enron would arrange for a third party to invest the minimum 3 percent capital required in an SPE and then sell assets to that SPE. The SPE would finance the purchase of those assets by loans collateralized by Enron common stock. In some cases, undisclosed side

9. J. Kahn, “Off Balance Sheet—And Out of Control,” *Fortune*, 18 February 2002, 84.

10. *Accounting Research Bulletin No. 51*, “Consolidated Financial Statements” (New York: AICPA, 1959).

11. D. Henry, H. Timmons, S. Rosenbush, and M. Arndt, “Who Else Is Hiding Debt?” *Business Week*, 28 January 2002, 36–37.

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

agreements made by Enron with an SPE's nominal owners insulated those individuals from any losses on their investments and, in fact, guaranteed them a windfall profit. Even more troubling, Enron often sold assets at grossly inflated prices to their SPEs, allowing the company to manufacture large "paper" gains on those transactions.

Enron made only nominal financial statement disclosures for its SPE transactions and those disclosures were typically presented in confusing, if not cryptic, language. One accounting professor observed that the inadequate disclosures that companies such as Enron provided for their SPE transactions meant that, "the nonprofessional [investor] has no idea of the extent of the [given firm's] real liabilities."¹² *The Wall Street Journal* added to that sentiment when it suggested that Enron's brief and obscure disclosures for its off-balance sheet liabilities and related-party transactions "were so complicated as to be practically indecipherable."¹³

Just as difficult to analyze for most investors was the integrity of the hefty profits reported each successive period by Enron. As Sherron Watkins revealed in the letter she sent to Kenneth Lay in August 2001, many of Enron's SPE transactions resulted in the company's profits being inflated by unrealized gains on increases in the market value of its own common stock. In the fall of 2001, Enron's board of directors appointed a Special Investigative Committee chaired by William C. Powers, dean of the University of Texas Law School, to study the company's large SPE transactions. In February 2002, that committee issued a lengthy report of its findings, a document commonly referred to as the Powers Report by the press. This report discussed at length the "Byzantine" nature of Enron's SPE transactions and the enormous and improper gains those transactions produced for the company.

Accounting principles generally forbid a company from recognizing an increase in the value of its capital stock in its income statement. . . . The substance of the Raptors [SPE transactions] effectively allowed Enron to report gains on its income statement that were . . . [attributable to] Enron stock, and contracts to receive Enron stock, held by the Raptors.¹⁴

The primary motivation for Enron's extensive use of SPEs and the related accounting machinations was the company's growing need for capital during the 1990s. As Kenneth Lay and Jeffrey Skilling transformed Enron from a fairly standard natural gas supplier into a New Economy intermediary for the energy industries, the company had a constant need for additional capital to finance that transformation. Like most new business endeavors, Enron's Internet-based operations did not produce positive cash flows immediately. To convince lenders to continue pumping cash into Enron, the company's management team realized that their firm would have to maintain a high credit rating, which, in turn, required the company to release impressive financial statements each succeeding period.

A related factor that motivated Enron's executives to window dress their company's financial statements was the need to sustain Enron's stock price at a high level. Many of the SPE loan agreements negotiated by Enron included so-called price "triggers." If the market price of Enron's stock dropped below a designated level (trigger), Enron was required to provide additional stock to collateralize the given loan, to make significant cash payments to the SPE, or to restructure prior transactions with the SPE.

12. *Ibid.*

13. J. Emshwiller and R. Smith, "Murky Waters: A Primer on the Enron Partnerships," *The Wall Street Journal* (online), 21 January 2002.

14. W. C. Powers, R. S. Troubh, and H. S. Winokur, "Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation," 1 February 2002, 129–130.

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

CASE 1.3 ENRON CORPORATION

35

In a worst-case scenario, Enron might be forced to dissolve an SPE and merge its assets and liabilities into the company's consolidated financial statements.

What made Enron's stock price so important was the fact that some of the company's most important deals with the partnerships [SPEs] run by Mr. Fastow—deals that had allowed Enron to keep hundreds of millions of dollars of potential losses off its books—were financed, in effect, with Enron stock. Those transactions could fall apart if the stock price fell too far.¹⁵

As Enron's stock price drifted lower throughout 2001, the complex labyrinth of legal and accounting gimmicks underlying the company's finances became a shaky house of cards. Making matters worse were large losses suffered by many of Enron's SPEs on the assets they had purchased from Enron. Enron executives were forced to pour additional resources into many of those SPEs to keep them solvent. Contributing to the financial problems of Enron's major SPEs was alleged self-dealing by Enron officials involved in operating those SPEs. Andrew Fastow realized \$30 million in profits on his investments in Enron SPEs that he oversaw at the same time he was serving as the company's CFO. Several of his friends also reaped windfall profits on investments in those same SPEs. Some of these individuals "earned" a profit of as much as \$1 million on an initial investment of \$5,800. Even more startling was the fact that Fastow's friends realized these gains in as little as 60 days.

By October 2001, the falling price of Enron's stock, the weight of the losses suffered by the company's large SPEs, and concerns being raised by Andersen auditors forced company executives to act. Enron's management assumed control and ownership of several of the company's troubled SPEs and incorporated their dismal financial statement data into Enron's consolidated financial statements. This decision led to the large loss reported by Enron in the fall of 2001 and the related restatement of the company's earnings for the previous five years. On December 2, 2001, the transformed New Age company filed its bankruptcy petition in New Age fashion—via the Internet. Only six months earlier, Jeffrey Skilling had been buoyant when commenting on Enron's first quarter results for 2001. "So in conclusion, first-quarter results were great. We are very optimistic about our new businesses and are confident that our record of growth is sustainable for many years to come."¹⁶

As law enforcement authorities, Congressional investigative committees, and business journalists rifled through the mass of Enron documents that became publicly available during early 2002, the abusive accounting and financial reporting practices that had been used by the company surfaced. Enron's creative use of SPEs became the primary target of critics; however, the company also made extensive use of other accounting gimmicks. For example, Enron had abused the mark-to-market accounting method for its long-term contracts involving various energy commodities, primarily natural gas and electricity. Given the nature of their business, energy-trading firms regularly enter into long-term contracts to deliver energy commodities. Some of Enron's commodity contracts extended over periods of more than 20 years and involved massive quantities of the given commodity. When Enron finalized these deals, company officials often made tenuous assumptions that inflated the profits booked on the contracts.

Energy traders must book all the projected profits from a supply contract in the quarter in which the deal is made, even if the contract spans many years. That means companies can inflate profits by using unrealistic price forecasts, as Enron has been accused of doing. If a company contracted to buy natural gas through 2010 for \$3 per thousand

15. Eichenwald and Henriques, "Web of Details."

16. *Ibid.*

Username: Oleksandra Lemeshko **Book:** Auditing Cases, International Edition, 9th Edition. No part of any book may be reproduced or transmitted in any form by any means without the publisher's prior written permission. Use (other than pursuant to the qualified fair use privilege) in violation of the law or these Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.

*cubic feet, an energy-trading desk could aggressively assume it would be able to supply gas in each year at a cost of just \$2, for a \$1 profit margin.*¹⁷

The avalanche of startling revelations regarding Enron's aggressive business, accounting, and financial reporting decisions reported by the business press during the early weeks of 2002 created a firestorm of anger and criticism directed at Enron's key executives, principally Kenneth Lay, Jeffrey Skilling, and Andrew Fastow. A common theme of the allegations leveled at the three executives was that they had created a corporate culture that fostered, if not encouraged, "rule breaking." *Fortune* magazine observed that, "If nothing else, Lay allowed a culture of rule breaking to flourish,"¹⁸ while Sherron Watkins testified that Enron's corporate culture was "arrogant" and "intimidating" and discouraged employees from reporting and investigating ethical lapses and questionable business dealings.¹⁹ Finally, a top executive of Dynegy, a company that briefly considered merging with Enron during late 2001, reported that "the lack of internal controls [within Enron] was mindboggling."²⁰

Both Kenneth Lay and Andrew Fastow invoked their Fifth Amendment rights against self-incrimination when asked to testify before Congress in early 2002. Jeffrey Skilling did not. While being peppered by Congressional investigators regarding Enron's questionable accounting and financial reporting decisions, Skilling replied calmly and repeatedly: "I am not an accountant." A well-accepted premise in the financial reporting domain is that corporate executives and their accountants are ultimately responsible for the integrity of their company's financial statements. Nevertheless, frustration stemming from the lack of answers provided by Enron insiders to key accounting and financial reporting-related questions eventually caused Congressional investigators, the business press, and the public to focus their attention, their questions, and their scorn on Enron's independent audit firm, Andersen. These parties insisted that Andersen representatives explain why their audits of Enron had failed to result in more transparent, if not reliable, financial statements for the company. More pointedly, those critics demanded that Andersen explain how it was able to issue unqualified audit opinions on Enron's financial statements throughout its 15-year tenure as the company's independent audit firm.

Say It Ain't So Joe

Joseph Berardino became Andersen's chief executive shortly before the firm was swamped by the storm of criticism surrounding the collapse of its second-largest client, Enron Corporation. Berardino launched his business career with Andersen in 1972 immediately after graduating from college and just a few months before Leonard Spacek ended his long and illustrious career with the firm. Throughout its history, the Andersen firm had a policy of speaking with one voice, the voice of its chief executive. So, the unpleasant task of responding to the angry and often self-righteous accusations hurled at Andersen following Enron's demise fell to Berardino, although he had not been a party to the key decisions made during the Enron audits.

A common question directed at Berardino was whether his firm had been aware of the allegations Sherron Watkins made during August 2001 and, if so, how had Andersen responded to those allegations. Watkins testified before Congress that shortly after she communicated her concerns regarding Enron's questionable accounting and financial reporting decisions to Kenneth Lay, she had met with a

17. P. Coy, S. A. Forest, and D. Foust, "Enron: How Good an Energy Trader?" *Business Week*, 11 February 2002, 42–43.

18. B. McLean, "Monster Mess," *Fortune*, 4 February 2002, 94.

19. Hamburger, "Watkins Tells of 'Arrogant' Culture."

20. N. Banjeree, D. Barboza, and A. Warren, "At Enron, Lavish Excess Often Came before Success," *The New York Times* (online), 26 February 2002.