

The Enron scandal



Tobias Pavel 910422
Mylene Encontro 850224

Chalmers University of Technology
Financial Risk, MVE220
Examiner: Holger Rootzén

2012-12-02 Göteborg

This report has been written and analyzed by both group members jointly.

Abstract

From the 1990's until the fall of 2001, Enron was famous throughout the business world and was known as an innovator, technology powerhouse, and a corporation with no fear. The sudden fall of Enron in the end of 2001 shattered not just the business world but also the lives of their employees and the people who believed that their soar to greatness was genuine. Their collapse was followed by a series of revelations on how they manipulated their success.

Introduction

Enron shocked the world from being “America’s most innovative company” to America's biggest corporate bankruptcy at its time. At its peak, Enron was America's seventh largest corporation. Enron gave the illusion that it was a steady company with good revenue but that was not the case, a large part of Enron’s profits were made of paper. This was made possible by masterfully designed accounting and morally questionable acts by traders and executives. Deep debt and surfacing information about hiding losses gave the company big problems and in the late 2001 Enron declared bankruptcy under Chapter 11 of the United States Bankruptcy Code.

Many factors affected Enron's surge to the top and its sudden fall. In this report we will discuss and present what we think were the main reasons of their rise and fall.

Enron’s surge to the top

From energy to trading

Kenneth Lay was one of the key spokesmen when it came to deregulation of the energy market, much because of his personal connection to the Bush family. In the early 1990's the United States congress approved a legislation that deregulated the sale of natural gas. Not long before this Lay was one of the initiators that made it possible to sell electricity on the free market. This major deregulation in the energy market gave Enron the opportunity to sell their energy at higher prices, which equivalently lead to greater revenue.

This was the start of Enron's journey from an energy company to a trading company. The focus went from energy markets to finding new ways of earning money. Large investments were made around the world to expand its business and open itself for new markets. Enron was named America’s most innovative company six years in a row by Fortune's Most Admired Companies survey. This made the company attractive for top graduates out of the best universities across America, which gave the company more competence and a big urge to strive forward. The strive forward was the same as the aim to increase the stock price. Enron employees were partly paid in stocks so increasing the stock price became a main interest.

Mark-to-market Accounting

In 1990, Jeffery Skilling joined Enron Corporation and in 1997, he was appointed as the company's Chief Executive Officer. Skilling demanded to change Enron's accounting system from a straightforward kind of accounting where Enron had listed actual revenue and costs of supplying and selling gas to the mark-to-market accounting system. The mark-to-market method requires estimations of future incomes when a long-term contract is signed. These estimations were based on the future net value of the cash flow, costs related to the contract were often hard to predict. This means that the estimated income from projects were included

in Enron's accounting even though the money was not yet received and if there were any changes such as additional income or loss it would show up in subsequent periods. Investors were given misleading information because of the deviation in the estimations.

Enron was the first non-financial company to use the mark-to-market method. The U.S. Securities and Exchange Commission gave Enron their approval to use the method on January 30, 1992. (The smartest guy in the room, 2004)

Special Purpose Entity

Special purpose entities are legal entities that are created only to carry out a specific or temporary task. The purposes are to handle assets either by funding or by risk management. A sponsor creates the entities but the funding comes from investors. The financial reporting has many rules about if the entity is separated from the sponsor. In Enron's case the special purpose entities were not only used to dodge the traditional accounting conventions but also so they could hide debts. The entities made it possible for Enron to underestimate, hide, its debts and overestimate its equity.

A new strategy

Enron was by 1992 the largest seller of natural gas in North America, their earnings before interest and taxes was \$122 million. To grow further, Enron followed a differentiation strategy that were based on that the company owned and operated a variety of assets, pipelines, broadband services, paper plants, water plants and electricity plants. Enron did not only make money on its assets, it also traded actively with contracts of the products and services it provided, making further revenue. This made Enron a favorite among investors and between 1990 and end of 1998 Enron's stock price increased 311%. The increase didn't stop there, 1999 it increased 56% and 2000 it increased an additional 87%. The index for the market the same two years was +20% and -10%. Enron's stock price was 83.13 dollars and its market value was just above 60 billion dollars the 31 December of 2000. (The fall of Enron, 2003)

The Commodity Futures Modernization Act of 2000, which ensured the deregulation of over-the-counter derivatives, helped Enron with their derivatives business. One example was during the California electricity crisis (2000-2001) where they manipulated the California energy market and sent electricity prices surging by at least a factor of eight. During that time, the price of natural gas was trading as much as \$60 per thousand cubic feet in California (which was previously selling for about \$3 per thousand cubic feet). This kind of manipulation increased Enron's stock price and revenues. But this not so clever manipulation of Enron made itself a political target and accelerated the ruins of their finances.

Enron's collapse

Mark-to-market Accounting

The use of mark-to-market accounting later backfired. The company's aggressive accounting had corrupted Enron's books and had allowed the company to be far too optimistic in its assumptions about the future profits. Cash is a necessity for any company to run and Enron mostly had paper revenue, so by the middle of 2001, they came to the conclusion that the cash crisis had struck them.

The Enron Culture

In Enron, bonuses and incentives in form of cash or stock options came in bundles, only if you were good enough and if you were considered one of the moneymakers. This mentality made Enron a very competitive work place. Everyone was in a hurry to close deals (good or bad) because right after a closed deal, they got their bonuses regardless of the result of the deal. This became a problem since there were a lot of projects being made but no follow-ups. No one wanted to be responsible of a done deal, they just wanted to close it and get their bonus.

Performance review committee was also a factor why employees in Enron were so aggressive. It created a culture within Enron that replaced cooperation with competition. The committee gave ratings from 1 to 5, 1 being the highest and in Enron, the 1 mark meant that you will get a good sum of bonus. If you were in the lowest 5 to 6 percent of this rankings, that meant that you are not good enough to stay in Enron and you had to pack your things because you will lose your job anytime soon.

Special Purpose Entity

In order to hide losses and fabricate earnings, Andrew Fastow created multiple SPEs. Some SPE's are Chewco, LJM1, LJM2 and Raptor. When news about the debt hiding surfaced, Enron's stock began to fall and several SPEs began to collapse as a result of the drop of Enron's stock price. For an SPE to legal, they have to satisfy 3 requirements: (1) at least 3% of the equity had to come from outside investors (i.e. not-Enron), (2) the entity could not be controlled by Enron, and (3) Enron was not liable for any loans or other liabilities. (Bryce, 2002) An internal investigation of the SPEs showed they were not independent since they were run by Enron employees (i.e. LJM was run by Andy Fastow while ChewCo was run by Kopper). Therefore, they had to be disclosed in Enron's financial statements depressing earnings and debt levels severely

Key players

Enron was housed by bright and talented employees and everyone thinks they are so smart or smarter than the others that they think they could always get away with 'crime'.

Jeffrey Skilling was the one responsible in implementing mark-to-market accounting in Enron. Under his management, Enron launched EnronOnline, which is an Internet based service where contracts on energy commodities could be traded with Enron. In the end, Enron could not cover the capital costs of their transactions, which is also one of the reasons that sent the company to bankruptcy.

Andrew Fastow was the Chief Financial Officer of Enron who was the mastermind of the Special Purpose Entities like LJM1, LJM2, etc. in Enron. He made the complicated financial structures so that Enron could hide their losses and debts.

Rebecca Mark was the head of the failed businesses of Enron, which were Enron International and Azurix. Some of here projects were the \$3 billion power plant in Dabhol, India and the expensive acquisition of Wessex Water. She also used the Enron Jet with her trips around the world. One executive even mentioned that whenever Mark attends a meeting, it costs the company at least \$60,000 (that would cover just her transportation).

Ofcourse, who could forget the contribution of the Chairman and CEO of Enron, Kenneth Lay, regarding Enron's bankruptcy. Aside from straying away from the business because he

was too busy socializing, he and his family misused the company assets. At one point, they were all using the company jets for personal travels. He was also involved in conspiracy and fraud in the company in order to hide its downfall.

Aftermath of Enron's bankruptcy

The bankruptcy affected at least the 21,000 Enron employees. During the four years before the declaration of bankruptcy where shareholders lost \$74 billion, approximately \$40-45 billions could be traced back to fraud (Wikipedia, 2012). 20,000 former employees won a suit against Enron in May 2004 worth \$85 million This was the compensation for nearly \$2 billion in pension funds that were lost (Doran, 2004).

Not everything is about money, a lot of people lost their steady income, their security to feed their families and many people's futures were shattered due to the loss of pension.

Sarbanes-Oxley Act is a US federal law that came after the Enron scandal. The act contains a set of standards that regulate public company boards, management and public accounting firms. Some of the main regulations is that all companies must have a majority of independent directors, nominating and compensation committee has to have independent directors also the audit committee should consist of members that are financially educated and one of the members have to been an expert (Wikipedia, 2012).

On January 14, 2004, Andy Fastow and his wife Lea both pleaded guilty and got a highly unusual package deal. Andy was sentenced 10 years without parole in exchange of testifying against Lay, Skilling and other former Enron executives. Prosecutors were so impressed with his performance that his final sentence was shortened to 6 years.

The jury in the Lay and Skilling trial returned its verdict on May 25, 2006. Lay was convicted to all 6 charges he faced (securities and wire fraud) and subject to a maximum of 45 years in prison. Forty-one days later, Ken Lay died in Aspen because of heart attack; that is even before his sentence was scheduled. On the other hand, Skilling was found guilty on nineteen of twenty eight-counts which includes securities and wire fraud. On October 23, 2006, Skilling was sentenced to 24 years and 4 months in prison.

Conclusions and Recommendations

Conclusions

Morally questionable acts were made from both executives and traders. One thing that is unavoidable is the fact that employees at Enron were partially paid in stocks which motivated the workers to take actions that were unethical in order to raise the stock price and equivalently their own money. As seen in the California case traders manipulated the market in favor of the company.

Enron culture was heavily influenced by competition and since the employees were motivated by fat bonuses and scared of getting laid off if they did not perform well, and in effect resulted to an unhealthy competition between the co-workers. The colleagues would rather

stab each other in the back than help one another to close a deal. Employees getting paid in stock did not help, neither the working environment nor the competition among colleagues. The working environment at Enron became unbearable and from an outsider's point of view, you can see that it is not impossible that illegal and immoral things were done. Incentives such as money are always strong, we think that there is a higher probability that the greed will take over and people would do anything if the price is right.

Mark-to-market accounting mixed with the use of SPEs made Enron look financially healthy when it actually was bleeding, bleeding severely. Misleading information was given to the investors due to the accounting system, which eventually led to decreasing stock price when the information about this started to surface. We think this was just a matter of time rather than a question about if they would get away with it. Sooner or later more and more of the bad investments had to be questioned because of its great sizes and also because at some time it had to show that there were short of real cash in the company.

We think the downfall of Enron was caused by several factors. Among many are the topics we have chosen to present in this paper, the mark-to-market method, the competitive working environment and the use of special purpose entities. Not to forget is the importance of the people behind this, Lay, Skilling, Fastow and Mark. The Enron scandal is not only a story about complex accounting it is also a story about the people who made it possible. People that made decisions affecting not only themselves or the 21.000 employees at Enron but also America as a whole.

Recommendations

- Incentives must be paid after a project is done or at least when the company is really profiting from that certain project.
- Operational risk should be minimized and there should be some sort of check up.
- Careful selection of accounting approach and financial structures to use.
- Minimized payment in stocks.

Further readings

For those who are interested with the story of Enron and wants to know more about the details of their (un)fame, then we recommend the books *Pipe Dreams* by Robert Bryce and *The Smartest Guys in the Room* by Bethany Mclean and Peter Elkind. Personally, *Pipe Dreams* is an easier book to read and easy to follow too because of the chronological arrangement of events. If you just have a few hours to spare for this subject matter, there are a lot of articles written in the internet about Enron and there is also a 110 minutes documentary about it which is also entitled *Enron: The Smartest Guys in the Room*.

References

Internet

Doran, James (2004-05-14). Enron Staff win \$85m, *The Times*, 2012-12-01

Sarbanes-Oxley Act. http://en.wikipedia.org/wiki/Sarbanes-Oxley_Act. 2012-12-01

Enron scandal, http://en.wikipedia.org/wiki/Enron_scandal 2012-12-01

Books

Mclean, B & Elkin, P. (2004) *The smartest guys in the room*. New York. Fortune.

Bryce, R. (2002) *Pipe Dreams: Greed, Ego, and the death of Enron*. Oxford: PublicAffairs.

Healy, Paul M. Krishna G. Palepu. (2003), *The Fall of Enron*. Journal of Economic Perspectives

Movie

Alex Gibney. (2005). *Enron: The smartest guys in the room*. Documentary. Magnolia Pictures.