RECOMMENDED READING

Conspiracy of Fools: A True Story

by Kurt Eichenwald (2005, Broadway Books, New York City, 742 pages)

REVIEWED BY BOWEN H. "BUZZ" MCCOY, CRE

THE MOST COMPLETE STORY OF THE ENRON SCANDAL to date has been written by Kurt Eichenwald. a seventeen-year *New York Times* veteran. A two-time winner of the George Polk Award for excellence in journalism and a 2000 finalist for the Pulitzer Prize, Eichenwald has based his account on more than a thousand hours of interviews with over a hundred participants in the events, as well as a review of tens of thousands of confidential corporate and government documents, including FBI notes and testimony before federal grand juries.

The book is written as a narrative, and Eichenwald manages to build suspense, along with incongruity, even though we all know the final outcome. The Enron scandal did not burst out, fully grown, in a matter of days. Widespread corner cutting, steadily falling standards and compromised financial discipline had been festering for close to a decade. Warnings about funny numbers and unrealistic expectations went unheeded, and investors celebrated reckless or incomprehensible business strategies that helped the stock price defy the laws of gravity.

Eichenwald depicts the Enron scandal as not simply the outgrowth of rampant lawbreaking. The true story was more complex and more disturbing. Crime was just one ingredient, along with shocking incompetence, unjustified arrogance, compromised ethics, and an utter contempt for market judgment. It was Enron's tragedy to be run by people smart enough to know how to maneuver around the rules, but not wise enough to understand why the rules had been written in the first place.

No single person was responsible. It took the shortcomings of a handful of executives along with a community of bankers, lawyers and accountants eager to win the company's fees, a government willing to abide absurdly lax rules and a class of investor more interested in quick wealth than long term rewards. The impact was broad, including the destruction of Enron, the demise of Arthur Anderson, the termination of the chief of the Securities & Exchange Commission and the passing by Congress of the most onerous corporate compliance legislation since the Great Depression.

Eichenwald depicts most Enron executives as wanting to do the right thing. Robert Jaedicke, outside director and chair of the audit committee, was concerned about Arthur Anderson being appointed both auditor and consultant to Enron. As early as 1987 a pair of renegade oil traders at Enron was shut down by CEO Kenneth Lay, who was quoted: "I promise you, we will never again risk Enron's credibility in business ventures without first making sure we thoroughly understand the risks."

President Jeffrey Skilling helped push Arthur Anderson to change Enron's accounting from a customary accrual basis to "mark to market" where up to twenty years of future earnings could be recognized at a discounted value in the current year. Such accounting, among other matters, caused a "snowball" affect whereby Enron had to book increasingly huge amounts of future revenues in order to depict year to year growth to investors. Chief financial officer Andrew Fastow, swore that Enron was shielded from interest rate risk, failing to take note of the elemental financial fact that the rate utilized to discount future earnings was itself a risk related interest rate calculation by Enron of the likelihood of achieving the earnings predicted many years in the future.

About our Featured Columnist

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Such inflated earnings gave a misleading picture of the firm's financial condition, misleading all the senior executives and the board of directors as well. The harsh fact was that such inflated revenues were not backed up by cash. The assets were puffed up and borrowed against. The borrowings represented cash which had to be repaid, and the bulk of the revenues did not produce cash in the early years. To compound the problem, Fastow played the yield curve, borrowing huge amounts at low rates, financing the imputed value of long-term contracts with overnight money represented by bank borrowing and commercial paper, which could be pulled at the discretion of the investors.

One justification given for moving to "mark to market" accounting was that the company was moving from a regulated pipeline business to a short-term commodities trading business. That was true in part, but the company was also investing in a series of gigantic long-term asset plays including a multi-billion dollar energy plant in India and a United Kingdom waterworks business. Those international executives who brought in large long-term billion dollar projects which would take years to build and generate cash were paid huge up-front cash bonuses.

Fastow and others preoccupied themselves with building their personal wealth illegally while concocting crazy financial deals for the company. They arrogantly portrayed themselves as financial geniuses and disparaged all traditional pipeline and financial types, including those who wrote business plans, purchased insurance, calculated honest investment returns or kept track of cash and debt maturities. Enron began pursuing wildly contradicting strategies. One (pre-booking future years' revenues) brought in large earnings but little cash; the other (long-term power projects) consumed large amounts of cash and produced next to no earnings for years. This potentially put Enron's liquidity and credit rating at risk. The company was on a collision course with itself, and none of the senior officers or directors had the faintest idea what the net result could be.

For several years Arthur Anderson's practice group in Houston and New York stated categorically that Enron's accounting was incorrect, but the Arthur Anderson account manager in Houston over ruled them. In similar fashion, younger executives within Enron who raised critical issues were given unattractive assignments, penalized in their annual reviews and bonus payments or terminated. Excess ran wild. Swagger became more important that substance. The usual controls over expenses, risk positions and financing constraints were not imposed. First class travel, or utilization of corporate jets, became standard. There was no control of purchasing. Businesses were added on with no unifying strategy, running from trading to pipelines, to water companies to broadband to rental videos. Enron was creating and trading financial derivatives to protect customers from the business effects of bad weather.

There was a great need to fill the gap between reported earnings and cash flow. Fastow's group did this by figuring out ever more complex ways of borrowing. Bank loans were structured to look like gas trades, known as prepays, and were reported as operating cash flow. Off book deals were assembled to funnel in other money from banks and outside lenders. The tax department structured deals that created future tax benefits, which Enron claimed all up front.

Fastow utilized a "thin capitalization" rule to put debt off balance sheet, with equity contributions as low as three percent. He even cheated on that, having the equity put up by related parties (including the gay partner of an Enron executive), or even, with subterfuge, by Enron itself, thus voiding all the deals. These deals carried about half the debt of the company, made Fastow about $45 million one year, were unreported to the board of directors, and were unsupportable by Enrons' cash flow. Meanwhile, Eichenwald reports, Fastow was not particularly smart, and he did not understand accounting or treasury operations. When he finally had to divulge his financing self interests to the board, the board waived Enron's code of conduct, based upon lies Fastow told them about the arrangements he had made. His deals were named Jedi, Chewco, LJM, Raptor and Braveheart, among others.

On the final day of 1999, in a few hours, Enron generated more than 40 percent of the $1.2 billion in operating cash flow it would report for the year, almost all of it in money that would be returned to Citibank in a couple of weeks, with interest. Thus Enron emulated the very worst of the savings and loans from the previous cycle of scandals. Enron traders exacerbated the California energy crisis. In one case, through lies and illegal maneuvers, they increased congestion costs on the California power grid, netting an additional $30 million in profits for Enron.

While all this was going on, financial publications such as *Fortune* and *Business Week* lauded Lay, Skilling and Fastow. *The Wall Street Journal* got closer to the truth.

Ken Lay, seemingly totally ignorant and obtuse about what was going on in his company, hob-nobbed with Bush I and II, Cheney, Greenspan, and anyone else who might be useful to his purposes. Eichenwald reports that Lay's infor-

mation about the business was usually several years out of date.

A senior partner at Arthur Anderson complained that Enron was a high-risk, maximum exposure client who dictated to their accountants what their quality control measures should be. Once again he was overruled at the local level.

The under-reported off balance sheet transactions finally sank the company. There were triggers in the deals which called for debt repayment if the Enron common stock price fell below a certain trigger point or if Enron's bonds were to be accorded a less than investment grade rating. Both events happened, almost over night, catching the financial community and many executives at Enron, and the board, totally off guard. There were Enron executives and Arthur Anderson partners who had warned of this for months, but they were arrogantly dismissed as "not understanding the business." Yet, when the chips were down, the financial staff of Enron could not produce a balance sheet, a cash flow statement, or a debt maturity table.

Arthur Anderson, which had signed a consent in the Waste Management case, forbidding the firm, by permanent injunction, from ever deceiving anyone in the future, began shredding documents. Meanwhile Lay, still seemingly in total ignorance, told the employees their stock in the employee savings plan was safe, while selling Enron stock himself to pay off bank loans. At one point a senior executive yelled at Lay, "*The Wall Street Journal* knows more about what is going on in this company than you do!" Lay announced later, "The only reason our share price has fallen so far is because of short sellers and the media." A merger with competitor, Dynegy, was terminated when Lay reported the wrong stock exchange ratio to his board. Had it gone through, Lay was entitled to a $61 million severance package. Another executive announced: "You have to understand. I am working for a delusional chairman who thinks all the company has is a PR problem that can be solved with a press release."

The trials and verdicts are still ahead for Jeffrey Skilling and Kenneth Lay, but Eichenwald has provided us with a thoroughly researched, carefully documented and solidly written account of the Enron tale up to this point. Once again we are reminded of the difference between doing deals and building a business, and of our own personal responsibility as business leaders to know the difference and act kpon that knowledge.

Whether or not Lay and Skilling can argue their way out of jail, they have already been convicted at a level much deeper than the machinations of the law. They are guilty of the deep sin of pride and hubris—the sin that Dante in the *Divine Comedy* placed in the lowest reaches of Hell. They, like Ulysses, are false counselors who betrayed the trust that was a part of their leadership positions.

The Creator gave us the free will to choose between good and evil. The Creator also gave some the gift of leadership, and we should be able to rely on the goodness and wise judgment of our leaders to show us the way. Such true leaders do not claim that they "did not know." They can be relied upon to take ultimate responsibility and to help us find deeper meaning for our lives in the workplace.

In causing the demise of Enron as they knew it, as well as Arthur Anderson, and in being the catalyst for the imposition of onerous and bureaucratic regulations on all public companies, the former senior officials at Enron have decreased the level of trust that is basic to American business, thereby causing grave harm to our way of life. ■