



## Knowledge Mismanagement and Corporate Ethics

By Ben Mowbray for APQC

Knowledge management has become an invaluable focus for many companies. KM initiatives aim to efficiently solve problems, help employees remain up-to-date on the latest developments in their field, and provide a mechanism for employee feedback up and down an organizational ladder. Successful knowledge management can even save a global business from sudden ruin.

The spectacular downfall of Enron stands as a cautionary tale of a company that allowed its lines of communication to be compromised, or indeed ensured that those lines were closed. Speaking at APQC's recent knowledge management conference in Houston was Enron's whistle-blower Sherron Watkins. Named one of *Time Magazine's* persons of the year in 2002 for notifying Enron CEO Ken Lay of the company's fraudulent accounting practices, Watkins spoke to conference attendees about pressures in the workplace to meet targets and the early indicators of mismanagement at Enron.

"I would like to tell you a success story about how knowledge management worked while I was [at Enron]," Watkins told the audience. "But actually, Enron is a great example of both formal and informal knowledge management channels that resulted in unchecked corporate accounting throughout much of the company, which at times turned fraudulent."

### Finding Trouble

In summer 2001 Watkins was assisting CFO Andrew Fastow in prioritizing assets the company had for sale in order to raise cash. "I was working with spreadsheets, which listed about 200 companies, or 200 assets," said Watkins. "That's when I stumbled across the raptor entity."

These entities were subsidiaries of LJM, an outside investment firm in which Fastow was a founder and general partner. In that capacity, he had raised \$600 million of limited partner money. Watkins described this "unprecedented conflict of interest:" "As CFO of Enron, Fastow had fiduciary duties to Enron, but as general partner of LJM, his fiduciary obligations were to increase the returns of the limited partners. The problem was that LJM's primary line of business was to do deals with Enron. It was buying assets from Enron and entering into trades with Enron. So in every single business decision, Andy had to choose sides. Does Enron win in this, or does LJM win in this? And we know from the indictment that he chose LJM."

Many of the LJM transactions had no economic justifications, said Watkins. They strictly existed to help Enron manipulate its financial statements.

By summer 2001, the entities owed Enron \$700 million. Watkins approached the business unit managers for these assets to find why this loss was coming back to Enron. She found that the entities were capitalized solely with the promise of Enron's stock in the future. There was no third-party money. "On a cash-on-cash basis, LJM was out of these vehicles and they were capitalized by nothing but a promise of Enron stock," said Watkins. "I was horrified. I thought this was the worst accounting fraud that I had ever seen."

In 2000 \$500 million in losses and underlying deductions appeared to be offset by \$500 million in revenue from the raptor entities. But that revenue was fraudulent. "Over 50 percent of the earnings in 2000 were falsified," said Watkins.

## Internal Reaction

"My first reaction was to get out of there as fast as I could and try to confront Jeff Skilling on my last day," said Watkins.

Before she had secured a new job and consequently approached CEO Skilling, he quit in August. Citing personal reasons to the *Wall Street Journal*, Skilling left Enron after stock prices had dropped \$35 during the summer months. "He was depressed about the stock price, didn't know how he was going to get it back up, and just couldn't sleep at night," said Watkins. "So it was stressing him out too much, and he was quitting and going home rich. That, to me, is pathetic. ... You can't abandon your troops."

Ken Lay stepped out of retirement to act as CEO. "I really reacted out of knee-jerk reaction to let him know that the company had probably committed accounting fraud," said Watkins. "We all know what happened after that. He really dismissed my concerns, gravitated toward good news, and I really think, did everything wrong."

Enron attempted to write off the raptor entities on October 16, 2001, which lowered the income statement by \$700 million and lowered shareholders' equity by \$1.2 billion. "Enron was used to really kind of bullying their way through earnings releases and financial interviews," said Watkins. "[Investors] can understand making some bad business decisions and having to have a write off. They don't understand what is in effect a 'never mind,' a 'do-over.'"

On October 16, the stock price was \$33. By the end of November, it was trading at 9 cents a share.

"When I look back at the fall of 2001, I think I was, first off, very, very naive," said Watkins. "I realize now that for Ken Lay to accept what I was saying, he would really have to fall on his sword. He was still CEO or chairman when most of these transactions were done, so these things happened on his watch even if he wasn't paying attention. He would have probably had to resign had he done what I wanted, which was to restate the financial statements and come clean about the problems."

## The Emperor's New Clothes

Watkins uses the children's fable "The Emperor's New Clothes" to explain what happened at Enron. "Almost everyone remembers that the emperor is naked and goes down the parade route, and a boy shouts out that he has got no clothes on," said Watkins. "It's more interesting to note how he gets there in the first place. First off, it takes an emperor who is too vain, focused on his own appearance, and not on running his kingdom. That fits Ken Lay."

Watkins said that Lay was more focused on Bush's presidential campaign, building a new baseball stadium for the Houston Astros, and possibly taking a political post on Bush's cabinet or running for mayor of Houston. Although Watkins was proud of the company's community focus, she believes that was Lay's exclusive focus. "So someone who was not paying attention allowed swindlers into the kingdom," said Watkins. "In my opinion, those swindlers were Jeff Skilling and Andy Fastow."

In the fable, the king is convinced by the swindlers that only those who are stupid or unfit for office cannot see the beautiful cloth. "That's the way these accounting schemes were done," said Watkins. "When they got created, I would bet ... that most of the executives in the room barely paid attention to this little clause that Enron stock could be used by the raptors if they were ever underwater. It was not a huge part of the structure; it was like a little footnote."

Lay's own insecurities, said Watkins, also played a part in not questioning the accounting. To the executives, as well as Enron's board, the numbers were presented as "cutting-edge accounting." Watkins said, "You are not going to ask a question that shows you don't get this, and a lot of people were intimidated into saying, 'Yeah, I see how that works.'"

"That sums up nicely what happened when I went to Ken Lay with my inflammatory memos in August 2001. He turned to the executives around him and said: 'She says I've got no clothes on. What do you think?' And they all backed off and said, 'I've got no idea. Arthur Andersen says you've got clothes on. I think you should go ask Andersen,'" said Watkins. "They couldn't make a decision on their own, and it allowed Ken Lay to gravitate toward good news and not fully accept the trouble the company was in."

### **Knowledge Block and Corporate Culture**

Watkins discussed how Enron strayed, through formal and informal channels by employing a complicated accounting and finance structure. "The poison went throughout the system, throughout the company ... with the help of a centralized SWAT team of specialized finance and accounting employees," said Watkins.

The primary structure Enron favored, said Watkins, focused on deals with legitimate earnings and good prospects for future earnings. These deals were aggressively placed in special-purposed entities that borrowed money against future earnings, with Enron recognizing the "borrowed money" as revenue. Debt was disguised as revenue, thus inflating Enron's earnings. She provided the example of the Blockbuster-Enron partnership to deliver movies online. "Enron put that Blockbuster deal into a special purpose entity," said Watkins, "and borrowed \$110 million against the future cash flow of this 20-year venture and booked that as revenue in the fourth quarter of 2000 and the first quarter of 2001. Blockbuster recognized no revenues on this; it was sort of like a beta test program. The joint venture actually collapsed in early 2001."

When Enron declared bankruptcy, it was revealed that Enron's debt was not \$13 billion as shareholders had thought, but actually \$38 billion. "You can't look through Enron's financial statements and even cobble together where that extra \$25 billion is," said Watkins.

The reason, she explained, that mismanagement permeated throughout the system was a corporate-wide global finance structure and corporate-wide transaction account structure. "Front-loading potential future profits in one year as revenue through off-balance sheet debt deals: that is how knowledge sharing worked at Enron."

Watkins said that several people in the company had protested about the conflict of interest between LJM and Enron, many of whom were actually in the room when the raptor structures were being birthed. In each case, they were shut down and sometimes demoted.

"Other people were chastised strongly by their bosses, told that this was none of their business, that Andersen had signed off on these things, and they should stick to their own knitting," said Watkins. "That reverberated throughout the groups. ... Once good people were shut down, that really shut down the whole company from complaining. Others just left the company."

According to Watkins, someone could simply visit Enron's Yahoo! Message board and find Enron insiders warning investors to stay away. Watkins quoted one of these clandestine sources in her presentation: "The Enron executives have been running an elaborate con scheme that has fooled even the most sophisticated analysts. The first sign of trouble will be an earnings shortfall. ... Criminal charges will be brought against Enron executives for their misdeeds. Class-action lawsuits will complete the demise of Enron." Watkins is quick to note that this message appeared while Enron's stock was trading at \$50 to \$60 dollars a share.

Feedback mechanisms were fought from the top, said Watkins, and the "cultural rot" extended to second-level and third-level executives. This was evidenced through the exceptionally inflated retention bonuses that were given at a time when employees lost pension savings and were not sure if they would even receive severance pay. "That is just as crooked as what Andy Fastow did," said Watkins. "They stuck their hands in the cash drawer the week before bankruptcy and gave themselves five to eight times their base pay. So they had a wonderful cushion. They didn't have to worry about finding a job for quite a long period of time. In fact, most of them are still at Enron making their annual base pay, with that nice little

hefty retention bonus just sitting in their bank account.”

Watkins said that she was most troubled by Wall Street research analysts who had Enron as a strong buy as late as October 2001. “It was this week in the news, when ... Merrill Lynch, Credit Suisse, and Solomon Smith Barney had admitted issuing fraudulent research reports.”

Watkins refuted claims from research analysts that Enron accounting was too well disguised by citing public files of suspicious quarterly cash flow numbers. “This is available for everyone to look at, but it looks like the research analysts on Wall Street ignored it. ... Enron’s cash flow from operations first quarter of 2000 was a negative \$457 million; second quarter, a negative \$90 million; third quarter, positive \$647 million; and fourth quarter, amazingly, positive \$4.7 billion. The annual numbers look great: \$979 million in net income and \$4.7 billion in cash flow from operations. But anyone looking at the quarterly numbers, which the proprietary research analysts were doing, concluded that they couldn’t understand Enron’s cash flow. Nobody’s cash flow is that spotty; this smacks of debt deals that were disguised as revenue deals. This smacks of manipulating cash flow from operations.”

The poignant lesson learned from this is for CEOs to truly embrace reform, said Watkins. “We seem to have created this imperial CEO class of business leaders that don’t want the good days to end. ... I think the problem with investors is that they don’t know how to find the good example; they don’t know how to find the Warren Buffets of the world. We’ve got to make some changes so that investors feel confident to come back to the marketplace.”

Employees, Watkins said, are the best defense against fraud. Unfortunately, that channel had been shut down at Enron. “There was really something wrong with Enron’s feedback system to the top,” said Watkins. “It was really being filtered from a lot of people.” Knowledge management can let the head know what the feet already know; sometimes -- certainly in Enron’s case -- that could be the knowledge that the ground is giving way.

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