

# The Enron Accounting Scandal

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## Table of Contents

<b>Executive Summary</b> .....	3
<b>(I) Introduction to the Enron case and the organizations involved</b> .....	5
Background information & industry.....	5
Organizations and officers involved.....	6
Accounting firm and partners involved.....	8
Enron's industry.....	9
Enron's injured parties.....	10
<b>(II) Enron's accounting fraud and misrepresentation</b> .....	11
Explanation of the fraud.....	11
Damages incurred.....	12
Final outcome of the Case.....	13
How the fraud was discovered.....	13
<b>(III) Enron's Influences and Ethical Concerns</b> .....	14
<b>(IV) Enron's poor decisions and the better alternatives</b> .....	18
<b>(V) The lesson to be learned from Enron</b> .....	22
References.....	25
Group Activity Log .....	27

## **Executive Summary**

Enron was founded originally as a natural gas pipeline company in Houston, Texas in 1985 and quickly expanded into creating a market for itself – the energy trade. Their business included many long term risky investments that had no short term revenues, which lead the company to create special purpose entities (SPE's) to spread the risk of these investments. Although this spread of risk was in itself not illegal, the way the SPE's were created and ultimately managed was. To create these illegal SPE's, Enron used the 3% rule (EITF 90-15), which states that 3% of subsidiary's startup capital must come from an outside investor; Enron actually received this outside investment from managers in Enron or their wives.

Enron's auditor has also been accused of conducting business in an unethical manner in its attempt to retain the loyalty of Enron executives. Current laws and SEC regulations allow firms like Arthur Andersen to provided consulting services to a company and then turn around and provide the audited report about the financial results of these consulting activities; therefore making an "independent audit" by Arthur Andersen independent in name only.

Our legal system allows companies like Enron to manage their own employee pension funds, producing a conflict of interest because the company has an incentive to use these funds in ways that benefit the company even when they negatively affect employees. Most companies also have codes of ethics that prohibit managers and executives from getting involved in another business. The managers and executives are faced with a conflict of interest because they have a duty to act in the best interest of the company and its shareholders.

Enron's top level management violated several accounting laws, SPE laws, and bent the accounting rules to satisfy their own desires to profit in the short term, completely ignoring long term repercussions for investors, stockholders, employees and the business itself. When Enron corrected these problems in their financial statements, they restated with a loss of \$609 million, Wall Street devalued their equity by \$1.2 billion, and less than a month later filed for bankruptcy.

Most of the problems faced by Enron derive from the immoral and unethical actions taken on by the board of directors in their attempt to achieve personal profits. In order to prevent these unethical acts from re-occurring among other organizations, there needs to be an emphasis on the integrity of executives. Due to accounting frauds of organizations such as Enron, the SEC has begun to take significant steps in preventing loopholes within the accounting and financial disclosure system by enacting the Sarbanes-Oxley bill. Due to the accounting frauds that occurred in the Enron scandal, several accounting firms have begun reorganizing their employees towards remaining loyal to the ethical standards demanded by the SEC. In order for companies to prevent an Enron-like scandal, there needs to be supervision over managers and executives as they exercise their own business judgments about what is in the best interest for an organization.

## **(I) Introduction to the Enron case and the organizations involved**

### **Background Information & Industry**

Enron was founded as a pipeline company in Houston in 1985. Enron was a company that was able to profit by providing the delivery of gas to utility companies and businesses at the fair value market price. As the deregulation of electrical power markets arose, Enron with the help of former chairman Kenneth Lay decided to diversify their business portfolio and enter into becoming an energy broker who traded electricity and other commodities. Enron took what would prove be a fatal turn that would ultimately meet their demise by ignoring one of the most important foundations of their business: bringing buyers and sellers together. Instead of Enron bringing them together, they had chosen to enter into a contract with the seller and signed a contract with the buyer, thus profiting on the difference of the selling and buying price of the commodity. Enron was able to keep its books closed, making them the only party that knew both prices of the commodity, which enabled Enron's rise to power in the service industry.

According to the Washington post<sup>1</sup> Enron employed several PhDs in mathematics, physics, and economics to help manage the risk they were about to embark on. Enron proceeded to enter into diversified and complex contracts with customers and utilized a large group of highly skilled employees to help decipher, manage and conceal the high risks Enron took. Enron's attempt to create a constellation of partnerships that would allow managers to shift debt and losses off of the books would soon fail. In August of 2001, the now infamous internal whistle blower Sherron Watkins, formerly the Enron Vice President for corporate development, sent an

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<sup>1</sup> [www.washingtonpost.com/wp-srv/business/enron/front.html](http://www.washingtonpost.com/wp-srv/business/enron/front.html)

email to Kenneth Lay, warning him that Enron would “implode in a wave of accounting scandals”. CEO Jeffrey Skilling suddenly resigns, two months after the memo was sent to Lay. Enron, with the help of the Andersen Accounting firm, would lose control of their illegal attempt to conceal the debt and losses of the company. Ultimately, Enron would become bankrupt. This scandal is the one of America’s largest investigations into a firm’s illegal accounting practices and attempt to conceal it from the shareholders and credit lenders.

### **Organizations and Officers Involved**

To unmask the Enron scandal and find out what really happened, several organizations and officers of Enron are working together. Among the organizations responsible for unfolding the Enron scandal are the United States Congress, US Department of Justice, IRS, Securities and Exchange Commission, and the United States penal system. Congress is now responsible for combing through thousands of documents and scheduling hearings in the court system. The US Department of Justice is focusing on the investigation into Enron who possibly defrauded investors by purposefully covering up financial information and shredded financial documents. The Securities and Exchange Commission (SEC) will examine the accounting practices of Arthur Andersen and Enron’s reports of overstated earnings to investors and creditors. The SEC joined with the US Department of Justice in investigating Enron and Andersen’s alleged shredding of important financial documents

The organizations involved in the scandal were Citigroup, Morgan Chase, Andersen Accounting, and of course Enron. The Citibank group and Morgan Chase are the financial institutions responsible for providing the funds necessary to commit the

fraudulent activity. Andersen and Enron concealed and eventually shredded financial documentation that would help expose the fraud. The conflict of interests and greed in the organizations is what led to the exposure of this economic scandal.

Some of the key officers in the Enron scandal are: Kenneth L. Lay, former Enron Chairman and CEO (resigned Jan. 23, 2002), Andrew Fastow, former Enron Chief Financial Officer (resigned Oct. 24, 2001), Jeffrey Skilling, former Enron Chief Executive Officer (resigned Aug. 14, 2001), J. Clifford Baxter, former Enron Vice Chairman (resigned May 2, 2001), Wendy L. Gramm, on Enron's Board of Directors serving on its audit committee, and Sherron Watkins, former Enron Vice President for Corporate Development who was titled by congress to be the internal whistle blower.

“Kenneth Lay and Enron poured millions of dollars into political parties, cultivating access and using the entree to lobby Congress, the White House and regulatory agencies for action that was critical to the energy company's spectacular growth. In addition to being one of the single largest financial backers of President George W. Bush's political career, Lay is also one of the president's friends. With the exception of a six-month period in 2001 when he relinquished the CEO title to his successor, Jeffrey Skilling, Lay held the top two positions in the company since February 1986 until January 2002.”<sup>2</sup>

Andrew Fastow was removed as Enron's CFO on Oct. 24, 2001 as the SEC began to investigate conflicts of interest in two partnerships he created and managed. Those partnerships earned him around \$30 million in management fees from the deals in addition to his Enron salary. Prior to becoming CFO in March 1998, he held the position of senior vice president of finance.

Jeffery Skilling served as the CEO of Enron for six months in 2001 before resigning for personal reasons. Skilling joined Enron in 1990 after leading McKinsey &

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<sup>2</sup> [www.college.hmco.com/business/phk/business/7e/students/andersen.html](http://www.college.hmco.com/business/phk/business/7e/students/andersen.html)

Company's energy and chemical consulting practices. He became president and COO in December 1996, and served on the company's board of directors.

J. Clifford Baxter was one of 29 former and current Enron executives and board members named as defendants in a federal lawsuit, after he sold 577,436 shares of Enron stock for \$35.2 million before Enron's collapse. Baxter resigned as vice chairman on May 2, 2001 and at the time was credited for helping build Enron's wholesale business. He was found shot to death in a car Jan. 15, 2002, in an apparent suicide. Baxter's complaints about secret partnerships were cited in a letter to then-Chairman Kenneth L. Lay in August of 2001, by former Vice President Sherron Watkins.

Watkins, the whistleblower, warned Kenneth L. Lay that the company might "implode in a wave of accounting scandals," in August of 2001. Watkins describes "a veil of secrecy" around partnerships, that involves the energy-trader's former chief financial officer, Andrew Fastow.<sup>3</sup>

### **Accounting Firm and Partners Involved**

It was the job of Andersen Consulting, one of the nation's top five recognized accounting firms, to ensure the accuracy and reliability of the financial statements of Enron so that creditors and investors could make good financial decisions. However, it is now Andersen that is under investigation for illegal and unethical accounting practices which places both companies, Andersen and Enron, in the spotlight in the largest account fraud cases at the time. Enron hired Andersen, the reputable accounting firm, to conduct corporate financial audits. Enron was one of Andersen's largest accounts, and also a major business partner to Enron as they sold millions of dollars in consulting service. Due to these relationships that Enron had with Arthur Andersen, it was just too

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<sup>3</sup> [www.college.hmco.com/business/phk/business/7e/students/andersen.html](http://www.college.hmco.com/business/phk/business/7e/students/andersen.html)

easy for both Enron and the accounting firm to work together in covering up financial losses and debt. Andersen was also responsible for some of Enron's internal bookkeeping, with some of Andersen's employees eventually leaving to work for Enron.

At the Andersen reins of this accounting scandal is chief executive officer Joseph F. Berardino. Berardino fired the lead Enron auditor David Duncan after it was learned that he had ordered the shredding of Enron audit related documents that would have disclosed true financial representation. Arthur Andersen also by oversaw some of the key factors that triggered disproportionate earnings and growth.

Enron's stock peaked at over \$90 per share but quickly bottomed out at 9 cents per share. Stockholders, investors, and creditors wanted to know how one of the nation's top accounting firms could have missed such shifts and irregularities in Enron's accounting practices, which is one factor that led to investigation into the accounting practices of the firm. As a result, the US Department of Justice brought obstruction of justice charges against Andersen which ultimately ran Andersen out of business. With such charges Andersen found themselves in unfamiliar territory, and filed for bankruptcy shortly thereafter.

### **Enron's Industry**

Enron, which started out as an energy supplier, evolved into an energy contract trader. Enron, in the final stages of its existence, became involved in numerous markets such as broadband internet. The majority of Enron's markets were not verifiable, as many were involved in the SPE (special purpose entity) fraud which responsible for Enron's downfall.

## **Enron's Injured Parties**

Enron's collapse has injured several parties including banks, stockholders, politicians, and former employees. Enron announced in October 2001 that they incurred a \$638 million dollar loss for their third quarter and overstated their earnings by \$586 million over the past four years. With Enron also liable for up to \$3 billion in debt to various partnerships, the demise of Enron assured. Wall Street reduced the value of stockholders equity by \$1.2 billion, which Enron did not announce at the time. This resulted in stock losses in the billions. The devaluation of Enron's equity ultimately lead to the delisting of Enron from the New York Stock Exchange. Enron employees found themselves unemployed with worthless 401K accounts, leaving their retirement funds virtually empty.

J.P Morgan Chase and the Citibank group announced losses of \$456 million, and \$228 million as a result of Enron's bankruptcy. Additionally, political parties, such as the Bush administration, who accepted contributions from Enron were finding themselves in positions where returning the funds to Enron or donating them to a charitable cause were the only options .

Although many stockholders had lost everything, it was the employees of Enron who were injured the most. Employees were given and encouraged to invest in company stock which was now worth nothing, and also now find themselves with similar skill sets in competition with each other in seeking new work. Enron's irresponsible and selfishness acts have cost many of their loyal employees their deserved security and unbearable thoughts of what their future will hold.

## **(II) Enron's Accounting Fraud and Misrepresentation**

### **Explanation of the Fraud**

The accounting techniques used to misrepresent the financial statements were a combination of many different complex tactics. The first tactic was using ghost companies (SPEs) which they would transfer money to and from and different banks which would issue these ghost company loans. The end result was an extraordinarily complex set of financial statements which disguised the loans as cash flow, using their "independent SPEs" to incur Enron's losses on paper and "create" profits. Another tactic that Enron used was by forecasting the futures market of energy sales. Below is an excerpt from an article written by Joseph Kay on the accounting irregularities:

"Enron was fond of another procedure known as mark-to-market, which allowed it to increase the value of present assets held by the company (e.g., long-term contracts for the sale of energy) by estimating future market prices. Since Enron dominated the energy trading business, the prices by which it marked-to-market were largely subjective—that is, determined by Enron itself in accordance with the earnings it wanted to report. These manipulations will not increase reported cash flow, since no money is listed as actually coming into the company."

Mark-to-market trading is when a stock or security is held for an extended period of time, and treated as if it was sold at the end of the year (December 31). Losses or gains are reported based on the stock/security price at that time. One drawback of the mark-to-market system is that once a company or trader has elected to use this method, it is extremely difficult to revert to another system. Fairmark Press states "you can change the election only with the consent of the Internal Revenue Service, and they generally won't grant this consent if your reason for changing is simply that the election didn't turn out to your advantage."

Albrecht, a PhD in the AICPA (American Institution of Certified Public Accountants), states about the role of Enron SPEs involved in the accounting fraud:

“Many SPE (special purpose entities) transactions were timed (or illegally back-dated) just near end of quarters so that income could be booked just in time and in amounts needed, to meet investor expectations.”

Enron was able to use EITF (Emerging Issues Task Force) resolution 90-15, created in 1990, which allowed them to create and maintain the SPEs which allowed them to conceal the fraud. EITF 90-15 only requires 3% of capital/assets to be contributed by independent external sources in order for an SPE to exist. Albrecht states in his report that about EITF 90-15:

EITF 90-15” (The 3% rule) Allowed corporations such as Enron to “not consolidate” if outsiders contributed even 3% of the capital (the other 97% could come from the company.) 90-15 was a license to create imaginary profits and hide genuine losses. FAS 57 require disclosure of these types of relationships (FAS 57 was proposed and implemented after the Enron scandal).

Enron had a negative \$597 million dollar cash flow in the first half 2000 by taking loans from banks such as Citigroup and Morgan-Chase totaling nearly \$3.4 billion. Enron accrued approximately 2 million dollars in interest each day, which had to be paid in cash according to Kay. In fact Enron would have recorded actual losses in its last 6 years of business, had its employees not qualified and filed for tax incentives.

### **Damages Incurred**

The monetary damage incurred by the stockholders, employees, and other companies in the Enron scandal involved hundreds of billions of dollars. Employee pension plans can no longer be paid, stock holders saw Enron stock plummet to \$0.09

cents a share from over \$90 dollars per share, hundreds of millions of dollars in fines were issued to the banks, Andersen Accounting went bankrupt due to fines and civil suits, and other intangibles such as lost time and emotional strain also occurred.

The SEC fined Morgan-chase \$135 million, and \$700 million in two different cases dealing with the Enron collapse. Citigroup was fined a total of over \$1.42 billion. In addition to fines and settlements, Citigroup and Morgan-Chase incurred \$456 million and \$228 million respectively in losses from the Enron bankruptcy. These fines and losses do not cover legal fees or mandatory payments to agencies other than the SEC.

### **Final Outcome of the Case**

The Enron scandal led to civil and criminal trials involving Citigroup, Morgan-Chase, Merrill-Lynch, and Andersen Accounting, fines issued to the banks involved. Five out of the six criminally charged employees were found guilty, including Dan Boyle the former vice president at Enron's global finance group, James A. Brown, the former managing director of Merrill's strategic asset lease and finance group, Daniel Bayly, the former head of global investment banking at Merrill, William Fuhs, a former vice president, and Robert Furst a managing director in the investment banking division. Sheila Kahanek, the former Enron accountant, was the only party that was acquitted.

### **How the fraud was discovered**

The accounting misstatements were discovered starting when on “November 8<sup>th</sup> of 2001 Enron told investors they were restating earnings for the past 4 and  $\frac{3}{4}$  years” (Albrecht). Declaring bankruptcy shortly after restating its earnings was also a clue. The “smoking gun” that was not in the accounting books was when Sherron Watkins, a

vice president at the time, wrote a memo to chairman Kenneth Lay about the fraud that was occurring.

The governmental organizations involved in the Enron investigation are the SEC and IRS. The SEC investigated the fraud, issued fines, and filed criminal and civil charges against the companies involved and the Department of Justice (Enron Task Force) prosecuted the accused firms. The IRS's role is unclear because of the investigative reports involving the scandal not being available due to Enron's rights as a private taxpayer, according to Business Week.

### **(III) Enron's Influences and Ethical Concerns<sup>4</sup>**

The Enron scandal is one of the largest corporate collapses in United States history, where Enron's rapid success turned out to be an elaborate scam involving lies about its profits and the concealment of debts that did not appear on the company's accounting books. This scandal demonstrated the need for a complete re-evaluation of ethical quality of business culture within leading organizations and the reconstruction of accounting and corporate laws concerning these misconducts. The ethical issues faced by Enron can be explained from a personal, organizational, and systemic level. The personal level describes the causes that drive greed and ill conceived acts within an individual. The organizational level describes the causes of unhealthy and unethical decisions made among groups of individuals and the systematic level describes causes that are primarily driven by external influences. The insights obtained from these three levels will provide a thorough explanation of the causes behind the scandal which eventually lead to the downfall of Enron.

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<sup>4</sup> <http://www.scu.edu/ethics/publications/ethicalperspectives/enronpanel.html>

The personal level calls for the character evaluation of the four main individuals that participated in the various frauds that were committed by Enron. These three individuals include the former president and CEO of Enron, Jeffrey Skilling; former chief financial officer in charge of LJM, Andrew Fastow; founder, former chairman, and CEO, Kenneth Lay; and auditor Arthur Andersen. The values and ethical behaviors of these three individuals have continuously been called into question. The former CEO Jeffrey Skilling was charged with fraud and insider trading, making him the highest ranking former executive charged in the collapse of Enron. A total of 36 charges were held against Skilling as he participated in the use of various devious and manipulative tactics to manipulate Enron's financial statements. He faced 10 counts of insider trading, 15 counts of securities fraud, 4 counts of wire fraud, and 6 counts of making false statements to auditors. Skilling was also accused of selling more than 500,000 shares of Enron's stock for more than \$21 million, in turn profiting by cashing in more stock several months prior to the collapse of Enron.<sup>5</sup>

Former chief financial officer Andrew Fastow, was primarily held responsible for creating several SPEs that were strategically designed to transfer Enron's debts to an outside company and remove these debts off the books without giving up control over Enron's assets. Fastow has been charged with approximately 78 federal charges of money laundering, insider trading, fraud, conspiracy, and obstruction of justice. Fastow, along with several others, were involved in his "financial gaming," making \$42 million on

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<sup>5</sup> "Skilling indicted for fraud." CNN Money  
[money.cnn.com/2004/02/19/news/companies/skilling/](http://money.cnn.com/2004/02/19/news/companies/skilling/)

investments totaling \$161,000. He was the creator of the complex financial system that Enron drove towards achieving tremendous growth.<sup>6</sup>

Former chairman and CEO, Kenneth Lay, has been charged with civil charges in regard to a wide-ranging scheme to fraud by falsifying Enron's financial results and misleading public representations about Enron's performance. The scheme of fraud involves the selling of large amounts of Enron's stock at prices that did not reflect its true value. Lay was able to sell over \$70 million in Enron's stock back to the company to repay cash advances on an unsecured line of credit. He also participated in the selling of an additional \$20 million in Enron stock. Lay's profit from the sales was considered illegal gains resulting from his scheme of defraud.<sup>7</sup>

Arthur Andersen, Enron's auditor, has also be accused of committing unethical conduct in his attempt to retain the loyalty of Enron executives. Andersen was charged with criminal charges of obstruction of justice by shredding documents and deleting computer files related to Enron's auditing reports.

Many of the charges directed towards these individuals are a clear indication of acquiring personal profits. The greedy managerial act of acquiring profit based on self-interest was seen in each character described above. The ethical issues come to question the character of these individuals as they place Enron's future survival at risk in order to achieve personal financial profits. Despite the various character flaws of these individuals, they may very well be good people that were merely influenced by the

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<sup>6</sup> Saporito, Bill. "How Fastow helped Enron fall." Time Online Edition: Business & Technology.  
[www.time.com/time/business/article/0,8599,201871,00.html](http://www.time.com/time/business/article/0,8599,201871,00.html)

<sup>7</sup> "Kenneth Lay: A fallen hero." BBC News: Business. January 24, 2002.  
[news.bbc.co.uk/1/hi/business/1779445.stm](http://news.bbc.co.uk/1/hi/business/1779445.stm)

corporate culture which leads to the impact of groups on the construction of corporate decisions and organizational cultures.

On the group level many individuals are swayed to make certain decision based on the influence of fellow group members. The interactions that take place among groups have a tendency to formulate group think; which are individual decisions that are greatly influenced by the ideas generated by the group and characterizes conformity to prevailing points of view. Individuals, for reasons tied to corporate culture, adopted their ethics to corporate ethics associated with their roles as managers. Many of the acts were committed by managers who felt they were inclined to do so by the pressures demanded by their managerial roles, causing them to act in an unethical manner. The close relationships that were formed among top leading executives and the board of directors grew arrogant, thinking they were invincible. This hard headed mentality formulated by these executives created a corporate cultural norm that drove the concept of profitability and success, no matter what the cost. These norms would also lead to the humiliation and mistreatment of whistle-blowers by various players. Enron's corporate culture promoted "up-or-out", where Skilling would pit people against each other to achieve the greatest amount of productivity. He knew that by keeping employees scared and competing, he could maintain a sense of control over the success of Enron. Individuals that survived the pressures of this culture began to think they were gods.

On the systematic level, many external factors have also contributed to groups or individuals making decision contradictory to what they may normally do. An external factor that allowed the actions of these executives was due largely to the legal and

regulatory structure. Current laws and SEC regulations allow firms like Andersen to provided consulting services to a company and then turn around and provide the audited report about the financial results of these consulting activities, which is an obvious conflict of interest. Another regulatory problem that occurs is the ability for private companies like Enron to hire and pay its own auditors. This again causes a conflict of interest because the auditor has an incentive not to issue an unfavorable report on the company. Our legal system also allows companies like Enron to manage their own employee pension funds. This, once again, produces a conflict of interest because the company has an incentive to use these funds in ways that benefit the company even when they negatively affect employees. Finally, most companies have codes of ethics that prohibit managers and executives from getting involved in another business. Unfortunately, due to the lack of regulations, these codes of ethics are voluntary and can be set aside by the board of directors. The managers and executives are faced with a conflict of interest because they have a duty to act in the best interest of the company and its shareholders. There are no laws preventing managers and executives to exercise their own business judgment about what is the best interest of the company.

#### **(IV) Enron's poor decisions and the better alternatives**

In the Enron case many professional duties were neglected at both the management level and the accounting level. What seems to be the most important of all the duties though was outside autonomy, in both doing business and checking the

accounting records, which is required by law. Since Andersen was the accounting firm handling both their auditing and their financial records for business, an “independent audit” by Andersen Consulting was, in reality, independent in name only.<sup>8</sup> Andrew Fastow, the Chief Financial Officer of Enron pushed many deals across where he had a vested interest on both sides of the deal. By creating and knowingly participating in these deals, he put his financial greed above the responsibility to his position for the company. He managed the LJM (Raptor and Condor) subsidiaries, which were created to buy stock and hide debt for Enron – personally making him over \$30 million outside of his salary.<sup>9</sup> “Chewco” (JEDI), a special purpose entity created by Enron, was owned by the wife of Michael Kopper – a manager at Enron. Andrew Fastow ran up the price when Enron decided to buy Chewco. Kopper and his wife profited, even receiving \$1.5 million in bonuses from Enron – which was shared with Fastow.<sup>10</sup> Without these conflicts of interest being allowed to happen (some of which the board of director’s knew about), Enron might have never been in the position they are in now.

Enron also failed to follow the accounting rules (Generally Accepted Accounting Principles). A completed financial statement with notes should be able to explain to the layman what is happening financially with the company. Any deviations in GAAP need to be noted on the financial statements. The famous note 16<sup>11</sup> on their financial report mysteriously reports a profit of \$500 million – which was in actuality was profit reported in part by the value of Enron stock<sup>12</sup>. This and other extremely risky investments were

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<sup>8</sup> [http://www.consumerfed.org/enron\\_auditor\\_pr.PDF](http://www.consumerfed.org/enron_auditor_pr.PDF)

<sup>9</sup> <http://www.chron.com/cs/CDA/story.hts/special/enron/1125793>

<sup>10</sup> <http://www.enronfraudinfocenter.com/information.php>

<sup>11</sup> <http://www.enron.com/corp/investors/annuals/2000/ar2000.pdf>

<sup>12</sup> <http://abcnews.go.com/sections/pdf/layletter020115.pdf>

mentioned very vaguely in the footnotes.<sup>13</sup> If stockholders knew this would they have changed their investments? If the answer is yes, then it must be noted clearly – but it wasn't. The accountants and auditors, who were being paid by Enron, failed to accurately state the position of the company and let these technicalities pass.

Accountants also failed to consolidate SPE's into Enron's financial statements when the special purpose entity (Chewco) could no longer be recognized as a separate entity. This led to a misleading report of the financial health of Enron in turn resulting in a restatement of income in 2001, which increased Enron's reported debt by over \$2.5 Billion and reporting as far back as 1997<sup>6</sup>. As one report said, "You couldn't slip these things by anyone ... They're simply too big, and too many people were involved for it to go unnoticed."<sup>14</sup> The Private Securities Litigation Reform Act reduced the auditor's liability for incorrectly reporting income which although not illegal, did not provide any incentive to stop these actions.<sup>15</sup>

Morally both upper management of Enron and the accountants served to line their own pockets with money while misleading the investors, creditors, and fellow employees. Upper management even sold stock as they encouraged normal employees to buy it<sup>16</sup>. In the Sherron Walkins whistle-blower letter, she says that without a doubt "executive management of the company must have a clear and precise knowledge of these transactions"<sup>17</sup>. They emphasized values in maximizing short term profits through increased stock prices, and placed little value on the creditors, employees, and investors.

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<sup>13</sup> <http://accounting.cba.uic.edu/Enron/Admin/Notes%20-%20Ram.PDF>

<sup>14</sup> <http://www.chron.com/cs/CDA/story.hts/special/enron/1125793>

<sup>15</sup> [http://www.consumerfed.org/enron\\_auditor\\_pr.PDF](http://www.consumerfed.org/enron_auditor_pr.PDF)

<sup>16</sup> <http://www.wsws.org/articles/2004/feb2004/skil-f24.shtml>

<sup>17</sup> <http://abcnews.go.com/sections/pdf/layletter020115.pdf>

Enron violated many laws while seeking to maximize profits. They violated most of the anti-fraud, reporting, books & records, and internal controls of the federal securities laws<sup>18</sup>. They also violated the SPE (special purpose entity) accounting rules which lead to a major restatement of records, and their eventual downfall. They pushed and stretched many other accounting rules to reflect a better financial position than Enron was actually in.

*“The darkest hour in any man's life is when he sits down to plan how to get money without earning it” – Horace Greeley.*

What could Enron have done to correct this problem before it happened? As it turns out, many things; but mainly the removal of the conflicts of interest, simplification of partnerships, and a stronger board of directors. By removing the conflicts of interests and the ability to create SPEs, many of Enron's problems would not have been created. Enron allowed Andrew Fastow to control two SPE's that were knowingly connected to Enron, gave him an opportunity to abuse his power. Allowing Chewco to be owned by the wife of an Enron manager opened up even more conflicts of interests. Moving these companies off to a separate individual with little or no ties to Enron would have reduced the likelihood that this scandal would happen, if at all. Enron also had conflicts of interest with Andersen Accounting. Enron should have hired Arthur Andersen to strictly work on either their books, or their financial audits; but not both. This would have given a “big brother” sense for Enron's accounting, which could have eliminated the possibility of Enron pushing numbers around.

Complex partnerships with SPE's and other companies were also an area where Enron could have changed. Although major corporate partnerships will always

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<sup>18</sup> [http://www.consumerfed.org/enron\\_auditor\\_pr.PDF](http://www.consumerfed.org/enron_auditor_pr.PDF)

inherently be complicated; the complicity that the typical Enron partnership had was strides above this. By reducing this complexity, the ability to push around and hide debts would have been greatly reduced, including the ability to hide this information in their financial statements.

The board of director's for Enron also needed to change. They were well aware of the conflict of interest arisen in the LJM partnerships that Andrew Fastow wanted to run, as so was Wall Street<sup>19</sup>, but did little to prevent him from actually managing those partnerships. They eventually had him step down, but not until after those deals were completed. A board of directors needed to be created that carefully considered what Fastow was asking for and make a decision in the best interests of the company, not for themselves or Fastow's own personal gain.

### **(V) The lessons to be learned from Enron**

Many different companies committed the cardinal sin in this case: they let their personal motives interfere with good business sense, and created a conflict of interest. Enron executives placed their own personal wealth above the welfare of the company and the stockholders. Personal gain, greed, lack of ethics, and a general feeling of being above the law were the factors that brought down Enron.

Enron was able to conceal its losses and create imaginary profits by creating ghost companies such as raptor. These companies shuttled money from banks to Enron, who reported it as profit. This is legal as long as 3% of the capital is contributed from outside sources. When Skilling had invested his own money to do this, it should

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<sup>19</sup> <http://www.chron.com/cs/CDA/story.hts/special/enron/1125793>

not have been considered outside capital. The Arthur Andersen firm overlooked this factor most likely because of their involvement in keeping Enron's books, and the size of Enron itself.

After time had elapsed and earnings were restated, an investigation ensued, resulting in prison sentences for some, the collapse of 2 businesses (Enron and Andersen), and enormous fines in the hundreds of millions of dollars. These small repercussions do not come close to the financial backlash of the Enron collapse and the total damage of the ordeal estimated over 100 billion dollars.

The moral theories or frameworks that apply to this case are the utilitarian, fairness, common good, and agency approach. All of these theories apply to this case; unfortunately each moral choice that was made regarding these theories has been the incorrect choice. The choices made should serve as how not to make ethical choices. Enron has yet to see a single example of an Enron executive making a decision which is ethically sound, and in the best interests of the company and its stockholders outside of the whistleblower Sherron Watkins.

Among these various lessons that have been learned from this case, it is absolutely essential that the financial disclosure system, SEC laws and regulations undergo dramatic reconstruction. Due to accounting frauds of organizations such as Enron, the SEC has begun to take great steps in preventing loopholes within the accounting and financial disclosure system. The Financial Accounting Standards Board has started to establish regulations and standards that are more direct and understandable to organizations. The SEC has also begun to re-evaluate the 1995 Private Securities Litigation Reform Act, which relaxed the restrictions that essentially

would have monitored the behaviors that led to the collapse of Enron. Many government officials have also taken steps towards creating more laws against unethical acts that are committed within large corporations. Many government officials show great concern amending all non-auditing services. Due to the accounting frauds that occurred in the Enron scandal, several accounting firms have begun reorganizing their employees towards remaining loyal to the ethical standards demanded by the SEC. These firms are taking an initiative of alternating auditors, as well as adhering to a continuous review process of every auditing report. There needs to be some form of regulation of ownership of both auditing and consulting services by the same accounting firm. The Enron case illustrates a number of flaws in the reporting system, which needs to undergo thorough re-evaluation and criticism before making any immediate alterations.

Essentially most of the problems faced by Enron derive from the immoral and unethical actions taken on by the board of directors in their attempt to achieve personal profits. In order to prevent these unethical acts from occurring, there needs to be an enormous emphasis on the truthfulness and integrity of executives. In order for companies to prevent an Enron-like scandal, there needs to be supervision over managers and executives as they exercise their own business judgments about what is in the best interest for an organization.

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### Group Activity Log

<b>Case Study 1: Enron</b>	<b>Group Members</b>		<b>Group member's Responsibilities</b>
	Jennifer A. Buondonno		Research, 1-5 compile report, edit and design PowerPoint presentation
	Nirmala David		Research 1-5, compile report, edit and design PowerPoint presentation
	Robert Pufky		Research 1-5, compile report, edit and design PowerPoint presentation
	Matt Rollings		Research 1-5, compile report, edit and design PowerPoint presentation
<b>Meeting Dates</b>	<b>Meeting Type</b>		<b>Time Spent</b>
12/12/04	Physical		30 minuets
12/14/04	Online	Throughout day/evening	Group Members Participating in Meeting
12/23/04	Physical	90 minutes	Jennifer, Bob, Nim
12/24/04	Online	Throughout day/evening	All members
12/27/04	Telephone	45 minutes	Matt, Jennifer
12/27/04	Email	Throughout day/evening	Bob, Matt
12/29/04	Email	Throughout day/evening	Jennifer & Bob
12/30/04	Online	Throughout day/evening	All Members
01/02/05	Online	Throughout day/evening	All Members
01/03/05	Physical	3 hours	All Members
01/03/05	Email	Throughout day/evening	Jennifer, Matt, Nim
01/03/05	Physical	3 hours	Nim & Bob
01/03/05	Physical	1 hour	All Members
01/03/05	Telephone	30 minutes	Jennifer & Matt
01/04/05	Online	Throughout day/evening	Jennifer, Bob, Matt
01/05/05	Physical	2 hours	Bob, Nim
01/05/05	Physical	3 hours	All Members