

## **Derivatives of a Cruel Accounting\***

October 16, 2001 began the energy trading industries' implosion. On the 16<sup>th</sup>, Enron announced record earnings growth, a nonrecurring income loss of \$1.01 billion. By the end of that day, Kenneth Lay had accepted congratulations for another great quarter in his analyst conference call, on CNNfn and, undoubtedly, elsewhere. In the conference call, a \$1.2 billion balance sheet restatement was also mentioned. Enron closed up fifty-eight cents. Enron had over \$60 billion in assets, over \$10 billion of equity book value and over \$25 billion in equity market capitalization.

On October 17<sup>th</sup>, storm clouds rose. The sources of Enron's nonrecurring losses were clear, but the \$1.2 billion related party equity restatement was not understood. Wall Street Journal reporter Rebecca Smith and others pushed for answers. In her October 18<sup>th</sup> article, Ms. Smith reported Enron's responses: "the confusion factor wasn't worth the trouble of trying to continue this," and it's " 'just a balance-sheet issue' and therefore wasn't deemed 'material' for disclosure purposes."

Technically, these statements were correct. Furthermore, I maintain that Enron's accounting, while very aggressive, was in technical compliance with audit rules. Yet, four major indictments have been handed down, there have been two individual admissions of guilt, Arthur Andersen is extinct, and the remnants of Enron were auctioned on September 25<sup>th</sup> and 26<sup>th</sup>. These outcomes are right.

Enron applied aggressive interpretations of three Statements of Financial Accounting Standards (SFAS) to greatly improve their financial accounting performance: SFAS 123, SFAS 133, and SFAS 125/140. Under Andrew Fastow's direction, Enron Global Finance abused the standards as part of their cover for fraud. The reporting and regulatory environment in which Enron's structures metastasized has not been and is unlikely to be cleaned up by more rules. Others will inevitably derive ways to circumvent legalistic directives.

Literal compliance with and misapplication of SFAS 123 and SFAS 125/140 accounting standards permitted Enron's SFAS 133 derivative fair value presentations to

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be “unfair.” Despite SFAS 123, Enron employee stock and option plan shares were allocated not to employee compensation but to support failing investments. Despite SFAS 125/140 third party investment rules, consolidation and special purpose entity standards were applied to Enron’s own equity transactions.

Enron manifest two conditions that led to their demise: Lax Board oversight and deriving income from own equity transactions. Despite knowing about poor performance in Enron’s merchant investment portfolio, the Board did not look for associated write-downs. These investments became known as “bad assets.” Instead of leading to losses and write-downs, bad assets were transferred to a related party - special purpose entity (SPEs). Simultaneously, Enron transferred undervalued Enron equity restricted shares and derivative-related claims to the SPEs. For symmetry, under valued Enron equity claims are called “good assets.” Most of Enron's non-consolidated SPE's were transfers of both bad and good assets to an SPE against receipt of cash, a note and/or other claims from the SPE.

The second and most important feature of Enron's asset management was Enron’s own equity transfers into their related parties. Even though these transfers did not create value, SFAS 133 implied that an SPE recognized a profit on such a transfer. Profits on good asset transfers covered SPE bad asset losses.\*

From the inception of the SPE transactions in 1997 until year-end 2000, Enron’s share price generally rose. Therefore, Enron stock that was transferred to the related parties got “better,” while bad asset transfers generally got “worse.”

In dissecting Enron’s collapse, actions taken on three dates stand out, December 21, 2000, March 21, 2001 and September 30, 2001. In December 2000 under SFAS 114, Raptor SPE I and III notes were “impaired.” Therefore, Enron earnings would decrease by the amount of the impairment charge, and the analysts’ consensus earnings estimate would not be met. Instead, Enron appears to have **FORCED** Mr. Fastow’s other LJM-Raptor partnerships to support Raptors I and III with their excess equity. Therefore at

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\* The Enron and LJM audit interpretations differ but had the same outcome as our interpretation: Discounted restricted shares were transferred to the SPEs and, subsequently, the restriction discount was removed in assessing “fair value.” Restricted shares with fixed maturity dates should be treated as derivatives and not follow usual audit treatment of restricted shares.

this time, someone in Enron other than Mr. Fastow or his designee, Michael Koppers, exercised control over the Raptor I and III SPEs. With this action, someone superior to Mr. Fastow broke securities laws.

As Enron's shares weakened in the spring of 2001, Raptor total losses rose significantly. On March 22, 2001, Enron's board approved massive Enron equity transfers into the Raptors. Sufficient Enron equity claims were transferred so that Enron's Raptor notes were "unimpaired."

Enron shares stabilized in the second quarter of 2001, but resumed their slide in the third quarter. By September 2001, the Raptors were down again. At that time, one of two actions was possible. Either an impairment charge was needed, or the structures would have to be unwound.

If the impairment charge had been made, Arthur Andersen's "Accounting 101" error would also have been corrected: \$1.2 billion of Enron paid-in capital surplus would be restated as "paid-in capital surplus – notes receivable." It was possible that such a restatement could have been explained to the financial press, analysts and investors. The downside of this action was that future declines in Enron's share price would lead to more losses.

Enron chose to unwind all of their Raptor, Chewco and JEDI SPEs. Few, if any, understood these changes. Attention and questions broadened to encompass all of Enron's structured transactions.

Confusion reigned until November 19, 2001 when Enron's 10-Q Report was filed and Enron met with its bankers to restructure their debt. The 10-Q Report did little to clear up market perception of Enron's state. The bank meeting revealed Enron's state in stark detail. Enron had over two times as much off-balance sheet debt as was on its balance sheet. Despite what may have been a reasonably sound North American energy business, the debt burden from Enron's past international and e-business investments drowned the entire firm.

On November 29, 2001, Enron's bankruptcy was triggered by the downgrade of its debt below investment grade. This downgrade activated a call provision in some loan

indentures, and Enron could not refund the loans. On November 30<sup>th</sup>, bankruptcy was declared.

In retrospect, the fall of some corporation, like Enron, and its related transgressions should not be surprising. Once any market peaks, some businesses will have over expanded, over committed, and been over estimated. Some times, major crimes will be committed.

Substitutes and competitors for Enron's economic activities existed and exist. Despite Enron's representations of dire consequences from its failure, other companies, regulators and politicians recognized the actual situation and did not step in to save Enron. Basically, the market as currently structured worked.

Against the possible response of re-regulating energy and other financial market sectors, I advocate leaving investors at risk to evaluate investment opportunity and allocate their capital. In line with this broad point, however, I do suggest accelerating three initiatives:

1. All claims including derivatives and insurance referenced to a firm's own equity value should be disclosed.
2. If a significant transaction is not accounted for on the same basis for both trade counter-parties, these discrepancies should be disclosed.
3. Auditor accountability must extend beyond literal GAAP- and AICPA-compliance.

These suggestions are summarized directly: any party or person who provides a valuation fairness opinion that is based on privileged information from the entity that is being evaluated cannot stand behind a set of rules as their defense against incompetence or worse.

In my opinion, Enron's statements were largely "audited in accordance with generally accepted auditing standards." Going forward, audit and other value fairness practice and opinions must conclude in a clear and active voice:

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company and its subsidiaries.