When a company looks too good to be true, it usually is.

The Rise and Fall of Enron

BY C. WILLIAM THOMAS

If you’re like most, you’ve been astonished, disillusioned and angered as you learned of the meteoric rise and fall of Enron Corp. Remember the company’s television commercial of not so long ago, ending with the reverberating phrase, “Ask why, why, why?” That question is now on everyone’s lips. The Enron case is a dream for academics who conduct research and teach. For those currently or formerly involved with the company, such as creditors, auditors, the SEC and accounting regulators, it’s a nightmare that will continue for a long time.

Formal investigations of Enron are now under way, headed by the company’s board, the SEC, the Justice Department and Congress. The exact causes and details of the disaster may not be known for months. The purpose of this article is to summarize preliminary observations about the collapse, as well as changes in financial reporting, auditing and corporate governance that are being proposed in response by Big Five accounting firms, the AICPA and the SEC.

IN A WAY IT’S SIMPLE, IN A WAY IT’S NOT

On the surface, the motives and attitudes behind decisions and events leading to Enron’s eventual downfall appear simple enough: individual and collective greed born in an atmosphere of market euphoria and corporate arrogance. Hardly anyone—the company, its employees, analysts or individual investors—wanted to believe the company was too good to be true. So, for a while, hardly anyone did. Many kept on buying the stock, the corporate mantra and the dream. In the meantime, the company made many high-risk deals, some of which were outside the company’s typical asset risk control process. Many went sour in the early months of 2001 as Enron’s stock price and debt rating imploded because of loss of investor and creditor trust. Methods the company used to disclose (or creatively obscure) its complicated financial dealings were erroneous and, in the view of some, downright deceptive. The company’s lack of transparency in reporting its financial affairs, followed by financial restatements disclosing billions of dollars of omitted liabilities and losses, contributed to its demise. The whole affair happened under the watchful eye of Arthur Andersen LLP, which kept a whole floor of auditors assigned at Enron year-round.

THE BEGINNING PRESAGES THE END

In 1985, after federal deregulation of natural gas pipelines, Enron was born from the merger of Houston Natural Gas and InterNorth, a Nebraska pipeline company. In the process of the merger, Enron incurred massive debt and, as the result of deregulation, no longer had exclusive rights to its pipelines. In order to survive, the company had to come up with a new and innovative business strategy to generate profits and cash flow. Kenneth Lay, CEO, hired McKinsey & Co. to assist in developing Enron’s business strategy. It assigned a young consultant named Jeffrey Skilling to the engagement. Skilling, who had a background in banking and asset and liability management, proposed a revolutionary solution to Enron’s credit, cash and profit woes in the gas pipeline business: create a “gas bank” in which Enron would buy gas from a network of suppliers and sell it to a network of consumers, contractually guaranteeing both the supply and the price, charging fees for the transactions and assuming the associated risks. Thanks to the young consultant, the company created both a new product and a new paradigm for the industry—the energy derivative.

(continued on page 42)
Lay was so impressed with Skilling’s genius that he created a new division in 1990 called Enron Finance Corp. and hired Skilling to run it. Under Skilling’s leadership, Enron Finance Corp. soon dominated the market for natural gas contracts, with more contacts, more access to supplies and more customers than any of its competitors. With its market power, Enron could predict future prices with great accuracy, thereby guaranteeing superior profits.

THE BEST, THE BRIGHTEST AND THE DREADED PRC

Skilling began to change the corporate culture of Enron to match the company’s transformed image as a trading business. He set out on a quest to hire the best and brightest traders, recruiting associates from the top MBA schools in the country and competing with the largest and most prestigious investment banks for talent. In exchange for grueling schedules, Enron pampered its associates with a long list of corporate perks, including concierge services and a company gym. Skilling rewarded production with merit-based bonuses that had no cap, permitting traders to “eat what they killed.”

One of Skilling’s earliest hires in 1990 was Andrew Fastow, a 29-year-old Kellogg MBA who had been working on leveraged buyouts and other complicated deals at Continental Illinois Bank in Chicago. Fastow became Skilling’s protégé in the same way Skilling had become Lay’s. Fastow moved swiftly through the ranks and was promoted to chief financial officer in 1998. As Skilling oversaw the building of the company’s vast trading operation, Fastow oversaw its financing by ever more complicated means.

As Enron’s reputation with the outside world grew, the internal culture apparently began to take a darker tone. Skilling instituted the performance review committee (PRC), which became known as the harshest employee-ranking system in the country. It was known as the “360-degree review” based on the values of Enron—respect, integrity, communication and excellence (RICE). However, associates came to feel that the only real performance measure was the amount of profits they could produce. In order to achieve top ratings, everyone in the organization became instantly motivated to “do deals” and post earnings. Employees were regularly rated on a scale of 1 to 5, with 5s usually being fired within six months. The lower an employee’s PRC score, the closer he or she got to being shown the door. Skilling’s division was known for replacing up to 15% of its workforce every year. Fierce internal competition prevailed and immediate gratification was prized above long-term potential. Paranoia flourished and trading contracts began to contain highly restrictive confidentiality clauses. Secrecy became the order of the day for the nation’s largest wholesale buyer and seller of natural gas and electricity. Revenue grew to $7 billion from $2 billion, and the number of employees in the division skyrocketed to more than 2,000 from 200. Using the same concept that had been so successful with the gas bank, they were ready to create a market for anything that anyone was willing to trade: futures contracts in coal, paper, steel, water and even weather.

Perhaps Enron’s most exciting development in the eyes of the financial world was the creation of Enron Online (EOL) in October 1999. EOL, an electronic commodities trading Web site, was significant for at least two reasons. First, Enron was a counterparty to every transaction conducted on the platform. Traders received extremely valuable information regarding the “long” and “short” parties to each trade as well as the products’ prices in real-time. Second, given that Enron was either a buyer or a seller in every transaction, credit risk management was crucial and Enron’s credit was the cornerstone that gave the energy community the confidence that EOL provided a safe transaction environment. EOL became an overnight success, handling $335 billion in online commodity trades in 2000.

The world of technology opened up the Internet, and the IPO market for technology and broadband communications companies started to take off. In January 2000 Enron announced an ambitious plan to build a high-speed broadband telecommunications network and to trade network capacity, or bandwidth, in the same way it traded electricity or natural gas. In July of that year Enron and Blockbuster announced a deal to provide video on demand to customers throughout the world via high-speed Internet lines. As Enron poured hundreds of millions into broadband with very little return, Wall Street rewarded the strategy with as much as $40 on the stock price—a factor that would have to be discounted later when the broadband bubble burst. In August 2000 Enron’s stock hit an all-time high of $90.56, and the company was being touted by Fortune and other business
were within acceptable ranges. Fastow continually lobbied the agencies, Enron had to make sure the company’s leverage ratios or whether they aligned with the strategic goals of the company. As one knowledgeable Enron employee put it: “Good deal vs. bad deal? Didn’t matter. If it had a positive net present value (NPV) it could get done. Sometimes positive NPV didn’t even matter in the name of strategic significance.” Enron’s foundations were developing cracks and Skilling’s house of paper built on the stilts of trust had begun to crumble.

THE ROLE OF MARK-TO-MARKET ACCOUNTING

Enron incorporated “mark-to-market accounting” for the energy trading business in the mid-1990s and used it on an unprecedented scale for its trading transactions. Under mark-to-market rules, whenever companies have outstanding energy-related or other derivative contracts (either assets or liabilities) on their balance sheets at the end of a particular quarter, they must adjust them to fair market value, booking unrealized gains or losses to the income statement of the period. A difficulty with application of these rules in accounting for long-term futures contracts in commodities such as gas is that there are often no quoted prices upon which to base valuations. Companies having these types of derivative instruments are free to develop and use discretionary valuation models based on their own assumptions and methods.

The Financial Accounting Standards Board’s (FASB) emerging issues task force has debated the subject of how to value and disclose energy-related contracts for several years. It has been able to conclude only that a one-size-fits-all approach will not work and that to require companies to disclose all of the assumptions and estimates underlying earnings would produce disclosures that were so voluminous they would be of little value. For a company such as Enron, under continuous pressure to beat earnings estimates, it is possible that valuation estimates might have considerably overstated earnings. Furthermore, unrealized trading gains accounted for slightly more than half of the company’s $1.41 billion reported pretax profit for 2000 and about one-third of its reported pretax profit for 1999.

CAPITALISM AT WORK

In the latter part of the 1990s, companies such as Dynegy, Duke Energy, El Paso and Williams began following Enron’s lead. Enron’s competitive advantage, as well as its huge profit margins, had begun to erode by the end of 2000. Each new market entrant’s successes squeezed Enron’s profit margins further. It ran with increasing leverage, thus becoming more like a hedge fund than a trading company. Meanwhile, energy prices began to fall in the first quarter of 2001 and the world economy headed into a recession, thus dampening energy market volatility and reducing the opportunity for the large, rapid trading gains that had formerly made Enron so profitable. Deals, especially in the finance division, were done at a rapid pace without much regard to whether they aligned with the strategic goals of the company or whether they complied with the company’s risk management policies. As one knowledgeable Enron employee put it: “Good deal vs. bad deal? Didn’t matter. If it had a positive net present value (NPV) it could get done. Sometimes positive NPV didn’t even matter in the name of strategic significance.” Enron’s foundations were developing cracks and Skilling’s house of paper built on the stilts of trust had begun to crumble.

RELATED PARTIES AND COMPLEX SPECIAL PURPOSE ENTITIES

In order to satisfy Moody’s and Standard & Poor’s credit rating agencies, Enron had to make sure the company’s leverage ratios were within acceptable ranges. Fastow continually lobbied the ratings agencies to raise Enron’s credit rating, apparently to no avail. That notwithstanding, there were other ways to lower the company’s debt ratio. Reducing hard assets while earning increasing paper profits served to increase Enron’s return on assets (ROA) and reduce its debt-to-total-assets ratio, making the company more attractive to credit rating agencies and investors. Enron, like many other companies, used “special purpose entities” (SPEs) to access capital or hedge risk. By using SPEs such as limited partnerships with outside parties, a company is permitted to increase leverage and ROA without having to report debt on its balance sheet. The company contributes hard assets and related debt to an SPE in exchange for an interest. The SPE then borrows large sums of money from a financial institution to purchase assets or conduct other business without the debt or assets showing up on the company’s financial statements. The company can also sell leveraged assets to the SPE and book a profit. To avoid classification of the SPE as a subsidiary (thereby forcing the entity to include the SPE’s financial position and results of operations in its financial statements), FASB guidelines require that only 3% of the SPE be owned by an outside investor.

Under Fastow’s leadership, Enron took the use of SPEs to new heights of complexity and sophistication, capitalizing them with not only a variety of hard assets and liabilities, but also extremely complex derivative financial instruments, its own restricted stock, rights to acquire its stock and related liabilities. As its financial dealings became more complicated, the company apparently also used SPEs to “park” troubled assets that were falling in value, such as certain overseas energy facilities, the broadband operation or stock in companies that had been spun off to the public. Transferring these assets to SPEs meant their losses would be kept off Enron’s books. To compensate partnership investors for downside risk, Enron promised issuance of additional shares of its stock. As the value of the assets in these partnerships fell, Enron began to incur larger and larger obligations to issue its own stock later down the road. Compounding the problem toward the end was the precipitous fall in the value of Enron stock. Enron conducted business through thousands of SPEs. The most controversial of them were LJM Cayman LP and LJM2 Co-Investment LP, run by Fastow himself. From 1999 through July 2001, these entities paid Fastow more than $30 million in management fees, far more than his Enron salary, supposedly with the approval of top management and Enron’s board of directors. In turn, the LJM partnerships invested in another group of SPEs, known as the Raptor vehicles, which were designed in part to hedge an Enron investment in a bankrupt broadband company, Rhythm NetConnections. As part of the capitalization of the Raptor entities, Enron issued common stock in exchange for a note receivable of $1.2 billion. Enron increased notes receivable and shareholders’ equity to reflect this transaction, which appears to violate generally accepted accounting principles. Additionally, Enron failed to consolidate the LJM and Raptor SPEs into their financial statements when subsequent information revealed they should have been consolidated.

OBSOLETE DISCLOSURES REVEALED

A very confusing footnote in Enron’s 2000 financial statements described the above transactions. Douglas Carmichael, the
Wollman Distinguished Professor of Accounting at Baruch College in New York City, told the Wall Street Journal in November of 2001 that most people would be hard pressed to understand the effects of these disclosures on the financial statements, casting doubt on both the quality of the company's earnings as well as the business purpose of the transaction. By April 2001 other skeptics arrived on the scene. A number of analysts questioned the lack of transparency of Enron's disclosures. One analyst was quoted as saying, “The notes just don't make sense, and we read notes for a living.” Skilling was very quick to reply with arrogant comments and, in one case, even called an analyst a derogatory name. What Skilling and Fastow apparently underestimated was that, because of such actions, the market was beginning to perceive the company with greater and greater skepticism, thus eroding its trust and the company’s reputation.

**IT ALL COMES TUMBLING DOWN**

In February 2001 Lay announced his retirement and named Skilling president and CEO of Enron. In February Skilling held the company's annual conference with analysts, bragging that the stock (then valued around $80) should be trading at around $126 per share.

In March Enron and Blockbuster announced the cancellation of their video-on-demand deal. By that time the stock had fallen to the mid-$60s. Throughout the spring and summer, risky deals Enron had made in underperforming investments of various kinds began to unravel, causing it to suffer a huge cash shortfall. Senior management, which had been voting with its feet since August 2000, selling Enron stock in the bull market, continued to exit, collectively hundreds of millions of dollars richer for the experience. On August 14, just six months after being named CEO, Skilling himself resigned, citing “personal reasons.” The stock price slipped below $40 that week and, except for a brief recovery in early October after the sale of Portland General, continued its slide to below $30 a share.

Also in August, in an internal memorandum to Lay, a company vice-president, Sherron Watkins, described her reservations about the lack of disclosure of the substance of the related party transactions with the SPEs run by Fastow. She concluded the memo by stating her fear that the company might “implode under a series of accounting scandals.” Lay notified the company's attorneys, Vinson & Elkins, as well as the audit partner at Enron's auditing firm, Arthur Andersen LLP, so the matter could be investigated further. The proverbial “ship” of Enron had struck the iceberg that would eventually sink it.

On October 16 Enron announced its first quarterly loss in more than four years after taking charges of $1 billion on poorly performing businesses. The company terminated the Raptor hedging arrangements which, if they had continued, would have resulted in its issuing 58 million Enron shares to offset the company's private equity losses, severely diluting earnings. It also disclosed the reversal of the $1.2 billion entry to assets and equities it had made as a result of dealings with these arrangements. It was this disclosure that got the SEC's attention.

On October 17 the company announced it had changed plan administrators for its employees’ 401(k) pension plan, thus by law locking their investments for a period of 30 days and preventing workers from selling their Enron stock. The company contends this decision had in fact been made months earlier. However true that might be, the timing of the decision certainly has raised suspicions.

On October 22 Enron announced the SEC was looking into the related party transactions between Enron and the partnerships owned by Fastow, who was fired two days later. On November 8 Enron announced a restatement of its financial statements back to 1997 to reflect consolidation of the SPEs it had omitted, as well as to book Andersen's recommended adjustments from those years, which the company had previously "deemed immaterial." This restatement resulted in another $591 million in losses over the four years as well as an additional $628 million in liabilities as of the end of 2000. The equity markets immediately reacted to the restatement, driving the stock price to less than $10 a share. One analyst's report stated the company had burned through $5 billion in cash in 50 days.

A merger agreement with smaller cross-town competitor Dynegy was announced on November 9, but rescinded by Dynegy on November 28 on the basis of Enron's lack of full disclosure of its off-balance-sheet debt, downgrading Enron's rating to junk status. On November 30 the stock closed at an astonishing 26 cents a share. The company filed for bankruptcy protection on December 2.

**THE AFTERMATH**

Unquestionably, the Enron implosion has wreaked more havoc on the accounting profession than any other case in U.S. history. Critics in the media, Congress and elsewhere are calling into question not only the adequacy of U.S. disclosure practices but also the integrity of the independent audit process. The general public still questions how CPA firms can maintain audit independence while at the same time engaging in consulting work, often for fees that dwarf those of the audit. Companies that deal in special purpose entities and complex financial instruments similar to Enron's have suffered significant declines in their stock prices. The scandal threatens to undermine confidence in financial markets in the United States and abroad.

In a characteristic move, the SEC and the public accounting profession have been among the first to respond to the Enron crisis. Unfortunately, and sadly reminiscent of financial disasters in the 1970s and 1980s, this response will likely be viewed by investors, creditors, lawmakers and employees of Enron as "too little, too late."
In an “op-ed” piece for the Wall Street Journal on December 11, SEC Chairman Harvey Pitt called the current outdated reporting and financial disclosure system the financial “perfect storm.” He stated that under the current quarterly and annual reporting system, information is often stale on arrival and mandated financial disclosures are often “arcane and impenetrable.” To reassure investors and restore confidence in financial reporting, Pitt called for a joint response from the public and private sectors that included, among other things,

- A system of “current” disclosures, supplementing and updating quarterly and annual information with disclosure of material information on a real-time basis.
- Public company disclosure of significant current “trend” and “evaluative” data in addition to historical information.
- Identification of “most critical accounting principles” by all public companies in their annual reports.
- More timely and responsive accounting standard setting on the part of the private sector.
- An environment of cooperation between the SEC and registrants that encourages public companies and their auditors to seek advice on disclosure issues in advance.
- An effective and transparent system of self-regulation for the accounting profession, subject to SEC’s rigorous, but nonduplicative, oversight.
- More proactive oversight by audit committees who understand financial accounting principles as well as how they are applied.

The CEOs of the Big Five accounting firms made a joint statement on December 4 committing to develop improved guidance on disclosure of related party transactions, SPEs and market risks for derivatives including energy contracts for the 2001 reporting period. In addition, the Big Five called for modernization of the financial reporting system in the United States to make it more timely and relevant, including more nonfinancial information on entity performance. They also vowed to streamline the accounting standard-setting process to make it more responsive to the rapid changes that occur in a technology-driven economy.

Since the Enron debacle, the AICPA has been engaged in significant damage control measures to restore confidence in the profession, displaying the banner “Enron: The AICPA, the Profession, and the Public Interest” on its Web site. It has announced the imminent issuance of an exposure draft on a new audit standard on fraud (the third in five years), providing more specific guidance than currently found in SAS no. 82, Consideration of Fraud in a Financial Statement Audit. The Institute has also promised a revised standard on reviews of quarterly financial statements, as well as the issuance, in the second quarter of 2002, of an exposure draft of a standard to improve the audit process. These standards had already been on the drawing board as part of the AICPA’s response to the report of the Blue Ribbon Panel on Audit Effectiveness, issued in 2000.

In late December the AICPA issued a tool kit for auditors to use in identifying and auditing related party transactions. While it breaks no new ground, the tool kit provides, in one place, an overview of the accounting and auditing literature, SEC requirements and best practice guidance concerning related party transactions. It also includes checklists and other tools for auditors to use in gathering evidence and disclosing related party transactions.

In January the AICPA board of directors announced that it would cooperate fully with the SEC’s proposal for new rules for the peer review and disciplinary process for CPA firms of SEC registrants. The new system would be managed by a board, a majority of which would be public members, enhancing the peer review process for the largest firms and requiring more rigorous and continuous monitoring. The staff of the new board would administer the reviews. In protest, the Public Oversight Board informed Pitt that it would terminate its existence in March 2002, leaving the future peer review process in a state of uncertainty. The SEC and the AICPA are now engaged in talks with the POB to reassure the board it will continue to be a vital part of the peer review process in the future.

The AICPA has also approved a resolution to support prohibitions that would prevent audit firms from performing systems design and implementation as well as internal audit outsourcing for public audit clients. While asserting that it does not believe prohibition of these services will make audits more effective or prevent financial failures, the board has stated it feels the move is necessary to restore public confidence in the profession. These prohibitions were at the center of the controversy last year between the profession and the SEC under the direction of former Chairman Arthur Levitt. Big Five CPA firms and the AICPA lobbied heavily and prevailed in that controversy, winning the right to retain these services and being required only to disclose their fees.

The impact of Enron is now being felt at the highest levels of government as legislators engage in endless debate and accusation, quarreling over the influence of money in politics. The GAO has requested that the White House disclose documents concerning appointments to President George W. Bush’s Task Force on Energy, chaired by Vice-President Dick Cheney, former CEO of Halliburton. The White House has refused, and the GAO has filed suit, the first of its kind in history. Congressional investigations are expected to continue well into 2002 and beyond. Lawmakers are expected to investigate not only disclosure practices at Enron, but for all public companies, concerning SPEs, related party transactions and use of “mark-to-market” accounting.

Kenneth Lay resigned as Enron’s CEO, under pressure from creditor groups. Lay, Skilling and Fastow still have much to explain. In addition, Enron’s board of directors, and especially the audit committee, will be in the “hot seat” and rightfully so.

(continued on page 47)
The Justice Department opened a criminal investigation and formed a national task force made up of federal prosecutors in Houston, San Francisco, New York and several other cities to investigate the possibility of fraud in the company's dealings. Interestingly, to illustrate how far-reaching Enron's ties are to government and political sources at all levels, U.S. Attorney General John Ashcroft, as well as his entire Houston office, disqualified themselves from the investigation because of either political, economic or family ties.

It appears that 2002 is shaping up to be a year of unprecedented changes for a profession that is already coping with an identity crisis.

WHERE WERE THE AUDITORS?

Arthur Andersen LLP, after settling two other massive lawsuits earlier in 2001, is preparing for a storm of litigation as well as a possible criminal investigation in the wake of the Enron collapse. Enron was the firm's second-largest client. Andersen, who had the job not only of Enron's external but also its internal audits for the years in question, kept a staff on permanent assignment at Enron's offices. Many of Enron's internal accountants, CFOs and controllers were former Andersen executives. Because of these relationships, as well as Andersen's extensive concurrent consulting practice, members of Congress, the press and others are calling Andersen's audit independence into question. Indeed, they are using the case to raise doubts about the credibility of the audit process for all Big Five firms who do such work.

So far, Andersen has acknowledged its role in the fiasco, while defending its accounting and auditing practices. In a Wall Street Journal editorial on December 4, as well as in testimony before Congress the following week, Joseph Berardino, CEO, was forthright in his views. He committed the firm to full cooperation in the investigations as well as to a leadership role in potential solutions.

Enron dismissed Andersen as its auditor on January 17, 2002, citing document destruction and lack of guidance on accounting policy issues as the reasons. Andersen countered with the contention that in its mind the relationship had terminated on December 2, 2001, the day the firm filed for Chapter 11 bankruptcy protection.

The fact that Andersen is no longer officially associated with Enron will, unfortunately, have little impact on forces now in place that may, in the eyes of some, determine the firm's very future. Andersen is now under formal investigation by the SEC as well as various committees of both the U.S. Senate and House of Representatives of the U.S. Congress. To make matters worse for it, and to the astonishment of many, Andersen admitted it destroyed perhaps thousands of documents and electronic files related to the engagement, in accordance with "firm policy," supposedly before the SEC issued a subpoena for them. The firm's lawyers issued an internal memorandum on October 12 reminding employees of the firm's document retention and destruction policies. The firm fired David B. Duncan, partner in charge of the Enron engagement, placed four other partners on leave and replaced the entire management team of the Houston office. Duncan invoked his Fifth Amendment rights against self-incrimination at a congressional hearing in January. Several other Andersen partners testified that Duncan and his staff acted in violation of firm policy. However, in view of the timing of the October 12 memorandum, Congress and the press are questioning whether the decision to shred documents extended further up the chain of command. Andersen has suspended its firm policy for retention of records and asked former U.S. Senator John Danforth to conduct a comprehensive review of the firm's records management policy and to recommend improvements.

In a move to bolster its image, Andersen also has retained former Federal Reserve Chairman Paul Volcker to lead an outside board that will advise it in making "fundamental change" in its audit process. Other members of the board include P. Roy Vagelos, former chairman and CEO of Merck & Co., and Charles A. Bowsher, current chairman of the Public Oversight Board, which disbanded in March. Volcker also named a seven-member advisory panel made up of prominent corporate and accounting executives that will review proposed reforms to the firm's audit process.

Hindsight is so clear that it sometimes belies the complexity of the problem. Although fraud has not yet been proven to be a factor in Enron's misstatements, some of the classic risk factors associated with management fraud outlined in SAS no. 82 are evident in the Enron case. Those include management characteristics, industry conditions and operating characteristics of the company. Although written five years ago, the list almost looks as if it were excerpted from Enron's case:

- Unduly aggressive earnings targets and management bonus compensation based on those targets.
- Excessive interest by management in maintaining stock price or earnings trend through the use of unusually aggressive accounting practices.
- Management setting unduly aggressive financial targets and expectations for operating personnel.
- Inability to generate sufficient cash flow from operations while reporting earnings and earnings growth.
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments such as...reliability of financial instruments.
- Significant related party transactions.

These factors are common threads in the tapestry that is described of the environment leading to fraud. They were incorporated into SAS no. 82 on the basis of research into fraud cases of the 1970s and 1980s in the hope that auditors would learn from the past. Andersen will have to explain when and how it identified these factors, as well as how it re-
sponded and how it communicated with Enron’s board about them.

More important, Andersen will have to explain why it delayed notifying the SEC after learning of the internal Enron memo warning of problems. In addition, it will have to explain why the Houston office destroyed the thousands of documents related to the Enron audits for 1997 through 2000. Only time will tell, but it appears the firm is in serious trouble. In the end, and also characteristic of cases like this, the chief parties likely to benefit from this process are the attorneys.

THE HUMAN FACTOR

The Enron story has produced many victims, the most tragic of which is a former vice-chairman of the company who committed suicide, apparently in connection with his role in the scandal. Another 4,500 individuals have seen their careers ended abruptly by the reckless acts of a few. Enron’s core values of respect, integrity, communication and excellence stand in satirical contrast to allegations now being made public. Personally, I had referred several of our best and brightest accounting, finance and MBA graduates to Enron, hoping they could gain valuable experience from seeing things done right. These included a very bright training consultant who had lost her job in 2000 with a Houston consulting firm as a result of a reduction in force. She has lost her second job in 18 months through no fault of her own. Other former students still hanging on at Enron face an uncertain future as the company fights for survival. The old saying goes, “Lessons learned hard are learned best.” Some former Enron employees are embittered by the way they have been treated by the company that was once “the best in the business.” Others disagree. In the words of one of my former students who is still hanging on: “Just for the record, my time and experience at Enron have been nothing short of fantastic. I could not have asked for a better place to be or better people to work with. Please, though, remember this: Never take customer and employee confidence for granted. That confidence is easy to lose and tough—to impossible—to regain.”

C. WILLIAM THOMAS, CPA, PhD, is the J.E. Bush Professor of Accounting in the Hankamer School of Business at Baylor University in Waco. Mr. Thomas can be reached at Bill_Thomas@baylor.edu. This article originally appeared in the March/April 2002 issue of Today’s CPA, published by the Texas Society of CPAs.

Resources

- “The Enron Crisis: the AICPA, the Profession and the Public Interest.” www.aicpa.org.
- Statement from Big Five CEOs on Enron, PR newswire.