HARVARD | BUSINESS | SCHOOL

9-109-039

REV: SEPTEMBER 19, 2013

PAUL HEALY

KRISHNA PALEPU

The Fall of Enron

Founded in 1985 as a natural gas pipeline company, Enron rapidly emerged as a pioneer in the deregulated energy market. Within 15 years, the company built leading businesses in energy trading and international energy-asset construction. In 2000, Enron reported operating revenues of $100.8 billion and earnings of $979 million (see **Exhibit 1**); Fortune magazine rated it the world's most innovative large company for the sixth year in a row; and investors valued the company at more than $60 billion, a multiple of 64 times earnings and six times book value.

Yet within a year, Enron's reputation was shattered. Many of its leading executives departed, the company owned up to violations of accounting rules and took a major write-down, its stock became virtually worthless (see **Exhibit 2**), and it was forced to file for bankruptcy. How could such an apparently successful company collapse in this manner? How could the governance agents responsible for overseeing and reviewing the company's management, strategy, internal controls, and financial reporting have failed to foresee the problems in time to take corrective action?

Enron's Business

In 1985, InterNorth acquired Houston Natural Gas (HNG) to form HNG/InterNorth, a natural gas pipeline company that owned 37,000 miles of intra- and interstate pipelines for transporting natural gas between gas wellhead producers and utilities. Six months after the acquisition, Ken Lay, who had been the CEO and Chairman of HNG (see **Exhibit 3** for a biography of Lay), was appointed CEO of the new company. Lay moved the company from Omaha to Houston and renamed it Enron.

Energy-Trading Model

At the time of Enron's creation, the U.S. gas market was in the midst of deregulation. Prior to 1985, the Federal Energy Regulatory Commission (FERC) required interstate pipeline firms to make long-term commitments to purchase minimum gas volumes from wellhead producers at regulated prices that exceeded market spot prices. Pipelines passed along these higher costs to their customers by selling a bundled product of gas and delivery services. However, rules established in 1985 (FERC Order No. 436) decoupled the purchase and delivery of gas. As a result, gas users could realize cost savings by purchasing natural gas at spot prices (which were much lower than the bundled prices offered by the pipelines) and separately contracting with pipeline firms for delivery.[1] The new

Professors Paul Healy and Krishna Palepu prepared this case. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Copyright © 2008, 2009, 2010, 2011, 2012, 2013 President and Fellows of Harvard College. To order copies or request permission to reproduce materials, call 1-800-545-7685, write Harvard Business School Publishing, Boston, MA 02163, or go to www.hbsp.harvard.edu/educators. This publication may not be digitized, photocopied, or otherwise reproduced, posted, or transmitted, without the permission of Harvard Business School.

regulation transformed pipeline firms from companies that provided customers with bundled gas purchase and delivery services, to firms that primarily provided gas transportation.

One side effect of the deregulation was to expose gas users to short-term volatility in gas spot prices, making their planning and pricing more challenging. Jeffrey Skilling, a McKinsey & Company senior partner who provided strategy advice to Enron, recognized that Enron could take advantage of its position as the largest interstate pipeline firm to help gas buyers manage this volatility.[2] To do so, Enron entered into long-term fixed-price contracts with its customers, guaranteeing them stable gas prices for the duration of the contract. To manage the risks associated with these commitments, Enron used long-term fixed-price contracts to purchase gas from producers and financial derivatives (such as swaps, and forward and futures contracts) to reduce its exposure to fluctuations in spot prices on future gas purchases required to meet the delivery commitments of its long-term customer contracts.

Skilling joined the firm in 1990 as president of Enron Finance Corp., responsible for trading operations (see **Exhibit 3** for a biography of Skilling). By 1993, the company was the largest seller of natural gas in North America and gas trading contributed $316 million to its earnings before interest and taxes (see **Exhibit 4**). The November 1999 creation of EnronOnline, a Web-based transaction system that allowed users to buy, sell, and trade commodity products online with Enron on a global basis, enabled the company to grow its trading business even more aggressively. By the fourth quarter of 2000, each of its traders generated an average of 3,084 transactions per year versus 672 in 1999.[3]

In the late 1990s, Skilling refined the trading model further. He argued that "heavy" assets, such as pipelines, increased the company's debt burden and were a drag on rates of return. Instead, the key to dominating the trading market was information. Skilling recommended that Enron hold heavy assets only if they were useful for generating information. The company subsequently began divesting and syndicating heavy assets to pursue an "asset light" strategy. A presentation to the Finance Committee of the Board indicated that by October 2000, $27 billion of Enron's $60 billion in heavy assets had been sold or syndicated.[4] As a result, by late 2000, it was estimated that in the natural gas sector Enron sold 20 times its pipeline capacity, and yet it owned 5,000 fewer miles of pipeline than it did when the company was founded in 1985.[5]

Extending the Trading Model

As president of Enron's trading operations, Skilling argued that Enron's gas-trading innovation could be successfully extended to other markets. The company focused on markets that were highly inefficient and had the following characteristics: They were fragmented and undergoing significant change, particularly deregulation; distribution channels were complex, capital intensive, and dedicated to a single commodity; sales cycles were lengthy; supply and service contract quality and standards were loosely defined; pricing was opaque, without public disclosure; and buyers had limited flexibility to manage key business risks.[6] In each market that it entered, Enron sought to rapidly acquire physical capacity so that it could guarantee delivery to customers. It would then provide customers with contractual arrangements that helped them manage their business risks. Finally, Enron would manage its own exposure to price volatility arising from future delivery commitments to customers by using financial derivatives.

The first market developed after natural gas was electric power. In 1997, Enron acquired electric power generation, transmission, and distribution expertise by buying Portland General Electric, an electric utility based in Oregon, for $2.1 billion. Soon after, it acquired electricity distributors in Brazil and Argentina. However, the electricity market had one complication over its gas counterpart:

Electricity could not be stored to satisfy peak demand, leading to even higher price volatility than in the gas market. To implement its model, Enron had to find a way to ensure that it could meet its commitments to provide electric power in peak periods. It responded to this challenge by building "peaking plants" designed to meet short-term spikes in demand. The apparent success of this approach increased Enron's management's confidence that the trading model could be applied successfully to other markets.[7]

In January 2000, Enron announced the formation of Enron Broadband Services (EBS), to extend the trading model into bandwidth trading. By the end of the third quarter of 2001, EBS had reportedly invested more than $1 billion in capital expenditures to support its bandwidth-trading operations. Other assets traded included coal, water, weather, pulp, and paper. The growth in Enron's trading businesses was reflected in segment results that showed revenue growth of 168 percent and earnings growth of 240 percent in 2000 (see **Exhibit 4**).

International Businesses

In addition to its energy-trading model, Enron was active in the international energy-asset construction business. Headed by Rebecca Mark, who vied with Skilling to be Lay's successor, Enron International was created to construct and manage energy assets outside the United States, particularly in markets where energy was being deregulated. The unit's first major project was the construction of the $1.4 billion Teesside power plant in the United Kingdom. Upon completion in 1993, Teesside was the largest gas-fired heat and power plant in the world and had been the largest project-financing transaction in the United Kingdom after the Chunnel. Once the project was completed, Enron became Teesside's largest gas-supply provider, and through it, obtained access to gas trading in Europe. Other large construction and asset-management projects included the $2.9 billion Dabhol Power Project in Mumbai, India, where Phase I construction was completed in May 1999;[8]the Sutton Bridge power plant in the United Kingdom, which was started in January 1997; as well as projects in Eastern Europe, Africa, the Middle East, China, and Central and South America. The Dabhol project proved to be particularly troubled, with delays arising from local criticism of the Indian state and national governments over the favorable terms offered to Enron.[9] By 1999, Enron had invested almost $3 billion in assets in developing markets (50% in Brazil and Argentina, and 15% in India);[10] by 2001 this total had grown to $10 to $15 billion.[11] Exhibit 4 shows Enron's International segment performance and the growth.

Mark also encouraged Enron to invest in the global water business. In 1998, it acquired Wessex Water PLC for $2.4 billion.[12] The new venture, run by Mark as part of Enron's Azurix subsidiary, sought to take advantage of increased privatization and consolidation within the water industry, and to pursue the development of water projects in Europe, Latin America, and Asia. In 1999, Enron sold 76 percent of Azurix in a public offering on the New York Stock Exchange.

Promoting Deregulation

Many of the markets that Enron entered were recently deregulated or were in the process of deregulation. Enron played an active role in lobbying for the deregulation. Early in his career, as a member of the forerunner of the Federal Energy Regulatory Commission, Lay had been a strong advocate for deregulation of prices in energy markets.[13] He later developed close personal connections to high-ranking government officials in both U.S. political parties. He contributed heavily to the presidential campaigns of George W. Bush and George H.W. Bush, was a prominent member of Vice President Cheney's task force to develop a national energy policy, served as cochairman of Bush's economic summit in Houston in 1990, and headed Houston's host committee for the Republican National Convention. He was also an occasional golf partner of President Clinton.[14]

As Enron's CEO, Lay deployed the company's resources and his personal connections to support expanded deregulation. The company employed more than 100 lobbyists in its Washington office and spent a large portion of the office's $6.5 million budget blocking attempts to regulate its derivatives-trading business and to influence the SEC, FERC, and the Commodity Futures Trading Commission, which oversaw its businesses.[15] As a result of these efforts, Enron was able to develop a trading operation that was effectively unregulated.[16] Its lobbying activities also extended to Great Britain and India, where it sought to minimize government oversight of its large construction projects.[17]

Managing Talent

Enron viewed itself as a company that was built on innovation, and it was consistently rated among the most innovative large companies in the world. To create this culture, Enron aggressively recruited the "best and brightest[18.]" It competed with the leading investment banks and consulting firms for top business school students, and it recruited scientists and engineers who could help the firms' traders stay one step ahead of the competition in trading strategies. Recruits were lured with attractive signing bonuses and the promise of earning annual bonuses of as much as 100% of their salaries.[19] Once hired, they were encouraged to move around the organization freely to positions where they felt they could add value and generate additional revenue.

To evaluate and develop its employees, Enron relied on a biannual feedback system based on 360-degree reviews of employees from peers, customers, and supervisors.[20] A 20-person performance review committee, or PRC (appointed by Skilling), used this information to sort all employees with a given job title into one of six performance categories based on the value they created to the organization ("superior," "excellent," "strong," "satisfactory," "needs improvement," and "issues") using a forced curve.[21] Employees who were ranked in the bottom 20% risked being fired.[22] In discussing what the PRCs were looking for, Skilling noted: "You have to constantly show that you are adding value to the organization. That value can come in the form of new business ideas that make money or from doing the old business well and maintaining the organization while others go on to build a new business. And you get the benefit of the doubt for trying something new."[23] Skilling argued that the process reduced the effect of personal bias and office politics, because employees' careers were in the hands of a committee rather than their individual bosses. [24]

The performance evaluation process was used to drive employee compensation. Enron's salary and bonus awards were generous compared to industry norms. For 2000, the company awarded $750 million in cash bonuses. Superior originators of new deals and traders were particularly well rewarded.[a] The average salary for originators ranged from $150,000 to $200,000, but annual bonuses, which were based on the present value of future inflows from deals completed during the year, could be as high as $1 million.[25] For traders, bonuses were based on the present value of the trading profits they generated. Senior corporate executives received "phantom equity" in business units that could be converted into cash or Enron stock, multimillion-dollar bonuses if Enron's stock price hit a new target, and special bonuses for key accomplishments such as closing a major new deal.[26] Employees and executives were typically encouraged to accept bonus awards in the form of Enron stock or stock options.

[a] Deal originators were responsible for generating new contracts with customers, whereas traders were responsible for acquiring inventory and managing risks associated with fulfilling customer contracts.

Risk-Management Practices

Skilling recognized that the drive for innovation, with high levels of employee mobility and decentralized decision-making, necessitated a strong risk-management system. This was made especially clear in 1997 following a control breakdown in a North Sea gas project (J-Block) that led to a $675 million write-off.[27] Skilling created an independent group called Risk Assessment and Control (RAC) headed by a chief risk officer, Rick Buy, who reported directly to Skilling. RAC's responsibilities included analyzing significant financial and nonfinancial risks for all of Enron's businesses, projects, and transactions. RAC had a staff of 150 and an annual budget of $30 million.[28]

Buy explained the impact of RAC on the organization as follows:

> A lot of our capital-intensive international deals started looking a lot less attractive after factoring in things like currency risk and default probability. Some parts of the organization didn't want to hear that. We were the speed bump they would prefer to drive around.… But we try to work with business-unit people to keep the risk pendulum in the middle—between the total freedom that creates a J Block situation and rigid control that kills entrepreneurship.[29]

RAC evaluated the aggregate risks and rewards of the company's investments using a variety of information tools. Enron was one of the earliest adopters of value at risk (VAR) analysis, estimating with a 95% confidence level how much its investments could potentially lose in a given day in view of historical volatility and correlations in commodity prices, interest rates, and foreign exchange rates. The VAR analysis was supplemented by Monte Carlo simulations that examined how sudden economic shocks could impact the company's portfolios. RAC also used an information system known as RisktRAC, which separated all trades and contracts into 1,217 trading portfolios based on the type of exposure (e.g., interest rate, time horizon, location, or price risk).[30] Traders who were specialists in managing each of these risks were assigned responsibility for managing the separate portfolios and were supported by a research group that provided models and tools to help assess whether to trade, hold, or hedge particular investments. RisktRAC repriced the books at the end of each day and generated reports at the beginning of the next day showing the firm's overall position.[31]

To evaluate new business ideas, RAC reviewed the business plans, assessed their relation to Enron's existing core businesses, and conducted a value-at-risk analysis. The process concluded with a deal approval sheet (DASH) that provided a recommendation and a list of five or six key risks; it went to top managers and, if appropriate, to the board. New business plans were expected to "have some connection to the company's core business—such as sharing the hole with the gas pipeline in the case of fiber optic cables in the new communications venture—and they have to survive a run through the company's computer-based risk models."[32]

Central to Enron's control system was its 64-page Code of Ethics, which laid out accepted behaviors.[33] All employees were required to certify in writing that they had complied with the code and to come forward if they knew of violations. In addition, any investments made by senior managers where there were potential conflicts of interest with the company had to be approved by the Chairman of the Board and the CEO.[34]

Financial Reporting Challenges

Enron's complex business model—reaching across many products, including physical assets and trading operations, and crossing national boundaries—stretched the limits of accounting. Two issues were particularly challenging. First, its trading business involved complex long-term contracts. Enron lobbied successfully for accounting rules to permit the use of present value accounting for these contracts. Under this approach, known as mark-to-market accounting, when a long-term contract was signed, the present value of the stream of future contract inflows was recognized as revenues, and the present value of the expected costs of fulfilling the contract was expensed. Subsequent unrealized gains and losses in the market value of long-term contracts that were not hedged were required to be reported as part of annual earnings.

Since Enron's contracts with its customers were at fixed rates, estimating the present value of future inflows was not difficult. The challenge came in estimating the cost of fulfilling the contracts, a responsibility of Enron's traders. Forward contracts, where sellers committed to deliver specific commodities to buyers at some point in the future, were privately negotiated, not standardized, and required the two parties to bear each other's credit risks. Cost estimation was further complicated since many states had yet to deregulate energy, requiring Enron's traders to estimate the timing and likelihood of future deregulation, as well as its impact on spot prices. As a result, estimates of the cost of contract fulfillment were highly subjective.

The second challenge arose over the financial reporting for special-purpose entities (SPEs) that Enron used to implement its asset light strategy and to hedge investment gains. Financial reporting rules recognized an SPE as a separate entity from the sponsor if an independent third-party owner had a substantive equity stake that was "at risk" in the SPE, interpreted as at least 3% of the SPE's total debt and equity. The independent third-party owner also had to have a controlling (more than 50%) financial interest in the SPE. From Enron's perspective, if these rules were satisfied, any Enron assets sold to the SPE were removed from Enron's balance sheet, and any gain on sale included in its income. If the rules were not satisfied, Enron had to consolidate the SPE's assets and liabilities into its own balance sheet.[35]

By 2000, Enron had hundreds of special-purpose entities. Many were funded by independent equity investors and lenders and purchased forward contracts from gas producers, enabling Enron to eliminate the forward contract receivables from its balance sheet and to generate cash flow to meet its obligations to gas buyers under long-term fixed contracts. However, others led to questions about Enron's accounting. For example, one of its investments was a joint venture with Californian Public Employees' Retirement System (CALPERS) called JEDI. JEDI was an investment fund whose assets included 12 million Enron shares that were marked-to- market. Since Enron had joint control over the venture, JEDI was not consolidated and its debt was therefore not included on Enron's balance sheet. But Enron showed its share of any JEDI gains and losses (including the increase in value of Enron shares) in its income statement.[b] In November 1997 Enron reached an agreement to buy out CALPERS stake in JEDI for $383 million. To do so, it created Chewco, a SPE funded with $383 million of debt and equity. Chewco's capital consisted of a $240 million loan from Barclays Bank that was guaranteed by Enron; a $132 million loan from JEDI; $0.1 million of equity from Michael Kopper, an Enron employee who reported to CFO Andrew Fastow and who became the SPE's general partner; $11.4 million of equity from Big River, comprising an $11.1 million equity loan from Barclays Bank[c] and $0.3 million equity from Little River Funding (which was controlled by William Dodson, a close friend of Kopper).[36] Enron did not consolidate Chewco into its financials. Two members of Enron's board subsequently testified that the board was not informed of Kopper's involvement with Chewco,

[b] The inclusion of gains and losses in Enron shares in Enron income was discontinued in the third quarter of 2000, when Arthur Andersen determined that this policy was not in accordance with generally accepted accounting standards.

[c] Under the agreement, Barclays required the equity investors to establish "cash reserves" of $6.6 million fully pledged to secure the repayment of its $11.4 million equity loan.

as required under the company's Code of Ethics, and believed that Chewco was a completely unaffiliated third party.[37]

Another controversial SPE was LJM1, which was formed in 2000 to hedge unrealized gains from an Enron investment in an illiquid broadband stock (Rhythms NetConnections, Inc.) and to purchase Enron assets sold under its asset light strategy. Using mark-to-market accounting, Enron had reported a $186 million gain on the Rhythms stock in its 1999 income. To hedge this gain, Enron transferred forward contracts for 3.4 million Enron shares valued at $168 million to LJM1.[d] In return, Enron received a note for $64 million due March 31, 2000, and $104 million of put options on the Rhythms stock. PricewaterhouseCoopers provided a fairness opinion on the transaction. If Rhythms stock declined in value, LJM1 would sell a portion of its Enron stock and use the proceeds to purchase Rhythm stock from Enron at the agreed put price, thereby hedging Enron's investment gain. To facilitate the deal, Andrew Fastow, Enron's CFO, invested $1 million in LJM1 and served as the SPE's sole general partner. He then raised an additional $15 million in equity from two limited partners. Under the deal, Fastow was entitled to receive management fees and distributions that would enable him to earn a 25 percent return on his investment. In other transactions with Enron, LJM1 purchased a portion of the company's interest in a Brazilian power project and stock in a SPE called Osprey.[38] LJM1 was followed by other SPEs with similar structures and purposes, notably LJM2 and Raptor. None of these entities was consolidated in Enron's financial statements.

Board of Directors

The board of directors was responsible for appointing and, if necessary, removing the CEO, as well as for overseeing firm strategy and for approving major new corporate initiatives. In addition, the board delegated responsibility to an audit committee for overseeing the internal and external auditors and the financial reporting process, and responsibility to a compensation committee for evaluating the CEO's performance and setting CEO compensation.

Enron's board was chaired by Ken Lay and included highly respected business, academic, and government leaders (see **Exhibit 5**).[e] The board met five times per year and occasionally for special meetings. As was common at the time, it did not have a practice of meeting without management present.[39] Annual directors' fees were $50,000, with half set aside for payment upon retirement from the board. However, grants of stock and stock options pushed the total value of compensation for directors to around $330,000 in 2000, among the highest for public company boards.[40]

One of the challenges faced by Enron's board was the review and oversight of the SPEs created to acquire Enron assets or hedge its investment gains, and which were controlled by Enron executives. On June 28, 1999, at a special telephone conference meeting of the board, Fastow presented the proposal to create LJM1. Fastow explained how the deal would permit Enron to hedge the gains on the Rhythms stock. He also informed the board about his own compensation arrangements under the transaction. The board concluded that Fastow's participation would "not adversely affect the

[d] The market value of the shares was actually $276 million, but a lower value was placed on the stock because Enron restricted sale or transfer of most of the stock for four years.

[e] Many outside board members had financial ties with Enron. For example, Lord Wakeham was paid a monthly retainer of $6,000 for consulting services; John Urquart had received $493,914 from Enron since 1991 in consulting fees; Enron had entered hedging transactions worth tens of millions of dollars with Belco Oil and Gas (where Robert Belfer had been Chairman and CEO); and Enron and Ken Lay had donated more than $2.1 million to the M.D. Anderson Cancer Center (where Charles LeMaistre and John Mendelsohn were past and current presidents respectively), and more than $50,000 to George Mason University and the Mercatus Center (where Wendy Gramm worked).

interests of the Company" and voted, as permitted by Enron's Code of Ethics (see **Exhibit 6** for the relevant section of the code to allow Fastow to become general partner and investor in LJM1.[f,41] Fastow subsequently reported to the board that LJM1 had contributed more than $200 million in earnings and $2 billion in cash flow to Enron.[42]

In October 1999, the Finance Committee reviewed and approved Fastow's request for the creation of LJM2, another entity to be controlled by Fastow, and which would purchase and sell shares in Enron assets. The proposal was approved by the full board one day later. At the same time, the board accepted a management proposal that all of Enron's SPE transactions that were controlled by Fastow be subject to review and approval by Richard Causey (the chief accounting officer). One year later when LJM3 was approved by the board, additional controls included a review by Rick Buy (the chief risk officer) and Jeff Skilling, with annual review by the board's Audit and Compliance Committee. The board's Finance Committee also decided to review transactions on a quarterly basis and requested the Compensation and Management Development Committee to review Fastow's remuneration from the SPEs in which he was involved.[43] The Chairman of the Compensation Committee, Charles LeMaistre, made two requests to Mary Joyce, Enron's senior compensation officer, for information on outside income for all the company's senior officers. On both occasions Joyce indicated that she did not have the information and LeMaistre eventually let the matter drop.[44] The Audit and the Compensation Committees were informed on February 12, 2001 that further controls had been put in place to monitor transactions with Enron where there were potential conflicts of interest.[45]

Board documents at approvals of the Raptor SPEs, which like the LJM entities provided Enron with hedges that were backed by Enron stock, explained that the purpose of the Raptors was to protect Enron's income statement from losses and identified the risks from declines in the value of Enron stock. In April 2001, the Chair of the Finance Committee, Herb Winokur, requested an analysis of the risk for the Raptors from a decline in Enron's stock price. The report showed that if Enron's stock fell from the current price of $60 to $40, the Raptor assets would fall to zero and Enron would be required to produce around 35 million shares to support the Raptor commitments.[46]

Audit and Compliance Committee

In 2000, audit committees would typically meet just a few times during the year, and their members usually had only a modest background in accounting and finance. As outside directors, they relied extensively on information from management as well as internal and external auditors. Enron's audit committee, however, had several members with strong financial expertise, including a professor of accounting who was former dean of the Stanford Business School, as well as a former chairman of the U.S. Commodity Futures Trading Commission, among other experienced business leaders.

At its meetings, Enron's Audit and Compliance Committee reviewed a wide range of reports from management and the internal and external auditors. For example, at its February 12, 2001 meeting, which lasted for 85 minutes, the committee's agenda covered the Audit and Compliance Committee Report as well as reviews of reports on: (a) Enron's compliance with generally accepted accounting standards and internal controls by Arthur Andersen, its external audit firm; (b) the adequacy of reserves and related party transactions; (c) disclosures relating to litigation risks and contingencies;

[f] The one-hour board meeting also discussed a stock split resolution, an increase in the number of shares in the company's stock compensation plan, the purchase of a new corporate jet, and an investment in a Middle East power plant (see U.S. Senate Report, p. 27).

(d) the 2000 financial statements, which noted new disclosures on broadband operations and provided updates on the wholesale business and credit risks; (e) executive and director use of company aircraft; (f) company policy for management communication with analysts and the impact of Regulation Fair Disclosure; (g) the 2001 Internal Control Audit Plan, which included an overview of key business trends, an assessment of key business risks, and a summary of changes in internal control efforts by businesses for 2001 compared to the period 1998 to 2000; and (h) a proposed revision in the Audit and Compliance Committee charter.[47]

Several presentations to the Audit Committee by Arthur Andersen, the external auditors, indicated that there were risks associated with Enron's accounting. A February 1999 briefing, presented nine accounting practices used by the company that were classified as particularly risky, and David Duncan, the lead audit partner on the Enron engagement, reportedly informed directors that although Andersen was "on board" with various Enron transactions, "many push the limits" and other auditors might take a "different view."[48] Similar presentations at meetings through 2001 identified Enron's use of highly structured and related-party transactions as high-risk areas.[49] Several Enron Audit Committee members recognized that the company was engaged in business practices that "had not been done by many companies in the world" and that as a result its accounting was "leading edge."[50]

Compensation and Management Development Committee

In 2000, Enron's Compensation and Management Development Committee awarded Ken Lay, the chairman, compensation of $18.2 million, comprising $1.3 million in salary, $7 million in bonus, $7.5 million in restricted stock, $0.8 million in stock options, $1.2 million in payout on a long-term incentive plan, and $0.38 million in perquisites. In addition, Lay received $123 million from exercising a portion of his Enron stock options, placing him among the highest paid CEOs for the year.[51] Jeffrey Skilling, who had replaced Lay as CEO in February 2001, was awarded $10.9 million ($0.85 million in salary, $5.6 million in bonus, $3.5 million in restricted stock, $0.87 million in options, and $0.05 million in perquisites. For the company in total, cash bonuses awarded for 2000 amounted to $750 million.

The Compensation Committee also provided Ken Lay with a $4 million line of credit from the company, which was increased to $7.5 million in August 2001. In May 1999, the Committee agreed to permit Lay to repay the line using company stock he owned. Records showed that in 2000, Lay began repeatedly drawing down the line of credit and then repaying with company stock. From October 2000 to October 2001, he used the credit line to obtain more than $77 million in cash, which he then repaid using his company stock. These transactions were reported to the SEC at the end of the fiscal year. Board and Compensation Committee members claimed they were unaware of the transactions at the time they occurred.

External Auditors

The external auditors were responsible for assessing whether a firm's financial statements were presented in accordance with generally accepted accounting standards (GAAP). As a result of changes in professional standards adopted in the 1970s, the audit industry became increasingly competitive during the 1980s and 1990s, with many client managers prepared to switch firms for lower fees.[g] At the same time, auditor litigation risks increased as a result of changes in legal standards. These changes prompted audit firms to mechanically apply consistent accounting and auditing standards, and to develop standardized audit procedures to lower costs and reduce their liability. They also began aggressively diversifying into higher-growth, higher-margin consulting services.

Arthur Andersen, Enron's external auditor since 1985, had a close working relation with its client. Beginning in 1993, Enron outsourced many of its internal audit functions to Andersen. About 40 Enron employees shifted to Andersen's payroll.[52] In addition, Andersen performed consulting services for Enron such as risk management, tax work, and appraisals of assets Enron was interested in buying or selling. In 2000, Arthur Andersen received $25 million in audit fees (27% of the audit fees of public clients for the Houston office that was primarily responsible for the Enron audit) and $27 million for consulting fees, including $5.7 million for services related to Chewco and other controversial SPEs. Over the years, 86 Andersen employees joined Enron, including its chief accounting officer, treasurer, and the chief financial officer after Fastow left the firm in 2001.

Internal Andersen documents indicate that Andersen viewed Enron as engaging in high-risk accounting. For example, in its 1999 and 2000 client risk analyses, Andersen classified Enron in its maximum risk category. The 2000 analysis, signed by Duncan and four other partners reported that management pressures and accounting and financial reporting risk were "very significant." Other comments explained that Enron's "personnel are very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to achieve derived financial reporting objectives."[53] In February 2001, an Andersen memo outlined a range of issues and discussed whether it made sense for Andersen to retain Enron as a client, but these concerns were never shared with Enron's audit committee or management.[54]

Enron's Rapid Demise

On August 14, 2001, eight months after succeeding Lay as Enron's CEO, Jeffrey Skilling surprised colleagues by announcing that he was resigning for family reasons, citing personal pressure from the company's 50percent stock-price decline from its high of $90 in September 2000. Skilling was replaced by Lay, who attempted to reassure investors by reporting that "absolutely…no accounting issue, no trading issue, no reserve issue, no previously unknown problem issues are involved [in Skilling's resignation]."[55]

Skilling was not the only senior executive to resign in the 1999–2000 period. Joe Sutton, who joined in 1992 and became vice chairman in 1999, left in November 2000. Rebecca Mark, who led Enron's international business and had been made head of the water business, resigned in August 2000. In May 2001, the firm lost Lou Pai, who had joined in 1987 and was CEO of Enron Energy Services; Tom White, who had been with the firm for 11 years; and Cliff Baxter, vice chair of strategy. One month later, Ken Rice, CEO of Enron Broadband Services, resigned. When Lay returned as CEO, only two senior managers had significant operational experience.

One day after Skilling's resignation, Sherron Watkins, a vice president for corporate development, sent an unsigned letter to Lay informing him that she feared the company was about to "implode in a wave of accounting scandals" (see **Exhibit 7**). Watkins raised concerns about aggressive accounting for certain SPEs and noted that many of these entities' assets comprised Enron stock, whose value

[g] Although the audit committee officially appointed the auditor, in reality the task was performed by management, who made a recommendation to the audit committee.

was declining, triggering requirements for equity infusions by Enron to satisfy capitalization requirements. Shortly after writing her letter, Watkins revealed her identity and met with Lay, revealing further concerns about profits made by Fastow and his partners in the LJM partnerships. Lay responded by passing a copy of the unsigned letter to general counsel, who appointed long-term outside counsel, Vinson & Elkins (V&E), to conduct an investigation.[h] V&E interviewed eight Enron officers, two Andersen partners, and Watkins. In its report, V&E concluded that the company's accounting was "creative" and "aggressive" but was not "inappropriate from a technical standpoint" and did not warrant further investigation.[56]

At the October 8, 2001 board meeting, the directors were informed about Watkins's letter. However, they were not provided her identity, were not informed that her letter raised questions about LJM and related party transactions, and did not see copies of the letter or V&E's report until after Enron had begun to collapse. At the same meeting, management announced that Enron would terminate hedges by the Raptor and LJM SPEs as a result of credit problems. As a result, there would be an $800 million earnings charge, later reduced to $544 million, to reflect the decline in value of Enron investments in broadband and water. Despite this bad news, most board members stated that they left the meeting unconcerned about the company's future, since the charge was a one-time event.[57]

The public earnings announcement on October 16, 2001, however, stunned Wall Street. Later that day, in a conference call with analysts, Lay revealed that the company would also be reducing shareholders' equity by $1.2 billion in connection with the early termination of structured finance arrangements for the LJM SPEs. Most of the company's directors first learned of this reduction when it was reported in the financial press, and many indicated that they had been misled about key aspects of the LJM deals.[58]

On October 21, 2001, a Wall Street Journal article reported on the details of Enron's transactions with the LJM SPEs and alleged that they had provided Fastow with income of more than $7 million. In response, the board directed Charles LeMaistre and John Duncan to phone Fastow and request information on his LJM investments and compensation. Fastow acknowledged that his total remuneration from LJM was $45 million. He was fired one day later.

The Securities and Exchange Commission opened an inquiry into potential conflicts of interest among Enron, its directors, and the special partnerships. Subsequent investigations by the Powers Committee, an independent investigation into Enron commissioned by its board of directors, confirmed that Fastow had profited handsomely from transactions between Enron and the SPEs he controlled, and that neither management nor the board had effectively implemented resolutions to review relevant transactions and Fastow's compensation.[59] Ten days after the write-off announcement, Enron's stock had dropped by 50%, the company was struggling to ensure that it had sufficient liquidity to support its trading business, and leading rating agencies had put the firm on credit watch.

On November 8, Enron announced that it was restating its financials for the prior four years to retroactively consolidate partnership arrangements. It conceded that its method of reporting for the SPEs violated accounting standards that required at least 3 percent of assets to be owned by independent equity investors. By ignoring this requirement, Enron was able to avoid consolidating these SPEs on its balance sheet, thereby overstating its profits and equity and understating its

[h] In a follow-up letter to Lay, Watkins specifically warned against appointing V&E as investigators, arguing that they had been involved in setting up the structured finance vehicles and therefore faced a conflict of interest.

liabilities. Restatements for the years 1997 to 2000, primarily to correct these violations, reduced earnings for the four-year period by $586 million (20 percent of profits for the period) and owners' equity by $929 million[60] (in addition to the $1.2 billion announced in mid-October).[61]

One day later, Enron agreed to be acquired by Dynegy, its primary competitor in the energy market, for $9 billion. However, when on November 28 major credit-rating agencies downgraded Enron's debt to junk-bond status, forcing the firm to retire $4 billion of its $13 billion debt, Dynegy pulled out of the proposed merger.[i] On December 2, Enron filed for bankruptcy in New York and simultaneously sued Dynegy for breach of contract.

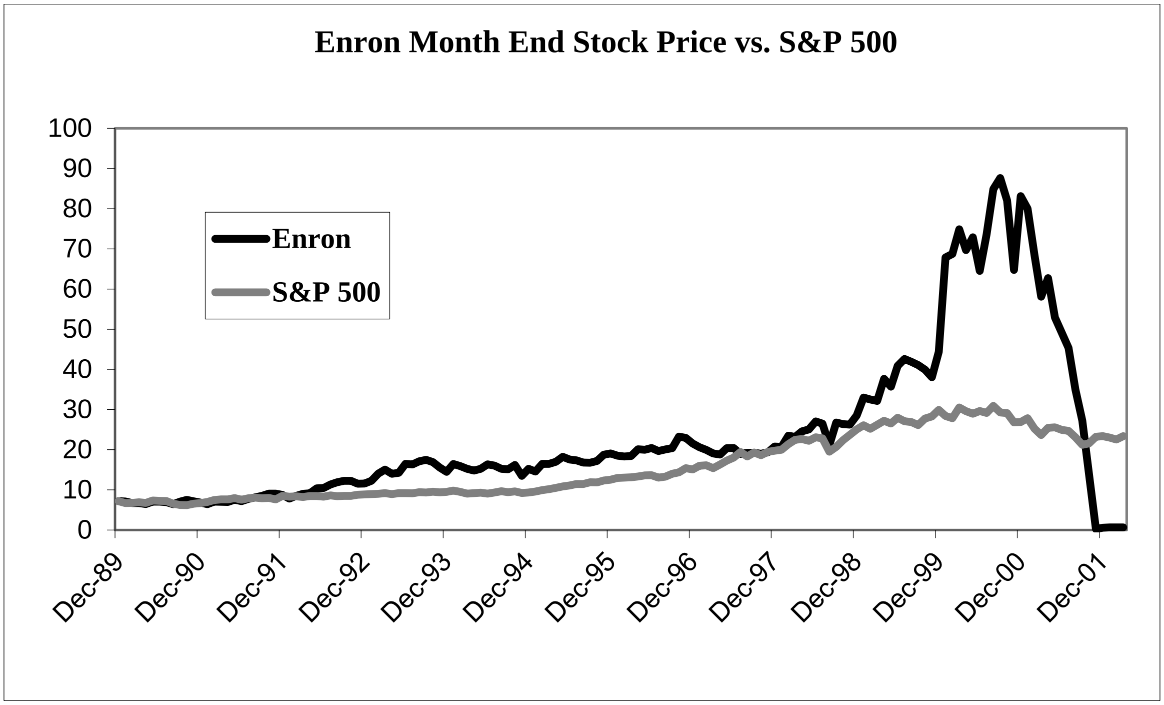
[i] Dynergy had energy and broadband trading businesses similar to those of Enron, and faced its own allegations of accounting misdoings and fraud in 2002, bringing it close to bankruptcy.

Exhibit 1 Selected Financial Data for Enron Corp. from 1995 to 2000

(in $ millions except for per share and share data)	1995	1996	1997	1998	1999	2000
Condensed Income Statement						
Operating revenues	$9,189	$13,289	$20,273	$31,260	$40,112	$100,789
Income before cumulative effect of accounting changes	520	584	105	703	1,024	979
Earnings on common stock	504	568	88	686	827	896
Dividends on common stock	205	212	243	312	355	368
Income before cumulative effect of accounting changes per share						
Basic	$1.04	$1.16	$0.16	$1.07	$1.36	$1.22
Diluted	$0.97	$1.08	$0.16	$1.01	$1.27	$1.12
Earnings on common stock						
Basic	$1.04	$1.16	$0.16	$1.07	$1.17	$1.22
Diluted	$0.97	$1.08	$0.16	$1.01	$1.10	$1.12
Common dividends per share	$0.41	$0.43	$0.46	$0.48	$0.50	$0.50
Shares outstanding at year-end (m)	490	502	614	662	716	752
Condensed Balance Sheet						
Total assets	$13,239	$16,137	$22,552	$29,350	$33,381	$65,503
Short-term and long-term debt	10,229	3,349	6,254	7,357	8,152	10,229
Minority interests	2,414	755	1,147	2,143	2,430	2,414
Company-obligated preferred securities of subsidiaries	904	592	993	1,001	1,000	904
Shareholders' equity	11,470	3,723	5,618	7,048	9,570	11,470
Total capital	25,017	8,419	14,012	17,549	21,152	25,017
Condensed Cash Flow Statement						
Net cash from operating activities	-$15	$884	$211	$1,640	$1,228	$4,779
Net cash used in investing activities	13	-1,074	-2,146	-3,965	-3,507	-4,264
Net increase (decrease) in long-term debt	519	65	1,210	1,033	-61	1,657
Net increase (decrease) in short-term borrowings	-250	217	464	-158	1,565	-1,595
Equity issuance (retirement)	-230	102	555	1,695	1,420	807
Dividends paid	-254	-281	-354	-414	-467	-523

Source: Enron Corp. 10-Ks.

Exhibit 2 Enron Ending Monthly Stock Price and S&P Index from December 1989 to December 2001



Source: Thomson Datastream.

Exhibit 3 Biographies of Kenneth Lay and Jeffrey Skilling

Kenneth Lay

Kenneth Lay was born on April 15, 1942 in Tyrone, Missouri. His father was a Baptist preacher who was forced to sell farm equipment and work in a feed store to make ends meet. Lay graduated Phi Beta Kappa in economics from the University of Missouri, where he also earned a master's degree. He began his career in 1965 as a corporate economist with Exxon Company. Lay joined the U.S. Navy in 1966 and served at the Pentagon as an economic researcher until 1971. During this time, he also completed a PhD in economics from the University of Houston. After his release from the Navy, one of his former superiors hired him to work for the Federal Energy Regulatory Commission. From 1972 to 1974, he served as Deputy Under Secretary for Energy at the U.S. Department of Interior. While in Washington, Lay was also an assistant professor at George Washington University, teaching graduate courses in micro- and macroeconomic theory and government–business relations.

In 1974, Lay joined Florida Gas Company and became president of its successor company, Continental Resources Company. In 1981, he left Continental to join Transco Energy Company in Houston, Texas. Three years later, he joined Houston Natural Gas Company as chairman and CEO. The company merged with InterNorth in 1985 and was later renamed Enron Corp. In 1986, Kenneth Lay was appointed chairman and chief executive officer of Enron.

With Enron's success, Lay became a highly respected business leader, spokesman for deregulation, and philanthropist. He served as a director on the boards of Compaq Computer Corporation, Eli Lilly and Company, and Trust Company of the West. He was also a member of the President's Council on Sustainable Development, the Business Council, the National Petroleum Council, the American Enterprise Institute, and the Board of Trustees of the H. John Heinz III Center for Science, Economics and the Environment. Within the Houston area, Lay chaired the Greater Houston Partnership, the University of Houston Board of Regents, the Houston Host Committee for the 1992 Republican National Convention, and co-chaired the 1990 Houston Economic Summit Host Committee. He was an active philanthropist, creating a family foundation with assets of $52 million in 1992, which supported causes such as former U.S. first lady Barbara Bush's literacy drive, M. D. Anderson Cancer Center, Houston's Holocaust Museum, and animal shelters.

Jeffrey Skilling

Jeffrey Skilling was born on November 25, 1953, in Pittsburgh, Pennsylvania, the son of a mechanical engineer. Skilling earned a BS in applied science from Southern Methodist University in 1975 and an MBA from Harvard Business School in 1979, graduating in the top 5% of his class. Upon graduation, he worked for McKinsey & Company in its energy and chemical consulting practices, and became one of the youngest partners in the company's history.

Skilling began working as a consultant for Enron in 1987 and helped the company create a forward market in natural gas. In 1990, Enron's CEO, Kenneth Lay, hired him from McKinsey to serve as chairman and chief executive officer of Enron Finance Corp. Skilling became the chairman of Enron Gas Services Co. in 1991 and was subsequently made CEO/managing director of Enron Capital & Trade Resources, the subsidiary responsible for Enron's energy trading and marketing. He was promoted to president and chief operating officer (second only to Lay) in 1997, while continuing to be head of Enron Capital & Trade Resources. Skilling was named CEO of Enron, replacing Lay, on February 12, 2001.

Colleagues lauded Skilling for his brilliance. But after he succeeded Lay, he raised eyebrows when he verbally assaulted a leading analyst who complained about the company's failure to provide analysts with a balance sheet and cash-flow statement in a timely manner. Skilling abruptly resigned as CEO of Enron on August 14, 2001, citing personal reasons for the decision.

Source: Compiled by casewriters using information from the Houston Chronicle Web sites
www.chron.com/content/chronicle/special/01/enron/lay/lay.html, and
www.chron.com/content/chronicle/special/01/enron/skilling/skilling.html.

Exhibit 4 Enron Segment and Stock Market Performance, 1993 to 2000

($millions)	1993	1994	1995	1996	1997	1998	1999	2000
Domestic Pipelines								
Revenues	$1,466	$976	$831	$806	$1,416	$1,849	$2,032	$2,955
Operating Earnings[a]	382	403	359	570	580	637	685	732
Operating Margin	26.1%	41.3%	43.2%	70.7%	40.9%	34.5%	33.7%	24.8%
Domestic Trading and Other								
Revenues	$6,621	$6,977	$7,269	$10,858	$16,659	$23,668	$28,684	$77,031
Operating Earnings[a]	316	359	344	332	766	403	592	2,014
Operating Margin	4.8%	5.1%	4.7%	3.1%	4.6%	1.7%	2.1%	2.6%
International								
Revenues	$914	$1,380	$1,334	$2,027	$2,945	$6,013	$9,936	$22,803
Operating Earnings[a]	134	189	196	300	(36)	574	722	351
Operating Margin	14.7%	13.7%	14.7%	14.8%	-1.2%	9.5%	7.3%	1.5%
Annual Return								
Enron	25%	5%	25%	13%	-4%	37%	56%	87%
S&P 500	7%	-2%	34%	20%	31%	27%	20%	-10%
Major Business Events	Teesside opened	Began elect. trading		Began Dabbol plant constn.	Acquired Portland General Corp.	Acquired Wessex Water in U.K. Began trading coal, water, weather, pulp, paper	Created Enron-Online	Trading contracts doubled; Formed Enron Broadband

Source: Enron 10-Ks.

Note: The figures reported are as originally announced by the company.

[a] Operating earnings are earnings before interest and taxes.

Exhibit 5 Enron Corporation Board of Directors

Name, Location, Position and/or Office(s) Held Previously	
Robert A. Belfer [a,c] New York, New York Chairman and CEO, Belco Oil & Gas Corp.	**Rebecca Mark-Jubasche** Houston, Texas Chairman and CEO, Azurix Corp.
Norman P. Blake, Jr. [c,d] Memphis, Tennessee CEO and Secretary General, U.S. Olympic Committee, and Former Chairman, President, and CEO, Promus Hotel Corporation	**John Mendelsohn** [b] Houston,·Texas President, University of Texas M.D. Anderson Cancer Center
Ronnie C. Chan [b,c] Hong Kong Chairman, Hang Lung Development Company Limited	**Jerome J. Meyer** [c] Wilsonville, Oregon Chairman, Tektronix, Inc.
John H. Duncan [a,d] Houston, Texas Former Chairman of the Executive Committee of Gulf & Western Industries, Inc.	**Paulo Ferraz Pereira** [b,c] Rio de Janeiro, Brazil President and CEO, Meriodinal Financial Group, and Former President and CEO, State Bank of Rio de Janeiro, Brazil
Joe H. Foya [b] Houston, Texas Retired Senior Partner, Bracewell & Patterson, and Former President and COO, Houston Natural Gas Corp.	**Frank Savage** [c,d] Stamford, Connecticut Chairman, Alliance Capital Management International (a division of Alliance Capital Management L.P.)
Wendy L.Gramm [b] Washington, D.C. Former Chairman, U$. Commodity Futures Trading Commission	**Jeffrey K. Skilling** [a,c] Houston, Texas President and COO, Enron Corp.
Ken L. Harrison Portland, Oregon Former Chairman and CEO, Portland General Electric Company	**John A. Urquhart** [c] Fairfield, Connecticut Senior Advisor to the Chairman, Enron Corp., President, John A. Urquhart Associates, and former Senior Vice President of Industrial and Power Systems, General Electric Company
Robert K. Jaedicke [b,d] Stanford, California Professor of Accounting (Emeritus) and Former Dean, Graduate School of Business, Stanford University	**John Wakeham** [b] London, England Former U.K. Secretary of State for Energy and Leader of the Houses of Lords and Commons
Kenneth L. Lay [a] Houston, Texas Chairman and CEO, Enron Corp	**Herbert S. Winokur, Jr.** [a,c] Greenwich, Connecticut Chairman and CEO, Capricorn Holdings, Inc., and former Senior Executive Vice. President, Penn Central Corporation
Charles A. LeMaistre [a,d] San Antonio, Texas President Emeritus, University of Texas M.D. Anderson Cancer Center	

Source: Enron Corporation, March 30, 2000, 10-K.

[a] Executive Committee [b] Audit Committee [c] Finance Committee [d] Compensation Committee

Exhibit 6 Excerpts from Enron's Code of Ethics

Conflicts of Interests, Investments, and Outside Business Interests of Officers and Employees

The primary consideration of each full-time (regular as well as temporary) officer and employee should be the fact that the employer is entitled to expect of such person complete loyalty to the best interests of the Company and the maximum application of skill, talent, education, etc., to the discharge of his or her job responsibilities, without any reservations. Therefore, it follows that no full-time officer or employee should

- Engage in any outside enterprise which could interfere in any way with job performance
- Make investments or perform services for his or her or related interest in any enterprise under any circumstances where, by reason of the nature of the business conducted by such enterprise, there is, or could be, a disparity or conflict of interest between the officer or employee and the Company; or
- Own an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.

Notwithstanding any provision to the contrary in this Policy on Investments, securities of publicly owned corporations which are regularly traded on the open market may be owned without disclosure if they are not purchased as a result of confidential knowledge about the Company's operations relations, business, or negotiations with such corporations.

If an investment of personal funds by an officer or employee in a venture or enterprise will not entail personal services or managerial attention, and if there appears to be no conflict or disparity of interest involved, the following procedure nevertheless shall be followed if all or any part of the business of the venture or enterprise is identical with, or similar or directly related to, that conducted by the Company, or if such business consists of the furnishing of goods or services of a type utilized to a material extent by the Company:

- The officer or employee desiring to make such an investment shall submit in writing to the Chairman of the board and Chief Executive Officer of Enron Corp. a brief summary of relevant facts; and
- The Chairman of the Board and Chief Executive Officer of Enron Corp. shall consider carefully the summary of relevant facts, and if he concludes that there appears to be no probability of any conflict of interest arising out of the proposed investment, the officer or employee shall be so notified and may then make the proposed investment in full reliance upon the findings of the Chairman of the Board and Chief Executive Officer of Enron Corp.

In the event the Chairman of the Board and Chief Executive Officer of Enron Corp. should desire to make such an investment, he may do so only upon approval of the majority of a quorum of the Executive Committee of the Board of Directors of Enron Corp., other than himself, at any regular or special meeting of such Committee.

Every officer and employee shall be under a continuing duty to report, in the manner set forth above, any situation where by reason of economic or other interest in an enterprise there is then present the possibility of a conflict of interest between the officer or employee and the Company. This obligation includes but is not limited to (1) any existing personal investment at the date of promulgation of this policy, (2) any existing personal investment at the time of employment of any officer or employee by the Company, and (3) any existing personal investment, whether or not previously approved, which may become in conflict with the provisions of this policy because of changes in the business of the Company or changes in the business of outside enterprise in which investment has been made.

Note: The Code of Ethics was also referred to in meetings as the "Company's Conduct of Business Affairs Policies" or the "Code of Conduct."

Source: Enron company documents.

Exhibit 7 Excerpt from Sherron Watkins's Letter to Ken Lay

January 20, 2002

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting--most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other good will write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of $800 million from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor. Much of that stock has declined significantly--Avici by 98 percent from $178 million, to $5 million; the New Power Company by 80 percent from $40 a share, to $6 a share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My eight years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for "personal reasons" but I would think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in two years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about a way to do this, but I keep bumping into one big problem--we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001, and it's a bit like robbing the bank in one year and trying to pay it back two years later. Nice try, but investors were hurt, they bought at $70 and $80 a share looking for $120 a share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all-employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Source: U.S. Government Accountability Office, Testimony Before the Committee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives; *The Financial Collapse of Enron – Part 3,* testimony of Sharon Watkins, Vice President of Corporate Development, Enron Corporation, February 14, 2002, http:www.access.gpo.gov/congress/house, accessed May 2012. (Also available in print as GAO-77-991CC (Washington, D.C.: Government Printing Office, 2002).)

Endnotes

[1] James H. McGrew, "FERC: Federal Energy Regulatory Commission," American Bar Association Section of Environment, Energy, and Resources, published by American Bar Association, 2003.

[2] Paul Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives*, 17, Spring 2003, p. 6.

[3] Healy and Palepu, "The Fall of Enron," p. 7.

[4] Report prepared by Permanent Subcommittee of Investigations of the Committee on Governmental Affairs, U.S. Senate, "The Role of the Board of Directors in Enron's Collapse," July 8, 2002, p. 8.

[5] Healy and Palepu, "The Fall of Enron," p. 7.

[6] Malcolm S. Salter, "Innovation Corrupted: The Rise and Fall of Enron (A) (Abridged)," HBS No. 308-101, (Boston: Harvard Business School Publishing, 2008), p. 6.

[7] Salter, "Innovation Corrupted (A)," p. 5.

[8] Salter, "Innovation Corrupted (A)," p. 7.

[9] Salter, "Innovation Corrupted (A)," p. 7.

[10] Pankaj Ghemawat and David Lane, "Enron: Entrepreneurial Energy," HBS No. 700-079.

[11] Enron Corp. 10-Q filing, May 15, 2001, EDGAR online, accessed March 2008.

[12] Salter, "Innovation Corrupted," p. 8.

[13] Salter, "Innovation Corrupted (A)," p. 10-11.

[14] Salter, "Innovation Corrupted (A)," p. 11-12.

[15] Salter, "Innovation Corrupted (A)," p. 11.

[16] Stephen Labaton, "1997 Exemption Set Stage for Enron Woes," *New York Times*, January 22, 2002.

[17] Salter, "Innovation Corrupted (A)," p. 13.

[18] Salter, "Innovation Corrupted (A)," pp. 12-13.

[19] Salter, "Innovation Corrupted (A)," p. 13.

[20] Salter, "Innovation Corrupted (A)," p. 13

[21] Salter, "Innovation Corrupted (A)," p. 13.

[22] Salter, "Innovation Corrupted (A)," p. 13.

[23] Jeff Skilling, speech at Harvard Business School, April 26, 2001.

[24] Skilling, speech at HBS, April 26, 2001.

[25] Salter, "Innovation Corrupted (A)," p. 15.

[26] Jason Leopold and Jessica Berthold, "Enron's Filings Show Lavish Compensation Was Awarded to Many Senior Executives," *Wall Street Journal*, March 18, 2002. Phantom Equity is designed to track the performance of the relevant unit's performance, even though the unit has no stock of its own.

[27] Salter, "Innovation Corrupted (A)," p. 17.

[28] Salter, "Innovation Corrupted (A)," p. 17.

[29] Christopher Bartlett and Meg Glinska, "Enron's Transformation: From Gas Pipelines to New Economy," HBS No. 301-064 (Boston: Harvard Business School Publishing, 2001), p. 9.

[30] Salter, "Innovation Corrupted (A)," p. 17.

[31] Vince Kaminski and John Martin, "Transforming Enron: The Value of Active Management," *Journal of Applied Corporate Finance*, Vol. 13(4), Winter 2001, p. 45.

[32] Christopher Koch, "Reinvent Now," *CIO-100*, August 15, 1999.

[33] Salter, "Innovation Corrupted (A)," p. 18.

[34] Salter, "Innovation Corrupted (A)," p. 18.

[35] Salter, "Innovation Corrupted: The Rise and Fall of Enron (B)," HBS No. 905-049 (Boston: Harvard Business School Publishing, 2005), p. 29.

[36] Harold Bierman, *Accounting & Finance Lessons of Enron: A Case Study* (Singapore: World Scientific Publishing Co., 2008), p 70.

[37] Bierman, *Accounting & Finance Lessons of Enron: A Case Study*, p. 81.

[38] U.S. Senate Report, "The Role of the Board of Directors in Enron's Collapse," July 8, 2002, p. 42.

[39] U.S. Senate Report, "The Role of the Board of Directors in Enron's Collapse," p. 10.

[40] Salter, "Innovation Corrupted (B)," HBS No. 905-049, p. 13.

[41] William C. Powers, Jr., Chair, Raymond S. Troubh, Herbert S. Winokur, Jr., "Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation," February 1, 2002, p. 69.

[42] Enron: The Joint Committee on Taxation's Investigative Report, Hearing Before the Committee on Finance, U.S. Senate, One Hundred Eighth Congress, First Session, February 13, 2003, p. 22.

[43] Enron: The Joint Committee on Taxation's Investigative Report, p. 30.

[44] Enron: The Joint Committee on Taxation's Investigative Report, p. 35.

[45] Powers, Jr., Troubh, and Winokur, Jr., "Report of Investigation by the Special Investigative Committee," pp. 153–156.

[46] U.S. Senate Report, "The Role of the Board of Directors in Enron's Collapse," pp. 46-47.

[47] Paul Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives*, 17, Spring 2003, p. 14.

[48] Enron: The Joint Committee on Taxation's Investigative Report, p. 17.

[49] Enron: The Joint Committee on Taxation's Investigative Report, p 17.

[50] Enron: The Joint Committee on Taxation's Investigative Report, p. 20.

[51] Forbes list of highest paid CEOs, 2000, http://www.forbes.com/finance/lists/12/2000/.

[52] George R. Aldhizer III, James D. Cashell, and Dale R. Martin, "Internal Audit Outsourcing," The CPA Journal, 2006, http://www.nysscpa.org/cpajournal/2003/0803/features/f083803.htm, accessed August 2013.

[53] Enron: The Joint Committee on Taxation's Investigative Report, p. 18.

[54] Salter, "Innovation Corrupted (B)," p. 14.

[55] Michael McNamee, Wendy Zellner, Stephanie Anderson Forest, and Laura Cohn, "What Did Lay Know on Aug. 20?" *BusinessWeek Online*, January 23, 2002.

[56] Salter, “Innovation Corrupted (B),” p. 15.

[57] Enron: The Joint Committee on Taxation’s Investigative Report, p. 48.

[58] Enron: The Joint Committee on Taxation’s Investigative Report, p. 38.

[59] Powers, Jr., Troubh, and Winokur, Jr., “Report of Investigation by the Special Investigative Committee,” pp. 158–172.

[60] Securities and Exchange Commission, Form 8-K, filed November 8, 2001, http://pdf.secdatabase.com/512/0000950129-01-503835.pdf, accessed September 2013.

[61] Salter, “Innovation Corrupted (B),” p. 19.