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ENRON AND ARTHUR ANDERSEN: THE CASE OF THE CROOKED E AND THE FALLEN A

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ABSTRACT

Outside the US, the failures of Enron and Arthur Andersen remain puzzles. How could the accounting and audit failures associated with Enron and Arthur Andersen happen in the US where auditing is sophisticated, accounting principles are strong, and disclosure is emphasized? This is a teaching case for persons outside the US to review the financial reporting and auditing issues related to Enron and to explain the regulation of accounting and auditing in the US. It has broad implications for corporate governance and accounting regulation in other countries as well.

In the years after the Enron Corporation declared bankruptcy in 2001 and Arthur Andersen failed in 2002, people are still asking, especially those outside the US, how could this happen? What went wrong? The US has a well-developed set of Generally Accepted Accounting Principles (GAAP) that requires extensive disclosures in audited financial statements, and a well-established federal agency, the Securities and Exchange Commission (SEC) that monitors financial reporting.

This case is written for accounting students and others, who are outside the US, to explore the financial reporting and auditing issues related to the debacles at Enron and Andersen and to explain the financial reporting environment in the US. The case is presented in four parts. Part I presents general information about Enron and Andersen. In Part II, the government and legal system of the US, and the regulation of financial reporting and auditing, is described. In Part III, US accounting principles and disclosures are discussed. Finally, in Part IV, the specific financial reporting and auditing aspects of Enron are analyzed, including a review of reforms in the aftermath of Enron. Exhibit 1 provides a list of accounting terminology that may be a useful reference. Introductory observations presented in Exhibit 2 give insight to start the case.

EXHIBIT 1

Terminology

AICPA	American Institute of Certified Public Accountants. Private voluntary professional organization of certified public accountants in the US.
CPA	Certified Public Accountant. The only professional person who may audit public companies and issue audit opinions in the US.
FASB	Financial Accounting Standards Board. A private organization designated by Securities and Exchange Commission to establish generally accepted accounting principles for publicly traded companies.
GAAP	Generally Accepted Accounting Principles. Guidelines for the presentation of financial statements in the US.
GAAS	Generally Accepted Auditing Standards. Guidelines and procedures used by certified public accountants to conduct audits. Formerly established by the American Institute of Certified Public Accountants. Responsibility now with the Public Company Accounting Oversight Board for public companies.
PCAOB	Public Company Accounting Oversight Board. Board established by the US Congress to oversee virtually all aspects of the auditing of publicly traded companies.
Private company	A company for which shares are not traded publicly, thus regulated by the states rather than the Securities and Exchange Commission. Some companies' shares may be sold publicly solely within a single state and thus be regulated only by a state.
Public company (also publicly traded company)	A company for which shares trade publicly in interstate commerce and therefore must be registered with the Securities and Exchange Commission. All companies listed on any of the stock exchanges in the US are public companies.

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EXHIBIT 1 (continued)

SEC registrant	Any company that offers its securities in interstate commerce and therefore must register with the Securities and Exchange Commission (SEC). Securities can include debt securities as well as shares of stock. A very small number of companies sell debt securities in interstate commerce but do not sell shares. Such companies are nonetheless required to register with the SEC and are subject to SEC regulation.
SEC	Securities and Exchange Commission. The agency of the US Government with the primary responsibility for regulation of securities markets.
SPE	Special Purpose Entity. An entity that is created by another company to engage in a limited specific type of business activity, such as owing or leasing real estate.
State board (or state board of accountancy)	An agency in each state that regulates the licensing of certified public accountants and the conduct of accounting within the state, including codes of ethics.

EXHIBIT 2
Introductory Observations

- When faced with massive greed, collusion, and lapse of ethics among company officials, external auditors, outside legal counsel, bankers, and investment firms, it is highly unlikely that any realistic form of regulation would have been able to prevent the financial losses to the employees, shareholders, and creditors of Enron. Enron as a corporate entity did not benefit from the greed. Rather, its shareholders and its employees who had their pension funds invested in Enron shares suffered large financial losses. The SEC and the Texas State Board of Public Accountancy, as well as the US Congress, acted quickly, and began reforms that may minimize similar losses in the future. Arthur Andersen received the ultimate "punishment," being forced into bankruptcy by the market place, and became a negative example for other major accounting firms. The regulatory approach of the US federal government continues to be a model that other countries are considering. As one example, in January 2006, Mexico adopted reforms that are very similar to those of the Sarbanes-Oxley Act.
- Enron the corporate entity likely did not commit obvious major crimes. Enron misled outsiders and misrepresented its financial situation. Under US law, misleading misrepresentation is not *necessarily* a crime. Fraud is a crime, however, but criminal intent to defraud is very difficult to prove. Arthur Andersen was found guilty of

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EXHIBIT 2 (continued)

committing one crime, obstruction of justice, for having destroyed potential evidence by shredding documents, knowing that such documents could be used in an investigation by the SEC. Specific individuals associated with Enron have been charged with serious crimes, and some Enron officials plead guilty to crimes, including conspiracy to mislead through unfair financial reports.

- Enron and Andersen both acted with an obvious disregard of any notion of ethical conduct. The breaches of ethics are so obvious they need not be presented in detail. Interesting issues about ethics of the legal, banking, and financial analysis professions are also apparent, but are beyond the scope of this case. It is important to note that breach of ethics is not a crime, ethics and crime are separate issues.
- Enron violated GAAP, through 1) incorrect accounting for SPEs including failure to consolidate, selective use of the equity method of accounting, and failure to eliminate the impact of transactions among entities, 2) failure to provide complete disclosure, and 3) unfair financial reporting. It is now apparent that both Enron and Arthur Andersen 1) viewed GAAP as rules rather than principles 2) sought to interpret GAAP in the most aggressive manner, 3) did not consider the fairness principle, one of the most fundamental of GAAP, and 4) ignored the legal precedent that emphasizes fairness over detailed rules, as well as the accounting concept that emphasizes economic substance over legal form.
- In other countries, similar bankruptcies have occurred without such a scandal because of one or a combination of four factors: 1) non-Anglo-Saxon companies typically have few public shareholders; 2) few countries other than the US have employee pension funds invested in a company's own stock; 3) no blatant crimes have been committed or regulations broken, and unfair financial reporting *per se* is not a crime; 4) a culture of business secrecy often prevails; transparency in reporting is not an objective. The recent Parmalat situation has generated a scandal because crimes, presumably theft, allegedly occurred.
- The need for reform is indicated by the Enron case and reforms are occurring in the US. These reforms are designed to give the SEC and the new PCAOB a more activist regulatory role. Public regulation is replacing self-regulation for auditors of public companies. For public companies, the regulation of auditing, traditionally left to the states, is shifting to the federal level. Some aspects of the reform, though, cannot be accomplished by legislative action, regulation, or decree. For example, financial analysts and others cannot be mandated to read and to heed disclosures in financial statements.

PART I ENRON AND ANDERSEN – A UNIQUE AND INNOVATIVE COMPANY WITH A PRESTIGIOUS AUDITOR

Enron was a leading energy commodities and service company with revenue of US $101 billion in 2000. It employed about 21,000 people, mostly at its headquarters in Houston, Texas. Enron began in 1985 with the merger of two companies, Houston Natural Gas and InterNorth, which sold and transported natural gas. After the merger, Enron was applauded for being innovative in opening new markets. To create new markets, Enron acted as a bank for commodities, buying a commodity from suppliers and selling it to buyers. For example, it would contract to sell natural gas for future delivery at a fixed price. Then if it wanted to hedge the transaction, it would contract again to buy natural gas at the same future date. These types of future contracts are among those called derivatives. To deal with the buyers and sellers who were central to a "trading partners" strategy, sound credit and liquidity were essential. Enron had to deliver cash when buy transactions were settled financially. Therefore, it became important for Enron to generate cash flow and report cash flow internally. Throughout its existence, Enron relied crucially on borrowed cash for its day-to-day operations.

With past success, bull markets, debt, inexperienced employees, and diverse businesses, Enron raced to become anything and everything. Its businesses were foreign and domestic, low-tech and high-tech, commercial and residential, wholesale and retail, and regulated and unregulated. It is unlikely that any company could have developed the expertise required. So, it is not surprising that weaknesses emerged.

As Enron grew, it began to trade commodities about which its employees knew little. Its commodity banking expanded from natural gas into electricity, Internet broadband, weather futures, and other goods and services. As Enron's trading grew, its assets shifted from fixed assets such as pipelines, to intangibles, especially contractual rights to commodities, a form of derivatives. Often budgetary and other basic controls were abandoned. Enron did not have a unified strategy. As a result, its aggressive dealmakers transformed Enron from an operating company to an investment fund. Enron's management and its auditors were not prepared for this transformation and unable to recognize the risks. For many top executives, business was not about selling goods and services; it was about managing earnings, managing reported cash flow, and managing the numbers.

Andersen was among the most prestigious international accounting firms in the world. Accounting students in the US often viewed it as the most glamorous and desirable employer. Andersen marketed itself as having fewer offices than its competitors because it operated with larger offices to serve prominent clients. Although Andersen's client base was diversified, it often had "high flying" companies such as Enron and WorldCom as clients. Enron was Andersen's second largest client, and the largest client in Andersen's Houston office. Players in Enron and in Andersen are presented in Exhibit 3 and the downfall is described in Exhibit 4.

PART II GOVERNMENT, LEGAL, AND ACCOUNTING ENVIRONMENT OF THE U.S.

Government and Legal System

Separation of Powers

The separation of powers between the federal government and the states is one of the most fundamental aspects of government in the US. The Constitution of the US grants to the federal government only those powers that the states have explicitly ceded to it; all other powers remain by

EXHIBIT 3

Key Players in the Enron-Andersen Case

- Kenneth Lay was Enron's Chief Executive Officer (CEO) since 1985. Lay gave up his position in early 2001 to Jeffrey Skilling, but was re-elected in August 2001 when Skilling resigned. Under pressures from creditors, Lay resigned in January 2002. Skilling reported that he left due to personal reasons after more than ten years with Enron. Lay and Skilling allegedly played major roles in the bankruptcy, but did not have a direct impact on the financial reporting and auditing issues.

- Andrew Fastow was Enron’s Chief Financial Officer (CFO) until October 2001, when Lay fired him. Fastow had the reputation of being a money wizard who constructed the complex financial vehicles that drove Enron’s growth. Since 1993, Fastow created SPEs that permitted accounting deceptions. Fastow plead guilty in a plea-bargaining arrangement with his wife, who was also implicated.

- David Delainey was the CEO of the retail and wholesale energy divisions. He plead guilty to insider trading, for knowingly participating in manipulating reported financial performance.

- Ben Gilsan, Jr. was treasurer of Enron until he was fired in October 2001, for benefiting personally from one of Enron’s complex SPE investments. He was a former accountant with Andersen and played a key role in accounting-related deceptions. He plead guilty to one count of conspiracy related to financial reporting deception.

- Michael Kopper was Fastow’s assistant who was actively and aggressively involved in creating and managing SPEs, and in the accounting deception, along with Ben Gilsan. He plead guilty to a lesser charge and has been cooperating with the government to investigate and prosecute others.

- Richard Causey was the chief accountant working under Fastow. He plead guilty to crimes related to unfair financial reporting in a plea-bargaining arrangement in exchange for his information in the prosecution of Lay and Skilling.

- Sherron Watkins previously had a senior position at Enron that was eliminated in a downsizing activity. She was later re-hired and played a major role as the so-called “whistle blower” who started the downfall. She had worked several years as an accountant for Arthur Andersen and then moved to Enron where she worked for Andrew Fastow for eight years.

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EXHIBIT 3 (continued)

- David Duncan, a partner in the Houston office of Andersen, headed the Enron audit and allegedly orchestrated a document shredding campaign. Arthur Andersen terminated Duncan's partnership shortly after events became known publicly.

- Joseph Bernardino, managing partner and CEO of Andersen, tried to defend its audit of Enron rather than admitting failures and accepting the consequences.

- Carl Bass, head of the Professional Standards Group at the Houston office of Andersen. Bass advised against the auditors' accepting certain misleading accounting practices of Enron, but Joseph Bernardino overruled him because of complaints by Duncan.

default with the states. Because two of the powers granted to the federal government are international relations and national defense, many persons outside the US assume the federal government is more powerful than it actually is, and assume that it can control the states.

Instead, the states are essentially sovereign and control many aspects of day-to-day life and conduct of business. Property rights, enforceability of contracts, and marital status, among other things, are controlled by the states, and the US federal government must recognize the states' authority. One of the powers granted to the US federal government is regulation of interstate and international commerce. Because Enron's shares of stock were sold publicly in interstate commerce, its financial reporting was regulated by the SEC, a federal agency. However, the accounting profession, notably auditing, is regulated primarily by the states. Andersen was subject to regulation of Enron's financial reporting by the SEC and the regulation of its audit of Enron by the Texas State Board of Public Accountancy (http://www.tsbpa.state.tx.us/).

Legal System

In the US, the federal government and all of the states except Louisiana follow English common law. The case law aspect of English common law is relevant here. Often, written statutory law is unclear or incomplete. Courts then use case law to make decisions. Using case law, decisions of cases in one court are legal precedents in law that, in addition to written law, are to be followed by other courts *in the same system of courts*. This case-law concept varies from Roman code law that applies in most industrialized non-Anglo-Saxon countries, in which only written statutory law is used for legal decisions. State courts are not obligated to follow legal precedents of federal case law or of case law in other states.

Regulation of Financial Reporting and Auditing in the US

Regulation of financial reporting and auditing in the US falls into three areas. A summary of details is presented in Exhibit 5.

EXHIBIT 4

The Downfall

- **Watkins informed CEO of potential crisis.** Shortly after Lay resumed the CEO position, Watkins wrote an anonymous letter to him, then sent a signed letter, and visited personally. She informed Lay that Enron's financial reporting was becoming much too aggressive and misleading, and that the company would implode soon if the misrepresentations were discovered, unless actions were taken. Lay, having been informed, could not deny knowledge of the problem and engaged Enron's primary outside law firm, Vinson and Elkins, to investigate and to advise whether Enron needed to take specific action.

- **Law firm responded that no action is needed.** Vinson and Elkins responded that the charges were serious, but that no action was needed because the accounting was acceptable. This raises an interesting issue about the ethics of the legal profession issuing an opinion on accounting issues. During the investigation, Vinson and Elkins consulted with Arthur Andersen. The fact that Vinson and Elkins would bring the issue to Enron's outside auditor raises serious ethical issues. Shortly after the Vinson and Elkins report, Lay and his wife sold some personal shares of Enron, leading to charges of trading based on confidential inside information.

- **Enron restated its financial statements.** In October 2001, shortly after the Vinson and Elkins report, Enron and Andersen announced that Enron's financial results for previous years would be restated to reflect lower profits and a less favorable financial position. In November 2001, the restated results were released. The market price of Enron decreased steadily and the announcement triggered interest from the SEC and the Texas State Board of Public Accountancy. Subsequently, Enron declared bankruptcy.

- **Andersen convicted and ceased to conduct business.** In June 2002, Andersen was convicted in a US federal court of the crime of obstructing justice by shredding working papers related to Enron audits because Andersen personnel knew that the papers would be evidence in a SEC investigation. A criminal conviction would mean that Andersen could not audit SEC registrants. Andersen announced its intent to go out of business before the SEC took formal action to bar it from auditing SEC clients. In a symbolic action, in August 2002, the Texas State Board of Public Accountancy revoked Arthur Andersen's license to practice accounting in the State of Texas because of the firm's professional and ethical misconduct. In June 2005, the US Supreme Court overturned Andersen's conviction on a legal technicality, but did not absolve Andersen from guilt.

EXHIBIT 5

Regulations of Accounting in the US

	Nature of Company		
	Public Companies Traded Interstate (more than one state)	Public Companies Traded Intrastate (within one state)	Private Companies not Traded Publicly
Aspect of Regulation			
A. ACTIVITIES			
Right to Practice in General	State Boards	State Boards	State Boards
Right to Practice Before SEC	US / SEC	N/A	N/A
Conduct of Audits	Formerly: State boards based on GAAS. Currently: PCAOB with SEC oversight	State boards based on GAAS	State boards based on GAAS
B. FINANCIAL INFORMATION			
Financial Reporting	SEC based on GAAP	State law and regulation	None

The Practice of Public Accounting and Auditing

Public accounting regulation includes rules of professional and ethical conduct, testing and licensing of auditors, and similar items. In Texas, as in other states, regulation of the public practice of auditing includes certifying and licensing public accountants and enforcing rules for professional conduct. An audit opinion may be signed only by a licensed Certified Public Accountant (CPA). The Texas State Board of Public Accountancy, like most of the state boards, is non-activist, meaning it does not actively monitor accounting activity, but instead punishes accountants who violate standards of professional conduct.

The SEC requires that SEC registrants must be audited by a CPA licensed by a state. Also, the SEC grants permission for specific accounting firms to represent clients before the SEC. The SEC has relied largely on the states for the regulation and qualification of accountants.

Private voluntary professional associations, such as the American Institute of Certified Public Accountants (AICPA), have influence, but no direct role in regulating financial reporting and auditing. Historically, however, the AICPA had more influence on the practice of public accounting than it now has.

Financial Reporting

The SEC as well as state securities agencies and various private stock exchanges specify the kinds of financial reports that public companies must issue. The SEC web site http://www.sec.gov gives the SEC requirements. Among other things, the SEC requires registrants to file unaudited quarterly financial statements (10-Qs) and audited annual financial reports (10-Ks). SEC filings are available to the public via Internet or via written request, and annual reports must be sent to shareholders individually.

In general, the approach of the SEC is non-activist; it does not attempt to monitor information. Instead, by assuring information is available to the public, it has relied on the market place to be self-regulating, based on the notion that financial markets are efficient and will respond immediately and in an unbiased manner to publicly available information. The expectation is that the SEC will respond quickly with enforcement action and apply sanctions when suspected irregularities are brought to its attention. In some cases, the SEC does monitor the reports of companies that it suspects of improper reporting. The SEC is now under pressure to expand its monitoring and enforcement activities.

Conduct of Audits

Audits in the US are performed in accordance with Generally Accepted Auditing Standards (GAAS); auditing is not addressed by GAAP. Until 2002, auditing was largely self-regulated. Auditing standards were established by the Auditing Standards Board (ASB), a senior technical committee of the AICPA. Additionally, mandatory quality reviews for auditing firms with AIPCA members were directed by the AICPA's Division of Firms and conducted by members of the AIPCA.

In 2002, in response to a wave of financial reporting scandals, the US Congress adopted the Sarbanes-Oxley Act. Part of this act provides for the creation of the Public Companies Accounting Oversight Board (PCAOB) to establish auditing standards with approval by the SEC and to oversee the quality of work performed by auditing firms. Thus, the auditing of publicly traded companies is now regulated by the US federal government rather than by the profession itself.

PART III FINANCIAL REPORTING PRINCIPLES AND DISCLOSURES

US federal law requires publicly traded companies to present financial reports in accordance with GAAP, and the SEC has the authority to establish GAAP. Rather than exercising this right, the SEC has relied on other organizations to set financial reporting standards under its oversight. The evolution of written GAAP is presented in Exhibit 6. Currently, the Financial Accounting Standards Board (FASB) establishes GAAP for publicly traded companies. The FASB began as a private-sector organization but has evolved into a quasi-public organization supported by the US federal government and by sales of publications.

In the US, there is no expectation that a company would use the same accounting principles for external financial reporting as for income tax reporting. For income tax purposes, companies tend to minimize taxable income. Thus, it is common and ethical for companies to report less taxable income than financial statement income. This differs from a substantial number of other industrialized countries in which income tax reporting and financial reporting are expected to be the same, and failure to report the same amounts would be unethical and usually illegal.

Nature of US GAAP

GAAP in the US are a complex set of principles, opinions, and statements, both unwritten and written, that have evolved over time. Some, such as the principles of fairness, conservatism, full disclosure, and entity, and basic concepts such as bad debts and depreciation, have never been fully committed to writing and are found in written form only in literature written about them, such as textbooks. Written GAAP began in the 1930s as described in Exhibit 6. In addition to FASB statements, certain documents of the FASB, e.g. Emerging Issue Task Force (EITF) statements, are interim GAAP until the FASB issues a formal statement, if at all. Also, SEC position statements on financial reporting issues are interim GAAP until a formal pronouncement of the FASB occurs. US GAAP for consolidated financial reporting (group accounting) and the equity method of accounting, which are central to the Enron-Andersen case, are presented in Exhibit 7.

The Fairness Principle

Recently, the SEC has emphasized the fairness principle of GAAP and the economic substance of transactions over the legal form. One major example involves the equity method of accounting (discussed in Exhibit 7), in which some companies were limiting investments to 19.9% in order to avoid what was perceived as a 20% rule for applying the equity method. The SEC

EXHIBIT 6

Evolution of Written GAAP in the US

AICPA:

Beginning in the 1930s, the Committee on Accounting Procedure (CAP) of the AICPA issued Accounting Research Bulletins (ARB), which contained broad principles, many of which were deliberately vague and flexible.

Beginning in the 1950s, the Accounting Principles Board (APB) of the AICPA published opinions that were GAAP. The APB issued more than thirty opinions before it ceased operations.

Both the CAP and the APB had limited success because they were viewed as lacking power and independence, being controlled by the public accounting profession, and were not sufficiently broad-based to have support of major stakeholders.

FASB:

Since the 1970s, GAAP have been promulgated by the FASB. The FASB began as an independent, voluntary association of major stakeholders and was funded largely by donations from companies and public accounting firms. As a result of recent reforms of the US Congress, the FASB now receives no private funding. The US government contributes about one-third of the operating costs; the remainder of the resources come from the sale of publications.

EXHIBIT 7

**Consolidated Financial Reporting (Group Accounting)
and the Equity Method of Accounting in the US**

Consolidated Financial Reporting:

In the US, consolidated financial reporting (often called "group accounting" outside the US) is required when one entity owns more than 50% of another entity and can control its operations. The only significant condition that would lead to non-consolidation would be lack of control of one entity by another because of ownership of 50% or less, or other legal restrictions on the ability of one entity to control another entity. Consolidated financial reporting is complex and cannot be covered in detail here. Briefly, when entities are consolidated, the impacts of all transactions among them are eliminated and individual items on all financial statements are combined and reported as though a single reporting entity exists. Supplemental disclosures are required about the consolidated entities, principles of consolidation, and related items. Under US GAAP, consolidation of controlled entities is the *only* acceptable method of financial reporting unless specific conditions indicate non-consolidation. This differs from many countries in which consolidated financial reporting is often viewed as supplemental, or both consolidated and parent company financial statements are presented with equal emphasis. In the US, separate reporting on both a consolidated and non-consolidated basis would be viewed as unfair and misleading.

The Equity Method of Accounting:

Under US GAAP, the equity method of accounting is used when one entity has a significant influence over another, but not complete control. Significant influence is presumed to exist when one entity owns 20% or more of the equity of another entity, unless evidence exists to the contrary. If ownership is less than 20%, the equity method is required if significant influence of one entity over the other exists, a point that has been reiterated by the SEC in recent years. The equity method is also used when there is more than 50% ownership of one entity by another, but for some reason control is not possible or consolidation is not possible. The impacts of transactions among the related entities are eliminated.

emphasized that the 20% amount is only a guideline and that fairness requires the equity method if significant influence exists.

Guidelines, not Regulations

In the US, written GAAP are strong and powerful guidelines, but they are not absolute requirements and do not have the force of law. There is a strong expectation that GAAP will be followed, and failure to follow them can lead to serious questions about fairness of financial reporting. Nonetheless, written standards do not cover every possible circumstance, and are often designed to allow flexibility.

Compliance with US GAAP *per se* is not a defense against criminal charges. In a landmark US federal court case, the so-called Continental Vending case, U.S. v. Simon (425 F. 2nd 796 [1969]), the criminal defendants claimed they had complied with US GAAP (and also GAAS) while auditing financial reports and produced expert witnesses who supported their position. The judge ruled that it was irrelevant whether the auditor complied with GAAP or not; the issue was whether the financial information was fair and whether the defendants benefited fraudulently from the misleading information. The defendants were convicted of the crime, the first time practicing public accountants had been held criminally liable under US federal securities law. Continental Vending was a decision of a US federal appeals court. Under English common law, the decision is a legal precedent for other judges in US federal courts in which Enron-related cases might be tried. Subsequent court decisions have followed the Continental Vending precedent. The news media, in reporting the trials of top Enron executives in early 2006, have commented that the Continental Vending case applies to the Enron trial.

Tendency Towards Details

Despite the fact that the courts have stated that following US GAAP *per se* is not a legal defense against misrepresenting financial statement information, the accounting profession and reporting companies in the US hold the naïve expectation that following GAAP *per se* is sufficient for fair presentation of financial reports and avoiding criminal and civil prosecution. As a result, they have put a great deal of pressure on the FASB to develop increasingly detailed and specific standards.

Focus on the Numbers

Another recent trend, especially since the 1990s, is a focus on numbers in the financial reports, especially the "bottom line" net income amount. This focus on numbers is reflected in the use of computer models by financial analysts and fund managers that are based on certain numbers, ratios, trends, etc. These models monitor financial information and ratios with trigger points that identify companies for further scrutiny if the amounts or ratios do not meet expected values.

Disclosures

A central feature of US financial reporting is disclosure of information in addition to the financial statements themselves. In recent years, the FASB has been accused of covering up bad financial reporting with increased disclosure, especially when the FASB allowed financial reporting procedures that permit favorable financial numbers, but then required disclosure of details that have the opposite effect. The disclosure requirement is based on the premise that markets are efficient, so financial analysts and others will read the disclosures and interpret the reported numbers appropriately. A typical annual report of a major US corporation will have 30 or more footnote disclosures.

PART IV WHAT WAS WRONG WITH ENRON AND ANDERSEN

This case focuses on financial reporting and auditing issues, although there were obviously many serious problems within Enron and Andersen.

Financial Reporting Issues

Enron and Andersen presented many financial reporting issues. The case deals only with the major ones: mark-to-market accounting, financial reporting for Special Purpose Entities (SPEs), and reporting of shares issued.

Mark-to-Market Accounting.

Enron traded futures contracts that are classified as derivatives because they derive their value from an underlying asset. The market for futures reduces the volatility of prices for sellers and for buyers by fixing a price at a future date. Enron reported its derivatives using what it called mark-to-market accounting. Under this method, rather than the derivative being reported at historical cost, it is reported at fair market value of the underlying asset, which assumes the presence of a well developed market. In the absence of quoted prices from active markets, the prices of similar assets or present value techniques may be used to establish a valuation.

How did mark-to-market accounting work at Enron? Assume Enron had two option contracts matched over the same time period for the same amount of a commodity; one contract was to buy the commodity and the other contract was to sell the commodity. Enron would look into the future, assume both contracts were exercised and net the results. After allowing for delivery costs and for reserves for other unforeseen costs, the net income (loss) was estimated over the life of the matched contracts. Then this estimated net income (loss) was discounted for the time value of money, to its present value and recorded as a gain (loss). The method required that each year the estimated future earning be re-estimated and marked up or down.

At Enron, the earnings reported under mark-to-market accounting were easy to manipulate because active markets did not exist for contracts that sometimes had terms as long as 20 years. So it was necessary to estimate future earnings. Enron controlled the estimation of its earnings, earnings which were recognized for the entire term of the contract in the first year of the contract. The assumption is that earnings are created by securing contracts rather than by rendering performance on contracts. One advantage for Enron's management of immediate recognition of earnings was that executive compensation, which was based on earnings, was inflated.

Enron exacerbated many problems by using mark-to-market accounting. Because earnings were recognized immediately for the entire life of the contract, a short-term focus was encouraged and earnings were volatile. Additional contracts had to be sold in the immediate short-term to report any earnings. So Enron expanded mark-to-market accounting to trading in electricity, broadband, fuel additives, and other items that were not commodities, such as deferred tax benefits. For many of these commodities there was no active market, even in the short-term. Because, in many cases, it is doubtful the underlying assets existed, it appears Enron reported fictitious earnings. A major problem was that these estimated earnings did not generate liquidity; cash flow from actual execution of the contracts lagged far behind the recognition of earnings.

The risk was enormous. If the market reversed, mark-to-market accounting required the recognition of losses, possibly enormous losses. A huge gap opened between realistic estimation of earnings and Enron's estimations based on aggressive assumptions about interest rates, continuing viability of other parties to contract, taxes, regulations, technology, demand, etc. When changing market conditions necessitated a mark down and the recognition of a loss, Enron hid, delayed or ignored the loss. Andersen apparently did not question any of the values assigned to the contracts or object to tactics to hide, delay or ignore losses. Some of Enron's most abusive SPEs were created to avoid reporting mark-to-market losses.

Financial Reporting of Enron's SPEs

SPEs are typically created for purposes such as owning and leasing real estate. Enron had over 3,000 SPEs, many times more than any other company. Initially, some SPEs were legitimate for risk management. However, the vast majority of the SPEs in the years preceding bankruptcy were used to manipulate financial reports. The SPEs almost always had complex structures with interlocking ownership and with Enron sometimes holding an equity interest. The CFO of Enron and/or other employees held equity interests. Senior executives or other employees of Enron managed and operated the activities of the SPE while being paid salaries by Enron and receiving no compensation from the SPE. Enron's board of directors exempted its CFO from Enron's conflict of interest policies. As a result, he was able to control both sides of transactions and enrich himself.

Many of the financial reporting issues at Enron related to the concept of entity -- failure to consolidate entities, selective use of the equity method of accounting for entities, and failure to eliminate the effects of transactions among the entities. As a result of these irregularities, Enron manipulated its financial reports in several ways, including the following:

- Enron did not report debt on its balance sheet. Through collaboration with major banks, SPEs borrowed money, often with direct or indirect guarantees from Enron. The cash was used to benefit Enron, but was not necessarily transferred to Enron. Enron did not report debt on its financial reports. It did not disclose the contingent liability for the debt as required by GAAP. Various methods described next were used to transfer the cash and further manipulate financial reports.

- Enron had investments in companies (which were not SPEs) that it consolidated or reported on the equity method. When the investments began to show losses, they were transferred to SPEs so Enron would not reflect the losses. Enron did not consolidate or report the SPEs on the equity method, and thus avoided reporting the loss. Often the "sale" of the investment to the SPE generated a reported gain, and a cash payment from the SPE to Enron to pay for the investment could be used to transfer borrowed cash. This process allowed Enron to manipulate its reported cash flow by disguising cash from borrowing as cash flow from sale of investments.

- Enron sold services to SPEs for large amounts in order to inflate its sales revenue and income. Because Enron did not use the equity method of accounting, the cost to the SPE was not reflected by Enron. The cash payment from the SPE to Enron for the "services" could be borrowed cash. Thus Enron would report cash flow from operations rather than from borrowing.

- One Enron unit would sell energy to a SPE that would then resell the energy to another Enron unit. The SPE would borrow money to pay for the energy; banks often collaborated by helping to set up offshore SPEs to disguise the transaction. The cash was transferred to the selling unit of Enron that reported an increase in revenues, although not necessarily in profits. In addition, by doing this, Enron manipulated cash flow to report positive cash flow from operations.

Enron and Andersen sought a position from the SEC staff on circumstances under which Enron could avoid consolidating its SPEs. The SEC staff position response, consistent with the EITF statement, stated consolidation could be avoided only if there were a substantial outside equity ownership interest in the SPE and if the SPE were independently managed and not controlled by Enron. The response stated it would not specify what constituted "substantial outside equity ownership"; it emphasized that the three percent amount in the EITF statement was a guideline and should be viewed as an absolute minimum. In all cases, Enron managed the activities of its SPEs directly or indirectly. Many of the transactions between Enron and the SPEs would not have been conducted with independent outside entities. In all cases, Enron owned a majority interest either directly or indirectly through Fastow, Gilsan, Kopper, and other Enron employees.

Even if non-consolidation could somehow be justified, US GAAP normally require that the equity method of accounting be used and that the impact of transactions among Enron and the SPEs be eliminated. Enron did selectively use the equity method of accounting, but did not eliminate the impact of transactions among itself and the SPEs.

Disclosures about SPEs

US GAAP specified by the FASB and SEC require disclosure of details about related-party transactions, such as those among Enron and its SPEs, including the nature of the relationship, description of transactions, dollar amounts of transactions, and amounts due to or from the related party at year end. Enron did in fact disclose certain information about its transactions with its SPEs. But Enron did not disclose specific details required by FASB pronouncements. Further, the disclosures were obscure and obtuse. Nonetheless, the disclosures were sufficient to draw attention to the issues, and should have prompted questioning by the financial analysts and others who monitored Enron's financial statements. It seems apparent that bankers and analysts were cooperating with Enron to avoid making public statements that would jeopardize Enron's stock and the ability of the bank or investment company to profit from Enron business. In 2006, as reported by *USA Today* among other sources, major US and international banks and investment companies paid over $7 billion in civil penalties to a group of investors led by the University of California for damages the investors suffered because the banks and investment companies participated in transactions designed to manipulate financial reports of Enron.

Improper Reporting of Shares Issued

Enron issued shares of its stock to several SPEs, executives, and others. Many of the shares were in exchange for notes receivable. US GAAP does not permit recording a receivable in exchange for the issuance of shares of stock. From improper reporting, Enron overstated assets and equities by over $1.2 billion, a material amount, even for a company as large as Enron. But, Andersen overlooked the transaction.

Audit Issues

Distinct from its accounting, a number of auditing issues pertain to the debacle of Enron and Andersen.

Commercialization and Independence

To be professional and effective, auditors must be independent of management and evaluate the financial representations of management for all users of financial statements. Less than 30% of the fees that Andersen received from Enron came from auditing, with the balance of fees coming from consulting. Andersen acted as Enron's external auditor and as its internal auditor. Andersen's work as a consultant raises several questions. Would Andersen act in an independent manner when auditing its work as consultants? Would Andersen fail to scrutinize Enron's financial statement thoroughly as a result of its dependence on Enron's consulting fees? These are difficult questions to answer. It appears that Andersen's audit team, when faced with accounting issues, chose to ignore them, acquiesced in silence to unsound accounting, or embraced accounting schemes as an advocate for its client.

Internal Control Weaknesses at Enron

Auditors assess the internal controls of a client to determine the extent to which they can rely on a client's accounting system. Enron had too many internal control weaknesses to be given here. Two serious weaknesses were that the CFO was exempted from a conflicts of interest policy, and internal controls over SPEs were a sham, existing in form but not in substance. Many financial officials lacked the background for their jobs, and assets, notably foreign assets, were not physically secured. The tracking of daily cash was lax, debt maturities were not scheduled, off balance sheet debt was ignored although the obligation remained, and company-wide risk was disregarded. Internal controls were inadequate; contingent liabilities were not disclosed; and, Andersen ignored all of these weaknesses.

Evaluation of Accounting -- Materiality

Auditors focus on material misrepresentations. A misrepresentation is material if knowledge of the misrepresentation would change the decisions of the user of financial statements. When Enron began to restate its financial statements and investors began to grasp its misrepresentations, the response of the market is indisputable as to materiality. Many errors were known, but were dismissed by Andersen as immaterial. Other errors may not have been known, but should have been known if reasonable inquiry would have revealed them.

Related-Party Transactions

Related-party transactions in which Enron's CFO, in substance, acted as buyer and seller in the same transaction posed special challenges to audit. When similar transactions cannot be identified and active markets do not exist, the auditor has the unsolvable problem of finding a way to know the intent of the party controlling the transaction. So one must ask, what evidence did

Andersen have to acquiesce to Enron's assertion that its related-party transactions, controlled by its CFO, were the equivalent of arms-length transactions? And, if there was no evidence to support this assertion, on what basis did Andersen judge the assertion?

Business Model, Experiences, and Organizational Culture

What was the role of business models, organizational culture and the experiences of employees? At Enron and at Andersen, the business model and the organizational culture were changing. Enron was moving to a new business model dominated by intangible assets, the rights to buy and sell commodities. This change in assets was driven by a new organizational culture which then aggressively cultivated it own growth. As auditors moved to become part of a consulting industry, their business model and organizational culture were changing too. It is likely that both the changes at Enron and at Andersen were increasing risks for investors. Enron's movement away from the dominance of fixed assets to the dominance of intangible assets was likely to increase volatility, and this prospect was compounded by the use of mark-to-market accounting. Also, Andersen's movement away from the professionalization of auditing to the commercialization of consulting was likely to weaken auditors as monitors of management. Into the mix of changing business models and cultures, add people who were not equipped for the changes. The young trading executives at Enron chased the deal for earnings, while failing to grasp the risks attached to the intangibles that were driving growth in earnings. Likewise, young auditors at Andersen embraced consulting, while failing to understand the risk of audit failure.

Internal Control at Andersen

For investors to have confidence in financial reporting, it is essential that both the reporting company and its auditor have strong internal controls. Information that has surfaced indicates that Andersen had serious internal control weaknesses. Accounting advice from Andersen's national office was disregarded by the on-site audit team; no controls were in place to assure the advice was followed. What controls failed at Andersen to permit this? Enron was Andersen's second largest client. Why did the protections of audit review by a second partner and of peer review not operate? Why were indications of the manipulation of earnings by Andersen's detection model largely ignored? Why did Andersen acquiesce to the demands of Enron to remove from its audit a respected professional? Was Enron, in substance, in charge of its own audit? Given that Andersen, because of its role in another scandal, was operating under a consent order from the SEC, why were its internal controls not reviewed and strengthened? The simplistic answer of one bad partner is not defensible. Accounting firms whose own internal control systems are weak do not merit investor confidence. Did Enron and Andersen travel together to a dangerous moment in time partially because each organization neglected the fundamentals of internal control?

AFTERMATH AND REFORMS

The Enron-Andersen debacle continues to generate news and likely will for a long time as the SEC files additional criminal charges and civil settlements are negotiated. Enron as a corporate entity is emerging from bankruptcy and continues to operate because many of its business activities are sound. Andersen was convicted in a US federal court for shredding documents, knowing they might be used as evidence in legal proceedings. As a result, Andersen lost its credibility and lost clients. Moreover, Andersen lost its license to practice accounting in the State of Texas because of professional misconduct. While this applied only to Texas, such a loss destroyed the firm's credibility. Andersen had already announced its intent to cease to operate, and in the process it was able to sell most of its practices outside the US. There was no possibility of selling practices within the US because competing firms were not willing to pay for clients they could obtain for no cost. In 2005, the US Supreme Court overturned Andersen's criminal conviction and sent it back to the lower court for re-trial. The English-language media have emphasized that the Supreme Court did not exonerate Andersen from guilt and the media stated that it is likely that Andersen was in fact guilty of the crime. Nonetheless, it is highly unlikely the case will be re-tried because such a trial would be pointless.

Efficiency of Markets is Open to Question

For at least the last 20 years, the regulation of financial reporting in the US has been based on the assumption that markets are efficient, i.e. they will react immediately and in an unbiased manner to all publicly available information. The SEC adopted its approach to regulation based on the assumption that all investors have access to financial intermediaries, e.g. financial analysts, and that the financial intermediaries will automatically act in the best interests of their clients, which will be in their own best interest as well. Thus, the focus of reporting financial information has been on providing information to the financial market place, not necessarily to individual investors. However, the assumption that the best interest of financial analysts parallels the best interests of investors is now questionable.

Enron disclosed correct information about its related party transactions with SPEs, although obscure and obtuse, along with misleading financial numbers on the financial statements themselves. These disclosures were sufficient to raise questions by financial intermediaries, but they were largely ignored. Moreover, models using publicly available information that are widely used by banks and others to predict financial distress predicted Enron's potential for failure several months before its failure. This information was also apparently ignored. Information in recent civil cases settled by the SEC indicates that Enron's banks and financial analysts acted in their own best short-term interests, mostly ignoring Enron's manipulations in order to keep lucrative business from Enron. As a result, the financial intermediaries did not act in the best interests of investors. It is too soon to predict the impact of this apparent lack of market efficiency on future regulation of financial reporting in the US.

Reforms

The US Congress responded quickly to the Enron debacle and other scandals by adopting an extensive set of reforms. Most of the reforms are contained in the Sarbanes-Oxley Act of 2002. Much has been written about the Sarbanes-Oxley Act that need not be repeated here. This act applies only to those companies that sell shares in interstate commerce. Although the act does not override any accounting regulatory activity of the states, it substantially expands federal regulation with respect to SEC registrants.

Certification by CEOs and CFOs of Fairness of Financial Reporting

One of the most significant reforms to date has been the requirement that CEOs and CFOs of SEC registrants must personally certify the fairness of the financial statements. It is important to note that the US Congress purposely focused on fairness and not compliance with GAAP. This requirement subjects the officers to individual criminal charges and/or civil liability and thus presumably motivates officers, especially the CEO, to become actively involved in financial reporting processes. Also, the act substantially restricts the kind of consulting which an auditor may do for an audit client.

European CEOs of SEC registrants objected strongly to the certification requirement, arguing 1) that such requirements infringe on the national sovereignty of other countries, and 2) that regulatory mechanisms in Europe are adequate, and even preferable to those in the US. The SEC has pointedly refused to accept these arguments, stating that the European companies have voluntarily chosen to have access to capital markets in the US, and therefore they have voluntarily subjected themselves to US law. Since that time, the Royal Ahold and Parmalat scandals occurred and the objections of the European companies have moderated.

Public Company Accounting Oversight Board (PCAOB) Created.

The US Congress created the PCAOB (www.pcoabus.org), a new body to regulate auditing and other matters not directly related to this case. The oversight board will register and inspect accounting firms that audit SEC registrants. Large accounting firms will be inspected annually and small firms every three years. Many of the activities regulated by this new oversight board are those that traditionally have been self-regulated by the accounting profession or have been regulated only by states. The act's requirements apply to all SEC registrants, including foreign registrants, and to all auditors, including foreign auditors, who participate in auditing SEC registrants. Accounting firms outside the US, including the major international accounting firms, objected to this requirement. In July 2004, the PCAOB adopted rules that will allow the regulatory process of some countries to substitute for continuing review by the PCOAB after a one-time application by the non-US firm and an assessment of the local country's regulatory system. At the current time, only accounting firms in Japan, Canada, and many European countries including the UK are expected to be granted this exemption by the PCAOB.

Standards Setting Processes

It seems virtually certain that subtle but significant reform in the standards-setting process will occur. Rule-based approaches to accounting standards are open to question. The FASB is now funded with public funds rather than by its former stakeholders. The relationship among the SEC, the FASB, and the International Accounting Standards Board (IASB) remains to be resolved. The PCAOB will establish GAAS. Among the changes in auditing standards is a requirement that auditors render separate opinions on internal controls in addition to an opinion on financial statements.

Limitations Are Inherent in Reforms

Some reforms cannot be accomplished by additional regulation, legislation, and oversight. For example, regulatory reform cannot force financial analysts and others to read and respond to disclosures in financial reports. Nonetheless, it seems almost certain that the entire area of financial accounting disclosure will come under much greater examination by all the stakeholders in the process.

Integration of Management Control Systems and Financial Reporting

Companies are giving a new focus on the integration of management control systems and external financial reporting. It is important to note that this management control is different from internal control, which is an integral part of the Sarbanes-Oxley Act. Management control involves systems and mechanisms that are put in place to assure a company and its operating units achieve the goals and objectives of the company in accordance with its strategies. Internal control, by contrast, involves specific procedures that are designed to assure compliance with company rules and policies. Traditionally, management control and financial reporting have been viewed separately, with management control systems focusing on such topics as budget preparation and performance evaluation, while financial reporting focused on GAAP. Current attention is at the early stages of recognizing that fair financial reporting is essential, along with being profitable, for a company to survive over the long run. Therefore, management control systems must include some internal inducements, behavioral and otherwise, to motivate managers to ensure the company does indeed report fairly.

SUMMARY COMMENTS

Enron was a massive failure, partly because of its size, partly because of its complexity, partly because the controls to protect the integrity of capital markets failed, and especially because of the massive greed and collusion of key participants. Management failed, auditors failed, analysts failed, creditors/bankers failed, and regulators failed. The intersection of multiple failures sent a signal of structural problems. Suddenly, the consequence of deceptive financial data resulting from structural failure in the capital markets was not merely a hypothetical possibility. The speed with which the system responded indicates the importance of fairly presented financial information.

REFERENCE

U.S. v. Simon (425 F. 2nd 796 [1969]) commonly known as the Continental Vending case.

Discussion Questions

1. Use your images of the history, culture, and society of the US to discuss the way the financial reporting regulatory environment has evolved to its current form. Please note that this discussion is not intended to require research, but instead should be based entirely on images and stereotypes that you may have formed from such sources as television, movies, and news media. Discuss how these images can be used to help interpret the Enron-Andersen case.
2. Identify at least one major non-Anglo Saxon country that has financial markets and repeat the same discussion as in question 1. Do not use your country of residence. Identify contrasts with the US.
3. Identify the factors that may have led to the non-activist approach to regulation that exists in the US, both at the state and federal levels with respect to auditing practice and financial

reporting that were presented in Part II. Discuss the benefits and limitations of this non-activist approach. Identify at least one alternative to the non-activist approach and discuss the benefits and limitations of the alternate approach.

4. Using a debit-credit format (called active-passive in some countries) and US GAAP, present summaries in journal entry form using hypothetical numbers for:
   a. Mark-to-market accounting as used by Enron described on pages 40-41.
   b. Transactions with SPEs described on pages 42-43; describe the way Enron benefitted from the accounting.
   c. Shares issued in exchange for notes receivable
5. Discuss the way your response to item 4 would be different, if at all, if IFRS were followed.
6. Discuss the reasons why the events of the Enron-Andersen case suggest that financial markets in the US may not be as efficient as previously believed. Discuss the possible implications of this lack of market efficiency.
7. Describe in general terms the breaches of professional and ethical conduct that occurred within Enron and Andersen. Use the Internet or other resources to identify professional and ethical codes of conduct in the US that would apply to the Enron-Andersen case. Discuss the differences between breaches of professional or ethical conduct and crimes.
8. Using the events of the Enron-Andersen case as a guide, discuss ways in which management control systems might be developed to integrate fair financial reporting.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.bryant.edu.