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Enron, Accounting, and Lawyers

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Enron, Accounting and Lawyers

Even if you went to law school so you wouldn't have to deal with numbers or accounting, please read on. I know you're busy *and* you're tired of reading about Enron, but the corporation's collapse painfully illustrates the importance of financial accounting to *all lawyers* (and that means YOU!).

For years, accounting has been called "the language of business." Virtually every lawyer represents businesses, their owners or clients such as creditors and customers. Could you effectively practice law in China if you did not speak, or at least understand, Chinese? Especially after Enron, lawyers cannot competently represent clients if they do not grasp certain basic principles about accounting.

While accounting rules have become increasingly complex, and few law students or lawyers receive formal training in accounting, lawyers can watch financial statements and related disclosures for "red flags." Although the facts underlying Enron's collapse continue to come to light, for now all lawyers would do well to consider the following listing of the top 10 accounting lessons for lawyers from the scandal. (For extra credit, please give copies of this article to your 10 favorite lawyers.)

1. *Where's the beef?*

A complete set of financial statements includes an income statement, a balance sheet, a statement of cash flows, a statement of changes in owners' equity and the accompanying notes. The Enron crisis accelerated when the company's 2001 third-quarter earnings press release on October 16, 2001, provided only an income statement and not a balance sheet, statement of cash flows or statement of changes in shareholders' equity. (Remarkably, Enron failed to provide a balance sheet in its earnings releases dating back to 1996.) In response to questions from analysts, Enron's management later disclosed that Enron recorded a \$1.2 billion reduction in shareholders' equity. Because the income statement does not reflect this item, without a balance sheet or statement of changes in shareholders' equity, investors could not see a complete and accurate picture of Enron's financial condition and

operating results. In addition, the cash flow statement, possibly the lawyer's best friend in such situations, also would have alerted a careful reader to problems including the business's declining profitability. As Enron's collapse demonstrates, a missing financial statement may indicate that the enterprise seeks to hide disappointing results. Enron's eventual issuance of its missing balance sheet and the large write-down of shareholders' equity in the balance sheet triggered a loss of investor confidence, which caused Enron's share price to fall, accelerated debt repayment obligations and ultimately led to Enron's bankruptcy. The Enron scandal illustrates that *each* financial statement offers important information necessary to maintain investor and creditor confidence. A lawyer should ask probing questions any time an enterprise does not provide a complete set of financial statements, plus accompanying notes.

2. Old dogs, new tricks.

Generally accepted accounting principles (GAAP) often offer choices in financial accounting treatments. Although the “consistency principle” generally requires enterprises to use the same accounting principles to treat the same transactions similarly from year-to-year, this consistency requirement does not apply to new business activities. The business community refers to the “rules” governing the compilation of accounting data into financial statements and the accompanying notes as GAAP. GAAP, however, typically allows choices among permissible alternatives and almost always requires estimates and assumptions that affect the amounts shown in the financial statements, including the reported amounts of assets, liabilities, revenues and expenses. Especially in today’s world, business transactions and practices evolve more rapidly than rule-makers can promulgate accounting rules. For several reasons, therefore, GAAP does not provide a set of black-and-white rules that produce a single “bottom-line” number that a lawyer can use natural law to verify. Commonly referred to as “earnings management,” corporate managers can often use GAAP’s flexibility to show operating results in line with projections and expectations. Especially when an enterprise’s business changes (witness Enron’s evolution from a regional natural gas company to a global energy and commodities trader), lawyers should pay particular attention to the accounting principles an enterprise uses to account for transactions arising from the new business activities.



3. Looks aren’t everything.

Pro forma reporting can distort an enterprise’s financial appearance. In its 2001 third-quarter earnings release, Enron reported “recurring” net income of \$393 million. Such *pro forma* reporting, which provides numbers “as if” certain (often undescribed) assumptions apply, does not follow GAAP. Even a simple analysis of the earnings release reveals that Enron actually suffered a \$618 million *net loss* under GAAP. By labeling \$1.01 billion as “one-time” or “nonrecurring” charges, mostly related to investment and asset write-downs and restructuring charges, the company turned its \$618 million net loss, purportedly using GAAP, into \$393 million in net income. Such write-downs and charges, however, would seem to represent normal business expenses and losses.

In an effort to focus investors on results from “normal” business operations, an enterprise may, knowingly or innocently, mislead investors. Initially, *pro forma* reporting can hide troubling financial results. For instance, in its 2000 fourth-quarter earnings release, Enron boasted a 25 percent increase in earnings per share (EPS) for the full

year 2000 over 1999, and a 32 percent increase in earnings per share for the 2000 fourth quarter over the 1999 fourth quarter. Buried in the last section of its earnings release, however, the company told a very different story. Enron disclosed that EPS for 2000, including nonrecurring charges, increased only from \$1.10 per share in 1999 to \$1.12 per share in 2000. These amounts translated to an increase of only 1.8 percent, compared to the 25 percent increase Enron reported at the beginning of its earnings release. Next, Enron disclosed that 2000 fourth quarter EPS, after nonrecurring charges, totaled \$0.05, a decrease of 83.8 percent from 1999 fourth quarter, in contrast to the 32 percent increase it reported at the beginning of the release. Interestingly, earlier in the quarter, Enron predicted that it would post a fourth quarter EPS of \$0.35. Excluding what it called nonrecurring items allowed Enron to exceed those expectations. If Enron had included the nonrecurring items, its results would have fallen below that prediction.

Second, an enterprise can use *pro forma* reporting to manage earnings. Earnings management typically tries to increase net income (or reduce the size of a loss) relative to what the business would otherwise report under GAAP. Enterprises, however, sometimes exclude nonrecurring gains in an effort to report lower net income, which translates to smaller profit-sharing payments to employees (or reduced income tax obligations). Lawyers drafting agreements that rely on earnings to set prices or to trigger payments, for example, should distinguish *pro forma* earnings from net income calculated in compliance with GAAP. Without distinguishing between the two benchmarks, parties to such an agreement can manipulate earnings by labeling some items as one-time or nonrecurring.



Lawyers should also carefully scrutinize financial statements, disclosures and transactions that involve an auditor who may have compromised independence, whether in fact or in appearance.

4. Sometimes, looks are everything.

Auditor independence matters — both in appearance and in fact. During the late 1990s, the largest public accounting firms increasingly provided non-audit services, such as consulting, internal audits and tax advising, often for the very enterprises they audited. During 2000, Enron paid \$52 million to Arthur Andersen — \$25 million for auditing services, and an additional \$27 million for non-auditing services — and ranked as Andersen's second largest client. In addition, an internal Andersen memo regarding the retention of Enron as an audit client refers to \$100 million a year in potential revenues from Enron.

Unlike lawyers who must zealously represent their clients, auditors' real responsibilities flow to the investing public, not to the enterprise that hires them. By evaluating an enterprise's financial statements and expressing an opinion as to whether those statements fairly present, in all material respects, the enterprise's financial position and operating results, an auditor seeks to help maintain investor and creditor confidence. To satisfy generally accepted auditing standards, an auditor must remain independent from any enterprises it audits — both in fact and in appearance. When non-audit fees comprise a substantial piece of an auditor's income from the audit client, those fees might tempt an auditor to overlook an enterprise's "aggressive" accounting simply to retain the client's non-audit business. At a minimum, substantial fees paid to auditors for non-audit related services call the appearance of independence into question. Even if the auditor continues, in fact, to exercise objective judgment, such relationships impair the appearance of independence. As the recent malaise that has afflicted the stock markets in the United States ably demonstrates, even the *perception* of lack of independence can shake investor confidence in the quality of financial statements. Because investors view a lack of independence, whether in appearance or in fact, with a critical eye, lawyers should encourage clients to preserve independence, both in fact and in appearance. Lawyers should also carefully scrutinize financial statements, disclosures and transactions that involve an auditor who may have compromised independence, whether in fact or in appearance.

5. With friends like these, . . .

Related-party transactions, especially those involving a special purpose entity (SPE), can distort an enterprise's apparent financial condition and operating results. Although related-party transactions may increase efficiency in transacting business, they may also allow an enterprise to manipulate its earnings by the way the enterprise sets prices or allocates expenses. Similarly, an enterprise may use SPEs for legitimate purposes, such as to limit exposure to risk in certain investments, such as credit card receivables or residential mortgages. An enterprise, the "sponsor," generally forms an SPE to transfer risks from such investments to outside investors.

Enron's transactions with its SPEs, including the so-called Chewco and LJM partnerships, highlight the dangers that can arise from related-party transactions. As a small, but relatively simple example, Enron sold an interest in a Polish company to LJM2 for \$30 million on December 21, 1999. While Enron intended to sell the interest to an unrelated party, the company could not find a buyer before the end of the year. The sale allowed Enron to record a gain of \$16 million on a transaction that Enron could not close with a third party. Remarkably, Enron later bought back LJM2's interest for \$31.9 million after it failed to find an outside buyer. Another deal allowed Enron to report a \$111 million gain on the transfer of an agreement with Blockbuster Video to deliver movies on demand, even after Enron realized that no real profits would ever flow from the underlying agreement.

The related-party transactions with SPEs, often occurring at the end of a fiscal period, allowed Enron to manipulate its reported earnings, to close deals at desired amounts quickly, to hide debt, and to conceal poor performing assets. Such transactions, which frequently occurred at the end

of a quarter or year, allowed Enron to meet its earnings expectations and to sustain its stock price. In fact, Enron sometimes even backdated such transactions to the previous period, in an effort to “manufacture” income for that period. Because Enron entered into those transactions with “friendly” related parties, the company could quickly and easily negotiate terms that allowed its earnings to appear on target. In addition, Enron used its earliest SPEs to obtain financing without showing the related liability on its balance sheet. Finally, Enron used SPEs to move poor-performing assets off of its balance sheet. By transferring such assets to SPEs, Enron could hide later declines in the value of those assets.

GAAP requires an enterprise to disclose information about material related-party transactions in the notes to the financial statements. In particular, an enterprise must disclose the nature of any relationships involved and also provide a description of the transactions for each period for which the financial statements present an income statement, including any information necessary to understand the transactions’ effects on the financial statements; the dollar amounts of the transactions and the effects of any changes in the method used to establish terms when compared to those followed in the preceding period; and amounts due from or to related parties on each balance sheet date and the related terms governing those amounts. The disclosures should not imply that the transactions contained terms equivalent to those that would have prevailed in an arms’-length transaction unless management can substantiate that claim. Enron did disclose various related-party transactions in the notes to its financial statements, but not in any detail.

Lawyers who assist in related-party transactions should carefully examine the transactions and their

client’s securities disclosures in an effort to assure that those disclosures accurately describe the transactions’ true nature and effects on the financial statements. Likewise, lawyers negotiating other transactions or pursuing

other claims, especially when future or past earnings determine legal rights and obligations, should keep in mind that an enterprise can use related-party transactions to manipulate earnings.

6. *Details, details, details.*

Corporations should develop and adhere to internal controls (both administrative and accounting). Administrative controls generally refer to an enterprise’s plan of organization, procedures and records that lead up to management’s approval of transactions. Accounting controls, by comparison, describe the plans, procedures and records that an enterprise uses to safeguard assets and produce reliable financial information. Enron’s administrative controls included policies designed to minimize conflicts of interest and to ensure that transactions fairly benefitted the company. Not only did recent events prove Enron’s administrative controls inadequate, but those events also showed that Enron failed to follow the controls that it had put in place.

For example, when Enron’s board approved a policy that allowed the company to enter into transactions with certain entities owned by Enron officers, the implementing procedures explicitly required management to use a “Deal Approval Sheet.” By requiring certain disclosures and the approval of Enron’s chief executive officer, the Deal Approval Sheets sought to ensure that the contractual provisions in such transactions would closely resemble the terms that would have materialized in an arms’-length transaction. In fact, the chief executive officer’s signature does not appear on the sheets for several specific transactions. Moreover, the current absence of sheets for other transactions suggests that Enron did not complete any such document in those transactions.

As another example, Andrew Fastow, Enron’s former chief financial officer, and, for a time, the general partner of the several partnerships that entered into transactions with Enron, reportedly earned more than \$30 million from his investments in those enterprises. Even though the board seemed to recognize the conflict of interest inherent in such related-party transactions, the board failed to require that Mr. Fastow report his profits from the partnerships to the company. Such disclosures almost certainly would have alerted the board to the possibility that the underlying transactions unfairly benefitted the related parties, to the detriment of Enron and its shareholders. Other items in this list document that Enron failed to implement adequate accounting controls.

Although top management bears the initial responsibility to develop, implement and, when necessary, revise adequate internal controls, overall oversight falls to the board of directors, who often rely on lawyers for advice. Internal controls work effectively only when those who bear responsibility for developing, implementing, and overseeing those controls stress the need to adhere to all policies and procedures and lead by adhering to those rules themselves. In recent years, the SEC has brought administrative actions and imposed so-called “tone-at-the-top liability” under the Foreign Corrupt Practices Act, which applies to all SEC registrants, including enterprises that engage only in domestic operations. Strong internal controls enhance the likelihood that the enterprise will engage in sound, beneficial transactions and reduce the chances that an enterprise will incur the enormous losses that can result from internal control failures.

7. *If it walks like a duck, . . .*

In recognizing revenue (and accounting generally), substance prevails over form. Under GAAP, an enterprise cannot recognize revenue until the business has substantially completed performance in a bona fide exchange transaction. If a transaction does not unconditionally transfer the risks that typically accompany a “sale,” the enterprise may not recognize revenue.

Enron’s announcement regarding a \$544 million after-tax charge to earnings in October 2001 revealed a serious flaw in its prior financial statements: Enron had improperly recognized revenue from transactions with its SPEs. In short, Enron recorded revenue after transferring certain assets to those SPEs, even though credit guarantees, promises to protect the purchasers from any loss from decline in value or buyback agreements caused the company to retain the risks of ownership even after the transfers. As a result, Enron had not truly “earned” the revenue it reported.

Enron’s “sham” transactions resemble schemes that ultimately led to the demise of Drexel Burnham and the imprisonment of Michael Milken, that appeared so frequently during the savings and loan crisis, and that accompany most financial accounting frauds today. Milken ultimately pled guilty to charges involving “parking,” whereby Drexel Burnham purchased securities from third parties with the understanding that the investment banking firm would quickly resell the securities back to the third parties at a fixed price. Similarly, the Federal Home Loan Bank Board took control of Lincoln Savings and Loan Association in 1989 after discovering, among other things, that Lincoln or its affiliates had recognized income on sales of real estate even though the funds for the down payments had emanated from Lincoln itself. In substance, Lincoln or its affiliates had retained the risks of ownership and could not recognize revenue from the sales.

The issue of substance over form applies not only to managers and accountants, but to attorneys as well. The litigation that follows from financial frauds can impose enormous financial costs. In addition, a lawyer who fails to investigate, or perhaps spot, a “red flag,” such as a side agreement or guarantee, can face staggering personal liability for malpractice. Whether drafting, negotiating or interpreting contractual provisions that refer to “net income” or “earnings,” performing “due diligence” to determine whether a particular transaction will further a client’s best interests or rendering a “true sale” opinion regarding whether a transferor that retains some involvement with the transferred asset (or the transferee) has surrendered economic control over the asset to justify treating the transaction as a sale for financial accounting purposes, substance over form requires an attorney to look beyond the form of a transaction and to try to identify any arrangements that may affect the transaction’s economic realities. In particular, understanding the motivations for a transaction offers an important clue to the transaction’s substance. Enron often transferred assets to SPEs to hide losses or to remove liabilities from its balance sheet. Although most clients or adversaries will not expressly state such desires, such effects should also alert attorneys to issues of substance over form.

Again, inadequate disclosure can subject enterprises to liability and lawyers to malpractice claims.

8. *Promises, promises.*

Any time an enterprise guarantees the indebtedness of another in material amounts, the enterprise must disclose the nature and amount of the guarantees in the notes to the financial statements. When Enron’s SPEs sought credit, the lenders often required that Enron guarantee the debt. On several occasions, Enron guaranteed amounts that various SPEs borrowed by promising to pay cash or to issue additional common shares to repay the debt if the market price of Enron’s common shares dropped under a set amount or if Enron’s bond rating fell below investment grade. While the notes to Enron’s financial statements disclosed guarantees of the indebtedness of others, Enron did not mention that its potential liability on those guarantees, which shared common debt repayment triggers, totaled \$4 billion. When material, GAAP specifically requires an enterprise to disclose the nature and amount of guarantees of the indebtedness of others. Again, inadequate disclosure can subject enterprises to liability and lawyers to malpractice claims.



Because provisions in many of Enron's credit agreements required the company to maintain an investment grade credit rating, the downgrades triggered debt repayment obligations, which accelerated Enron's bankruptcy.



9. *If it sounds too good to be true,*

An enterprise cannot recognize income from issuing its own shares and generally should not record a net increase in shareholders' equity when it issues stock in exchange for a note receivable. At the risk of oversimplifying, Enron used related-party SPEs to hedge, or to protect itself from declines in the market value of, certain investments that Enron used current market prices to value on its books. In these arrangements, Enron transferred its own stock to the SPEs in exchange for a note or cash. In addition, Enron guaranteed, directly or indirectly, the SPE's value. The SPEs in turn hedged the underlying investments, using the transferred Enron stock as the principal source of payment for the hedges. The value of the underlying investments decreased, but the hedges allowed Enron to recognize a corresponding increase, resulting in a wash. The SPEs, however, could reimburse Enron for any decline in value of the investments only as long as the market price of Enron's common shares remained stable or increased. When

the value of Enron's common shares fell, Enron had to issue additional shares pursuant to its agreements with the SPEs and the related guarantees. These additional shares reduced Enron's stock value, which triggered additional guarantees. In the interim, Enron recognized about \$500 million in revenues from the hedges, which had really arisen from the issuance of the company's own shares. GAAP, however, does not allow an enterprise to record gains from the increase in the value of its capital stock on its income statement.

As previously mentioned in the first item, Enron announced on October 16, 2001, that it had recorded a \$1.2 billion reduction in shareholders' equity, arising, in large part, from an accounting error. When Enron issued its common shares to several SPEs in exchange for notes receivable, Enron recorded the notes receivable as assets, thereby overstating shareholders' equity by \$1 billion. Although GAAP usually allows an enterprise to record notes receivable as assets, a different rule applies when an enterprise issues stock in exchange for the notes.

GAAP states that an enterprise should treat any notes received in payment for the enterprise's stock as an offset to shareholders' equity. Only when the obligor pays the note can the enterprise record an increase in shareholders' equity for the amount actually paid.

Many credit agreements allow the lender to accelerate the repayment of the debt if the borrower's debt-to-shareholders' equity ratio exceeds a certain level or if the borrower fails to maintain a certain credit rating. Although Enron's \$1.2 billion reduction in shareholders' equity did not itself trigger any debt repayment obligations, investment ratings companies immediately placed Enron on review for downgrade. Soon after, the ratings companies downgraded Enron's credit rating to below investment grade. Because provisions in many of Enron's credit agreements required the company to maintain an investment grade credit rating, the downgrades triggered debt repayment obligations, which accelerated Enron's bankruptcy.



... Enron officers and employees often either ignored the lawyers' advice, or changed the transactions just enough to get around the lawyers' particular concerns.

10. *When the going gets tough, . . .*

Lawyers' duties to their clients include an obligation to object when a client proposes or uses questionable accounting policies or practices. In his well-publicized opinion in the *Lincoln Savings and Loan* case, Judge Sporkin asked where the lawyers were when Lincoln consummated various improper transactions, wondering why they did not attempt to prevent those transactions or disassociate themselves

from them. Now, more than 10 years later, we hear similar questions directed to Enron's lawyers. While Enron's lawyers, both in-house and outside counsel, did question some practices, Enron officers and employees often either ignored the lawyers' advice, or changed the transactions just enough to get around the lawyers' particular concerns. In some cases, Enron's lawyers apparently helped to complete the very transactions they questioned.

The attorney-client privilege prevents lawyers from disclosing client confidences. That privilege, however, does not prevent lawyers from discussing concerns with their clients, attempting to persuade their clients to choose another course of action, going up the "corporate ladder" or even withdrawing from representing their clients if a client declines to follow the lawyer's advice. When Enron's lawyers questioned Enron's practices, they voiced their concerns to Enron's in-house lawyers and its management, but not to the board of directors or the audit committee. Blind deference to accountants and auditors seems unwise and dangerous. We'll never know, but without hearing the concerns of Enron's lawyers, the board of directors or the audit committee arguably could not see an objective picture of those transactions and Enron's financial accounting practices.

Standing up takes courage. Let's hope that Enron's collapse encourages more lawyers to watch for accounting "red flags" and to respond courageously when they see them.

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