**ENRON’S TENTH ANNIVERSARY: THE CRIMES**

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Many of us if asked to recall the details of a past crime or injustice would be hard pressed to do so. Similarly, today’s young accountants all have heard about Enron as example of financial reporting failure. However, as the years pass, the details of this accounting crime also have faded. The tenth anniversary is a time for remembrance.

On November 8, 2001 [Enron filed form 8-K](http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/h91831e8-k.txt) to confess its accounting failures to the world. Even after a decade, we find the document interesting to read.

Enron opened the Form 8-K with a background statement about its special purpose entities (SPEs). Essentially the company defended its use of SPEs such as LJM1 and LJM2 because “many other companies” also employ SPEs. It then stated that a special committee would investigate whether they were used appropriately.

Let’s review the operation of SPEs and their accounting. Generally, SPEs are intermediaries between a corporation and a group of investors, usually creditors. The creditors lend money to the SPE, and the SPE in turn transfers cash to the corporation (sponsor). Simultaneously, the sponsor transfers assets to the SPE. As these transferred assets generate cash, the SPE then pays off its debts to the creditors.

SPEs serve two purposes, one legitimate and one not so legitimate. The legitimate purpose of the SPE occurs when the corporation dedicates assets to the SPE of sufficient quantity and quality to entice creditors to give the SPE a loan at a favorable interest rate. The creditors willingly do this because supposedly there is less credit risk in the SPE due to the asset coverage. Unfortunately, however, business enterprises also have employed SPEs to hide debt, because generally accepted accounting principles historically allowed firms to conceal the liability. While this treatment has generally been eliminated today, exceptions still are allowed. The FASB and the SEC could have closed this loophole decades ago but have chosen not to do so.

The rule that governed SPE accounting for Enron was [EITF 90-15](http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820913888&blobheader=application%2Fpdf). This EITF, which applied initially to leasing SPEs, stated that at least three percent of its total equity must come from an independent, outside source. If not, then the sponsor should consolidate the operations of the SPE with its own results. The effect of a consolidation is that the sponsor treats the transaction as a securitized borrowing; otherwise, a gain or loss is computed and the debt is off balance sheet.

The November 8, 2001 8-K also informs the reader that Enron needs to restate its financial statements from 1997 up to and including the second quarter of 2001 for several reasons. First, some restatement is needed “to reflect its conclusion that three entities did not meet certain accounting requirements and should have been consolidated.” However, the main requirement that was not met was the three percent threshold. In the next three paragraphs of the filing, Enron identified the three entities requiring consolidation as Chewco Investments, JEDI, and LJM1.

Enron also confesses that Chewco is a related party, which is significant because business enterprises have disclosure obligations for related party transactions. Related party transactions occur when the firm participates in a transaction with another entity or person that is not at “arms length.” In other words, the business enterprise transacts with another party that is somehow related to it, such as between a parent company and its subsidiaries, between a corporation and its pension plan, or between a firm and its managers. Because the firm might not engage in transactions with related parties that are truly arms-length transactions (for example, Fastow and others were accused of engineering some transactions to the detriment of Enron while enriching themselves), the FASB requires in FAS No. 57 that the entity disclose the related party transactions, including the dollar amounts involved. LJM1 and LJM2 were run by and partially owned by top managers within Enron, so the creation of these limited partnerships and the subsequent transactions between Enron and the limited partnerships constituted related party transactions. Enron’s disclosures about these related party transactions were cryptic, obscure, and made it very hard for a reader of the financial statements to discern their true nature. The November 8, 2001 filing admitted the nature of the transactions involved related parties but said little else at that time.

On page 9 of the 8-K Enron further described LJM1 and LJM2 as limited partnerships. Besides the issue of consolidation, the firm discussed the management issue and implied that Andrew Fastow had improperly sold his interests in LJM1 and LJM2 to Kopper and they did not seek the directors’ approval of various transactions. The filing then laid out these transactions: sales of assets to and from these entities; purchases of debt and equity interests by LJM1 or LJM2 into Enron’s SPEs or other affiliates; sale of a call option and a put option on physical assets and a subordinated loan to LJM2. The filing then provided details on these and related activities.

The 8-K filing further states that Enron was an investor in JEDI and should have consolidated those activities into Enron’s financial statements. Apparently, the company used the equity method to do the accounting, which is an off-balance sheet technique that hides the investee’s liabilities from readers of the financial reports.

Another restatement focused on Enron’s faulty accounting of improperly recorded $1.2 billion note receivables. These notes arose from LJM2’s investments in “four SPEs known as Raptor I-IV” in which they promised to ante up some assets in the future for a current equity claim in the limited partnership. Reporting these notes receivable as assets on the balance sheet, however, was clearly a violation of generally accepted accounting principles. Whenever there is subscribed stock for corporations or subscribed equity interests in partnerships, the SEC requires the subscription receivable to be reported as a contra stockholders’ equity account, i.e., it must be deducted from the enterprise’s stockholders’ equity. The rationale for this regulation is that state laws generally do not require subscribed stockholders or subscribed partners to pay off the notes. If these stockholders or partners do not pay off the note, state laws generally stipulate that they have no claims to the equity of the business. Given these rules, Enron should not have reported the receivable on the asset side of the balance sheet. Enron actually corrected this irregularity in a public statement on October 16, 2001 but discussed it more fully in the November 8 filing.

Further, Enron entered into various energy contracts that were connected with these note receivables and “could have obligated Enron to issue Enron common stock in the future in exchange for notes receivable.” But, Enron did not apply fair value measurements to these energy contracts. At the risk of oversimplifying the accounting, the rules require entities to report such contracts on the balance sheet at fair market value. When the firm holds a long position in an energy contract and energy prices rise (fall), then the balance sheet reports these contracts at higher (lower) amounts and the unrealized gain (loss) is placed in the income statement. The opposite is true when the company maintains a short position in the energy contract. Enron then said it was recognizing a $1 billion write-down in the third quarter of 2001 because of its energy contracts.

The net effect of these schemes is that Enron greatly underreported its debts and provided opaque disclosures about its business. When the investments of Enron and its subsidiaries and its limited partnerships went south, the underreported assets evaporated, leaving only the underreported liabilities. It is not surprising that these many foolish transactions and unconscionable shenanigans led the Company to bankruptcy on December 2, 2001.

Enron’s managers duped the rest of us. How and why the auditors, the board of directors, and credit rating agencies failed to protect the investment community is still debated today. What is clear is that we probably are no better off than we were then. Yes, we have Sarbanes-Oxley, but what of it? We also have endured a banking crisis that Sarbanes-Oxley was supposed to circumvent. Dodd-Frank likely will prove just as ineffective.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*