Enron

Presentation Outline

- Early Life of Arthur Andersen
- Enron—The Greatest Company in the World
- The Fall of Arthur Andersen
- Address Case Questions
- Additional Academic Sources—Lucci, Copeland

Early life of Arthur Anderson

- Founder is son of Norwegian immigrants
  - John and Mary Anderson
- Plano, Illinois
  - Also known as Norway, Illinois
- Arthur was born in 1885
  - Fascinated by numbers at a young age

Early life of Arthur Anderson

- Discipline, honesty, and a strong work ethic
  - Keys traits that John and Mary Anderson instilled in Arthur
- Arthur was orphaned at a young age
- High School Career
  - Worked a full time job and attended evening classes

Early Professional Life of Arthur Anderson

- College Career at University of Illinois
  - Worked as accountant for Allis-Chalmers while attending class
- Accepted entry level job at Price Waterhouse
  - Firm was first organized in Great Britain
- Youngest CPA in the state of Illinois
  - At the age of 23

Early Professional Life of Arthur Anderson

- Established partnership to provide accounting, auditing, etc.
  - Anderson, Delany & Company
- Delany left to go his own way
  - **Arthur Andersen & Company was established**
- 1915- Arthur faced his first professional dilemma
  - “Subsequent event” – disclosed in footnotes of the FS

Arthur Anderson & Company

- Dilemma with DuPont two decades later from first dilemma
  - Dismissed as their auditor for not agreeing with DuPont
- Anderson was opinionated, stubborn, and "difficult"
  - "Think straight, talk straight"
- Critics admitted that Anderson was point-blank honest
  - 100% integrity or be fired by Anderson

Arthur Anderson & Company

- Arthur created a niche for firm
  - Various energy industries
- Early 1930's, firm was a thriving practice
  - Leading regional firm in the Midwest
- Great Depression hit hard on Arthur's clients
  - Arthur Anderson convinced banks to keep funding his struggling energy clients

Arthur Anderson & Company

- Arthur Andersen gained respect from leading financial executives
  - Increased referral of clients outside of Midwest
- Arthur was a spokesperson for his discipline
  - Lobbied for continuing professional education (CPE) requirement
- Arthur died in 1947
  - Left behind a firm that employed 1,000 plus accountants

Arthur Anderson & Company

- Leonard Space was the successor of Arthur
  - Earned a reputation as a no-nonsense professional
- Openly criticized the profession for sloppy standards
  - Accounting Principles Board (APB) established in 1950
    - Replaced with Financial Accounting Standards Board (FASB)
- Arthur Anderson & Co. established world’s largest private university
  - Arthur Anderson & Co. Center for Professional Education

Arthur Anderson & Company

- Leonard Space's strong leadership and business skills
  - Retired in 1973- arguably the most respectable firm in world
- Three decades later Arthur Anderson & Company:
  - Employed 80,000 professionals
  - Offices in 80 plus countries
  - Annual revenue was $10 billion
- In late 2001
  - Faced the biggest crisis in firm's history

ARTHUR ANDERSEN

The World's Greatest Company

- Northern Natural Gas Company
  - Founded in Omaha, Nebraska, in 1930
- Principle investor
  - Included a Texas-based company, Lone Star Gas Corporation
- Northern struggled with gaining customers
  - Home "explosions" caused by natural gas drove away customers

The World's Greatest Company

- During Depression Northern gained customers
  - "Cold stricken and shallow-pocketed"
- Experienced unlimited source of cheap labor during Depression
  - Allowed Northern to develop pipeline grid in Midwest
- Company became listed on New York Stock Exchange in 1947
  - Helped with meeting capital requirements

The World's Greatest Company

- During 1970, Northern became principle investor in Alaskan pipeline
  - Tap into Canada's natural gas reserves
- In 1980, Northern changed its name to InterNorth, Inc.
  - Expanded scope to oil exploration, chemicals, and coal mining
- In 1985, InterNorth purchased Houston Natural Gas Company
  - $2.3 billion and acquired 40,000 miles of pipelines

The World's Greatest Company

- In 1986, InterNorth changed its name to **Enron**
- Kenneth Lay was chosen as CEO
  - Former chairman of Houston Natural Gas
- Lay adopted aggressive growth strategy
  - Hired Jeffery Skilling as top subordinates

The World's Greatest Company

- During the 1990s, Skilling created a plan to transform Enron
  - Energy-trading company
- In early 2001, Skilling became CEO
  - Lay retained the title of chairman of the board

The World's Greatest Company

- Enron's 2000 annual report
  - 60 percent increase in transaction volume
- Increase fueled by EnronOnline
  - B2B (business to business) electronic market place for energy industries
- EnronOnline processed more than $335 billion of transactions
  - Largest e-commerce company in the world

The World's Greatest Company

Exhibit 1

ENRON'S REVENUE BY BUSINESS SEGMENT (BEFORE RESTATEMENT): 1995-2000[1]

	1995	1996	1997	1998	1999	2000
Exploration and Production	8.3%	6.2%	4.4%	2.8%	1.3%	0.4%
Transportation and Distribution	8.8%	5.5%	7.0%	5.9%	5%	2.9%
Retail Energy Services	4.4%	3.9%	3.4%	3.4%	4.5%	4.6%
Wholesale Energy Operations and Services	83.7%	89.6%	88.9%	88.7%	90.5%	94.2%
Corporate and Other	0.2%	0.1%	0.3%	1.7%	1.8%	(2.1%)
TOTAL REVENUE[2] US$ million	**$9,189**	**$13,289**	**$20,273**	**$31,260**	**$40,112**	**$100,789**

The World's Greatest Company

- January 2001
  - Lay's ultimate goal for Enron was to be " The World's Greatest Company"
- June 2001
  - Skilling was singled out as "the No.1 CEO in the entire country"
  - Enron was hailed as "America's most innovative company"
- Skilling was known for brassy, if not tacky comments.

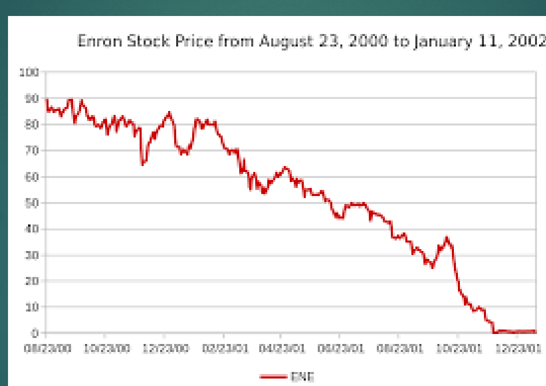
The World's Greatest Company

- Throughout 2001, Enron's stock price drifted lower
  - Stock price went from $80 to mid-$30
- Third quarter for Enron
  - Mysterious $1.2 billion reduction in owner's equity
- Reversal transaction
  - Notes Receivables shouldn't have been recorded as assets, but as a reduction of owner's equity.

The World's Greatest Company

- October 16, 2001 press release
  - Wiped out $600 million of profits. Stock price plummeted.
- December 2, 2001
  - Pressure from creditors, pending litigation, and investigations forced Enron to file bankruptcy.
- Largest corporate bankruptcy at the time(WorldCom- $100 Billion)
  - $60 billion loss to shareholders

The World's Greatest Company



The World's Greatest Company

- Jeffrey Skilling sudden and unexpected resignation as CEO
  - Suspicious
- Suspicion prompted Sherron Watkins(VP) to write a letter
  - Addressed to Kenneth Lay
  - Asked questions regarding the accounting decisions
- Letter made public

The World's Greatest Company

- How did they hide so much loss?
  - Use of complex transactions
- Enron created dozens of limited partnerships
  - Called SPE's or special purpose entities
- Creative names of these entities
  - Braveheart, Rawhide, Raptor, Condor, and Talon
  - CFO named a few of these entities after his children

The World's Greatest Company

- What was the motivation behind creating an SPE?
  - "debt avoidance"
- Throughout the 1990's
  - Companies took advantage of SPE's minimal legal and accounting guidelines
- Diverted massive amounts of their liabilities to off-balance sheet entities

The World's Greatest Company

- Sold assets at grossly inflated prices to their SPEs
  - Allowed larger "paper" gains
- Profits inflated by unrealized gains on increases in the market value of it's own common stock
- Primary motivation for extensive SPE use
  - Growing need for capital during the 1990s
  - Financing company transformation

The World's Greatest Company

- Need to sustain Enron's stock price at high level
  - SPEs included "loan triggers"
  - Required to provide additional stock, cash payments or restructure prior transactions
- Worst-case scenario
  - Dissolve SPE, merge assets and liabilities into consolidated financial statements

The World's Greatest Company

- SPEs had large losses on assets purchased from Enron
  - Forced to pour additional resources to SPEs
- Self-dealing by Enron officials in operation of SPEs
  - Fastow realized $30 million in profits while CFO
  - Several friends earned $1 million in profit from investment of $5,800 in as little as 60 days

The World's Greatest Company

- October 2001, Management assumed control of troubled SPEs
  - Incorporated financial statement data into Enron's consolidated financial statements
- New financial statements, new outcome
  - Large loss reported by Enron in Fall 2001
  - Restated company's earnings for previous 5 years
- December 2001, Enron filed bankruptcy

The World's Greatest Company

- Public firestorm of anger and criticism
  - Corporate culture of rule-breaking, arrogance, and intimidation
- Fifth amendment right of self-incrimination
  - Invoked by Kenneth Lay and Andrew Fastow
- "I am not an accountant"
  - Jeffrey Skilling's defense against questionable accounting tactics

The World's Greatest Company

- Numerous Enron Officials faced criminal indictments
  - Andrew Fastow, Jeffrey Skilling, and Kenneth Lay
- Andrew Fastow pleaded guilty to conspiracy to commit securities fraud and other charges
  - 10-year prison term—shortened to 6 years after testifying against Skilling and Lay
  - Required to forfeit $25 million of personal assets accumulated while at Enron

The World's Greatest Company

- Skilling and Lay convicted on multiple counts of fraud and conspiracy in May 2006
- Jeffrey Skilling sentenced to 24 years in prison
  - Shortened to 14 years in 2013
- Kenneth Lay died of a massive heart attack in June 2006
  - Federal judge overturned conviction
  - Lay no longer able to appeal

The Fall of Arthur Andersen

- Lack of answers from Enron leads to Arthur Andersen dismay
  - Why had audits failed to result in more reliable financial statements?
- Unqualified opinions issued
  - How could this happen on faulty financial statements?
- Andersen knew about Watkins complaint
  - Began to review previous decisions made by Enron

The Fall of Arthur Andersen

- Aware of Enron's rapidly deteriorating financial condition
  - Highly involved in restructuring certain SPEs to qualify as unconsolidated entities
- Made an error on SPE transaction
  - Promptly notified Enron to correct it
  - 20% of $600 million restatement was due to this item
- One-half of SPE minimum 3% external equity contributed by Enron
  - Does not qualify for SPE treatment
  - 80% of $600 million restatement was due to this item

The Fall of Arthur Andersen

- Joseph Berardino, CEO, right before firm swamped by criticism
  - Implied Enron's lack of honesty on SPE exempted Andersen of responsibility for accounting and financial reporting errors
- Only minimally involved in transactions
  - Resulted in $1.2 billion reduction of owner's equity
- 2001 financial statements had not been audited yet
  - Do not audit quarterly financial statements—not required

The Fall of Arthur Andersen

- First source of Criticism: Scope of Services
  - Offering a large product line of services to audit client
- Earned $52 million in fees from Enron
  - Only $25 million resulting in audit fees
- Jeopardizes independence
  - Receiving $1 million/week—objectivity disappears

The Fall of Arthur Andersen

- Second source of criticism: SPE-related transactions
  - Highly involved in aggressive accounting and financial reporting
- Third source of criticism: Shredding of Enron audit documents
  - Houston office destroyed a significant amount
  - Obstruction of Justice—incriminating evidence of role
- Criticism by Enron top management
  - Discharged Andersen as independent audit firm
  - Justified decision by referring to destruction of documents

The Fall of Arthur Andersen

- Berardino insisted poor business decisions were result of Enron's downfall
  - Resigned in March 2002 after failing to negotiate merger with Big Five firm.
- Dozens of clients dropped Andersen as independent audit firm
  - Mid-April 2002—laid off more than 25% of work-force
- David Duncan—Enron Audit Partner, pleaded guilty to obstruction of justice
  - Testified against Anderson

The Fall of Arthur Andersen

- June 2002, Federal Jury found firm guilty of obstruction of justice
  - Forced to terminate relationship with clients
  - Three years later, Supreme Court overturned decision—little too late
- Tainted and embarrassed every accountant
  - Public outcry to strengthen independent audit function
  - Improve accounting and financial reporting practices

Stricter Accounting Regulations

- FASB imposed stricter accounting and financial reporting guidelines on SPEs
  - Require most companies to include financial data in their consolidated financial statements
- Sarbanes-Oxley Act of 2002
  - Strengthen financial reporting for public companies
  - Improving rigor and quality of independent audits
  - Limits types of consulting services auditors can provide to clients
- Public Company Accounting Oversight Board (PCAOB)
  - Oversee independent audit function for SEC registrants

Question 1

- **The parties most responsible for Enron's crisis**
  - The Board of Directors in Enron
    - Kenneth Lay, Andrew Fastow and Jeffrey Skilling
    - Used aggressive growth strategy
    - Focused on enhancing Enron's operating result
    - Ignored the warning from Sherron Watkins
    - The conflicts between executives goals and stockholders interests

Question 1 Cont.

- Internal Audit Committee in Enron
  - Used SPEs to maintain their paper work healthy
- External Auditor, Arthur Anderson & Co.
  - Questioned about the independence of the external auditor
  - Should've noticed the suspicious in the Enron's financial report
  - Ignored Enron's misstatement in order to keep the clients

Question 2

- **Three types of consulting services that audit firms are now prohibited from providing to clients that are public companies**
  - Design of Accounting System
  - Review the Financial Statement
  - Provide Tax Consulting Services

Question 3

- **Do you believe that Andersen's involvement in those decisions violated any professional auditing standards?**
  - Independence
  - Internal Control Evaluation
  - Supervision
  - Reporting

Question 4

- **Which party "owns" audit work papers: the client or the audit firm?**
- Audit Firm
- Audit Work paper
  - Record of the audit procedures
  - Evidence of the audit procedures
  - Summary of the audit research
- Key Requirements
  - Must accordance with GAAP
  - Must disclosure if the information are not enough
  - Must issue an opinion or noted in the report when auditors can not state an opinion

Question 5

- **Five recommendations made to strengthen the independent audit function following the Enron scandal.**
- Established the independence by the audit firm
- Limited the audit firm from providing other non-audit services
- Require the company to change their independent audit firm periodically
- Require the independent auditors working more closely with the client's audit committee
- Prohibit client's executives from interfering with the independent auditor's work

Question 6

- **Has there been a shift of "professionalism" in public accounting? If so, explain how it has evolved over time.**
- Culture Shift
  - Non-disclosure of material misstatements—after SOX now required
- Changes in Regulation
  - Biggest reason for mandated professionalism
  - Independence with non-consulting services keeps firms cordial with clients

Question 7

- **What responsibilities, if any, do audit firms have with regard to the quarterly financial statements of their clients? In your opinion, should quarterly financial statements be audited?**
- No true responsibility unless client requests it
- In an ideal world quarterly financial statements would be audited
  - Realistically—this is not feasible
- Reviews of quarterly financial statements more likely
  - Ensure following appropriate accounting procedures

The Bankruptcy Heard Around the World - Lucci

- No longer self regulated
  - PCAOB and Audit Committees
- CEO confirmation of Financial Statements
  - 6 certification questions
- Increased power of the SEC

Post Enron Challenges for the Auditing Profession - Copeland

- 3 main challenges
  - Doing what auditors do better
  - Managing litigation costs
  - Attracting and retaining the best talent
- Investors should be skeptical

Conclusion

- Enron aggressive management strategies lead to their downfall
  - Use of SPEs and questionable accounting methods
- Arthur Andersen's lack of integrity and professionalism lead to their disbandment
- Sarbanes-Oxley was passed in response to the issues at Enron and Arthur Andersen
  - Importance of internal control is now seen as significant for operations
  - Consulting services limited
- PCAOB was created to help enforce new regulations

Questions?

References

- Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley
  - John Paul Lucci
- Post Enron Challenges for the Auditing Profession
  - Jim Copeland