Enron & Arthur Anderson: to comply is not enough

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Introduction

William Harris coined the term ""sprignal"" (spurious signal) in his investigation of strategic deception at RAND, drawing upon Roberta Wohlstetter's application of information theory to analyse the task of intelligence analysts as one of identifying signals amidst background "noise." Harris expanded that model to signals, "sprignals", and noise.

Enron Corp. mimicked this model of strategic surprise in which deliberate "signals" designed to lull or defeat warning systems were issued in ever increasing volume. These signals took a variety of forms such as "designer investment" vehicles, obscured financials, and corporate pronouncements. Enron's auditor, Arthur Andersen, alternatively abetted the creation of these signals or validated them as genuine.

This is a two-part story of those who generated those "sprignals", those who were taken in by them, and those that were powerless to halt them.

Part One

Spurious Signals – The Culpable, Gullible and the Hobbled

"Enron robbed the bank, Arthur Andersen provided the getaway car, and they say you were at the wheel," Rep. Jim Greenwood, R-Pa. to David Duncan, former lead-Andersen auditor for the Enron account

Enron Corp.

The Enron scandal is essentially a story of executives and auditors deceiving investors about the true state of its business. The complexity of Enron's business -- becoming less an energy trader and more of a publicly traded hedge fund, even an Internet bandwidth provider -- created extraordinary opportunity to obfuscate and conceal. This energy-trading giant became the largest US corporate bankruptcy by using a web of hundreds of complex partnerships to shield more than $1 billion in debt from investors and the Securities and Exchange Commission (SEC). Its long-time auditors, Arthur Andersen, certified the firm's financial statements.

The Powers Committee, the special panel of Enron directors that examined the company's off-balance-sheet partnerships, was unable to ferret out the truth about Chewco Investments, the off-balance-sheet partnership that finally forced Enron to slash its net income, add debt, and all but ensured its bankruptcy. A diagram of Chewco was said to make "IRS instructions seem like, say, directions for making toast." Four special purpose entities, known as the Raptor vehicles, enabled Enron to hide massive losses, while a partnership, Southampton Place, provided high returns to selected Enron executives.

The analyst community - guardians asleep

Testifying before a US Senate Governmental Affairs Committee on February 27, 2002, a blue ribbon group of sell-side, buy-side, and independent analysts painted two startlingly different opinions of Enron's financial monitoring and an analyst's operating environment.

Despite their professed independence and variations in technique, nearly every Wall Street sell-side analyst reached the same, wrong, conclusions about Enron in 2001 up to the eve of its bankruptcy on December 2, 2001 -- when it was too late to respond or rescue. As of October 18, all 15 analysts tracked by Thomson Financial/First Call rated Enron a "buy" with 12 of the 15 rating it a "strong buy." 11 of the 15, along with 3 "holds" and only 1 "strong sell," still recommended buying Enron stock as late as November 8 when Enron disclosed that nearly five years of earnings would have to be restated.

Anatol Feygin, an analyst for J.P. Morgan Securities, had his colleagues from Lehman Brothers, Inc., Credit Suisse First Boston, and Citigroup Salomon Smith Barney nodding in unison with the observation that, "We have very different methods and approaches and we all reach our conclusions based on our own independent analysis."

Feygin's testimony was representative of his colleagues when he said,

"Prior to issuing my report and my initial "Buy" recommendation on Enron stock, I conducted extensive research tapping all available public sources of information. This process lasted close to a year. I met with Enron senior management and other personnel in the wholesale and retail energy businesses of the company. I was impressed at the outset with Enron's business model and its management team. The rapidly deregulating energy markets offered Enron tremendous opportunity to grow earnings through the application of its innovative business model."

The odds of twelve analysts all reaching the same independent "buy" conclusion are estimated to be 100:1 against. All sell-side analysts believed that Enron's core business was sound; its business model was portable to other markets beyond energy, and its management team "deep and talented."

Senators were "agog" at the willingness of these analysts to recommend Enron shares even as valuations fell from roughly $90 per share to about $30, where it stagnated until Enron reported a $1 billion write-off and a $1.2 billion reduction in shareholder equity. All sell-side analysts avoided responsibility for missing the call, saw no reason to change their view of Enron, and instead blamed the lack of "complete and accurate information" from Enron and its auditor, Arthur Andersen.

Buy recommendations are Wall Street's rule. Thomson Financial/First Call says that Wall Street analyst recommendations are "roughly one-third strong buy," one-third "buy" and one-third "hold" with less than 2% being "sell" or "strong sell" and that analysts' recommendations "were at their most positive levels at the peak of the market in the spring of 2000."

Wall Street analysts stretched listeners' credulity when stating that they felt no pressure from the investment banking side of their securities firms. And, when asked if they were aware of their own firm's equity positions, or their role in underwriting Enron equity or debt, all said that they "only knew what they read in the newspapers."

Independent research houses, buy-side analysts, and non-profits painted a contrary opinion: red flags aplenty available early in 2001, massive and inherent conflicts of interest between analysts who recommend stocks and investment bankers who advise companies and sell securities, outright pressure from their own firms or from Enron to recommend the stock, and compromised relationships between analysts and the firms they cover. Wall Street analysts went so far as to reverse an industry norm to not "buck the trend."

This author had called Enron the "last dot.com" and that was reflected in Wall Street analysts' comments that Enron's meteoric share price rise and fall was "principally a broadband bubble." These analysts were recommending Enron's stock in spite of the trend -- a trend that evidenced no "bounce in the business [or] a shift in the trend." Howard Schilit, president of the Center for Financial Research & Analysis, observed that, "For any analyst to say there were no warning signs in the public filings, they could not have been reading the same public filings as I did."

Considering a page from European experience

Still to be decided is how to protect investors against such deception in the future. This author believes it necessary to increase oversight of auditors and to increase transparency of transactions. It is not enough to comply, to merely perform the letter of the law and GAAP accounting. All players in the capital markets need to (re)instil a sense of ethics akin to those that founded Arthur Andersen. When investors have timely, valid information, they do a good job protecting themselves by punishing the share price of bad firms, but they depend upon trust and probity in the operation of capital markets to secure and disseminate that information.

The complex nature of US firms makes it difficult to plug every loophole and remedy every possible deception with a new rule. There are two transatlantic schools of thought in rule setting. The US has typically opted for precise rules rather than broad principles, i.e. defining precisely how to deal with each and any situation whereas the Europeans tend to define general principles and let auditors decide how to apply them. The SEC commissioner, Harvey Pitt, observed, "the current system of disclosure is designed to avoid liability, not to inform anybody." A US rule requiring an item to be shown if it exceeds 5% gives mischief-makers an opportunity to strive for 4.99%.

The European Commission's commissioner for internal markets, Frits Bolkestein, noted, "Having rules is a good thing, but having rigid rules is perhaps not the best thing. You must give an accountant certain latitude to use his judgment. It's not merely a question of ticking boxes." The US environment needs less legalese and more leeway, under strict accountability, for auditors and corporate executives to explain the true health of a company. How that is to be achieved will be a hot topic of debate.

It remains to be seen if the Enron affair will encourage better behaviour. Some companies such as General Electric (US) are responding with more disclosure than the law now requires. Savvy investors could pursue a portfolio strategy recently recommended by the National Bureau of Economic Research that is based upon "purchasing shares in companies with the strongest investor protections and selling short those firms with the greatest management power." This strategy earned a return substantially above that of the general market. Self-interest from the accounting profession, publicly audited firms and their management, and legislators was already regrouping to resist cries for reform but it may yet be overcome by the pressure of the unfolding WorldCom disclosures, which once again include Andersen as its auditor

Part Two

Mixed Signals – Sins of Omission and Commission, Cooptation and Valor

Arthur Andersen under the lens

Andersen had already been implicated in fraud at a major client, Waste Management, leading to SEC fraud accusations. Seeming to have learned little from the experience, the firm settled without admitting wrongdoing, did not discipline auditors penalised by the SEC, even allowed one of those auditors to write the document-retention policy that became a central issue in its Enron trial. Federal prosecutors argued that Andersen began its October document shredding campaign to avoid violating its probation agreement with the SEC in 2001 -- a violation could cause a revocation of Andersen's license to practice.

Andersen knew Enron employed risky accounting methods but decided in February 2001 to stick with a client generating $52 million in 2000 revenue. Andersen displayed a blend of commission, omission, and disagreement in its relationship with Enron. Andersen's misgivings about Enron's business practices rose in third quarter 2001 as Andersen's Professional Standards Group (PSG) of internal consultants and the Enron audit team clashed over the energy trader's frequent attempts to push the bounds of generally accepted accounting principles. Enron was even able to affect the removal of a PSG member due to his conservative accounting stances. PSG observed that all of Enron's accounting tactics had the same purpose, i.e. to increase current income and revenue and decrease or delay reporting losses or debt, yet overall, Andersen seemed less dedicated to quality audits than to maximizing revenues, where the selling of consulting services was emphasised, and auditors who excelled at that were rewarded.

An Andersen partner, and former SEC investigator, that typically intervened for Andersen when accounting problems emerged that could attract the SEC's attention learned of the Chewco conflicts in late October or early November 2001. Accounting rules dictate that for a partnership to be independent of a company with which it does deals, at least 3% of the partnership's equity must be owned by a party independent of both. When Andersen learned that Chewco had been run by a former member of Enron CFO Andrew Fastow's staff who quit Enron to help run another Fastow-created partnership, LJM2, this partner urged Enron's board of directors to restate earnings from 1997 through the first half of 2001.

Two PSG partners testified that the Enron audit team initially ignored their advice regarding four "Raptor" entities part-owned by LJM2. The Raptors helped Enron keep debt off its books while earning millions. However, the Raptors were backed by Enron stock so as share prices fell, it decreased the Raptors' ability to pay IOUs that Enron had counted as income. Two of the Raptors were financially healthier than the others, so Andersen let Enron report them as a single group -- or "cross-collateralize" them -- to camouflage the ailing entities. Eventually the Raptor losses and failure to previously count Chewco and its debts as part of Enron overtook the firm, driving it into bankruptcy.

Andersen auditors warned that a computer analysis of Enron's financial activities in the third quarter of 2001, a week before the energy company shocked stockholders with a $638 million third-quarter loss and disclosure of a $1.2 billion reduction in shareholder equity, indicated "a red alert: a heightened risk of financial statement fraud." Enron also had disclosed that the SEC was probing its books as early as October 22, 2001. A massive destruction of Enron-related documents in Andersen's hands commenced on October 23 under the guise of a procedural document retirement program. Enron's highly public financial free fall had begun.

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The accounting industry -- defiance in pin stripes

The remaining "Final Four" large accounting firms appear to have drawn a different lesson from Andersen's conviction. With Andersen gone, the accounting industry hopes that it will be allowed to proceed with minimal changes. Instead of agreeing to any meaningful reforms, they and the American Institute of Certified Public Accountants, which acts as the accounting industry's lobbying arm and self-regulatory body, have portrayed Andersen's conviction as "a serious condemnation of the firm and its practices" rather than an indication of needed reform.

Girding for congressional and regulatory battle, the accounting industry objects to provisions curtailing consulting work performed by accountancies and requiring them periodically to change the partner-in-charge of major audits. While WorldCom may erase the option of deadlock, any foot-dragging favours the SEC to enact unilateral guidelines that few legislators would openly resist.

Even before WorldCom, criminal investigations had begun against companies like Computer Associates International and Adelphia Communications while federal prosecutors are said to be considering charges against Ernst & Young auditors who certified fraudulent financial statements at CUC International. If evidence of misconduct emerges by senior officials of a Final Four firm, the push for reform will gain further momentum.

Lifting a foot from the neck of the regulators

Seizing on a potential election-year issue, both houses of Congress, Democrat and Republican, are topping one another with proposals for greater strictures on accounting firms and instilling greater powers to the SEC. These legislators are the same individuals that accepted substantial campaign contributions from accounting firms and corporations open to audit. In return, they hobbled the SEC under former Chairman Levitt to the point of threatening withholding of funding and fought back an overdue strengthening of FASB (Financial Accounting Standards Board) rules regarding disclosure.

The SEC has offered to work with both houses of Congress but has stressed the importance of having a new means of accounting oversight in place by year end -- and that includes new SEC rules if Congress has not acted. The SEC intends to replace the current system in which accountancies largely self-police with an independent monitoring body to oversee the accounting industry and discipline auditors.

SEC Chairman Harvey Pitt said, "this is not a time to be stingy with our regulatory responses to some of the chicanery and fraud" that appear to have occurred at several publicly traded companies. The SEC is suggesting new rules requiring faster and broader disclosure of company changes, mandating CEOs and CFOs vouch personally for the accuracy of their firm's annual and quarterly financial reports, and certifying that the reports include everything that "a reasonable investor would consider important." Executives found in violation would be subject to potential enforcement action by the SEC or lawsuits filed by company shareholders.

Using the "8-K" form for reporting significant events or corporate changes, firms would be required to report important changes in their operations much faster than before and to report a wider group of changes under the new rules tentatively approved by the SEC. New items that would have to be reported include the kind of off-balance-sheet transactions that helped topple Enron; unexpected departures of top

Contributing Factors

- "Go-go" bull market demands higher stock performance despite declining fundamentals
- CEO compensation disproportionately tied to share price
- "Celebrity" class of CEOs and stock analysts enjoy uncritical adulation
- Wall Street analysts' conflicts of interest
- New, increasingly opaque business models
- "Designer investment" vehicles created by external law firms and in-house counsel, often in cooperation with auditors
- Credulous acceptance of these models by analysts and investors
- Auditors' weakened oversight due to their own growth needs
- Auditors' conflict of interest in auditing and consulting to the same client
- Self-interest of allied brokerage houses and banking firms
- Congressional campaign contributions from accountancies and firms open to audit
- Congressional hobbling of public and private regulatory bodies

Outcome:

- Substitution of fraud and self-dealing for legitimate growth

executives, senior managers or directors; defaults on company debt; and "lock-out" periods during which employees are barred from selling company stock from their retirement accounts.

A lesson in effective CI

Who were the sceptics and why?

- Short-sellers seeking profit from a stock's decline
- Independent/boutique/sell-side analysts
- Consumer/non-profit groups

Despite Enron's seeming achievements (and they were many: consistent meeting of earnings targets, outstanding profits growth for many quarters, avoidance of high valuations common to the tech sector, the energy sector wasn't in recession and appeared to have long-term growth prospects, a leader in its field, and adoration on Wall Street), the sceptics looked at simple fundamentals.

Red flags to these observers included low return on capital (despite impressive earnings-per-share growth), declining margins on pretax operating earnings, increasing leverage, the valuation placed on the firm's new broadband business, large sales of stock by senior executives, hard-to-follow related party deals (deals with entities that had some link to the firm), abstruse disclosures that could not reveal how Enron made strong profits even after talking to analysts who covered the firm, and omissions (such as a gross margin number for its trading business [wholesale services] that accounted for 96% of revenue).

These Cassandras endured withering criticism, more from Wall Street analysts than from Enron itself, who proclaimed that they suffered "fundamental misunderstandings about the energy market and Enron's business model."

CI practitioners must separate signal from "sprignal" and noise, fearlessly questioning assumptions, examining motives, running the data, looking for discontinuities, and making continuous "sniff tests" as to the merits of the whole. Failure to do so will maroon you with the sell-side analysts that had long backed Enron with "unabashed enthusiasm" and were at a loss for an explanation when the stock began to collapse.

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