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(Mis)Using Numbers in the Enron Story

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Abstract

Comment: Please check the APA style guide – I think the abstract is too long.

This paper investigates the numeric construction, rhetorical moves, and meta-theatre (defined as multiple stages for performing organization stories) pertaining to the widely publicized failure of Enron Corporation. We explore three ethnostatistical issues. First, we argue that some of Enron's investors and creditors as well as some stock analysts and even some accountants were misled about Enron's financial reporting practices and interpretations. We suggest this misreading was produced in part through meta-theatre. Second, we argue that, given a rudimentary knowledge of financial analysis, an analyst of moderate skill would have been able to make sense of Enron's financial problems despite the theatrics of Enron executives. Hence we seek to understand how financial issues were constructed by Enron such that the financial situation appeared non-problematic in the case. Third, we explore the possibility that some of the knowledgeable persons in the financial community were instructed not to tell investors, regulators, or reporters that Enron was in serious trouble. Thus while the nation's business reporters and the public-at-large appear to have missed the serious financial clues to Enron's ultimate fate, we show this occurred because Enron executives told Enron's financial story in carefully interpreted numbers, embellished with theatrics. We thus examine how statistics in financial reports and executive meta-theatrical presentations were used to persuade Wall Street experts to recommend Enron stock, when the writing was on the fourth wall. Our contribution to ethnostatistics is four fold. First, we show that financial reports and discourse are a suitable and important topic for ethnostatistical analysis. Second, we extend ethnostatistics beyond how academic professionals tell stories with numbers, to how professional practitioners in organizations tell such stories. Third we show the important role the rhetorical construction of financial performance measures played in the Enron failure. And fourth, we extend ethnostatistics by integrating ethnostatistics third moment of rhetoric with theatrical theory to show the situated and staged nature of the rhetoric of quantification.

Keywords: Ethnostatistics, storytelling, Enron, meta-theatre

Introduction

Ethnostatistics (Gephart, 1988) shows how academic professionals including researchers use statistics to make quantitative sense of social phenomena. Ethnostatistics is an application of Garfinkel's (1984) ethnomethodology to statistics.

Comment: 1967? There is no citation to Garfinkel in the reference list – Studies in EM, 1967, may be the suitable reference.

Ethnomethodology is a way to study members of a social group making sense of their surroundings, such as how patients are categorized by hospital staff and thus translated into admission statistics in hospitals. While ethnostatistics has been used to study the use of statistics produced by academic professionals in academic writing, it has not been used to look at practitioner professionals' uses of numbers. We study the Enron case to

understand how organizations make sense of financial data in the largest bankruptcy in U.S. history. In the Enron Case, ... The Enron actors created a rosy story using financial statement numbers to manage readers' impressions of their financial statement. The audience for this story included Wall Street analysts, stockbrokers, regulators (such as the SEC), and the financial press. In this paper, we show how financial professionals and financial reporters, not academics, begin to interpret and make sense of the Enron story.

Comment: Please insert a 2-3 sentence description before this sentence. You should discuss what happened in the Enron case so that the reader not familiar with this case will know what you are addressing. Readers especially in the future may not recall the substance of this case.

While numerous explanations of Enron's demise have been presented by researchers, none have used the ethnostatistical perspective to analyze the Enron debacle. We use this perspective and in so doing extend ethnostatistics with story method and theatre method in our look at Enron. In terms of story method, we recreate the story practitioners told through their financial documents. Theatre method is used to look at how Enron created and presented financial numbers on a Hollywood-style set, to misdirect spectators (analysts, regulators, investors) in an attempt to inflate the value of Enron stock. In prior work (Smith, Gardner, & Boje, 2004), we assessed Enron in terms of the first two

moments of ethnostatistics -- Level 1 which involves the production of statistics and consideration of where and how numbers originated, and Level 2 which examines the practices used to analyze the numbers. However, we did not examine the third level or moment of ethnostatistics -- the rhetoric of interpreting numbers. In this paper, we address the first two levels to provide a context for our detailed discussion of the role of storytelling and meta-theatre in the rhetorical production and legitimation of financial performance measures used by Enron.

We make the following contributions to methods. First, we extend ethnostatistics from the academic world to the world of practitioners in organizations. We use the perspective to emphasize the important role of rhetorical strategies during final stages of the Enron collapse, specifically from Jan 2001 to October 2001. Our paper shows it is important to understand how organizations persuade analysts, investors and others that the financial performance and overall financial health of the organization is strong. We explore how this persuasion was accomplished in the Enron case. Ethnostatistics thus allows us to examine the rhetoric used to embellish the numbers presented.

Second we move beyond the ethnomethodological roots of ethnostatistics to examine the rhetorical perspective on quantification – the third moment of ethnostatistics. In this process, we adopt a critical-postmodern perspective. Critical postmodern theory is the nexus of critical theory with postmodern theory (Alvesson & Deetz, 1996; Boje, Fitzgibbons, and Steingard, 1996: 90-1). Critical theory is a theoretical approach developed by the "Frankfurt School" of German social thinkers. Critical theory researchers use quantitative and qualitative methods to look at power and dominance in society and organizations. Postmodern researchers use mostly qualitative research to

Comment: I think it may be useful to move the discussion of crit-pm to the conclusion and to state therein that you adopted this perspective and to then explain how the perspective was (implicitly?) present in the paper.

look at how texts are produced, distributed, and consumed in popular culture; there is much dispute on the occurrence or not of a postmodern turn, or whether to focus on developing and applying a postmodern theory (Best & Kellner, 1997, 2001). Our preference is to develop a postmodern theory and method to use with critical theory's focus on power and rhetoric. As such, we think a critical postmodern perspective can extend ethnostatistics by focusing on the social production and social interpretation of statistics in use by organizations. In this article, we analyze Enron documents, excerpts from Congressional hearings, and various accounts from the business press to show how contradictions between the financial numbers Enron presented and the rhetoric used to convince the public, shareholders, employees, fund managers and reporters the financial numbers were "good." We explore the disparity between what numbers, as signs and symbols, are stated to represent and the inequalities they may represent in how power/knowledge are interrelated (Gephart, 2004).

Comment: Isn't this what ES does already? Is this sentence needed here?

Third, we show how the ethnostatistical perspective can inform research on organizational theatre and story. Organization theatre studies have primarily looked at the dramaturgy theory of Kenneth Burke and Erving Goffman (see reviews by Oswick, Keenoy & Grant, 2001; Boje, Luman & Cunliffe, 2003). In this literature, meta-theatre has two meanings. First for Turner (1985: 181), meta-theatre is the communication about the communication process, spectators and actors reflecting upon how actors do what they do on stage, "the ability to communicate about the communication process itself." Second, Boje and Rosile (2003a, b) define meta-theatre as the multiple theatres on which a cast of characters perform stories for spectators (employees, investors, customers, and/or vendors). In short, meta-theatre involves actors reflecting about their

communication process and it is the active enactment of story on multiple performance stages. Meta-theatre is relevant to narrative and story inquiry methods. Organizations, besides telling stories written into texts such as annual reports, tell stories theatrically. We are particularly concerned where a meta-theatre is created and temporarily staged so as to tell stories with numbers, where such staging clearly involves an effort to persuade investors and analysts about the veracity of particular financial measures and statistics. Using the concept of meta-theatre, our analysis seeks to demonstrate the interplay of the storytelling and theatrics of Enron. Enron put on its theatrical façade in order to misdirect otherwise persuade investors, analysts, and regulators that the numbers and analyses used and reported were credible and reliable, and that Enron is a sound investment.

Finally, we pose the question of why did the price of Enron's shares continue to grow, even at record breaking prices, when the financial statements did not support inflated share prices? And we ask, further, how was Enron able to create and sustain their illusion of success? To answer this question we reconstruct the Enron storytelling about its numbers from a review of archival documents from Enron and financial press, and previously published interviews with former Enron employees. We analyze how the financial community associated with the Enron stock "made sense" of the Enron story as it emerged. Our contribution, then, is to use ethnostatistics as a perspective and methodology to frame and explain how insiders and outsiders seemingly constructed their understanding of Enron. Given that Enron went from the seventh largest U.S. Corporation in sales to a bankrupt shell in the span of one year, the Enron case is a serious business debacle. We posit that ethnostatistics, extended by theatre and story theory, can provide insights into the *in situ* sensemaking and interpretation of numbers

that occurred at Enron and also in other corporate debacles. Ethnostatistics can potentially lead to a new understanding of the corporate financial illusion that was produced for mass consumption by Enron.

The next section of the paper discusses the methodology used in the paper. We then discuss the numeric constructions, rhetorical moves, and aspects of meta-theatre observed in the Enron case. We conclude by discussing implications our ideas have for ethnostatistical theory and methodology. We also discuss practical concerns for organizational financial disclosures and potential deception.

Comment: This sentence, in original or modified form, doesn't seem to enlighten much. Could you rephrase it and also perhaps revise this statement to accurately reflect the conclusions section of the paper?

Methodological Approach

There are three moments in ethnostatistical analysis: constructing numbers, analyzing numbers, and rhetorical interpretation. Each moment takes a somewhat different perspective on statistical phenomena and each requires a somewhat different type of data. The first-level of ethnostatistics uses qualitative methods to study the naturally occurring activities in the situation of social scientists (and others) producing numbers. Second-level ethnostatistics investigates the adequacy of basic technical and practical assumptions made in statistical analyses (production of tables). And the third level of ethnostatistics looks at how statistics (including tables of numbers) are used to persuade, using rhetoric. Rhetoric is the art of persuasion through language (McCloskey, 1985; Gephart, 1988). This study explores the rhetoric of quantitative justification and thus in general is a qualitative study of quantitative metrics employed to persuade.

Comment: I moved this paragraph up from the end of the sentence and added this sentence.

Comment: I cut and modified some stuff here.

Documents used as data for this article were key financial documents from Enron, specifically the FYE 2000 Financial Statements (reference –title of document?) and the first quarter of 2001 Financial Statements (for the period ending March 31, 2001)

Comment: Citations to the source documents are needed here and below.

(reference – title of document? Include full citation in reference list). These documents, including several scholarly and media reports of Enron actions, reveal the financial number story that Enron presented to the financial world in the first level of ethnostatistics (see section below). To examine the second level of ethnostatistics composed by Enron’s basic technical and practical assumptions related to profits, reported, we examined their Value-at-Risk model developed by Vince Kaminski. For the third level of ethnostatistics, statistics as rhetoric, we examined business press interpretations of Enron’s stock prices and financial health, documents from Enron US Congressional Transcripts and documents seized by the federal government. Additionally, accounts of Enron executives’ staged theatric performances for the public (analysts and regulators) and for Enron employees were reviewed to allow us to explore Enron’s meta-theatre -- how actors reflected on the meaning of their numbers & how the story was staged to misdirect the audience.

Comment: Could you give the sources or at least locations where the documents are found e.g. websites?

We then explain ethnostatistics and how we applied this methodology to the documents we analyzed.

Comment: I think this sentence should be replaced with a brief (1 paragraph) statement of how you analyzed or interpreted your data. You could also point out that you are not undertaking complete empirical studies for each level but rather that you are using this paper to show how one could address each level for cases such as Enron.

Number Social Construction

The first moment of ethnostatistics is an analysis of how numbers are created. Enron constructed financial numbers, statistical analyses, and interpretations to represent their company to employees, investors, regulators, and analysts. Although Enron claimed to have followed Generally Accepted Accounting Principles (GAAP) in the production of their financial statements, various disclosures were obfuscated and misleading through complex “off-balance sheet” transactions and scripted menageries that were staged for “outsiders” in producing financial disclosures which were not transparent. By

constructing an illusion of strong financial health and future growth, the reality of financial sickness and decay was well hidden (i.e. in obtuse footnotes). As this illusion began to falter, the inflated stock prices began to fall. Consider the fact that the closing market price Enron common stock on December 29, 2000 was \$83.125 per share. Only one year later the Enron Corporation was in bankruptcy and the closing market price for Enron common stock on December 31, 2001 was a paltry \$.60 per share. To better understand how Enron could manufacture such an illusion, a brief background is necessary.

Comment: It would be very useful to at least briefly address how illusions were created i.e. practices used to create illusions. One way to address this would be to summarize some of the practices used to construct 'good' numbers. You could address this here or in the next paragraph since your last sentence seems to be a lead in to such a statement.

Comment: How did it begin to falter? A phrase that describes this would be helpful e.g. 'following extensive questioning of numbers by Wall st analysts...'

In 1987, before off-the-balance partnerships were being generated at Enron, energy markets were undergoing deregulation. This was a time when the financial community had trouble understanding how the numbers in financial reports worked under the recent deregulation of the financial industry. It is perhaps the first instance of Enron manufacturing illusions with rhetorical flare. The idea of a "Gas Bank" is storied, and morphs into a trading floor concept. The basic idea is that Enron would be an energy "bank," an intermediary between buyers and sellers of natural gas and would profit from the spread between the buying and selling price. In the "gas bank", gas producers were considered "depositors" in a sort of commercial bank and the consumers of energy were similar to "borrowers. Enron "pooled the deposits" (i.e. the supply commitments) to fund long-term contracts? (15 years or more) for the gas buyers (the borrowers). Jeffrey Skilling described Enron's Gas Bank strategy as, "get in early, push to open markets, position ourselves to compete, and compete hard when the opening comes" (Kaminski & Martin, 2001). The "Gas Bank" would give Enron exclusive knowledge of price information from its gas depositors and its gas customers. The initial Gas Bank plan

Comment: What does this say or mean?

Comment: There seems to be a missing object here – is contracts suitable?

lacked persuasive appeal; it did not persuade gas producers to sell Enron their reserves. Enron decided to offer money upfront to entice gas producers to deliver gas, later on, at the pre-agreed price. In Fastow's revision of the "gas bank" model, natural gas was deposited by producers and sold to consumers, with Cactus underwriting money lent by banks for the transaction.

Comment: Who or what is Cactus? this is the first mention of it.

In 1989, Enron executives came up with a "Gas Swap" strategy, to remedy failed negotiations between Enron and a Louisiana aluminum company; Enron could not physically transport gas from its own facilities and make the Louisiana deal profitable (Kaminski & Martin, 2001). That Gas Swap strategy "called for the customer to buy gas locally, paying a floating price, and simultaneously purchase a swap from Enron in which Enron would pay the producer's floating rates and the producer would pay Enron a fixed rate" (Kaminski & Martin, 2001, p. 44). The Gas Swap was a script-fix to the Gas Bank scenario; as in a commercial bank model, the Gas Swap would be equivalent to a "deposit guarantee system."

Comment: The meaning of this sentence is not clear to the reader. What is the point, i.e. so? And what does this show related to 1st level ES? Please revise this sentence and explain your point more clearly.

In the early 1990s, and until Enron's collapse, Andrew Fastow was the hero of the financial community. Our point here, is that Fastow, in the early going, was a highly celebrated risk manager. Even the *Journal of Corporate Finance*, a few months before the collapse, was singing Fastow's praises:

"If you ask an outsider what industry Enron is in they will say energy. If you ask an insider they will tell you that we are in the risk management business. We provide certainty of delivery and certainty of price," Andrew Fastow, CFO, Enron Corp (cited in Kaminski & Martin, 2001, p. 44).

Fastow constructed Enron numbers by employing complex contingent equity issues that kept the related debt off the Enron balance sheet. There were many admirers of Fastow. Standard and Poor's director, Ron Barone, for example, credits Fastow with the ability to

Comment: Please explain this sentence. How do complex contingent equity issues keep debt off the balance sheet? You could address this by adding "by" at the end of the sentence and then completing the phrase.

“think outside the box” because he kept credit ratings high while financing billions of assets (Banham, 1999). Fastow would become instrumental in the numerous off-the-balance-sheet partnerships known as Special Purpose Entities (SPEs) that would ultimately become the Achilles heel of Enron.

Comment: Could you briefly explain what these were and also what this paragraph shows?

Number Social Analysis

Included in the second moment of ethnostatistics is the methods-in-use for analyzing the assembled numbers and the related limitations of the numbers provided. Skilling and Fastow implemented an analysis of the numbers called the “Market Forward Price Curve” method; it was based upon Enron’s exclusive knowledge of price information (from gas depositors and customers to its Gas Bank). A forward price curve (for a traded commodity) is a list of all the future or forward price rates for the commodity being traded. For example, the rate at which a trader can buy natural gas in two years is the two-year forward rate. These forward curves are very important in commodity derivative trading since they determine the value of the commodity derivative contract. Each day, every commodity-trading desk posts a single forward price curve, calculated directly from gas market prices (and used to predict the future price of gas or other commodity).

Comment: This seems quite confusing to me. Please rephrase it for clarity and correctness.

The analysis methods used by Enron also included mismarking of forward curves. Enron traders selectively mismarked their forward curves, thus providing incorrect information on the curves. This was typically done in order to hide losses (Partnoy, 2002). The mismarking of price curves is very much a socially enacted method of number analysis. Traders were compensated based on their profits so if traders could hide losses by mismarking forward curves then they were likely to get a larger bonus as there

were profits rather than losses being reported. These were the numbers Fastow, as CFO, and Skilling as CEO, used to assess the performance of their energy traders. This kept them in line, and was part of the method of risk management. In sum, given the unique position of Enron certain commodity derivative contracts were more amenable to mismarking thereby resulting in fictitious profit reporting.

Certain derivative contracts were more susceptible to mismarking than others (Partnoy, 2002). A trader, for example, would be unlikely to mismark contracts that were publicly traded, such as the natural gas contracts traded on the New York Mercantile Exchange (NYMEX) because quotations for those contracts were publicly available; however, the NYMEX forward curve has a maturity of only six years. Because Enron created a market for long term contracts that exceeded six years, a trader would be more likely to mismark a ten-year natural gas forward rate because no publicly available and thus verifiable forward price curve existed for this time period. Thus Enron used these internally generated mismarked price curves to artificially inflate its profits.

The three moments of ethnostatistics are interrelated. In the case of Enron, the use of a complex and somewhat unfathomable statistical method that was created at the first level of ethnostatistics is itself a rhetorical device (part of the 2nd & 3rd moment of ethnostatistics). For example, in 1999 Fastow was honored with the CFO Excellence Award for Capital Structure Management and was credited by Ted Izatt of Lehman Brothers Inc. with “remarkably innovative financing,” (as cited in Banham, 1999, p. 2). In 1997, even with off the balance sheet partnerships, Enron still needed more capital (to offset the debt from growth) to continue commodity-trading deals. Enron did not want its methods to be called into question, which would have dire financial consequences.

Comment: This paragraph is confusing. Please clarify how each level is inter-related or, since you don't mention level 2 explicitly, please be consistent e.g. say “the different levels of ES are inter-related...”

“We couldn’t just issue equity and dilute shareholders in the near term,” Fastow says. “On the other hand, we couldn’t jeopardize our rating by issuing debt, which would raise the cost of capital and hinder our energy trading operations.” Plus, he says, “there was a one-to-three-year lag time” before Enron would receive any cash flow from its investments (as quoted in Banham, 1999, p. 2).

Fastow, as Banham (1999) states, walked a tightrope by issuing 17.2 million shares of common stock with no share-price dilution in a public offering in 1998. The analysis procedures and the rhetorical strategy were working. The credit agencies responded enthusiastically and Enron kept its BBB+ credit rating. Each time Enron succeeded in acquiring additional cash collateral, Fastow forced each of Enron’s business units to sell non-strategic assets totaling over a billion dollars. In a two year period of time, Fastow had doubled Enron’s total assets, allowing the Gas Bank model to continue.

Comment: How and why did this work? Please explain in a couple of sentences.

Comment: Again, I am unclear how acquiring cash is related to sales of assets and thus how this doubles assets. I think you mean that Enron acquired cash and simultaneously sold assets, thus increasing cash two ways – from cash collateral (isn’t this debt though?) and from cash from assets. Please clarify this statement.

The integrity of capital markets depends upon the accuracy of information provided to it by management. Accurate and timely information is an essential link between the firm and the environment in which it operates. According to Scott (1981, p. 89) “open systems are capable of self-maintenance on the basis of throughput of resources from the environment ...interaction with the environment is essential for open system functioning.” However, open system theory does not address power differences. We can see how at Enron, management was the “gatekeeper” of the information and thus had perfect information e.g. on long term forward price curves but only selectively provided this information content to the capital markets environment. The capital markets in turn should in theory recognize the existence of this information asymmetry. It is thus important to note that the numbers Enron disclosed were in fact manufactured by Enron management, and could have been called into question by analysts. Enron was in the risk

management business, and methods of statistical calculations for risk management were highly developed in the financial industry but unused by Enron.

Enron's 2000 annual report shows 95% of its revenues came from the "wholesale energy operations and services" (McLean, 2001, p. 123). This means that Enron had become a hedge fund trader, in order to deliver future gas purchases to customers, requiring a complex asset-liability risk management system to manage its own liquidity (Kaminski & Martin, 2001). Enron was in a very unique position as the first Gas Bank trader and needed to manage 1,260 trading "books" (Thomas, 2002, p.3). The long-term energy futures market was a relatively new and unregulated market which needed a way to track and disclose related trade values on the financial statements. In the next section, we examine the Value at Risk (VaR) model developed for Enron to analyze the value of the numbers they developed from hedge fund trading.

Enron's Value-at-Risk Model

There is a second method of socially analyzing the numbers of Enron. The value-at-risk (VaR) model is an accepted procedure for estimating the probability of portfolio losses that exceed a specified proportion or amount of the portfolio based upon a statistical analysis of historical price trends, correlations, and volatilities. In commodity options, volatility often relates to the underlying asset return from the present time until the expiration of the commodity option contract. Vince Kaminski was the Head of Enron's Research Department who designed tools for the pricing of commodity options and hedging strategies as well as the fixed price and derivative transactions for natural gas contracts. Kaminski is credited with developing a (VaR) model for Enron's portfolio to enable the daily fast paced trading at Enron to work structurally.

Below, the six points of the VaR used at Enron are summarized from Kaminski & Martin, (2001, 17-49).

1. Enron hired a chief risk officer (CRO) who reports directly to the firm's CEO and the board. The job of the CRO is to provide a systematic oversight of all corporate risk.
2. In each commodity market the company has a unique source of price information. A single forward price curve is made daily for each commodity by the company's traders and the CRO is responsible for validating those price curves. Outside verification is sought where possible in order to have a source of discipline.
3. Transactions are sorted into portfolios so products with similar risk are grouped together.
4. The books are re-priced each night so that market fluctuation in market price is immediately transparent. Compared to traditional, historical cost accounting methods, the value of the books are immediately represented on the firms asset and liability sections of the financial statements, rather than when they are purchased and sold.
5. The quantitative models Enron developed assess both price and credit risk of its positions. The VaR assumes a one day holding period at a 95% confidence level. A set of predictive models designed for use in assessing the future credit risk of the company was developed by their exposure to the 8,000 counter-parties involved with Enron.
6. The firm hedges deals originated by other units of the company or offers derivative instruments that are immediately hedged. Enron does not make bets on the future direction of market prices.

Comment: I think this section needs further refinement and clarification. Also, it may be useful if you change the format here. It may be better to state each point and then explain how the point was related to Enron and to ethnostatistics. This would involve mainly cutting and pasting but it would allow you to keep the bulleted points about the VaR close to the explanations of each point.

Using Kaminski's VaR model required strict internal procedures and adherence by both senior management and the Board. The first point in the VaR model is the most problematic of all. Enron hired Richard Buy to play the role of the independent CRO. While the duties of making investments were under Fastow and Skilling, the duties of managing risk were to be separate, requiring Buy to report to the Board and the CEO. This separation of duties appears to have happened only on paper. According to former Enron attorney Jordan Mintz, Enron's risk evaluation method was compromised. Buy's risk group and Fastow's "dealmakers were constantly in conflict" (as cited in Thomas, et. al., p. 3). When Buy did challenge Fastow's deals, he ended up in "corporate Siberia"

(Mintz, as cited in Thomas, p. 3). In Congressional testimony, Mintz also claimed he was warned by Buy not to report concerns about Fastow's off-the-books partnerships to Skilling. Buy told Mintz that Jeff was very fond of Fastow—"don't go there" (Taub, 2002, p. 2). Sherron Watkins claimed in her Congressional testimony that Buy rejected the opportunity to review her information on the Raptor partnerships..."he said, he'd rather not see it" (Watkins, as quoted in Schmidt, p. 5).

Unfortunately, the Board of Directors entrusted the top management officials and apparently abdicated the responsibility of its oversight mandate. The VaR model required the Board's oversight of the CRO and the firm's total risk. The board, particularly the audit committee, did not understand VaR and did not fulfill their oversight duties regarding risk (Sperry, 2002). The audit committee, said Richard Buy, "don't know the details of (the) trading business, they don't know about value-at-risk," (quoted from taped conversation in late 1999 or early 2000 which were seized during the federal investigation of Enron, in Sperry, p. 2). The Board also did not oversee the LJM partnerships Fastow asked them to approve. The most recent indictment of Enron (May 1, 2003) claims "The board went along with LJM after Fastow misled them into believing that then Chief Accounting Officer Richard Causey and Chief Risk Officer Richard Buy would review all of Enron's transactions with LJM to ensure their fairness" (Murphy, 2003, p. 1).

Comment: Please explain the LJM partnerships here or at the first point where they are relevant.

The second to fourth points of the VaR above discuss the creation of daily price curves, the CRO's responsibility for validating price curves and the re-pricing of daily price curves so that market price fluctuations are completely transparent; however, "market price fluctuations" should imply an unbiased price change from publicly traded

commodity contracts and derivatives. As we previously discussed, Enron's unique position as an exclusive market maker in commodity contracts with maturities exceeding six years provided an opportunity to mismark the prices. Partnoy (2002) noted that since Enron's commodity derivatives frequently had maturities ranging up to 29 years there were not existing market prices to serve as a benchmark for re-pricing and thus required the use of "professional judgment". In fact Enron completed over 5,000 weather derivative deals with a notational value of more than \$4.5 billion, and many of those deals could not be valued without a healthy dose of professional judgment (Partnoy, 2002).

Comment: It would be helpful, if possible, to explain or illustrate the operation of professional judgements e.g. how this was used to include and exclude things.

As mentioned above, strict internal discipline is required to accurately reflect the firm's total risk or "bets." Many internal policies relating to awareness and communication of risk and the review of adequate information by senior company officials must be adhered to on a regular basis. In addition to the lack of independence of Richard Buy and the Board's lack of understanding of risk, Enron failed to use their internally generated guidelines to manage their total risk (Sperry, 2002). Enron had several detailed policies to manage risk through awareness, communication, and oversight from adequate information, explained in voluminous manuals. WorldNetDaily obtained a copy of Enron's *An Overview of Petroleum Industry Commodity-Based Financial Derivatives* in April 2002 (Sperry, 2002). According to Sperry, Enron's manual contained several checklists addressing awareness, "Are senior management and Board members aware of the risks/rewards inherent in the financial activities?;" communication of risk, requiring "management level reports which effectively communicate risk;" and Board knowledge, the Board should be "provided adequate

information regarding the company's activities exposures, considering the significance and volatility of the exposure" (all quotes from Enron manual, quoted in Sperry, 2002, p. 2).

Comment: In general what is this paragraph showing? What is the point re level 2 ES?

The fifth point of the VaR model above calls for the use of a 95% confidence interval to be used by Enron. According to Albrecht (2003), the 95% confidence interval used by Enron is very high. A 95% confidence interval in this VaR model predicts the most positive outcome of future energy trades without disclosing any worst case scenario. As Partnoy (2002) noted, Enron said it relied on "the professional judgment of experienced business and risk managers" to assess worst case scenarios, which apparently Enron ultimately encountered. Thus, only reporting high and low month-end values for its trading and with incentives to smooth its profits and losses at month-end, investors had no way of knowing just how much risk Enron was actually taking. Further, the 95% confidence interval so critical to Enron's VaR model was further misleading by asserting that the model was viable 95% of the time for all related trading days. Partnoy (2002) provides a very insightful example. Enron reported VAR for what it called its "commodity price" risk – including natural gas derivatives trading – of \$66 million, more than triple the 1999 value. Enron reported VaR for its equity trading of \$59 million, more than double the 1999 value. A VaR of \$66 million meant that Enron could expect based on historical averages that on five percent of all trading days (on average, twelve business days during the year) its "commodity" derivatives trading operations alone would gain or lose \$66 million, a not trivial sum. In sum, given ability to mismark the related price curves and to incorporate such a high confidence interval in the VaR model,

Comment: How so? How does a 95% confidence interval predict the most positive and no worst case? Please explain.

Enron clearly obfuscated the risk management methodology and thereby give the illusion of sustainable growth with controlled risk.

Comment: Please show or at least discuss – in a couple of sentences – what Enron did, specifically, to obfuscate the risk management methodology.

Finally, in the sixth point of Enron’s VaR model, Kaminski calls for deals to be immediately hedged or to offer derivative instruments that are immediately hedged, but only for “deals” originated by other units of the company. Hedging activities are employed to reduce the downside risk of a decrease in the price of a security and can include short selling as well as employing the use of instruments such as put options. The implementation of immediate hedging activities controls for downside risk. Given the aforementioned manipulations and the illusion of controlled risk, was this merely for show, in other words, more corporate theatre to persuade?

Comment: Please don’t use rhetorical questions. Rephrase this into a declarative sentence if possible. What is the point related to ethnostatistics here?

In sum, the VaR model used by Enron led to the overly optimistic, even overstatement, of the firm’s investments. Additionally, the VaR model was neither implemented nor supervised properly by the Board of Directors and audit committee. Further, it appears that Enron intentionally mislead spectators and concealed the high risk of their commodity derivative contracts which comprised a substantial percentage of their financial results. Enron’s gains from derivatives were very substantial, more than \$16 billion from these activities in three years. To place this process of constructing and analyzing numbers in perspective, the gains Enron accrued from problematic use of the VaR were roughly comparable to the annual net revenue for all trading activities (including stocks, bonds, and derivatives) at the premier investment firm Goldman Sachs & Co. during the same period, a time in which Goldman Sachs first issued shares to the public. The key difference between Enron and Goldman Sachs is that Goldman Sachs seems to have disclosed information to investors about the volatility of its trading

Comment: Please briefly state or explain how this overstatement occurs.

operations. In contrast, Enron officials claimed that it was not a trading firm, and that derivatives were used for hedging purposes. As a result of this categorization, Enron's stock traded at much higher multiples of earnings than more candid trading-oriented firms.

Social Rhetorical Moves and the Theatrics of Firm Performance

Rhetoric is the third moment of ehnostatistics. In this section we want to focus on the rhetorical use of story and theatrics (i.e. metatheatre) by Enron executives, managers, and many of its employees. Metatheatre is both the reflection of actors on the communications they are communicating to spectators and it is the occurrence of many kinds and places of theatre in an organization (Turner, 1985; Boje & Rosile, 2002).

The term meta-theatre owes its origin to Victor Turner (1985). He used it to differentiate theatre in the day-to-day life of being actors in social settings, from the theatre that emerges in conflict situations. Boje and Rosile (2003) use the term 'meta-theatre,' somewhat differently, to describe the many performance stages, often simultaneous, such that people cannot be in every conference room, hallway meeting, phone call, or webcast to see for themselves what is going on. Instead people chase storylines, and even characters, from room to room, and rely on stories told by others, who have eye witness accounts to share. There is anecdotal evidence that Enron is meta-theatre in how it sets out to deceive using façade and illusion between one performance stage and another. We intend to preserve the conflict situation of social drama in Turner's use of meta-theatre, and the multiplicity of simultaneous stages and scripts in Boje and Rosile (2003). This allows for a more process-oriented approach to theatrics of organization.

Comment: This paragraph seems to depict meta-theatre as a first level ES phenomenon although in the next paragraph you discuss it as level 3. I suggest that you may wish to explain how meta-theatre operates at levels 1 and 3 (and perhaps 2?) and why you focus on it in the level 3 section.

We are looking at the process of using theatre to persuade others that the constructed numbers reflect the “real” situation of the firm. For example, each year (between 1998 and 2001) an elaborate theatre stage was constructed on Enron’s 6th floor to simulate a *real* trading floor; it’s expensive theatre, \$500 to set up each desk, and more for phones in this stage-crafted spectacle, and more for the 36-inch flat panel screens, and teleconference conference rooms. On this imitation Hollywood stage, the entire set was wired by computer technicians who feed fake statistics to the big screens. On the big day several hundred employees, including secretaries, played their rehearsed character roles, pretending to be “Energy Services” traders, doing mega deals. Jeffrey Skilling and Kenneth Lay played their starring role in the Enron *Dramatis Personae* to a target audience of invited Wall Street analysts, who can not tell *real* from *fake*.

Comment: Could you explain when? 1 day per year? For what event? The webcast? That is, when did Enron create and use its staged trading floor? Also, what are your sources?

According to former Enron employees, on the sixth floor of the company's downtown headquarters was a set, designed to trick analysts into believing business was booming... former employee Carol Elkin said that it was all an act, and that no trades were actually made there. The people on the phones were talking to each other.¹

Tuesday, October 23, 2001, Lay is huddled with a small group of advisors in a conference room adjoining his 50th-floor office suite. They are rehearsing “a carefully worded script” prepared by Enron’s publicists and several executives (Witt & Behr, 2002, p. A01). Lay is to preside over a live webcast chat with security analysts in an effort to quench the media firestorm about Fastow’s role in LJM partnerships. The script “suggested that no one at Enron was responsible for the LJM partnerships. Failure it would seem, was an orphan” (Witt & Behr, 2002, p. A01, emphasis added).

With minutes to spare before the conference, Ronald T. Astin, a lawyer with Enron's outside law firm, Vinson & Elkins LLP, was asked to help fix the **script**. He rewrote it to say that it was Fastow who presented the LJM proposal to the board.

Fastow read Astin's changes and exploded, Astin later told investigators. Fastow yelled that Astin was wrong about who was responsible for LJM. "It was Skilling!" he shouted.

At 8:30 a.m. Houston time, financial analysts from Boston to San Francisco joined the conference by phone and Internet.

"There has been a lot of recent attention to transactions Enron previously entered into with LJM, a private equity partnership," Lay said, addressing LJM and Fastow head on. "Let me reiterate a couple of things. We clearly heard investor concerns earlier this year, and Andy Fastow, Enron's chief financial officer, ceased all affiliations with LJM."

Lay added that Fastow was doing "an outstanding job."
"We're very concerned the way Andy's **character** has been kind of loosely thrown about over the last few days in certain articles," Lay said. Fastow's role at LJM had been monitored rigorously so that Enron's interests would never be compromised, he said.

On October 18, 2001 (Thursday), the SEC phoned Enron for details about Fastow and LJM Cayman and LJM2 Co-Investment partnerships. The next day (Friday), Enron shares ended the day at \$26.05. By Monday (October 22) news about the SEC had leaked in the financial wire services. Shares of Enron Corp. fell almost 21 percent (a drop of \$5.40 to close at \$20.65).

Comment: The chronology here is a bit inconsistent. I suggest you discuss Oct 18 before Oct. 23, i.e. put the historical details into chronological order.

At 8:30 A.M. (October 22) Lay was performing his theatre with 200 of Enron's top-tier managers, in the Dogwood room, a stage on the 3rd floor of Houston's downtown Hyatt (Witt & Behr, 2002, p. A01). The managers had yet to hear about the SEC investigation, and Lay was still supportive of Fastow. In the audience, the managers kept up with the action, but read their handheld Blackberry messaging devices. As Lay spoke, the SEC became known to the audience. As the audience erupted into questions, Lay tried

Comment: the SEC what became known? Investigation?

to answer. Then, Vince Kaminski raised his hand. This is the same Kaminski who co-authored the article about Fastow (Kaminski & Martin, 2001). As Witt and Behr (2002 p. A01) reconstruct the event from eye witness accounts:

Vince Kaminski, the respected and normally reserved head of research, raised his hand and told Lay, "I'm in the terrible position of having to disagree with you."

"It's okay, anybody can," Lay said, according to one account. He invited Kaminski, a Polish-born mathematics whiz and expert in risk management, to speak.

Kaminski strode to the podium and accepted the microphone. Enron should never have gotten involved in secret, high-risk deals with Fastow's private partnerships, he said. He had warned against that course back in June 1999.

"What Andy Fastow did was not only improper, it was terminally stupid," Kaminski said. "The only fighting chance we have is to come clean."

Lay looked "sort of blank," Hermann recalled. "It was like somebody getting pummeled, and he just stood there and took it."

Finally, Enron's new president, Greg Whalley, who had taken over when Jeffrey K. Skilling resigned in August, stepped in. "That's enough, Vince," he said.

In the Enron-*metatheatre*, as Ken Lay presided over his tele-conference call scripted to do damage control, Andersen accountants listened in, assembled as a virtual audience in another room. "The call did not go particularly well," Duncan, an Enron accountant, would later say. "There were many pointed questions asked that the company appeared to struggle to fully answer" (Witt & Behr, 2002, p. A01). Duncan held his own meeting, following the conference call, and told his audit team to get serious about complying with the Andersen's document-retention policy. "Andersen had known for days that Enron could expect a SEC subpoena for its records, Duncan later testified. But none had arrived by that afternoon" (Witt & Behr, 2002, p. A01). The audit team put in a call to Sharon

Comment: It may be useful to continue the sentence by discussing what the document retention policy stated or included.

Thibaut, who oversaw document shredding, to send empty trunks for them to pack documents they wanted shredded; they filled over 18 trunks and another 30 boxes. Thibaut could not handle the volume in Andersen's shredders, so she called an outside vendor, Shred-it, whose company motto is, "Your secrets are safe with us" (Witt & Behr, 2002, p. A01).

Comment: Please explain the point or implications of this paragraph if possible in a couple of sentences or so.

Enron's *metatheatre* is a network of stages, and Lay, a starring character, had to hurry along to another theatrical stage, a Hyatt ballroom where several thousand Enron employees were assembled as spectators. Lay begins his performance in dramatic fashion (Witt & Behr, 2002, p. A01):

"Let me say right up front, I am absolutely heartbroken about what's happened," Lay said.

"Many of you were a lot wealthier six to nine months ago, are now concerned about the college education for your kids, maybe the mortgage on your house, maybe your retirement, and for that I am incredibly sorry. But we are going to get it back."

Unlike previous performances, the employees were no longer willing to suspend belief. They became critical of Lay's performance. Index cards were passed from the spectators to the podium.

Lay read a series of questions from the audience. Nerves were frayed. Decorum had vanished. One employee had written: "I would like to know if you are on crack? If so, that would explain a lot. If not, you may want to start because it's going to be a long time before we trust you again."

One Enron trader, Jim Schwieger, challenged Lay in the question and answer session:

"Why," he asked, "is chief financial officer Andrew Fastow sharing the stage--and gainfully employed--considering that he just blown half a billion dollars mismanaging several Enron partnerships and earned \$30 million doing it?"

Lay reacted to the critical reviews. That same day (Tuesday, October 23, 2001), Lay took a \$4 million cash advance from Enron. In the next three days, he drew down another \$19 million. But, he repaid \$6 million by transferring stock he owned to Enron; this avoided the SEC insider trading reporting requirement. A board member later called this Lay's "ATM approach" (Witt & Behr, 2002, p. A01).

Comment: Could you explain this more fully and also discuss the relevance to level 3 ES?

CONCLUSION

We think that theatre, in particular metatheatre (its multiple stages) makes an important contribution to ethnostatistics. Rhetoric is theatrically enacted on the Hollywood-style 6th floor trading charade, and on the road shows put on by Enron executives. Ethnostatistics, on the other hand, makes an important contribution to organization theatre studies by showing that numbers and statistics including financial performance measures are an important and readily mystifiable part of organizational discourses. Our paper shows that the ways numbers and charts are interpreted can be quite theatrical. Thus Gephart's (1988) ethnostatistics theory can be applied to understand organizational theatre and the discursive forms that organizations use to tell their numbers stories. Specifically, we have extended ethnostatistics beyond the study of academic professionals using statistics to include how non-academic professionals in organizations compose, analyze, and sell their numbers.

Comment: It would be useful to briefly explain your contributions to levels 1 and 2, or at least the ground you covered, before addressing level 3 or rhetoric. A couple of sentences on each level (1 and 2) would suffice. Also in the conclusions I think you could mention you have taken a critical-postmodern approach to understanding statistics and you may wish to briefly discuss what this means or implies.

We believe ethnostatistics and the meta-theatre based analysis of statistics offer a significant contribution to the research on management and accounting. Specifically, this study used ethnostatistics to illustrate how Enron puts on its façade and created a charade in order to persuade investors, analysts, and regulators that the numbers and analyses

Enron had produced were credible, and that Enron was a reliable and sound investment. While there have been several approaches to theatre in management studies, we suggest that there need to be more studies of the processes by which theatre is used to persuade others that numbers are constructed and analyzed reliably and validly. While Enron was not successful in the end in persuading others about the veracity of its financial measures, it was initially able to use the inherent persuasiveness of theatre to get spectators to willingly suspend disbelief about the numbers Enron produced.

Using Gephart's (1988) ethnostatistics, we have shown how the actors involved with Enron generated, analyzed, and interpreted financial statistics. All three elements of ethnostatistics show how Enron's senior management created, analyzed and scripted the interpretation of their numbers to their advantage. We conclude Enron management used meta-theater, a network of stages, to influence the interpretation of the firm's financial statements. Surprisingly, many outsiders and even Enron employees found it difficult to understand exactly how Enron made money. The company's mysterious success lent itself well to explaining its rose-colored future through performance. In short, meta-theatre replaced transparency in financial reporting.

Comment: Good ending!

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Footnotes

¹ According to Barnes, Barnett, & Schmitt (2002), “Like that of the first Gas Bank plan, the origin of Cactus is controversial: New York businessman Bernard Glatzer, who sued Enron over the issue, claims Enron took the idea from him.”

² See Banerjee (2002); In another version it is only 75 employees: ‘To impress a group of visiting Wall Street stock analysts, Enron executives once ordered about 75 employees, including secretaries, throughout its headquarters to come down to the trading floor to man phones and pretend they were making deals. It was a scene right out of The Sting - and it worked. The analysts left believing Enron couldn't make deals fast enough’ (Gaber, 2002); A third source says only dozens of employees took part in the masquerade; and See Cron (2002). Houston.com Report: Enron designed fake trading floor (2002). Posted: 1:22 p.m. CST February 22, 2002
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³ The Washington Post, August 03, 2002, Saturday, Editorial; P. A18