Enron's Questionable Transactions – Frauds that Ultimately Changed Corporate Governance

This case has been reproduced with the permission of Cengage Learning Inc., from *Business & Professional Ethics for Directors, Executives & Accountants*, 9e, Leonard J. Brooks & Paul Dunn, published by Cengage Learning, Inc., ©2021, ISBN: 978-0-357-44188-6.

An understanding of the nature of Enron's questionable transactions is fundamental to understanding why Enron failed. What follows is an abbreviated overview of the essence of the major important transactions with the SPEs, including Chewco, LJM1, LJM2, and the Raptors. A much more detailed but still abbreviated summary of these transactions is included in the *Enron's Questionable Transactions Detailed Case* in the digital archive for this book at www.cengage.com.

Enron had been using specially created companies called SPEs for joint ventures, partnerships, and the syndication of assets for some time. But a series of happenstance events led to the realization by Enron personnel that SPEs could be used unethically and illegally to do the following:

- Overstate revenue and profits
- Raise cash and hide the related debt or obligations to repay
- Offset losses in Enron's stock investments in other companies
- Circumvent accounting rules for valuation of Enron's Treasury shares
- Improperly enrich several participating executives
- Manipulate Enron's stock price, thus misleading investors and enriching Enron executives who held stock options

In November 1997, Enron created an SPE called Chewco to raise funds or attract an investor to take over the interest of Enron's joint venture investment partner, CalPERS,[1] in an SPE called Joint Energy Development Investment Partnership (JEDI). Using Chewco, Enron had bought out CalPERS interest in JEDI with Enron-guaranteed bridge financing and tried to find another investor.

Enron's objective was to find another investor, called a *counterparty*, which would do the following:

- Be independent of Enron
- Invest at least 3% of the assets at risk
- Serve as the controlling shareholder in making decisions for Chewco

Enron wanted a 3%, independent, controlling investor because U.S. accounting rules would allow Chewco to be considered an independent company, and any transactions between Enron and Chewco would be considered at arm's length. This would allow "profit" made on asset sales

[1] The California Public Employees' Retirement System.

from Enron to Chewco to be included in Enron's profit even though Enron would own up to 97% of Chewco.

Unfortunately, Enron was unable to find an independent investor willing to invest the required 3% before its December 31, 1997, year end. Because there was no outside investor in the JEDI-Chewco chain, Enron was considered to be dealing with itself, and U.S. accounting rules required that Enron's financial statements be restated to remove any profits made on transactions between Enron and JEDI. Otherwise, Enron would be able to report profit on deals with itself, which, of course, would undermine the integrity of Enron's audited financial statements because there would be no external, independent validation of transfer prices. *Enron could set the prices to make whatever profit it desired and manipulate its financial statements at will*.

That, in fact, was exactly what happened. When no outside investor was found, Enron's CFO, Andrew Fastow, proposed that he be appointed to serve as Chewco's outside investor. Enron's lawyers pointed out that such involvement by a high-ranking Enron officer would need to be disclosed publicly, and one of Fastow's financial staff—a fact not shared with the board—Michael Kopper, who continued to be an Enron employee, was appointed as Chewco's 3%, independent, controlling investor, and the chicanery began.

Enron was able to "sell" (transfer really) assets to Chewco at a manipulatively high profit. *This allowed Enron to show profits on these asset sales and draw cash into Enron accounts without showing in Enron's financial statements that the cash stemmed from Chewco borrowings and would have to be repaid. Enron's obligations were understated—they were "hidden" and not disclosed to investors*.

Duplicity is also evident in the way that Chewco's funding was arranged. CalPERS's interest in JEDI was valued at $383 million; of that amount, Kopper and/or outside investors needed to be seen to provide 3%, or $11.5 million. The $383 million was arranged as follows[2]:

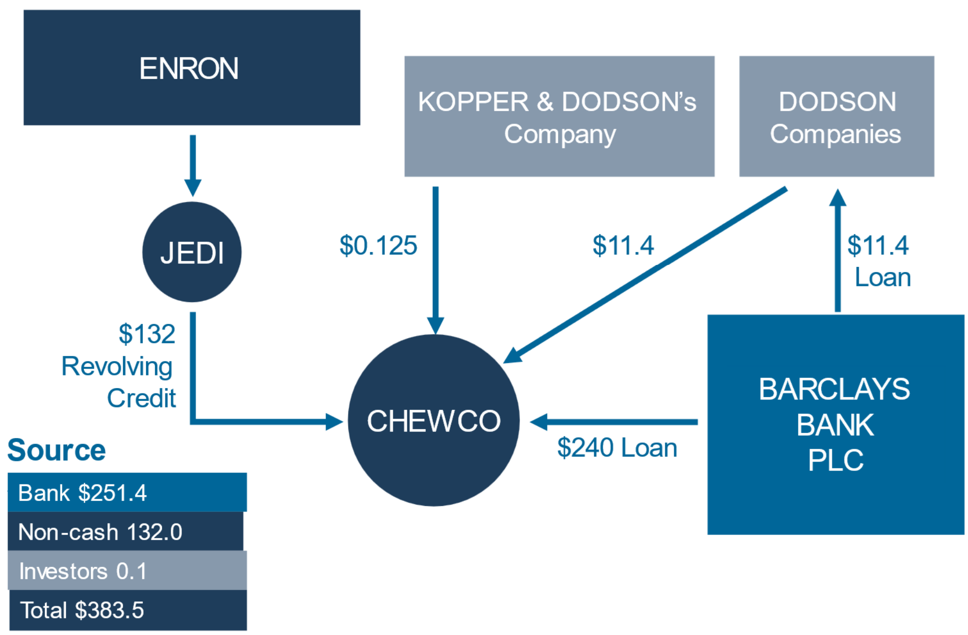
$240.0	Barclays Bank PLC—Enron would later guarantee this
132.0	JEDI to Chewco under a revolving credit agreement
0.1	Kopper and his friend Dodson ($125,000)
11.4	Barclays Bank PLC "loaned" to Dodson/Kopper companies
$383.5	

These financing arrangements are diagrammed in Figure C2.1.

[2] "Loaned" through shell companies and for "certificates" that would generate a yield.

FIGURE C2.1

CHEWCO FINANCING, IN MILLIONS



Essentially, Enron as majority owner put no cash into the SPE. A bank provided virtually all of the cash, and in reality the so-called 3%, independent, controlling investor had very little invested—not even close to the required 3% threshold. Nonetheless, Chewco was considered to qualify for treatment as an arm's-length entity for accounting purposes by Enron and its auditors, Arthur Andersen. Enron's board—and presumably Arthur Andersen—was kept in the dark.

A number of other issues in regard to Chewco transactions were noted in the Powers Report, including the following:

- Excessive management fees were paid to Kopper for little work.[3]
- Excessive valuations were used on winding up, thus transferring $10.5 million to Kopper.
- Kopper sought and received $2.6 million as indemnification from tax liability on the $10.5 million.
- Unsecured, nonrecourse loans totaling $15 million were made to Kopper and not recovered.
- Enron advance-booked revenues from Chewco.

This pattern of financing—no or low Enron cash invested, banks providing most of the funding, and Enron employees masquerading as 3%, independent, controlling investors—continued in other SPEs.Some of these SPEs, such as the LJM partnerships, were used to create buyers for

[3] Fastow's wife did most of the work.

Enron assets over which Enron could keep control but convert fixed assets into cash for growth at inflated prices, thus overstating cash and profits. Other SPEs, such as LJM1 and LJM2, provided illusionary hedge arrangements to protect Enron against losses in its merchant[4] investment portfolio, thereby falsely protecting Enron's reported profits.

In March 1998, Enron invested in Rhythms NetCommunications, Inc. (Rhythms), a business Internet service provider. Between March 1998 and May 1999, Enron's investment of $10 million in Rhythms stock soared to approximately $300 million. Enron recorded the increase in value as profit by increasing the value of its investment on its books. But Jeffrey K. Skilling, Enron's CEO, realized that the mark-to- market accounting procedure used would require continuous updating, and the change could have a significant negative effect on Enron's profits due to the volatility of Rhythms stock price. He also correctly foresaw that Rhythms stock price could plummet when the Internet bubble burst due to overcapacity.

LJM1 (LJM Cayman LP) was created to hedge against future volatility and losses on Enron's investment in Rhythms. If Rhythms stock price fell, Enron would have to record a loss in its investment. However, LJM1 was expected to pay Enron to offset the loss, so no net reduction would appear in overall Enron profit. As with Chewco, the company was funded with cash from other investors and banks based partly on promises of large guaranteed returns and yields. Enron invested its own shares but no cash.

In fact, LJM1 did have to pay cash to Enron as the price of Rhythms stock fell. This created a loss for LJM1 and reduced its equity. Moreover, at the same time as LJM1's cash was being paid to Enron, the market value of Enron's shares was also declining, thus reducing LJM1's equity even further. Ultimately, LJM1's effective equity eroded, as did the equity of the SPE (Swap Sub) Enron created as a 3% investment conduit. Swap Sub's equity actually became negative. *These erosions of cash and equity exposed the fact that the economic underpinning of the hedge of Rhythms stock was based on Enron's shares—in effect, Enron's profit was being hedged by Enron's own shares. Ultimately, hedging yourself against loss provides no economic security against loss at all*. Enron's shareholders had been misled by $95 million profit in 1999 and $8 million in 2000. These were the restatements announced in November 2001, just before Enron's bankruptcy on December 2, 2001.

Unfortunately for Enron, there were other flaws in the creation of LJM1 that ultimately rendered the arrangement useless, but by that time investors had been misled for many years. For example, there was no 3%, independent, controlling investor— Andrew Fastow sought special approval from Enron's chairman to suspend the conflict of interest provisions of Enron's *Code of Conduct* to become the sole managing/ general partner of LJM1 and Swap Sub; and Swap Sub's equity became negative and could not qualify for the 3% test unless Enron

[4] A merchant investment is an investment in a company's shares that are held for speculative purposes, not for control purposes.

advanced more shares, which it did. Ultimately, as Enron's stock price fell, Fastow decided the whole arrangement was not sustainable, and it was wound up on March 22, 2000. Once again, the windup arrangements were not properly valued; $70 million more than required was transferred from Enron, and LJM1 was also allowed to retain Enron shares worth $251 million.

Enron's shareholders were also misled by Enron's recording of profit on the Treasury shares used to capitalize the LJM1 arrangement. Enron provided the initial capital for LJM1 arrangements in the form of Enron's own Treasury stock, for which it received a promissory note. Enron recorded this transfer of shares at the existing market value, which was higher than the original value in its Treasury, and therefore recorded a profit on the transaction. Since no cash had changed hands, the price of transfer was not validated, and accounting rules should not have allowed the recording of any profit.

Initially, the LJM1 arrangements were thought to be so successful at generating profits on Treasury shares, hedging against investment losses, and generating cash, that LJM2 Co-Investment LP (LJM2) was created in October 1999 to provide hedges for further Enron merchant investments in Enron's investment portfolio. LJM2 in turn created four SPEs, called "Raptors," to carry out this strategy using similar methods of capitalization based on its own Treasury stock or options thereon.

For a while, the Raptors looked like they would work. In October 2000, Fastow reported to LJM2 investors that the Raptors had brought returns of 193%, 278%, 2,500%, and 125%, which was far in excess of the 30% annualized return described to the finance committee in May 2000. Of course, as we know now, Enron retained the economic risks.

Although nontransparent arrangements were used again, the flaws found in the LJM1 arrangements ultimately became apparent in the LJM2 arrangements, including the following:

- Enron was hedging itself, so no external economic hedges were created.
- Enron's falling stock price ultimately eroded the underlying equity and creditworthiness involved, and Enron had to advance more Treasury shares or options to buy them at preferential rates[5] or use them in "costless collar"[6] arrangements, all of which were further dilutive to Enron earnings per share.

---

[5] Raptors III and IV were not fully utilized and/or used to shore up the equity of Raptors I and II.

[6] A "costless collar" is a two-step arrangement wherein Enron offered to contain LJM2's risk of Enron's stock price falling below a lower limit using its own Treasury shares while at the same time making an offsetting arrangement for LJM2 to pay Enron if Enron's share price were to rise above a threshold. Since the arrangements offset one another in risk premium and Treasury stock was to be used, the transaction was considered to be an equity transaction, which did not affect the income statement of Enron. See page 110 of the Powers Report.

- Profits were improperly recorded on Treasury shares used or sheltered by nonexistent hedges.
- Enron officers and their helpers benefited.

In August 2001, matters became critical. Declining Enron share values and the resulting reduction in Raptor creditworthiness called for the delivery of so many Enron shares that the resulting dilution of Enron's earnings per share was realized to be too great to be sustainable. In September 2001, accountants at Arthur Andersen and Enron realized that the profits generated by recording Enron shares used for financing at market values was incorrect because no cash was received, and shareholders' equity was overstated by at least $1 billion.

The overall effect of the Raptors was to misleadingly inflate Enron's earnings during the middle period of 2000 to the end of the third quarter of 2001 (September 30) by $1,077 million, not including a September Raptor winding-up charge of $710 million.

On December 2, 2001, Enron became the largest bankruptcy in the world, leaving investors ruined, stunned, and outraged—and quite skeptical of the credibility of the corporate governance and accountability process. By that time, the Enron SPEs and related financial dealings had misled investors greatly. Almost 50% of the reported profits driving Enron stock up so dramatically were false. Table C2.1 summarizes the impacts of Enron's questionable transactions through key Enron SPEs.

TABLE C2.1

ENRON'S KEY SPECIAL PURPOSE ENTITIES (SPEs)

SPE SCHEME	PURPOSE	IMPACT
Chewco/JEDI	Syndicated investment	Off balance sheet liabilities hidden ($628 million), Revenues recognized early, Profits on own shares
LJM	Provided market for assets	Artificial profits, Off balance sheet liabilities hidden Equity overstated ($1.2 billion)
LJM1/Rhythms	Investment "hedge"	Unrecognized losses ($508 million)
LJM2/Raptors	Investment "hedge"	Unrecognized losses ($544 million)

Questions:

1. Why do you think that professional accountants on Enron's audit team failed to demonstrate sufficient professional skepticism to identify, understand the significance of, and/or act upon the following contributors to the company's bankruptcy:
    a) Enron was using SPE transactions to raise cash financing without showing the sources of funds, and the liability attached to it in its consolidated financial statements.
    b) Enron was selling assets, essentially to itself, at inflated prices to create roughly half of its reported profits during the late stages prior to its bankruptcy.
    c) Enron was hedging itself, so no external economic hedges were created.
    d) Profits were improperly recorded on Treasury shares used or sheltered by nonexistent hedges.
    e) Enron's falling stock price would ultimately be eroded the underlying equity and creditworthiness involved, and Enron had to advance more Treasury shares or options to buy them at preferential rates or use them in "costless collar" arrangements, all of which were further dilutive to Enron earnings per share.
2. What red flags should have triggered the professional skepticism of the audit team?
3. What basic question should the audit team have been asking themselves during the audit that would have helped orient the audit team's minds with regard to where and how much professional skepticism should have been applied? [worst case, too good to be, …]

Additional questions are available in the source publication: *Business & Professional Ethics for Directors, Executives & Accountants*, 9e, Leonard J. Brooks & Paul Dunn, published by Cengage Learning, Inc., ©2021, ISBN: 978-0-357-44188-6.

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.