# Case example 1.2

Enron was founded in 1985 with the merger of two US natural gas pipelines. In the 1990s it diversiﬁed into selling electricity and other activities; by 2000 it was one of the world’s largest companies when measured by reported annual revenue. It appeared to have a highly competent board of directors and **audit committee.** However, although investors and regulators were not aware of it at the time, the rapid growth in the reported assets and proﬁts of

Enron was attributable largely to misleading accounting practices. It inﬂated the value of its reported assets (sometimes recording expenses as assets) and it kept liabilities off its balance sheet by means of establishing ‘special purpose entities’. It also anticipated proﬁts by becoming the ﬁrst non-ﬁnancial services company to adopt ‘mark to market’ accounting techniques. This enabled it to earn proﬁts on long-term contracts ‘up front’ as soon as the contract started. In one case it claimed a large proﬁt on a 20-year contract agreed with Blockbuster Video in 2000, and continued to claim the proﬁt even after the project failed to work successfully and Blockbuster Video pulled out of the deal.

Senior management were rewarded on the basis of annual earnings and were highly motivated to continue reporting large increases in proﬁts, regardless of the longer-term consequences. Investors began to have doubts about the reliability of Enron’s reported proﬁts in 2001. A ‘whistleblower’ reported her concerns to the CEO, but her allegations of dubious accounting practices were ignored. However, in October 2001 Enron was eventually forced to announce that it would be re-stating its accounts for 1997–2000 to correct accounting violations. The SEC announced an investigation into the company, and the stock price collapsed. There were also doubts about whether Enron had sufﬁcient liquidity (cash) to remain in business for long. Its debt was downgraded to junk bond status and in December 2001 the company ﬁled for bankruptcy. Enron’s auditors were Arthur Andersen, one of the ‘big ﬁve’ global accounting ﬁrms. The ﬁrm – in particular its Houston ofﬁce – took extraordinary measures to protect its client. When the SEC investigation was announced in 2001, Andersen staff attempted to cover up evidence of negligence in its audit work by destroying several tons of documents, and many e-mails and computer ﬁles.

The ﬁrm, especially the Houston ofﬁce, was accused of losing its independence to Enron and overreliance on income from the non-audit work that it did for the company. Arthur Andersen was charged with obstructing the course of justice by shredding the documents and destroying the ﬁles. Although a guilty verdict was subsequently overturned by the Supreme Court, this was too late to save the ﬁrm from the loss of its major clients, and collapse. Several Enron employees were brought to trial for a number of ﬁnancial crimes. A former chief ﬁnancial ofﬁcer (CFO) of Enron was found guilty of crimes including fraud, money laundering, insider trading and conspiracy. Two former chief executive ofﬁcers (CEOs) were charged with a range of ﬁnancial crimes and brought to trial in 2006. Both were found guilty: one of them was imprisoned and the other died before sentence was passed.