Enron (2001)[1]

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The Enron scandal, one of the largest in the US corporate history was revealed in October 2001. It eventually led to the bankruptcy of the Enron Corporation, an American energy company, and the dissolution of Arthur Andersen, which was one of the five largest audit firms in the world. As a consequence, shareholders lost nearly $11 billion when Enron's stock price, which hit a high of US$90 per share in mid-2000, dived to less than $1 by the end of November 2001. The U.S. Securities and Exchange Commission (SEC) began an investigation, and a rival firm offered to purchase the company at an extremely low price. The deal fell through, and on December 2, 2001, Enron filed for bankruptcy under the American laws. Enron's $63.4 billion in assets made it the largest corporate bankruptcy in U.S. history at that time.

Many executives of Enron including the Chairman Mr. Kenneth Lay, President Mr. Jeffrey Skilling, and Chief Financial Officer 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 the Sarbanes-Oxley 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.

Rise of Enron

Enron was formed in 1985 by Kenneth Lay after merging the natural gas pipeline companies of Houston Natural Gas and InterNorth. In the early 1990s deregulation of sale of natural gas in the US made it possible for Enron to sell energy at higher prices, thereby significantly increasing its revenue[i]. Enron rose to become the largest seller of natural gas in North America by 1992. In an attempt to achieve further growth, Enron pursued a diversification strategy. The company owned and operated a variety of assets including gas pipelines, electricity plants, pulp and paper plants, water plants, and broadband services across the globe. The corporation also gained additional revenue by trading contracts for the array of products and services it was involved in[ii].

As a result, Enron's stock rose significantly from the start of the 1990s until year-end 1998 by 311 percent. The stock increased by 56 percent in 1999 and a further 87 percent in 2000, compared to a 20 percent increase and a 10 percent decline for the index during the same years. By December 31, 2000, Enron’s stock was priced at $83.13 and its market capitalization exceeded $60 billion-- 70 times of the earnings and six times of the book value. Not surprising, Enron was rated the most innovative large company in America in *Fortune*'s Most Admired Companies survey.

Causes of Downfall

In retrospect, a combination of issues ranging from complex business model followed by Enron to unethical practices of misrepresenting earnings and modifying the balance-sheet, poor financial reporting and non-transparent financial statements, creation of special purpose entities to hide debts from failed projects led to a sudden bankruptcy of the corporate giant. From 1997 until its demise, "the primary motivations for Enron's accounting and financial transactions seem to have been to keep reported income and reported cash flow up, asset values inflated, and liabilities off the books."[iii] Jeffrey Skilling, the CEO of the company for number of years developed a staff of executives that, through the use of accounting loopholes, special purpose entities, and poor financial reporting, were able to hide billions in debt from failed deals and projects. Skilling, constantly focused on meeting the expectations of the stock market, pushed for the use of mark-to-market accounting and pressured Enron executives to find new ways to hide its debt. Chief Financial Officer Andrew Fastow and other executives not only misled Enron's board of directors and audit committee on high-risk accounting practices, but also pressured Andersen to ignore the issues.

Faulty Revenue Recognition Model

Enron adopted the ‘merchant model’ of revenue reporting in respect of providing services in wholesale trading and risk management wherein the entire sales value was reported as revenue and products costs as cost of goods sold. This ‘merchant model’ approach is considered much more aggressive in the accounting interpretation than the ‘agent model’ where only trading and brokerage fees are recognised as revenue, not the full value of the transaction[iv]. Enron's method of reporting inflated trading revenue was later adopted by other companies in the energy trading industry in an attempt to stay competitive with the company's large increase in revenue. During 1996 to 2000, Enron's revenues increased by more than 750 percent, rising from $13.3 billion in 1996 to $100.8 billion in 2000. This extensive expansion of 65 percent per year was unprecedented in any industry, including the energy industry which typically considered growth of 2–3 percent per year to be respectable.

Mark-to-market accounting

Skilling forced the company to adopt mark-to-market accounting to account for its complex long-term contracts. Mark-to-market accounting requires that once a long-term contract was signed, income was estimated as the present value of net future cash flows. Often, the viability of these contracts and their related costs were difficult to judge.[v] Due to the large discrepancies of attempting to match profits and cash, investors were typically given false or misleading reports. However, in future years, the profits could not be included, so new and additional income were included from more projects to develop additional growth to appease investors. Enron later expanded its use to other areas in the company to help it meet the stock market projections.

Special Purpose Entities

Enron created special purpose entities-- limited partnerships or companies to fulfill a temporary or specific purpose of providing fund or managing risks associated with specific assets. Much of the problem of Enron related to complex and non-transparent dealings between Enron and SPEs (such as LJM 1, LJM 2, JEDI 1, JEDI 2, Chewco). The company disclosed minimal details on its use of special purpose entities. These firms were created by the company, but funded by independent equity investors and debt financing. The special purpose entities were used for more than just circumventing accounting conventions. Enron disclosed to its shareholders that it had hedged downside risk in its own illiquid investments using special purpose entities. The investors were oblivious to the fact that the special purpose entities were actually using the company's own stock and financial guarantees to finance these hedges. This allowed large losses to be concealed and created false impression that company's investments were hedged. The motive clearly was financial window-dressing rather than transfer of risk. By 2001, Enron had used hundreds of special purpose entities to hide its losses and debt[vi].

Excessive Executive compensation

Enron's compensation and performance management system was focused only on short-term earnings to maximize bonuses. Employees constantly looked to start high-volume deals, often disregarding the quality of cash flow or profits to get a higher rating for their performance review. In addition, accounting results were recorded as soon as possible to keep up with the company's stock price. This practice helped ensure deal-makers and the executives receiving large cash bonuses and stock options.[vii]

The company was constantly focusing on its stock price. Management was extensively compensated using stock options, similar to other U.S. companies. This setup of stock option awards caused management to create expectations of rapid growth in efforts to give the appearance of reported earnings to meet the expectations of the stock market. At December 31, 2000, Enron had 96 million shares outstanding under stock option plans (approximately 13 percent of common shares issued).

Extravagant spending was rampant throughout the company, especially among the executives. Employees had large expense accounts and many executives were paid sometimes twice as much as the competitors.

Risk mis-management

Risk management was crucial to Enron because of its long-term fixed commitments which needed to be hedged to prepare for the inevitable fluctuation of future energy prices[viii]. 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 instead of hedging it.

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[i] Paul and Palepu (2003)
[ii] Op.cit
[iii] Bodurtha (2003)
[iv] Dharan and Bufkins (2008)
[v] Paul and Palepu (2003)
[vi] Op cit
[vii] Dharan and bufking
[viii] Robert 2003