ENRON

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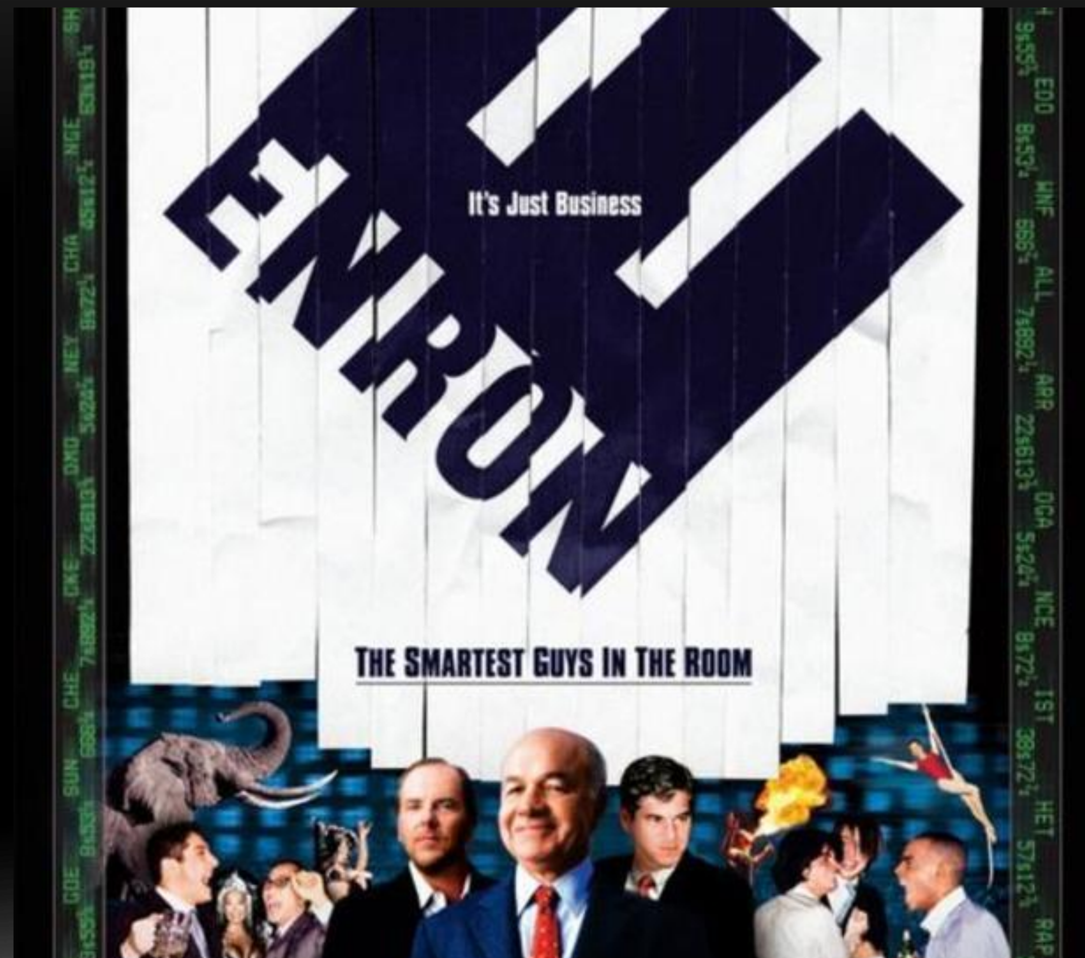
INTRODUCTION

Enron Corporation (former New York Stock Exchange ticker symbol ENE) was an American energy, commodities, and services company based in Houston, Texas. Before its bankruptcy on December 2, 2001, Enron employed approximately 20,000 staff and was one of the world's major electricity, natural gas, communications, and pulp and paper companies, with claimed revenues of nearly $111 billion during 2000.[1] Fortune named Enron "America's Most Innovative Company" for six consecutive years.



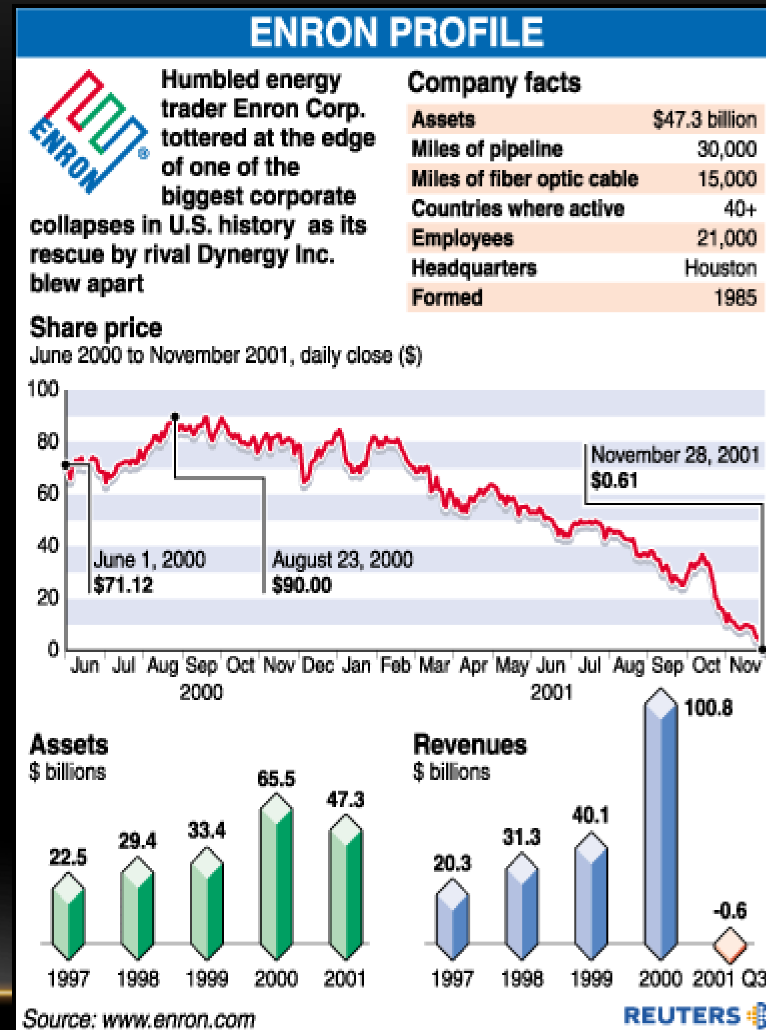
RISE OF ENRON

- Enron was formed in 1985 by **Kenneth Lay** after merging the natural gas pipeline companies of Houston Natural Gas and Inter North.
- Enron rose to become the largest seller of natural gas in North America by 1992.
- Enron pursued a diversification strategy in order to achieve further growth.
- LINE of BUSINESS :

Enron's predecessor was the Northern Natural Gas Company, which was formed in 1932, in Omaha, Nebraska. It was reorganized in 1979 as the main subsidiary of a holding company, InterNorth which was a diversified energy and energy related products company. InterNorth was a major business for natural gas production, transmission and marketing as well as for natural gas liquids and was an innovator in the plastics industry.

THE SCANDAL

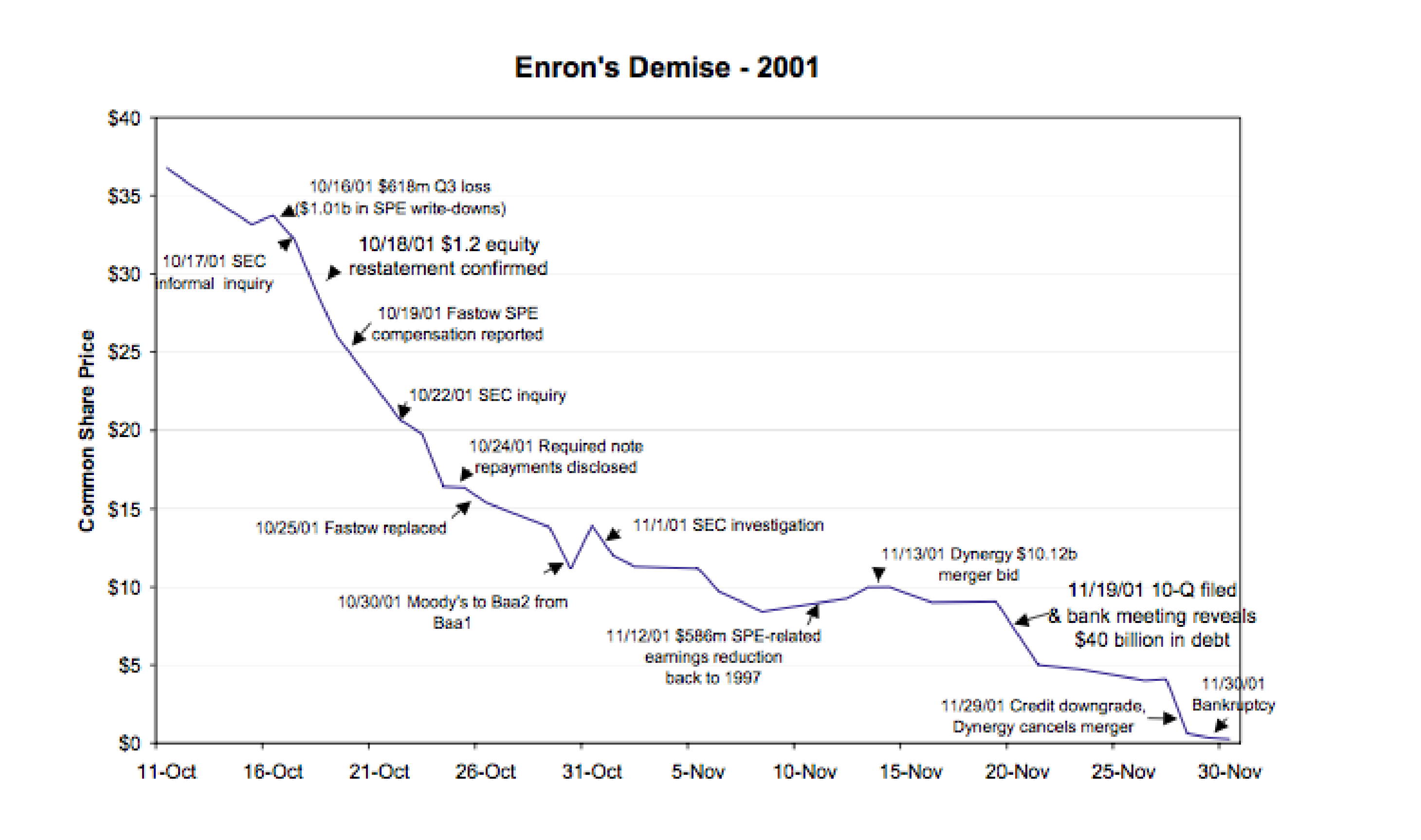
- As often happens with buccaneering entrepreneurs, it got a case of hubris. It figured if it could trade energy, it could trade anything, anywhere, in the new virtual marketplace. Newsprint. Television advertising time. Insurance risk. High-speed data transmission.
- All of these were converted into contracts -- called derivatives -- that were sold to investors. Enron poured billions into these trading ventures, and some failed. It turned out Enron was good at inventing businesses, but terrible at the tedious work of running them, judging by some appalling internal management audits discovered by The Times's Kurt Eichenwald.
- For a time, Enron swept its failures into creative hiding places, but ultimately the truth came out, confidence in the company collapsed and you now have a feeding frenzy.



THE SCANDAL

- To keep its mystique alive and its stock price growing, it set up partnerships where it could bury its losses, or generate imaginary revenues. Here's one of the more audacious examples, pieced together by The Wall Street Journal: Enron invested a bunch of money in a joint venture with Blockbuster to rent out movies online. The deal flopped eight months later. But in the meantime Enron had secretly set up a partnership with a Canadian bank. The bank essentially lent Enron $115 million in exchange for Enron's profits from the movie venture over its first 10 years. The Blockbuster deal never made a penny, but Enron counted the Canadian loan as a nice, fat profit.
- Enron also seems to have baffled the accountants at Arthur Andersen, the bankers at J. P. Morgan, the Wall Street geniuses who touted Enron stock, and those C.E.O.'s who kept voting Kenneth Lay, now abruptly retired, the mastermind of the year. Also (with some exceptions) the business press.

SEQUENCE OF EVENTS



SEQUENCE OF EVENTS

- In February 2001, Chief Accounting Officer Rick Causey told budget managers: "From an accounting standpoint, this will be our easiest year ever. We've got 2001 in the bag."

- By the late 1990s Enron's stock was trading for $80–90 per share, and few seemed to concern themselves with the opacity of the company's financial disclosures.

- In mid-July 2001, Enron reported revenues of $50.1 billion, almost triple year-to-date, and beating analysts' estimates by 3 cents a share.[81] Despite this, Enron's profit margin had stayed at a modest average of about 2.1%, and its share price had decreased by more than 30% since the same quarter of 2000.

SEQUENCE OF EVENTS

- As time passed, a number of serious concerns confronted the company, namely logistical difficulties in operating a new broadband communications trading unit, and the losses from constructing the Dabhol Power project, a large power plant in India. There was also increasing criticism of the company for the role that its subsidiary Enron Energy Services had in the California electricity crisis of 2000-2001.

- On August 14, Skilling announced he was resigning his position as CEO after only six months.Observers noted that in the months before his exit, Skilling had sold at minimum 450,000 shares of Enron at a value of around $33 million.The next day, however, Skilling admitted that a very significant reason for his departure was Enron's faltering price in the stock market.

SEQUENCE OF EVENTS

- On August 15, Sherron Watkins, vice president for corporate development, sent an anonymous letter to Lay warning him about the company's accounting practices. One statement in the letter said: "I am incredibly nervous that we will implode in a wave of accounting scandals."
- Lay consulted with other executives, and although they wanted to dismiss Watkins (as Texas law did not protect company whistle blowers), they decided against it to prevent a lawsuit.
- By the end of August 2001,Enron's investors were in significant need of reassurance, not only because the company's business was difficult to understand (even "indecipherable")[91] but also because it was difficult to properly describe the company in financial statements.
- On October 29, responding to growing concerns that Enron might have insufficient cash on hand, news spread that Enron was seeking a further $1–2 billion in financing from banks.[100] The next day, as feared, Moody's lowered Enron's credit rating from Baa1 to Baa2, two levels above junk status.

SEQUENCE OF EVENTS

- November began with the disclosure that the SEC was now pursuing a formal investigation, prompted by questions related to Enron's dealings with "related parties".
- On November 19 Enron disclosed to the public further evidence of its critical state of affairs. Most pressingly that the company had debt repayment obligations in the range of $9 billion by the end of 2002. Such debts were "vastly in excess" of its available cash.
- On November 28, 2001, Enron's two worst-possible outcomes came true: Dynegy Inc. unilaterally disengaged from the proposed acquisition of the company, and Enron's credit rating was reduced to junk status.
- The company had very little cash with which to operate, let alone satisfy enormous debts. Its stock price fell to $0.61 at the end of the day's trading.

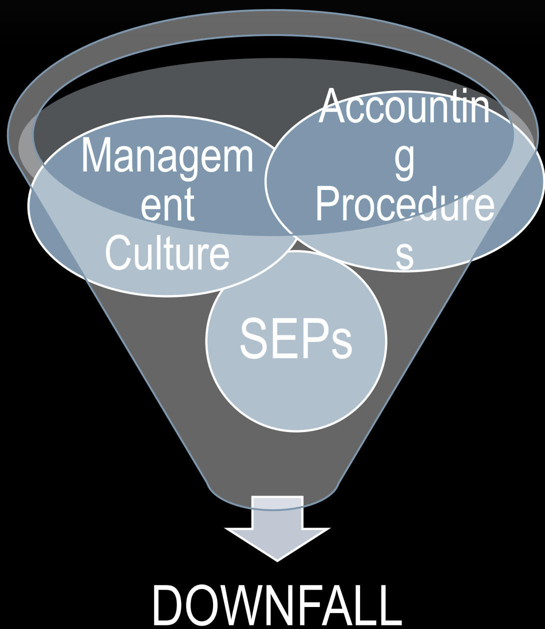
SEQUENCE OF EVENTS

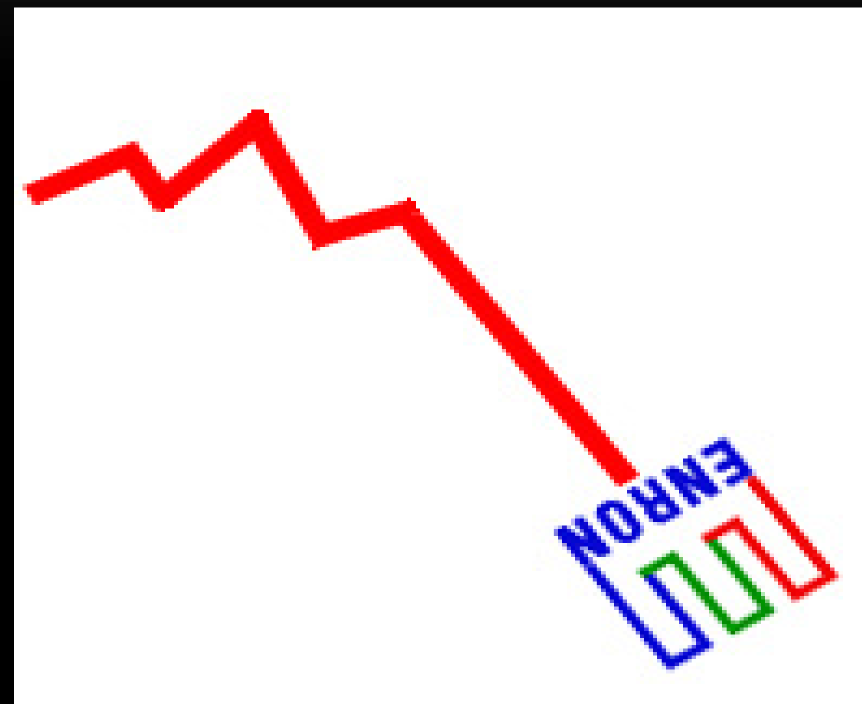
- Enron's European operations filed for bankruptcy on November 30, 2001, and it sought Chapter 11 protection two days later on December 2.
- It was the largest bankruptcy in U.S. history (before being surpassed by WorldCom's bankruptcy the next year), and resulted in 4,000 lost jobs.[3][127] The day that Enron filed for bankruptcy, the employees were told to pack their belongings and were given 30 minutes to vacate the building.[128] Nearly 62% of 15,000 employees' savings plans relied on Enron stock that was purchased at $83 in early 2001 and was now practically worthless.
- Enron's shareholders lost $74 billion in the four years before the company's bankruptcy ($40 to $45 billion was attributed to fraud).
- In May 2004, more than 20,000 of Enron's former employees won a suit of $85 million for compensation of $2 billion that was lost from their pensions.

U.S. Senator Byron Dorgan says :

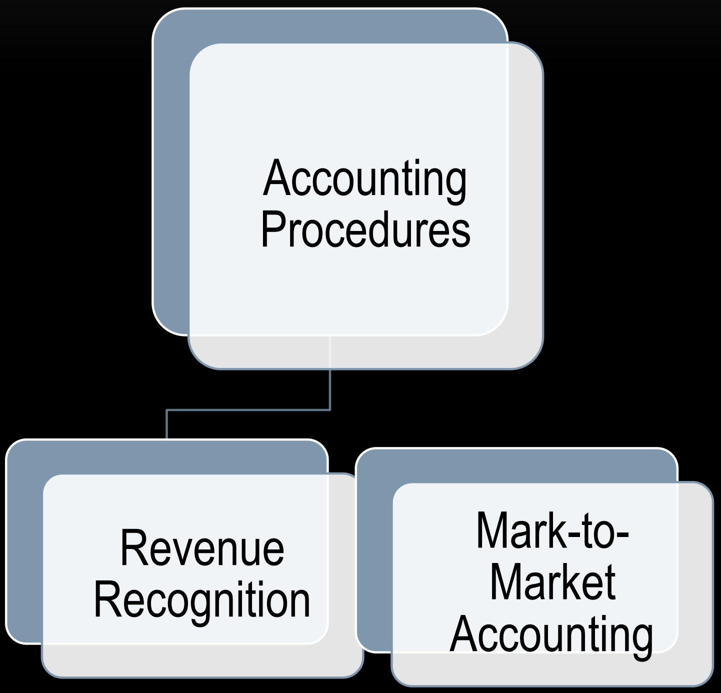
"In the Titanic, the captain went down with the ship. And Enron looks to me like the captain first gave himself and his friends a bonus, then lowered himself and the top folks down the lifeboat and then hollered up and said, 'By the way, everything is going to be just fine."

CAUSES OF THE DOWNFALL





ACCOUNTING PROCEDURES



- The conventional wisdom is that it was "innovative" accounting practices and their consequences that started the tide of losses that brought the energy giant down.
- Enron collapsed not so much because it had gotten too big, but because it was perceived to be much bigger than it really was in the first place.
- By decentralizing its operations into numerous subsidiaries and shell corporations, Enron was able to hide huge derivative losses that would have halted its growth much sooner if widely understood.
- In other words, losses were held off the book by subsidiary companies, while assets were stated.

REVENUE RECOGNITION

- Enron and other energy suppliers earned profits by providing services such as wholesale trading and risk management in addition to building and maintaining electric power plants, natural gas pipelines, storage, and processing facilities.
- When accepting the risk of buying and selling products, merchants are allowed to report the selling price as revenues and the products' costs as cost of goods sold.
- In contrast, an "agent" provides a service to the customer, but does not take the same risks as merchants for buying and selling. Service providers, when classified as agents, are able to report trading and brokerage fees as revenue, although not for the full value of the transaction.

MARK-TO-MARKET ACCOUNTING

- In Enron's natural gas business, the accounting had been fairly straightforward: in each time period, the company listed actual costs of supplying the gas and actual revenues received from selling it.
- However, when Skilling joined the company, he demanded that the trading business adopt mark-to-market accounting, citing that it would represent "true economic value."
- Enron became the first non-financial company to use the method to account for its complex long-term contract.
- Mark-to-market accounting requires that once a long-term contract was signed, income is estimated as the present value of net future cash flow.
- Due to the large discrepancies of attempting to match profits and cash, investors were typically given false or misleading reports.
- While using the method, income from projects could be recorded, although they might not have ever received the money, and in turn increasing financial earnings on the books.
- However, in future years, the profits could not be included, so new and additional income had to be included from more projects to develop additional growth to appease investors

FALLOUT FROM FRAUD

- Taken at its word, this rosy scenario made the company the darling of Wall Street, and it was able to borrow almost endlessly and expand into e-commerce and other questionable ventures.
- Its stock literally soared, which made employee compensation and pensions in the form of stock options seem very attractive.
- But what were already considered accounting practices on the edge of acceptable standards were eventually revealed to be outright fraudulent.
- The disgrace drove so much business away from and created such liability for accounting firm Arthur Anderson that it was itself forced out of business. By this time, though, the true value of the company had been revealed and the stock price collapsed, leaving employees with worthless options and pension packages. Of course, executives that understood the real picture sold their shares in advance of the collapsed and waltzed away with billions.

BANKRUPTCY

- Enron's stock price (former NYSE ticker symbol: ENE) from August 23, 2000 ($90) to January 11, 2002 ($0.12). As a result of the decrease of the stock price, shareholders lost nearly $11 billion.
- On November 28, 2001, Enron's two worst-possible outcomes came true: Dynegy Inc. unilaterally disengaged from the proposed acquisition of the company, and Enron's credit rating was reduced to junk status.
- Systemic consequences were felt, as Enron's creditors and other energy trading companies suffered the loss of several percentage points
- Enron was estimated to have about $23 billion in liabilities from both debt outstanding and guaranteed loans.
- Additionally, many of Enron's major assets were pledged to lenders in order to secure loans, causing doubt about what, if anything, unsecured creditors and eventually stockholders might receive in bankruptcy proceedings.
- On January 17, 2002 Enron dismissed Arthur Andersen as its auditor, citing its accounting advice and the destruction of documents. Andersen countered that it had already ended its relationship with the company when Enron became bankrupt.

MANAGEMENT CULTURE

- Executive Compensation
- Risk Management

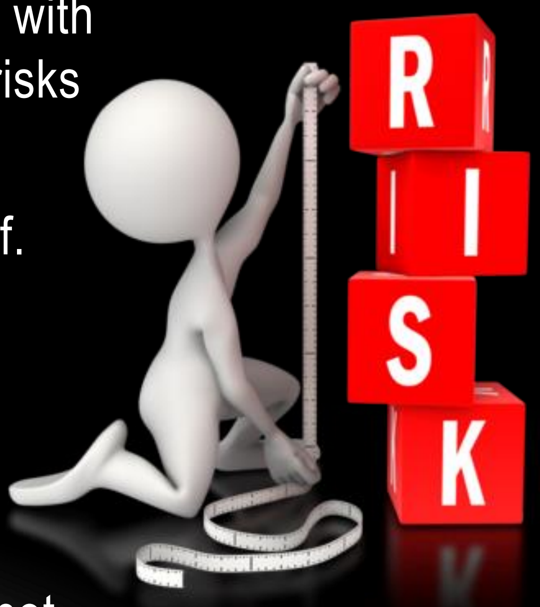
- It was facilitated by a corporate culture that encouraged greed and fraud, as exemplified by the energy traders who extorted California energy consumers.
- Rather than focus on creating real value, management's only goal was in maintaining the appearance of value, and therefore a rising stock price.
- This was exacerbated by a fiercely competitive corporate culture that rewarded results at any cost.
- Some divisions of Enron replaced as much as 15 percent of its work force annually, leaving employees to scramble for any advantage they could find to justify their continued employment.

EXECUTIVE COMPENSATION

- Although Enron's compensation and performance management system was designed to retain and reward its most valuable employees, the system contributed to a dysfunctional corporate culture that became obsessed with short-term earnings to maximize bonuses.
- Employees constantly tried to start deals, often disregarding the quality of cash flow or profits, in order to get a better rating for their performance review.
- Additionally, accounting results were recorded as soon as possible to keep up with the company's stock price. This practice helped ensure deal-makers and executives received large cash bonuses and stock options.

RISK MANAGEMENT

- Before its scandal, Enron was lauded for its sophisticated financial risk management tools.
- Enron established long-term fixed commitments which needed to be hedged to prepare for the invariable fluctuation of future energy prices.
- Enron's bankruptcy downfall was attributed to its reckless use of derivatives and special purpose entities. By hedging its risks with special purpose entities which it owned, Enron retained the risks associated with the transactions.
- This arrangement had Enron implementing hedges with itself.
- Although not all of Enron's widespread improper accounting practices were revealed to the board, the practices were dependent on board decisions.
- Even though Enron extensively relied on derivatives for its business, the company's Finance Committee and board did not have enough experience with derivatives to understand what they were being told.



SPECIAL PURPOSE ENTITIES

- Enron used special purpose entities—limited partnerships or companies created to fulfill a temporary or specific purpose to fund or manage risks associated with specific assets.
- The company elected to disclose minimal details on its use of "special purpose entities“.
- These shell companies were created by a sponsor, but funded by independent equity investors and debt financing.
- In total, by 2001, Enron had used hundreds of special purpose entities to hide its debt.
- Enron used a number of special purpose entities, such as partnerships in its Thomas and Condor tax shelters, financial asset securitization investment trusts (FASITs) in the Apache deal, real estate mortgage investment conduits (REMICs) in the Steele deal, and REMICs and real estate investment trusts (REITs) in the Cochise deal.

CORPORATE GOVERNANCE FLAWS

- Failure of the Board of Directors
- Audit Committee
- Low Ethical Standards
- Stakeholders
- Whistle Blower Policy

1. FAILURE OF THE BOARD OF DIRECTORS

- On paper, Enron had a model board of directors comprising predominantly outsiders with significant ownership stakes and a talented audit committee.
- Collapse of Enron may be construed as failure of the board of directors as it failed miserably in its oversight responsibilities.
- The directors failed to understand the related party transactions between Enron and SPEs. They also failed in implementing proper systems of control and risk management.
- The company extensively relied on derivatives for its business, the company's Finance Committee and board did not have comprehensive background in derivatives to grasp what they were being told.

2. AUDIT COMMITTEE :

- Enron's audit committee was criticized for it's brief meetings that would cover large amounts of material.
- In one meeting on February 12,2001, the committee met for an hour and a half.
- Enron's audit committee did not have the technical knowledge to properly question the auditors on accounting issues related to the company's SPEs.
- The audit committee failed to review the related party transactions with the SPEs.

3. LOW ETHICAL STANDARDS :

- Ethical standards of the company had come down to a very low level with the employees indulging in self-dealings.
- Senior executives were selling their holdings in the company while others were buying more and more. Extravagances were rampant.
- Employees were putting self-interest ahead of the corporate interest.

4. STAKEHOLDERS :

- Stakeholders of the company including creditors, credit rating agencies and regulators (mainly Securities and Exchange Commission) remained silent spectators until the scam became too evident.
- They failed to question the wrong accounting policies and faulty business model adopted by Enron.

5. WHISTLE BLOWER POILCY :

- The collapse of Enron could have been averted had the company had a whistle blower policy in place.
- Sherron Watkings, one of the employees of the company had raised concerns about some of the accounting concerns in Enron in 1996 but no notice was taken of her concerns and she was shifted to another department.
- Only in 2001 when she raised the matter of extensive frauds at SPEs gain more vociferously that the scandal came to the surface.

AFTERMATH OF THE SCAM

- It led to the bankruptcy of the Enron Corporation which was an American energy company. Enron's $63.4 billion in assets made it the largest corporate bankruptcy in U.S. history at that time.
- Shareholders lost nearly $11 billion.
- Many executives of Enron including- Mr. Kenneth Lay, Mr. Jeffrey Skilling and Mr.Andrew Fastow were indicted for a variety of charges and were later sentenced to prison.
- Enron's auditor, Arthur Andersen, was found guilty and ultimately the audit firm was closed down.
- Employees and shareholders received limited returns in lawsuits, despite losing billions in pensions and stock prices.
- In the aftermath of the scandal, new regulations and legislation (such as SOX Act) were enacted in the US to increase the accuracy of financial reporting for public companies and to expand the accountability of auditing firms to remain unbiased and independent of their clients.

DWINDLING INVESTORS CONFIDENCE

With dwindling investors' confidence the downfall of Enron was accelerated. In November, 2001 banks started cancelling Enron's credit facilities, and rating agencies downgraded company's ratings.

These constrained the financial position of the company further. It was clear by that time that Enron could no longer survive the shattered confidence. With failed deal of possible acquisition of Enron by a rival firm Dynegy, Enron was left with no alternative but to file bankruptcy in early December 2001.