Enron Should Not Have Been a Surprise and the Next Major Fraud Should Not Be Either

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The CFO of an Enron Special Purpose Entity (SPE) discusses unheeded warnings and dismissed red flags prior to the Enron accounting scandal. He provides these experiences from the perspective of 30 years as a CPA and CIA and as the former Vice President of Business and Finance of a multibillion dollar domestic division of a major oil company. Next an update is provided of the status of white collar crime; and, a discussion follows regarding the lessons learned from Enron and the prospects for future fraud.

INTRODUCTION

The name Enron is now infamous. The Enron fraud was not only one of the largest of many accounting scandals in the late 1900s and early 2000s; it was also the scandal that directly led to the demise of the international accounting firm of Arthur Andersen. While much has been written about this fraud, little information has previously been provided by partners of the many Special Purpose Entities (SPE) used by Enron to perpetuate the fraud. By providing a first person perspective by the CFO of one of the SPEs, this paper seeks to partially fill this gap. Following the CFO's input, a review of several white collar fraud surveys provides an update post Enron of the status of accounting fraud; and, in the final section, lessons learned from Enron and prospects for the future of accounting fraud are discussed.

PERSONAL PERSPECTIVE OF AN SPE'S CFO

In June of 2000, I (the lead author), along with four partners, signed an oil and gas exploration and development agreement with Enron. Our entry into this deal was not lightly undertaken: over a year of due diligence was conducted. We presented our business plan to all of the major venture capital providers in the U.S. oil and gas business. After substantial analysis, detailed negotiations, and many long nights and weekends of discussion and debate, we were satisfied and extremely pleased with the opportunity to partner with Enron. And rightly so! Enron, the darling of the energy business, had just agreed to an initial funding in our deal of $25 million.

We did not enter into this partnership agreement as novices: between the five of us we had over 120 years of oil and gas industry experience. Most recently, we had been the core of the executive team that managed a multibillion dollar domestic division of a major oil company. We left that firm to form this partnership. Our team consisted of the previous Division President, a petroleum engineer who had also been president of one of our major foreign operations; the Vice President of Operations and Engineering; the Vice President of Land and Public relations; the division's top reservoir engineer and oil and gas analyst; and myself, the Vice President of Business and Finance. In over ten years in this capacity I was responsible for all accounting, financial analysis, capital budgeting, long-range planning, competitor analysis, information systems, performance reporting, and internal control. My background and experience in getting to this position involved certification as both a CPA and a CIA, six years of corporate internal audit experience (domestic and international, from associate auditor up through audit director), and three years as a manager of internal control in our exploration division. I also spent three years in the corporate finance and treasury group, while pursuing an MBA at the University of Southern California, and four years as controller of the company's international coal division. I had extensive oil and gas accounting, financial, and internal control experience when I became CFO of the partnership with Enron.

As was mentioned, we were extraordinarily pleased in having negotiated our deal with Enron, and based upon all aspects of Enron's then reputation, we had reason to be pleased. The most tangible evidence of Enron's strength and success was the fact that their stock price had risen from just over $20 a share in 1998 to just under $90 a share in the year we signed our partnership agreement; third quarter revenues had increased by 50% from 1999 to 2000 bringing total revenues to over $60 billion; and, *Fortune Magazine* had chosen Enron the country's most innovative company for five years in a row (Schwartz & Watkins, 2003).

So far, this story sounds very positive. However, with hindsight we are all now very aware that by the end of the year following our triumphant partnership, Enron would be bankrupt, worthless, and the largest corporate fraud and complex and sophisticated accounting scandal in history.

As a CPA, experienced auditor, internal control specialist, and seasoned financial manager why didn't I have a hint of this massive fraud boiling just under the surface of our partner? I had spent months studying the company and had gotten a detailed look at their management of our partnership. I was familiar with every word of our contractual agreement; I knew we were considered a special purpose entity (SPE) and that we received our monthly funding from JEDI 1 and JEDI 2, which I knew were both owned by the California Public Employees Retirement System (CALPERS). Many of these statements are now buzzwords for elements of the ultimate fraud. Yet, I was as surprised as anyone when Enron announced bankruptcy and was as shocked as anyone when the accounting fraud was revealed. As I recount the events of the time and the surrounding situations, and as I now look back, aware of the benefit of hindsight, I try to determine why I was then not more concerned or suspicious as to the nature of certain activities and information.

From the beginning of our presentations, discussions, and negotiations with Enron, the scope and nature was that of total professionalism and business acumen. Everything was documented, the lawyers were always involved, and every "I" was dotted and "T" crossed. As a financial manager I had been involved in hundreds of similar dealings and the Enron representatives were as experienced and diligent as any with whom I had previously worked. The Enron team, with which we spent most of our time (at least several hundred hours) fine tuning and finalizing the deal, was especially experienced and prepared. All four of our contacts had substantial oil and gas backgrounds. Three of them were petroleum engineers, one of which had been hired away from Exxon, another from Amoco, and the third had most recently been the president of an independent oil and gas firm. All three also had MBAs from major schools and our primary contact graduated with honors from Harvard. The fourth member of their team was the financial and accounting representative. He was a CPA with an auditing background and substantial contract negotiations experience. This team exemplified the level of talent at Enron. For more than a decade Enron had prided itself in hiring the top people in the industry, "Ken Lay was a longtime proponent of hiring the best and brightest" (Salter, 2008 p. 61).

Over the next three months we hammered out a 50 plus page agreement that covered all aspects of our deal in great detail (it also included dozens of pages of specific attachments, maps, formulas, budgets and development plans). Our team scrutinized every word because this agreement could ultimately absorb a substantial portion of our personal wealth. Fortunately, we had one of the top oil and gas attorneys in

Texas (with 40 years of oil and gas contract experience) on our side to go up against Vinson and Elkins' small army of attorneys. Up until the very end of the tedious process of completing the agreement everything seemed completely professional, accurate, and as expected. The negotiations on all of the substantive issues had been made and the last minute cosmetic and format changes were being made when something strange occurred. We had previously settled on the provisions of the Management of Partner Affairs and, as the lawyers had said, "put that section to bed." It was a complex section, but written very straightforwardly and started with, "The General Partner may make all decisions and take all actions for the Partnership not otherwise provided for in this Agreement, including, without limitation, the following…"(Limited Partnership Agreement, 2000, p. 25). What followed were 38 specifically defined decisions, activities, and authorizations that we as General Partners were allowed/required to carry out to manage the partnership. Then, at the last minute, after a closing date had been set and ensuing celebrations planned, with no solicitation or comment on our part, an additional sentence was inserted just in front of the existing language regarding our responsibilities. The new sentence read, "The General Partner shall have full, complete, and exclusive authority to manage and control the business, affairs, and properties of the Partnership, to make all decisions regarding those matters, and to perform any and all other acts or activities customary or incident to the management of the Partnership's business" (Limited Partnership Agreement, 2000 p. 25). Within the context of the agreement, this new statement had no real meaning; it was completely restated and overridden by the statement that followed it that described specific general partner responsibilities. When I first saw this late addition I questioned its purpose. When I asked our attorney what it meant, why it might have been added, he shrugged and said that it was probably either a mistake or "boilerplate" added by some peripheral reviewer of the agreement. He said that unless the statement bothered me he would just leave it alone and not even go to the trouble of questioning or changing it. Other than seeming odd, the new statement certainly did not hurt, or effect our position. However, in hindsight, this statement could be quoted out of context and potentially support the argument that Enron did not run this partnership, which in reality, it did.

When the full story of the complex and multilayered accounting abuse and misrepresentations at Enron were revealed, I immediately thought back to this odd last minute change in the language. It now appears that Enron was simply adding "cover" language that would allow them to claim that the general partner was in total control of the partnership, which was a primary requirement to claim a partnership as an SPE and keep it off of the Enron balance sheet. While that specific language, on its own, stated absolute general partner control, the reality was that the Enron managers with whom we worked with were definitely in control of the activities of the partnership. They controlled the overall budget, final authorization on all projects, and all primary funding decisions, all of which required a majority vote, and they were the majority.

However, long before we got involved with Enron, they apparently had a distinct history of disdain for the rules of accounting. Ten years earlier in December of 1990 Jeff Skilling hired a bright young banker from Chicago who was an expert in financial securitizations; his name was Andy Fastow (Eichenwald, 2005). Shortly thereafter, in 1991, Fastow was already putting in place the first of thousands of SPEs, for example, one by the name of Cactus. In a meeting attended by Fastow and his team, Vinson & Elkins, and Arthur Andersen, a young Andersen accountant, Rick Causey (future Enron Chief Accounting Officer), explained the details of the accounting requirements for keeping an SPE off the balance sheet (Eichenwald, 2005). At the time the two primary criteria were that independent investors had to hold at least 3% of the equity of the SPE and that the independent investors managed and controlled the SPE, not Enron. After the meeting, when the accountants and lawyers had left the room, Fastow chuckled and said "who comes up with these ridiculous rules? This is such bullblank! Your gardener could hold the 3%" (Eichenwald, 2005 p.54). Fastow had just begun his career at Enron, and as we now know, was on his way to becoming the CFO, and these were the roots of his attitude towards appropriate accounting. This incident provided just one glimpse of the myriad of misleading and deceitful accounting practices that were going on at Enron. It was later determined that just a short list of these accounting devices included hiding debt and financial losses off balance sheet in nonqualifying SPEs, failing to disclose conflicts of interest between Enron executives and the ownership of certain SPEs, disguising significant contingent liabilities, misrepresenting debt as minority interest, reporting gains on asset sales that were simply transfers to other Enron controlled entities, and creating overstated gains by incredibly inflating the future value of projects in mark-to-market calculations (Salter, 2008).

An example of how far the firm strayed from professional integrity and honesty is captured in the story from *The Smartest People in the Room: The Amazing Rise and Scandalous Fall of Enron* (McLean & Elkind, 2004) in which an Enron accountant described an analogy of how they interpreted Generally Accepted Accounting Principles to meet their business needs. If they needed a "duck" to represent the results they desired for the financial statements, but the financial information described more of a "dog", then the accountants would review the accounting rules for a duck and follow those rules closely by painting the dogs feet yellow, the body white, attach an orange plastic beak and declare, technically, this is a duck. Even though it was still obvious that it was a dog, the accountants and the auditors would accept the rationale that they have the duck that was needed to fulfill the requirements for what Enron wanted to show on the financial statements. None of the accountants involved (Enron employed approximately 600 CPAs, [McLean & Elkind, 2004]) nor the auditors had the courage to say "that is a dog".

In the overwhelming brightness of the numerous spotlights on Enron's accounting in the aftermath of all of the investigations, a look back at the control language inserted into our agreement makes its purpose now seem glaringly obvious. However, in that same timeframe there were some even more obvious indicators that I was aware of and also chose to ignore. As later described in their paper, "Warnings from the Enron Message Board", Felton and Kim (2002) stated "we searched postings on the Yahoo! Enron Message Board from 1997 to 2001 for warnings of a crash to come. We found a compelling four-year history of Enron as told by apparent insiders through anonymous posts" (p. 1). Felton and Kim isolated 129 particularly pertinent comments that were posted from early 1998 through early 2002. These posts covered a random range of subjects from social to humorous to serious. However, as early as May 1998 very specific warnings about Enron's business dealings were being entered. For example, under the heading of "Ugly" was:

> Enron's aggressive management sometimes gets it into trouble. The final ugly is that Enron is a very complicated company, with a very complicated financial structure, and very complicated business deals. From cross commodity swaps, to volumetric production payments, to take or pays, Enron is run by about 20 guys who were the only ones that actually understand what is going on. (Felton & Kim, 2002, p. 10)

Another insightful comment occurred in June of 1999, "I suspect the books are cooked regularly at Enron and we may be to the place and time to take our medicine in the next earnings report" (Felton & Kim, 2002, p. 18**)**. This comment on the accounting was reinforced a few months later with an entry that read "I find Enron's 10Q and any reporting by Enron difficult to read as it is grouped in a way to deceive often. With so many accountants in the company and with the undisputed sharpest pencils in Houston I am suspicious of their reporting" (Felton & Kim, 2002, p. 23). A final example of a posting eight months before the declaration of bankruptcy was audaciously titled, "Enron Will Soon Collapse". The posting stated:

> It will soon be revealed that Enron is nothing more than house of cards that will implode before anyone realizes what happened. Enron has been cooking the books with smoke and mirrors. The Enron executives have been operating an elaborate con scheme that has fooled even the most sophisticated analysts. (Felton & Kim, 2002, p. 27)

As mentioned, I was aware of the Enron message board and visited the site several times. I remember reading a number of these postings and certainly had mixed emotions in regard to some of the most disparaging comments. However, there were just as many positive and supportive comments that refuted and even dismissed these negative posts. Apparently I looked to these positive postings as a way to rationalize away any possible concerns in the investment decision we made to partner with Enron. Now, when I look back and re-read some of these same postings there is sadness in the truth that belied some messages. For example:

> I have held Enron stock in savings, ESOP, and retirement accounts for the last 15 years. My wife and I together have accumulated more wealth through this corporation than you can possibly imagine for our petty initial investment. The vision of the company 15 years ago was that the returns would be sound for the next 20 years. What an understatement. Hold and enjoy. This is 100 year investment at worst. (Felton & Kim, 2002, p. 21)

This comment was made in the year before Enron's collapse. A similar comment can be found that states:

> This is the 20th largest company in the world and next year will be 15th. I have owned Enron since it was formed and will be able to retire next year at 44 when the stock hits $100, so just shut up and buy. (Felton & Kim, 2002, p. 24)

Additionally, I personally witnessed a milestone in the beginning of the end of Enron. On August 14, 2001 the CEO of Enron, Jeffrey Skilling, resigned. This announcement came as a shock to Houston, Wall Street, and especially the employees at Enron. On the evening of that same day I was having dinner with half a dozen Enron managers and vice presidents from their Marketing and Energy groups. I was the board president of the Nationwide Golf Tournament being held that week in Midland, Texas, and the Enron group was there being hosted as one of the major sponsors. As I sat at a reserved table in the dining room of the Hilton Hotel the Enron executives arrived at the table one by one. Without exception they each approached with a look of distracted apprehension and quickly fell into quiet discussion concerning the brief voice mail they had all received announcing Skilling's departure. Their discussion was punctuated with phrases like "so much for our brilliant leadership; magic black box of the trading group, where deals go in the front, no one knows for sure what happens, but profits spew out the back; and I knew we should not have become a company of all deals and no assets." The executives continued to grumble until a consensus was reached that Skilling had fled a sinking ship with a huge pile of money, while leaving the employees, such as themselves, to ride down the negative spiral (by the time Skilling departed Enron stock had fallen from a high of $90 to below $40 and within a few short months would be in the teens).

However, during this timeframe I simply saw all of these issues as someone else's problem. I came nowhere near putting all the pieces together. I never even entertained a thought that Enron was headed towards bankruptcy, nonetheless ever coming close to thinking that they were sitting on top of a massive accounting fraud. I was ensconced in the day-to-day management of our partnership. I was comfortable in a rationalization that considered only the positive news, Enron was still reporting positive earnings, the consensus of market analyst was still ranging from "buy" to "strong buy", and most importantly every time I sent our Enron contacts a funding request the money was wired into our bank account the very next day.

Unfortunately, it only took a few more weeks before my rationalizations received a rude awakening. At the end of September, I sent in the normal monthly cash call to Enron, the same one that for so many months had been immediately honored. The next day, as was my routine, I checked with our bank to confirm the receipt of the funds, but they were not there yet. Usually the day following each cash call I would see a wire transfer received from JEDI 1 and JEDI 2. As mentioned, these two entities were SPEs formed by Enron and owned predominantly by CALPERS. I was not too concerned about the funding not hitting our account, I would simply check again the next day. The next day the funds still had not arrived. I remained unconcerned, assuming that there had been some clerical or technical glitch and the money would be coming soon. However, I thought I should follow up and so I called our financial contact at Enron. I reached our contact who by now had become a fairly good friend. He was a CPA and we shared a similar background on the financial side of the oil and gas business. It was at this point when my financial contact asked, “do you need the money now?” that I finally reoriented my perspectives on the overall situation at Enron. This was a nonsensical question, he knew full well that the cash call was based on our currently due payables and without that funding I could not pay our bills on time. After politely making that point I was told that things were a little tight inside Enron and that it might take a few days to get the money transferred. Three weeks later we received our funding - the last money we ever received from Enron. In that same timeframe Enron reported a $618 million quarterly loss and $1.2 billion write-down of shareholder equity due to their partnerships, the SEC began an investigation, and Andy Fastow was fired. Shortly thereafter, on December 2, Enron declared bankruptcy. My partners and I spent the next two years completely unwinding our partnership. Fortunately, we had generated some fairly solid investments and through asset sales and careful use of a revolving loan, which I had put in place earlier in the summer, we were able to disentangle ourselves from Enron without suffering financial damage.

When it was all over we went our separate ways and pursued different opportunities. A big part of what I have left of my experience with Enron are my memories and a lingering wondering as to why, as an experienced financial professional, I had not anticipated the nature of the accounting fraud at Enron until everything fell apart at the end.

ACCOUNTING FRAUD SINCE ENRON

As we are all aware, the massive accounting fraud at Enron, coupled with the other accounting scandals of the time, lead to the passage of the Sarbanes-Oxley Act. This legislation was aimed at preventing future Enron’s. It has been over 10 years since Sarbanes-Oxley was signed and almost 12 years since the unraveling of Enron. The question remains, has the business world learned these lessons and has Sarbanes-Oxley had the major preventative impact on fraudulent activity that was predicted?

The depth and the breadth of the financial malfeasance in these last 10 years are still staggering. Consistent and repeated examples of significant financial frauds have darkened the landscape of global business in this past decade. The debacles at Enron, WorldCom, HealthSouth, Tyco, Global Crossings, Adelphia, and more recently Madoff, are all too well known by those in both business and academia and often by the public in general. But, is this fraudulent activity just in our history? Unfortunately, recent history indicates that fraudulent activity is “alive and well” – despite the efforts of the SEC and the costly regulations imposed by SOX, there is still a very high potential for fraudulent activity. Each of the “Big Four” CPA firms completes annual global fraud surveys and assessments. While a variety of issues were reported by each firm in their most recent fraud reports, the consistent finding of an expectation of higher levels of fraud was reported by all four surveys.

PricewaterhouseCoopers (PWC) reported in their *Global Economic Crime Survey* (PricewaterhouseCoopers, 2009) that fraud was “pervasive, persistent and pernicious” (p.4). They also found that 30% of the survey respondents had experienced an incident of fraud in the last 12 months. Additionally, PWC found that almost half of the respondents reported that the incidence of fraud during that timeframe was greater than the previous 12 months. “Hence we conclude that economic crime remains a pervasive business risk, which does not discriminate among its victims based upon the relative degree of their financial performance” (PricewaterhouseCoopers, 2009, p. 4). PWC (2009) went on to point out that, of the three primary categories of fraud (accounting fraud, bribery and corruption, and asset misappropriation), accounting fraud had grown the fastest by far, almost quadrupling (from 10% to 38%) in this decade as a form of reported fraud.

KPMG, in their *Fraud Survey 2009* (KPMG, 2009), found that 65% of executives surveyed cite fraud as being a significant risk to their company and 80% of respondents expect fraudulent activity to either maintain at the current levels or increase in the next 12 months. They went on to report that “inadequate controls of compliance programs heighten the risks of fraud and misconduct. Two-thirds of executives (66%) reported that inadequate internal controls or compliance programs at their organizations enable fraud and misconduct to go unchecked” (KPMG, 2009, p. 1).

A similar report emanated from a Deloitte survey (Deloitte, 2010) where 63.3% of 2,100 executives polled responded that they expected accounting fraud to increase during the 2010 -2011 timeframe as compared to the last three years. Of these responses, 38% also cited manipulation of revenue recognition as the area where they expected to see the highest incidence of misstatement.

Ernst & Young also recently completed their *11th Global Fraud Survey* (Ernst & Young, 2010). In their executive summary, Ernst & Young (2010) listed four primary findings:

- A substantial number of respondents reported suffering a significant fraud in the past two years…
- Despite the increased incidents of fraud, corporate entities' responses to fraud allegations appear ad hoc and inconsistent…
- Proactive measures to manage risk of fraud were also not universally contemplated…
- Measures to mitigate corruption and bribery exposure are still not standard practice for companies, including those to drive growth through acquisitions…(p.2)

The combination of these recent surveys speaks to the continuing significance of the incidence of business fraud in general and specifically accounting fraud. As mentioned, the current decade began with the largest business frauds in U.S. history, "The wave of financial scandals at the turn of the 21st century elevated the awareness of fraud and the auditor's responsibilities for detecting it" (Hogan, Rezaee, Riley, & Velury, 2008, p.232). However, despite this renewed emphasis on fraud detection auditing remains one of the least effective methods of fraud detection. The Association of Certified Fraud Examiners (ACFE) has consistently shown in their *ACFE Report to the Nations* (ACFE, 2010) that over the last decade both internal and especially external auditing have scored low percentages in fraud detection. In their most recent report (ACFE, 2010) internal auditing was reported as having been the method of fraud detection in 13.7% of the cases reported, with external auditing only representing 4.2% of the reported fraud detections. Fraud by its very nature is typically surreptitious and therefore, difficult to detect. So it is not surprising that audit reviews, particularly external, do not often uncover fraudulent activity. It is perplexing that after decades of development of formalized control devices (e.g., internal audit, external audit, management review, and internal control) that the number one detection methodology continues to be whistle-blowing (tips) as shown consistently by the *ACFE Report to the Nations* (ACFE, 2010). The ACFE (2010) stated the following:

> One of the principal goals of our research is to identify how past frauds were detected so that organizations can apply that knowledge to their future anti-fraud efforts. Tips were by far the most common detection method in our study, catching nearly three times as many frauds as any other form of detection. This is consistent with the findings in our prior reports. Tips have been far and away the most common means of detection in every study since 2002, when we began tracking the data. (p.16)

ACFE (2010) also reported fraudulent activity by category, frequency, and magnitude. In their most recent report, financial statement fraud, while listed on the low end of frequency (averaging just over 7% in the last two reports) has resulted in by far the greatest monetary loss with a median cost of just over four million dollars per fraudulent event. This median cost is over 10 times the average cost of the next largest category, bribery and corruption.

A significant related issue is that these financial statement frauds invariably involve, by the nature of their duties and responsibilities, management accountants. The significant frauds listed as previous examples all included, in one way or another, a management accountant making an erroneous accounting entry that lead to material misstatement of the financial reports. In many instances the management accountants were heavily involved in the perpetration of the fraud (e.g., Enron, WorldCom, and HealthSouth), and a number of them have been convicted for this fraudulent activity and sentenced to prison.

In addition to the substantial financial costs and potential criminal penalties associated with financial statement fraud, a recent study also indicated that frauds that ultimately resulted in external whistle-blowing had a substantial impact on the entity's stock value (Bowen, Call, & Rajgopal, 2010). Bowen et al.'s study reviewed the stock performance of 81 companies whose whistle-blowing had been reported in the media. The stock price of these accused companies dropped an average of 2.84% vs. the market; however, if the reported allegations concerned earnings management then the stock price dropped an average of 7.3%. These issues, actual financial loss to the company, criminal penalties, and stock depreciation, are all significant reasons to create a strong internal whistle-blowing process that effectively detects erroneous accounting activity at its initial point so that the magnitude of the malfeasance can be contained and the impact/corrections can be minimized.

In the middle of the decade, the memories of Enron, WorldCom, HealthSouth, Tyco, Global Crossings and Adelphia were still strong and the passage and implementation of the Sarbanes Oxley Act (SOX, 2002) dominated the financial accounting regulatory scene. Beneath it all lay another massive theft of investors monies created completely by fraudulent accounting in the form of Bernard Madoff's Ponzi scheme. This was not a case of fraudulent accounting entries, in this case the entirety of the financial statements were fabricated by Bernard Madoff and his staff. Madoff's public auditor, David Friehling, attested to the accuracy of the financial statements for 17 years without ever conducting a credible audit (Henriques, 2009).

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recently issued a long-term study entitled *Fraudulent Financial Reporting: 1998-2007* in which they reviewed 347 alleged cases of fraudulent financial reporting. Their results showed a total cumulative misstatement/ misappropriation of nearly $120 billion with a mean of nearly $400 million per case (COSO, 2010). This average fraudulent amount was 16 times the comparable fraudulent amount from their immediately previous 10 year study (1987 to 1997) which averaged $25 million. In the COSO study the three most common areas of misstatement involved revenue recognition, asset overstatement, and capitalization of expenses. Additionally, COSO (2010) stated that companies involved in press coverage of the alleged fraud experienced an average 16.7 percent abnormal drop in stock price and concluded the following:

> Long-term negative consequences of fraud were apparent. Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or material asset sales following discovery of fraud at rates much higher than those experienced by no-fraud firms. Our hope is that insights contained herein will encourage additional research to better understand organizational behaviors, leadership dynamics, and other important aspects of the financial reporting process that may have an impact on fraud prevention, deterrence, and detection. (p.iii)

PROSPECTS FOR THE FUTURE

As previously noted, fraudulent accounting is a high priority risk, and whistle-blowing is the number one method of fraud detection. Also, as was mentioned, management accountants are in a unique position when it comes to the perpetration of, or alternatively, the reporting of fraudulent accounting activity. In their study of management accountants and their potential to detect fraud, Charron and Lowe (2008) stated:

> Even though management accountants are not under the same regulations as external auditors, they should adopt an elevated attitude of skepticism to detect fraud within their respective organizations. Management accountants often have insights to details that may go unnoticed or unaudited by external or internal auditors. (p. 10)

And, aside from the question of whether or not management accountants should blow the whistle or should remain loyal to their organization and management, even in the face of questionable activity, is the bigger question of the overall set of motivations and circumstances that cause a fraud to occur.

In the book, *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (Kolb, 2010), Jonathan C. Lipson contributed chapter three, "Enron Rerun: The Credit Crisis in Three

Easy Pieces”. In his discussion of the causes of the most recent mortgage/credit crisis he does an excellent job of relating the situations that occurred in the Enron fraud and were repeated several years later in the credit crisis. Lipson defined three broad features that were common between Enron and the credit crisis: complexity, complacency and conflicts of interest. He stated, “Enron’s deals in today’s crisis share three sets of features that create illusions of wealth that confounded even seemingly sophisticated investors” (Kolb, 2010, p. 43).

The first feature, complexity, is probably the most easily observed. As has been discussed, Enron created thousands of off balance sheet SPEs and then interlaced these with a myriad of transactions that were so complex that they were difficult, if not impossible, for investors to understand. They were probably only barely understood by a few Enron insiders. Lipson (Kolb, 2010) explains how Enron’s multiple and layered securitizations of different forms of cash flow was mirrored in the credit crisis with the predominant instrument being the mortgage backed security. He then stated:

> Both Enron’s and today’s transactions involved hundreds - perhaps thousands - of pages of dense legal documentation. These contracts, or sets of contracts, created many complex rights and responsibilities. While some people doubtless understood the details of these transactions it is not clear that they were understood by the people who really matter – investors and regulators. (p. 44)

Another compounding layer of complexity was created in the form of what Lipson defined as “stealth guarantees” (Kolb, 2010, p. 44). In Enron’s case they provided a Total Return Swap that ostensibly provided indemnification if the security failed. In the credit crisis investors often purchased Credit Default Swaps as backup to the risk of the mortgage backed security. Even though these swaps had the general appearance of guarantees, the structure was so convoluted that it was hard to determine who was ultimately responsible in a case of default, and for what value. Also, in the case of Enron, these agreements were disingenuously called swaps instead of guarantees so that they could be kept off the balance sheet (Kolb, 2010).

The second feature described by Lipson that was common to but both the Enron scandal and the credit crisis was complacency by both regulatory agencies and investors. Examples of regulatory complacency abounded. A preponderance of the mortgage loans that are in trouble today were not generated by commercial banks, which are heavily regulated, but by mortgage brokers who are largely unregulated. In the Enron case the similar and most famous comparison was the deregulation of the California electricity markets. The SEC contributed to the credit crisis by loosening the limits on Investment Banks’ required debt-to-net capital ratio from 12 to 1 up to 40 to 1. In the Enron case the SEC failed to review and prohibit Total Return Swaps. Additionally, investors in both Enron securities and credit crisis securities invested heavily without asking the in-depth questions that were truly required to understand their investments (Kolb, 2010).

The most onerous feature of the credit crisis and particularly the Enron debacle was the existence of blatant, verging on shocking, conflicts of interest. The most obvious was that of Andrew Fastow’s direct management and ownership in Enron SPEs (Bierman, 2008). In Harold Bierman’s book, *Accounting/Finance Lessons of Enron: A Case Study,* he described 16 instances of a conflict of interest. In reference to the credit crisis Lipson discussed what he calls “a much broader and deeper array of conflicts of interest” (p. 48) that involved fraudulent borrowers, mortgage brokers, appraisers, investment banks, rating agencies, and hedge funds, all of which had an immediate monetary interest in generating as many mortgage loans as possible regardless of their economic viability (Kolb, 2010).

With the backdrop of the preponderance of an expectation of continued, and even increased, fraudulent accounting activity provided by major studies reviewed here, the question remains, “Can Enron happen again?” This question is best answered by a series of additional questions:

- Does greed still exist?
- Does mankind still have the ability to create structures and situations that are too complex for mankind to manage? (Complexity)

- Will rating agencies and investors ever lag behind in their understanding and management of new deal instrument structure? (Complacency)
- Will conflicts of interest between management and investors cease to exist?
- Will other involved parties; management accountants, public accountants, lawyers, rating agencies, market analyst, etc. fail to speak up when they see misrepresentation, malfeasance, and impropriety?

Unfortunately, the answer to all these questions is yes. In reflecting upon the recurrence of financial crisis, Jonathan C. Lipson concluded:

> The Enron scandal has much in common with today's credit crisis. Enron offered many lessons that could have helped us to avert this crisis - if we had chosen to learn from those lessons. We did not, however, learn from Enron. (Kolb, 2010, p. 43)

In his paper entitled, "Lessons Learned, Relearned, and Learned Again" the former Chairman of FASB, Bob Herz stated:

> Over the past twenty years, we've experienced several major financial and economic crises, including the S&L crisis, the reporting scandals (Enron, WorldCom, Etc.) and dot.com bubble in 2001-2002, and now, over the past year, the ongoing crisis in the credit and financial markets. Each time there are a number of lessons to be learned from these events. But, unfortunately, some of the lessons seem to be forgotten and have to be "relearned" again and again multiple times. (Herz, 2008, p. 1)

And finally, from one of the most well known Enron insiders, Sherron Watkins:

> Enron should not be viewed as an aberration, something that can't happen anywhere else. Because it's all about the rationalization that you're not doing anything wrong. We've involved [accountants] Arthur Andersen, we've involved the lawyers, the bankers know what we're doing. There's a sense, the diffusion of responsibility, that everyone was on the bandwagon. And it can happen again. (Gibney, 2005)

CONCLUSION

The authors agree that "It" can, and will, happen again. The lead author asks himself the following questions: If I were ever as close to an actual fraudulent situation with a number of the same indicators that occurred during my Enron partnership, would I be more aware of the presence of accounting fraud? How suspicious and skeptical was I supposed to be? As a management accountant when should I raise these issues and when should I sound an alarm? These are questions on which all accountants perhaps should reflect. As the saying goes, being forewarned is being forearmed. Accountants must learn from the lessons of previous accounting scandals and be forever skeptical and vigilant in protecting the publics' interest. History will repeat itself.

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