

OPEN SECRETS

Enron, Intelligence, and the Perils of Too Much Information

Malcolm Gladwell

On the afternoon of October 23, 2006, Jeffrey Skilling sat at a table at the front of a federal courtroom in Houston, Texas. He was wearing a navy blue suit and a tie. He was fifty-two years old, but looked older. Huddled around him were eight lawyers from his defense team. Outside, television-satellite trucks were parked up and down the block.

"We are here this afternoon," Judge Simeon Lake began, "for sentencing in *United States of America versus Jeffrey K. Skilling*, Criminal Case Number H-04-25." He addressed the defendant directly: "Mr. Skilling, you may now make a statement and present any information in mitigation."

Skilling stood up. Enron, the company he had built into an energy-trading leviathan, had collapsed into bankruptcy almost exactly five years before. In May, he had been convicted by a jury of fraud. Under a settlement agreement, almost everything he owned had been turned over to a fund to compensate former shareholders.

He spoke haltingly, stopping in midsentence. "In terms of remorse, Your Honor, I can't imagine more remorse," he said. He had "friends who have died, good men." He was innocent—"innocent of every one of these charges." He spoke for two or three minutes and sat down.

Judge Lake called on Anne Beliveaux, who worked as the senior administrative assistant in Enron's tax department for eighteen years. She was one of nine people who had asked to address the sentencing hearing.

"How would you like to be facing living off of sixteen hundred dollars a month, and that is what I'm facing," she said to Skilling. Her retirement savings had been wiped out by the Enron bankruptcy. "And, Mr. Skilling, that only is because of greed, nothing but greed. And you should be ashamed of yourself."

The next witness said that Skilling had destroyed a good company, the third witness that Enron had been undone by the misconduct of its management; another lashed out at Skilling directly. "Mr. Skilling has proven to be a liar, a thief, and a drunk," a woman named Dawn Powers Martin, a twenty-two-year veteran of Enron, told the court. "Mr. Skilling has cheated me and my daughter of our retirement dreams. Now it's his time to be robbed of his freedom to walk the earth as a free man." She turned to Skilling and said, "While you dine on Chateaubriand and champagne, my daughter and I clip grocery coupons and eat leftovers." And on and on it went.

The judge asked Skilling to rise.

"The evidence established that the defendant repeatedly lied to investors, including Enron's own employees, about various aspects of Enron's business," the judge said. He had no choice but to be harsh: Skilling would serve 292 months in prison—twenty-four years. The man who headed a firm that *Fortune* ranked among the "most admired" in the world had received one of the heaviest sentences ever given to a white-collar criminal. He would leave prison an old man, if he left prison at all.

"I only have one request, Your Honor," Daniel Petrocelli, Skilling's lawyer, said. "If he received ten fewer months, which shouldn't make a difference in terms of the goals of sentencing, if you do the math and you subtract fifteen percent for good time, he then qualifies under Bureau of Prisons policies to be able to serve his time at a lower facility. Just a ten-month reduction in sentence . . ."

It was a plea for leniency. Skilling wasn't a murderer or a rapist. He was a pillar of the Houston community, and a small adjustment in his sentence would keep him from spending the rest of his life among hardened criminals.

"No," Judge Lake said.

The national security expert Gregory Treverton has famously made a distinction between puzzles and mysteries. Osama bin Laden's whereabouts are a puzzle. We can't find him because we don't have enough information. The key to the puzzle will probably come from someone close to bin Laden, and until we can find that source, bin Laden will remain at large.

The problem of what would happen in Iraq after the toppling of Saddam Hussein was, by contrast, a mystery. It wasn't a question that had a simple, factual answer. Mysteries require judgments and the assessment of uncertainty, and the hard part is not that we have too little information but that we

have too much. The CIA had a position on what a post-invasion Iraq would look like, and so did the Pentagon and the State Department and Colin Powell and Dick Cheney and any number of political scientists and journalists and think-tank fellows. For that matter, so did every cabdriver in Baghdad.

The distinction is not trivial. If you consider the motivation and methods behind the attacks of September 11th to be mainly a puzzle, for instance, then the logical response is to increase the collection of intelligence, recruit more spies, add to the volume of information we have about Al Qaeda. If you consider September 11th a mystery, though, you'd have to wonder whether adding to the volume of information will only make things worse. You'd want to improve the analysis within the intelligence community; you'd want more thoughtful and skeptical people with the skills to look more closely at what we already know about Al Qaeda. You'd want to send the counterterrorism team from the CIA on a golfing trip twice a month with the counterterrorism teams from the FBI and the NSA and the Defense Department, so they could get to know one another and compare notes.

If things go wrong with a puzzle, identifying the culprit is easy: it's the person who withheld information. Mysteries, though, are a lot murkier: sometimes the information we've been given is inadequate, and sometimes we aren't very smart about making sense of what we've been given, and sometimes the question itself cannot be answered. Puzzles come to satisfying conclusions. Mysteries often don't.

If you sat through the trial of Jeffrey Skilling, you'd think that the Enron scandal was a puzzle. The company, the prosecution said, conducted shady side deals that no one quite understood. Senior executives withheld critical information from investors. Skilling, the architect of the firm's strategy, was a liar, a thief, and a drunk. *We were not told enough*—the classic puzzle premise—was the central assumption of the Enron prosecution.

"This is a simple case, ladies and gentlemen," the lead prosecutor for the Department of Justice said in his closing arguments to the jury:

Because it's so simple, I'm probably going to end before my allotted time. It's black-and-white. Truth and lies. The shareholders, ladies and gentlemen, . . . buy a share of stock, and for that they're not entitled to much but they're entitled to the truth. They're entitled for the officers and employees of the company to put their interests ahead of their own. They're entitled to be told what the financial condition of the company is. They are entitled to honesty, ladies and gentlemen.

But the prosecutor was wrong. Enron wasn't really a puzzle. It was a mystery.

In late July of 2000, Jonathan Weil, a reporter at the Dallas bureau of the *Wall Street Journal*, got a call from someone he knew in the investment-management business. Weil wrote the stock column called "Heard in Texas" for the paper's regional edition, and he had been closely following the big energy firms based in Houston—Dynegey, El Paso, and Enron. His caller had a suggestion. "He said, 'You really ought to check out Enron and Dynegey and see where their earnings come from,'" Weil recalled. "So I did."

Weil was interested in Enron's use of what is called *mark-to-market accounting*, which is a technique used by companies that engage in complicated financial trading. Suppose, for instance, that you are an energy company and you enter into a \$100 million contract with the state of California to deliver a billion kilowatt hours of electricity in 2016. How much is that contract worth? You aren't going to get paid for another ten years, and you aren't going to know until then whether you'll show a profit on the deal or a loss. Nonetheless, that \$100 million promise clearly matters to your bottom line. If electricity steadily drops in price over the next several years, the contract is going to become a hugely valuable asset. But if electricity starts to get more expensive as 2016 approaches, you could be out tens of millions of dollars. With mark-to-market accounting, you estimate how much revenue the deal is going to bring in and put that number in your books at the moment you sign the contract. If, down the line, the estimate changes, you adjust the balance sheet accordingly.

When a company using mark-to-market accounting says it has made a profit of \$10 million on revenues of \$100 million, then, it could mean one of two things. The company may actually have \$100 million in its bank accounts, of which \$10 million will remain after it has paid its bills. Or it may be guessing that it will make \$10 million on a deal where money may not actually change hands for years. Weil's source wanted him to see how much of the money Enron said it was making was "real."

Weil got copies of the firm's annual reports and quarterly filings and began comparing the income statements and the cash-flow statements. "It took me a while to figure out everything I needed to," Weil said. "It probably took a good month or so. There was a lot of noise in the financial statements, and to zero in on this particular issue you needed to cut through a lot of that." Weil spoke to Thomas Linsmeier, then an accounting professor at Michigan State, and they talked about how some finance companies in the 1990s had

used mark-to-market accounting on subprime loans—that is, loans made to higher-credit-risk consumers—and when the economy declined and consumers defaulted or paid off their loans more quickly than expected, the lenders suddenly realized that their estimates of how much money they were going to make were far too generous. Weil spoke to someone at the Financial Accounting Standards Board, to an analyst at the Moody's investment-rating agency, and to a dozen or so others. Then he went back to Enron's financial statements. His conclusions were sobering. In the second quarter of 2000, \$747 million of the money Enron said it had made was *unrealized*—that is, it was money that executives thought they were going to make at some point in the future. If you took that imaginary money away, Enron had shown a significant loss in the second quarter. This was one of the most admired companies in the United States, a firm that was then valued by the stock market as the seventh-largest corporation in the country, and there was practically no cash coming into its coffers.

Weil's story ran in the *Journal* on September 20, 2000. A few days later, it was read by a Wall Street financier named James Chanos. Chanos is a *short-seller*—an investor who tries to make money by betting that a company's stock will fall. "It pricked up my ears," Chanos said. "I read the 10-K and the 10-Q that first weekend," he went on, referring to the financial statements that public companies are required to file with federal regulators. "I went through it pretty quickly. I flagged right away the stuff that was questionable. I circled it. That was the first run-through. Then I flagged the pages and read the stuff I didn't understand, and reread it two or three times. I remember I spent a couple hours on it." Enron's profit margins and its return on equity were plunging, Chanos saw. Cash flow—the lifeblood of any business—had slowed to a trickle, and the company's rate of return was less than its cost of capital: it was as if you had borrowed money from the bank at 9 percent interest and invested it in a savings bond that paid you 7 percent interest. "They were basically liquidating themselves," Chanos said.

In November of that year, Chanos began shorting Enron stock. Over the next few months, he spread the word that he thought the company was in trouble. He tipped off a reporter for *Fortune*, Bethany McLean. She read the same reports that Chanos and Weil had, and came to the same conclusion. Her story, under the headline "IS ENRON OVERPRICED?," ran in March of 2001. More and more journalists and analysts began taking a closer look at Enron, and the stock began to fall. In August, Skilling resigned. Enron's credit rating was downgraded. Banks became reluctant to lend Enron the money it needed to make its trades. By December, the company had filed for bankruptcy.

Enron's downfall has been documented so extensively that it is easy to overlook how peculiar it was. Compare Enron, for instance, with Watergate, the prototypical scandal of the 1970s. To expose the White House cover-up, Bob Woodward and Carl Bernstein used a source—Deep Throat—who had access to many secrets, and whose identity had to be concealed. He warned Woodward and Bernstein that their phones might be tapped. When Woodward wanted to meet with Deep Throat, he would move a flowerpot with a red flag in it to the back of his apartment balcony. That evening, he would leave by the back stairs, take multiple taxis to make sure he wasn't being followed, and meet his source in an underground parking garage at 2 a.m. Here, from *All the President's Men*, is Woodward's climactic encounter with Deep Throat:

"Okay," he said softly. "This is very serious. You can safely say that fifty people worked for the White House and CRP to play games and spy and sabotage and gather intelligence. Some of it is beyond belief, kicking at the opposition in every imaginable way."

Deep Throat nodded confirmation as Woodward ran down items on a list of tactics that he and Bernstein had heard were used against the political opposition: bugging, following people, false press leaks, fake letters, canceling campaign rallies, investigating campaign workers' private lives, planting spies, stealing documents, planting provocateurs in political demonstrations.

"It's all in the files," Deep Throat said. "Justice and the Bureau know about it, even though it wasn't followed up."

Woodward was stunned. Fifty people directed by the White House and CRP to destroy the opposition, no holds barred?

Deep Throat nodded.

The White House had been willing to subvert—was that the right word?—the whole electoral process? Had actually gone ahead and tried to do it?

Another nod. Deep Throat looked queasy.

And hired fifty agents to do it?

"You can safely say more than fifty," Deep Throat said. Then he turned, walked up the ramp and out. It was nearly 6:00 a.m.

Watergate was a classic puzzle: Woodward and Bernstein were searching for a buried secret, and Deep Throat was their guide.

Did Jonathan Weil have a Deep Throat? Not really. He had a friend in the investment-management business with some suspicions about energy-trading companies like Enron, but the friend wasn't an insider. Nor did Weil's source

direct him to files detailing the clandestine activities of the company. He just told Weil to read a series of public documents that had been prepared and distributed by Enron itself. Woodward met with his secret source in an underground parking garage in the hours before dawn. Weil called up an accounting expert at Michigan State.

When Weil had finished his reporting, he called Enron for comment. "They had their chief accounting officer and six or seven people fly up to Dallas," Weil says. They met in a conference room at the *Journal's* offices. The Enron officials acknowledged that the money they said they earned was virtually all money that they hoped to earn. Weil and the Enron officials then had a long conversation about how certain Enron was about its estimates of future earnings. "They were telling me how brilliant the people who put together their mathematical models were," Weil says. "These were MIT PhDs. I said, 'Were your mathematical models last year telling you that the California electricity markets would be going berserk this year? No? Why not?' They said, 'Well, this is one of those crazy events.' It was late September 2000 so I said, 'Who do you think is going to win? Bush or Gore?' They said, 'We don't know.' I said, 'Don't you think it will make a difference to the market whether you have an environmentalist Democrat in the White House or a Texas oilman?'" It was all very civil. "There was no dispute about the numbers," Weil went on. "There was only a difference in how you should interpret them."

Of all the moments in the Enron unraveling, this meeting is surely the strangest. The prosecutor in the Enron case told the jury to send Jeffrey Skilling to prison because Enron had hidden the truth: You're "entitled to be told what the financial condition of the company is," the prosecutor had said. But what truth was Enron hiding here? Everything Weil learned for his Enron exposé came from Enron, and when he wanted to confirm his numbers, the company's executives got on a plane and sat down with him in a conference room in Dallas.

Nixon never went to see Woodward and Bernstein at the *Washington Post*. He hid in the White House.

The second, and perhaps more consequential, problem with Enron's accounting was its heavy reliance on what are called *special-purpose entities*, or S.P.E.s.

An S.P.E. works something like this. Your company isn't doing well; sales are down and you are heavily in debt. If you go to a bank to borrow \$100 million, it will probably charge you an extremely high interest rate, if it agrees

to lend to you at all. But you've got a bundle of oil leases that over the next four or five years are almost certain to bring in \$100 million. So you hand them over to a partnership—the S.P.E.—that you have set up with some outside investors. The bank then lends \$100 million to the partnership, and the partnership gives the money to you. That bit of financial maneuvering makes a big difference. This kind of transaction did not (at the time) have to be reported in the company's balance sheet. So a company could raise capital without increasing its indebtedness. And because the bank is almost certain the leases will generate enough money to pay off the loan, it's willing to lend its money at a much lower interest rate. S.P.E.s have become commonplace in corporate America.

Enron introduced all kinds of twists into the S.P.E. game. It didn't always put blue-chip assets into the partnerships—like oil leases that would reliably generate income. It sometimes sold off less-than-sterling assets. Nor did it always sell those assets to outsiders, who presumably would raise questions about the value of what they were buying. Enron had its own executives manage these partnerships. And the company would make the deals work—that is, get the partnerships and the banks to play along—by guaranteeing that, if whatever they had to sell declined in value, Enron would make up the difference with its own stock. In other words, Enron didn't sell parts of itself to an outside entity; it effectively sold parts of itself to itself—a strategy that was not only legally questionable but extraordinarily risky. It was Enron's tangle of financial obligations to the S.P.E.s that ended up triggering the collapse.

When the prosecution in the Skilling case argued that the company had misled its investors, they were referring, in part, to these S.P.E.s. Enron's management, the argument went, had an obligation to reveal the extent to which it had staked its financial livelihood on these shadowy side deals. As the Powers Committee, a panel charged with investigating Enron's demise, noted, the company "failed to achieve a fundamental objective: they did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of [Enron's] financial statements to understand what was going on." In short, we weren't told enough.

Here again, though, the lessons of the Enron case aren't nearly so straightforward. The public became aware of the nature of these S.P.E.s through the reporting of several of Weil's colleagues at the *Wall Street Journal*—principally John Emshwiller and Rebecca Smith—starting in the late summer of 2001. And how was Emshwiller tipped off to Enron's problems? The same way Jonathan Weil and Jim Chanos were: he read what Enron had reported

in its own public filings. Here is the description of Emshwiller's epiphany, as described in Kurt Eichenwald's *Conspiracy of Fools*, the definitive history of the Enron debacle. (Note the verb *scrounged*, which Eichenwald uses to describe how Emshwiller found the relevant Enron documents. What he means by that is *downloaded*.)

It was section eight, called "Related Party Transactions," that got John Emshwiller's juices flowing.

After being assigned to follow the Skilling resignation, Emshwiller had put in a request for an interview, then scrounged up a copy of Enron's most recent SEC filing in search of any nuggets.

What he found startled him. Words about some partnerships run by an unidentified "senior officer." Arcane stuff, maybe, but the numbers were huge. Enron reported more than \$240 million in revenues in the first six months of the year from its dealings with them.

Enron's S.P.E.s were, by any measure, evidence of extraordinary recklessness and incompetence. But you can't blame Enron for covering up the existence of its side deals. It didn't; it disclosed them. The argument against the company, then, is more accurately that it didn't tell its investors *enough* about its S.P.E.s. But what is enough? Enron had some three thousand S.P.E.s, and the paperwork for each one probably ran in excess of a thousand pages. It scarcely would have helped investors if Enron had made all three million pages public. What about an edited version of each deal? Steven Schwarcz, a professor at Duke Law School, recently examined a random sample of twenty S.P.E. disclosure statements from various corporations—that is, summaries of the deals put together for interested parties—and found that on average they ran to forty single-spaced pages. So a summary of Enron's S.P.E.s would have come to a hundred and twenty thousand single-spaced pages. What about a summary of all those summaries? That's what the bankruptcy examiner in the Enron case put together, and it took up a thousand pages. Well, then, what about a summary of the summary of the summaries? That's what the Powers Committee put together. The committee looked only at the "substance of the most significant transactions," and its accounting still ran to two hundred numbingly complicated pages and, as Schwarcz points out, that was "with the benefit of hindsight and with the assistance of some of the finest legal talent in the nation."

A puzzle grows simpler with the addition of each new piece of information: if I tell you that Osama bin Laden is hiding in Peshawar, I make the problem of finding him an order of magnitude easier, and if I add that he's

hiding in a neighborhood in the northwest corner of the city, the problem becomes simpler still. But here the rules seem different. According to the Powers report, many on Enron's board of directors failed to understand "the economic rationale, the consequences, and the risks" of their company's S.P.E. deals—and the directors sat in meetings where those deals were discussed in detail. In *Conspiracy of Fools*, Eichenwald convincingly argues that Andrew Fastow, Enron's chief financial officer, didn't understand the full economic implications of the deals, either, and he was the one who put them together.

"These were very, very sophisticated, complex transactions," says Anthony Catanach, who teaches accounting at the Villanova University School of Business and has written extensively on the Enron case. Referring to Enron's accounting firm, he said, "I'm not even sure any of Arthur Andersen's field staff at Enron would have been able to understand them, even if it was all in front of them. This is senior-management-type stuff. I spent *two months* looking at the Powers report, just diagramming it. These deals were really convoluted."

Enron's S.P.E.s, it should be noted, would have been this hard to understand even if they were standard issue. S.P.E.s are by nature difficult. A company creates an S.P.E. because it wants to reassure banks about the risks of making a loan. To provide that reassurance, the company gives its lenders and partners very detailed information about a specific portion of its business. And the more certainty a company creates for the lender—the more guarantees and safeguards and explanations it writes into the deal—the less comprehensible the transaction becomes to outsiders. Schwarcz writes that Enron's disclosure was "necessarily imperfect." You can try to make financial transactions understandable by simplifying them, in which case you run the risk of smoothing over some of their potential risks, or you can try to disclose every potential pitfall, in which case you'll make the disclosure so unwieldy that no one will be able to understand it. To Schwarcz, all Enron proves is that in an age of increasing financial complexity, the "disclosure paradigm"—the idea that the more a company tells us about its business, the better off we are—has become an anachronism.

During the summer of 1943, Nazi propaganda broadcasts boasted that the German military had developed a devastating "super weapon." Immediately, the Allied intelligence services went to work. Spies confirmed that the Germans had built a secret weapons factory. Aerial photographs taken over northern France showed a strange new concrete installation pointed in the direction of England. The Allies were worried. Bombing missions were sent to try to disrupt the mysterious operation, and plans were drawn up to deal

with the prospect of devastating new attacks on English cities. Nobody was sure, though, whether the weapon was real. There seemed to be weapons factories there, but it wasn't evident what was happening inside them. And there was a launching pad in northern France, but it might have been just a decoy, designed to distract the Allies from bombing real targets. The German secret weapon was a puzzle, and the Allies didn't have enough information to solve it. There was another way to think about the problem, though, which ultimately proved far more useful: treat the German secret weapon as a mystery.

The mystery solvers of the Second World War were small groups of analysts whose job was to listen to the overseas and domestic propaganda broadcasts of Japan and Germany. The British outfit had been around since shortly before the First World War and was run by the BBC. The American operation was known as the Screwball Division, the historian Stephen Mercado writes, and in the early 1940s had been housed in a nondescript office building on K Street, in Washington. The analysts listened to the same speeches that anyone with a shortwave radio could listen to. They simply sat at their desks with headphones on, working their way through hours and hours of Nazi broadcasts. Then they tried to figure out how what the Nazis said publicly—about, for instance, the possibility of a renewed offensive against Russia—revealed what they felt about, say, invading Russia. One journalist at the time described the propaganda analysts as “the greatest collection of individualists, international rolling stones, and slightly batty geniuses ever gathered together in one organization.” And they had very definite thoughts about the Nazis’ secret weapon.

The German leadership, first of all, was boasting about the secret weapon in domestic broadcasts. That was important. Propaganda was supposed to boost morale. If the Nazi leadership said things that turned out to be misleading, its credibility would fall. When German U-boats started running into increasingly effective Allied resistance in the spring of 1943, for example, Joseph Goebbels, the Nazi minister of propaganda, tacitly acknowledged the bad news, switching his emphasis from trumpeting recent victories to predicting long-term success, and blaming the weather for hampering U-boat operations. Up to that point, Goebbels had never lied to his own people about that sort of news. So if he said that Germany had a devastating secret weapon it meant, in all likelihood, that Germany had a devastating secret weapon.

Starting from that premise, the analysts then mined the Nazis’ public pronouncements for more insights. It was, they concluded, “beyond reasonable doubt” that as of November 1943 the weapon existed, that it was of an entirely

new type, that it could not be easily countered, that it would produce striking results, and that it would shock the civilian population upon whom it would be used. It was, furthermore, "highly probable" that the Germans were past the experimental stage as of May of 1943, and that something had happened in August of that year that significantly delayed deployment. The analysts based this inference, in part, on the fact that, in August, the Nazis abruptly stopped mentioning their secret weapon for ten days, and that when they started again, their threats took on a new, less certain, tone. Finally, it could be tentatively estimated that the weapon would be ready between the middle of January and the middle of April, with a month's margin of error on either side. That inference, in part, came from Nazi propaganda in late 1943, which suddenly became more serious and specific in tone, and it seemed unlikely that Goebbels would raise hopes in this way if he couldn't deliver within a few months. The secret weapon was the Nazis' fabled V-1 rocket, and virtually every one of the propaganda analysts' predictions turned out to be true.

The political scientist Alexander George described the sequence of V-1 rocket inferences in his 1959 book *Propaganda Analysis*, and the striking thing about his account is how contemporary it seems. The spies were fighting a nineteenth-century war. The analysts belonged to our age, and the lesson of their triumph is that the complex, uncertain issues that the modern world throws at us require the mystery paradigm.

Diagnosing prostate cancer used to be a puzzle, for example: the doctor would do a rectal exam and feel for a lumpy tumor on the surface of the patient's prostate. These days, though, we don't wait for patients to develop the symptoms of prostate cancer. Doctors now regularly test middle-aged men for elevated levels of PSA, a substance associated with prostate changes, and, if the results look problematic, they use ultrasound imaging to take a picture of the prostate. Then they perform a biopsy, removing tiny slices of the gland and examining the extracted tissue under a microscope. Much of that flood of information, however, is inconclusive: elevated levels of PSA don't always mean that you have cancer, and normal levels of PSA don't always mean that you don't—and, in any case, there's debate about what constitutes a normal PSA level. Nor is the biopsy definitive: because what a pathologist is looking for is early evidence of cancer—and in many cases merely something that might one day turn into cancer—two equally skilled pathologists can easily look at the same sample and disagree about whether there is any cancer present. Even if they do agree, they may disagree about the benefits of treatment, given that most prostate cancers grow so slowly that they never cause problems. The urologist is now charged with the task of making sense

of a maze of unreliable and conflicting claims. He is no longer confirming the presence of a malignancy. He's predicting it, and the certainties of his predecessors have been replaced with outcomes that can only be said to be "highly probable" or "tentatively estimated." What medical progress has meant for prostate cancer—and, as the physician H. Gilbert Welch argues in his book *Should I Be Tested for Cancer?*, for virtually every other cancer as well—is the transformation of diagnosis from a puzzle to a mystery.

That same transformation is happening in the intelligence world as well. During the Cold War, the broad context of our relationship with the Soviet bloc was stable and predictable. What we didn't know was details. As Gregory Treverton, who was a former vice-chair of the National Intelligence Council, writes in his book *Reshaping National Intelligence for an Age of Information*:

Then the pressing questions that preoccupied intelligence were puzzles, ones that could, in principle, have been answered definitively if only the information had been available: How big was the Soviet economy? How many missiles did the Soviet Union have? Had it launched a "bolt from the blue" attack? These puzzles were intelligence's stock-in-trade during the Cold War.

With the collapse of the Eastern bloc, Treverton and others have argued that the situation facing the intelligence community has turned upside down. Now most of the world is open, not closed. Intelligence officers aren't dependent on scraps from spies. They are inundated with information. Solving puzzles remains critical: we still want to know precisely where Osama bin Laden is hiding and where North Korea's nuclear-weapons facilities are situated. But mysteries increasingly take center stage. The stable and predictable divisions of East and West have been shattered. Now the task of the intelligence analyst is to help policymakers navigate the disorder. Several years ago, Admiral Bobby R. Inman was asked by a congressional commission what changes he thought would strengthen America's intelligence system. Inman used to head the National Security Agency, the nation's premier puzzle-solving authority, and was once the deputy director of the CIA. He was the embodiment of the Cold War intelligence structure. His answer: revive the State Department, the one part of the US foreign-policy establishment that isn't considered to be in the intelligence business at all. In a post-Cold War world of "openly available information," Inman said, "what you need are observers with language ability, with understanding of the religions, cultures of the countries they're observing." Inman thought we needed fewer spies and more slightly batty geniuses.

Enron revealed that the financial community needs to make the same transition. "In order for an economy to have an adequate system of financial reporting, it is not enough that companies make disclosures of financial information," the Yale law professor Jonathan Macey wrote in a landmark law review article that encouraged many to rethink the Enron case. "In addition, it is vital that there be a set of financial intermediaries, who are at least as competent and sophisticated at receiving, processing, and interpreting financial information . . . as the companies are at delivering it." Puzzles are "transmitter-dependent"; they turn on what we are told. Mysteries are "receiver-dependent"; they turn on the skills of the listener, and Macey argues that, as Enron's business practices grew more complicated, it was Wall Street's responsibility to keep pace.

Victor Fleischer, who teaches at the University of Colorado Law School, points out that one of the critical clues about Enron's condition lay in the fact that it paid no income tax in four of its last five years. Enron's use of mark-to-market accounting and S.P.E.s was an accounting game that made the company look as though it were earning far more money than it was. But the IRS doesn't accept mark-to-market accounting; you pay tax on income when you actually receive that income. And, from the IRS's perspective, all of Enron's fantastically complex maneuvering around its S.P.E.s was, as Fleischer puts it, "a non-event": until the partnership actually sells the asset—and makes either a profit or a loss—an S.P.E. is just an accounting fiction. Enron wasn't paying any taxes because, in the eyes of the IRS, Enron wasn't making any money.

If you looked at Enron from the perspective of the tax code, that is, you would have seen a very different picture of the company than if you had looked through the more traditional lens of the accounting profession. But in order to do that you would have to be trained in the tax code and be familiar with its particular conventions and intricacies, and know what questions to ask. "The fact of the gap between [Enron's] accounting income and taxable income was easily observed," Fleischer notes, but not the source of the gap. "The tax code requires special training."

Woodward and Bernstein didn't have any special training. They were in their twenties at the time of Watergate. In *All the President's Men*, they even joke about their inexperience: Woodward's expertise was mainly in office politics; Bernstein was a college dropout. But it hardly mattered, because cover-ups, whistle-blowers, secret tapes, and exposes—the principal elements of the puzzle—all require the application of energy and persistence, which are the virtues of youth. Mysteries demand experience and insight. Woodward and Bernstein would never have broken the Enron story.

"There have been scandals in corporate history where people are really making stuff up, but this wasn't a criminal enterprise of that kind," Macey says. "Enron was vanishingly close, in my view, to having complied with the accounting rules. They were going over the edge, just a little bit. And this kind of financial fraud—where people are simply stretching the truth—falls into the area that analysts and short-sellers are supposed to ferret out. The truth wasn't hidden. But you'd have to look at their financial statements, and you would have to say to yourself, 'What's that about?' It's almost as if they were saying, 'We're doing some really sleazy stuff in footnote 42, and if you want to know more about it, ask us.' And that's the thing. Nobody did."

Alexander George, in his history of propaganda analysis, looked at hundreds of the inferences drawn by the American analysts about the Nazis, and concluded that an astonishing 81 percent of them were accurate. George's account, however, spends almost as much time on the propaganda analysts' failures as on their successes. It was the British, for example, who did the best work on the V-1 rocket problem. They systematically tracked the "occurrence and volume" of Nazi reprisal threats, which is how they were able to pinpoint things like the setback suffered by the V-1 program in August of 1943 (it turned out that Allied bombs had caused serious damage) and the date of the Nazi V-1 rocket launch. K Street's analysis was lackluster in comparison. George writes that the Americans "did not develop analytical techniques and hypotheses of sufficient refinement," relying instead on "impressionistic" analysis. George was himself one of the slightly batty geniuses of K Street, and, of course, he could easily have excused his former colleagues. They never left their desks, after all. All they had to deal with was propaganda, and their big source was Goebbels, who was a liar, a thief, and a drunk. But that is puzzle thinking. In the case of puzzles, we put the offending target, the CEO, in jail for twenty-four years and assume that our work is done. Mysteries require that we revisit our list of culprits and be willing to spread the blame a little more broadly. Because if you can't find the truth in a mystery—even a mystery shrouded in propaganda—it's not just the fault of the propagandist. It's your fault as well.

In the spring of 1998, Macey notes, a group of six students at Cornell University's business school decided to do their term project on Enron. "It was for an advanced financial statement analysis class taught by a guy at Cornell called Charles Lee, who is pretty famous in financial circles," one member of the group, Jay Krueger, recalls. In the first part of the semester, Lee had led his students through a series of intensive case studies, teaching them techniques and sophisticated tools to make sense of the vast amounts

of information that companies disclose in their annual reports and SEC filings. Then the students picked a company and went off on their own. "One of the second-years had a summer-internship interview with Enron, and he was very interested in the energy sector," Krueger went on. "So he said, 'Let's do them.' It was about a six-week project, half a semester. Lots of group meetings. It was a ratio analysis, which is pretty standard business-school fare. You know, take fifty different financial ratios, then lay that on top of every piece of information you could find out about the company, the businesses, how their performance compared to other competitors."

The people in the group reviewed Enron's accounting practices as best they could. They analyzed each of Enron's businesses, in succession. They used statistical tools, designed to find telltale patterns in the company's financial performance—the Beneish model, the Lev and Thiagarajan indicators, the Edwards-Bell-Ohlsen analysis—and made their way through pages and pages of footnotes. "We really had a lot of questions about what was going on with their business model," Krueger said. The students' conclusions were straightforward. Enron was pursuing a far riskier strategy than its competitors. There were clear signs that "Enron may be manipulating its earnings." The stock was then at \$48—at its peak, two years later, it was almost double that—but the students found it overvalued. The report was posted on the website of the Cornell University business school, where it has been, ever since, for anyone who cares to read twenty-three pages of analysis. The students' recommendation was on the first page, in boldfaced type: "Sell."*

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*By today's standards, of course, Enron barely meets the threshold for financial scandal, not after the multitrillion-dollar financial meltdown of the past few years. But I wrote about it twice—here and a few years earlier in "The Talent Myth" because I felt it was really the paradigmatic scandal of the information age. History has borne this out. Had we taken the lessons of Enron more seriously, would we have had the financial crisis of 2008?