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Enron

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Summary

Once lauded as "America's Most Innovative Company," Texas-based energy trading company Enron enjoyed considerable success in the late 1990s, but by the end of 2001 they had plummeted into disgrace and bankruptcy. Founded by Kenneth Lay, Enron pivoted from supplying natural gas to acting as an intermediary between natural-gas customers and its producers. The establishment of web-based trading division Enron Online also brought in considerable revenue.

Increased competition led to executives Jeffrey Skilling and Andrew Fastow to hide Enron's decline in profits by using mark-to-market accounting and special purpose entities (SPEs). Prestigious audit firm Arthur Andersen did not raise the alarm, and by October 2001 the Securities and Exchange Commission opened an investigation into Enron's business practices, eventually charging many Enron executives with fraud and conspiracy, and convicting Lay, Skilling, and Fastow of wrongdoing.

When Enron filed for bankruptcy it devastated the 401(k) retirement savings of its employees and investors, and led to the establishment of the Sarbanes-Oxley Act to prevent similar behaviors by other publicly-held companies.

Main Content

Beginning and Growth

After the 1985 federal deregulation of natural gas pipelines, energy executive Kenneth Lay facilitated the merging of Houston Natural Gas Corporation and InterNorth, Inc., two natural gas companies, into a company renamed Enron in 1986. Lay held the positions of chairman and chief executive officer for Enron. The company lost the exclusive right to operate its pipelines following a series of laws in the early 1990s that resulted in the deregulation of the sale of natural gas.

Jeffrey Skilling, one of Enron's consultants and by 1996 its chief operating officer, served as the architect for Enron's transformation into an intermediary between natural-gas customers and its producers. The company now acted more like a hedge fund by trading energy derivative contracts. When Enron negotiated a contract to fix the sale price of natural gas from these producers, they were able to lessen the risk of price fluctuations.[1] Their efforts allowed them to charge fees and assume the risks for these transactions.[2] By quickly dominating the market for natural gas contracts, Enron generated large profits on their trades. (Bondarenko, 2021) Their success prompted *Fortune* magazine to name Enron "America's Most Innovative Company" every year from 1996 to 2001.[3]

Skilling also transformed Enron's culture to aggressively pursue as many profitable trades as possible in a short period of time, rewarding deal-makers with bonuses that had no cap. (Thomas, 2002) In addition, he fostered an extremely competitive environment by recruiting top MBA candidates from prestigious

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[1] Bondarenko, P. (2021, November 30). *Enron scandal.* Encyclopedia Britannica. https://www.britannica.com/event/Enron-scandal

[2] Thomas, C. W. (2002, April 1). *The rise and fall of Enron*. Journal of Accountancy. https://www.journalofaccountancy.com/issues/2002/apr/theriseandfallofenron.html

[3] Smith, R. (2018, December 10). *The Enron scandal.* Professor Robert B. Laughlin, Department of Physics, Stanford University. https://large.stanford.edu/courses/2018/ph240/smith1/

universities. One of these recruits, Andrew Fastow, quickly climbed the company ranks to become the company's chief financial officer. Fastow oversaw the company's finances by using complex investments while Skilling focused on building Enron's trading operations. (Bondarenko, 2021)

The boom years of the 1990s allowed Enron's rapid growth, particularly for trading derivative contracts for commodities such as electricity, coal, paper, steel, and even the weather in order to ``offset the risk of low volume of kilowatt hours."[4]

By 2001, the launch of web-based trading division Enron Online allowed it to execute trades worth around $2.5 billion per day. (Bondarenko, 2021) Enron Online succeeded for two reasons. One was that it served as a counterparty for every transaction on its site, and supplied traders with real-time information on the products' prices. Secondly, Enron's solid credit gave traders the confidence that Enron Online was a safe bet to process transactions. (Thomas, 2002)

The company also endeavored to build a telecommunications network for high-speed trading that never ended up profiting them. (Bondarenko, 2021)

Downfall

Over time, Enron's profits diminished due to increased competition, and company executives turned to the practice of mark-to-market accounting in order to mask the decline. This technique involves allowing the company to: "write unrealized future gains from some trading contracts into current income statements, thus giving the illusion of higher current profits." (Bondarenko, 2021) One of the problems with this method when it comes to long-term commodities futures is that there may be no quoted prices to base valuations upon. Therefore, companies with this type of derivative instrument are able to create and make use of discretionary valuation models based on their own circumstances. As stated in the *Journal of Accountancy*,

> For a company such as Enron, under continuous pressure to beat earnings estimates, it is possible that valuation estimates might have considerably overstated earnings. Furthermore, unrealized trading gains accounted for slightly more than half of the company's $1.41 billion reported pretax profit for 2000 and about one-third of its reported pretax profit for 1999. (Thomas, 2002)

The company's operations were then moved into special purpose entities (SPEs), or limited partnerships with outside parties. While this practice is used frequently by companies, Enron made use of thousands of SPEs as holding tanks for troubled assets. This practice kept such troubled assets off the books, masking the full scale of the losses. (Bondarenko, 2021) Fastow himself ran two of these SPEs, earning him $30 million plus in management fees from 1999 through mid-2001. The $30 million far eclipsed his regular Enron salary. (Thomas, 2002)

[4] Bruner, R. F., & Bodily, S. E. (2011, February 8). *Abstract: Enron Corporation's weather derivatives (a)*. SSRN. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=909681

External accounting audits provide necessary checks on businesses' operations. Prestigious accounting firm Arthur Andersen served as a consultant and auditor for Enron. In fact, one whole floor of Arthur Andersen worked full time at Enron. (Thomas, 2002) Enron vice president Sherron Watkins, later known as the whistleblower for Enron's troubles, says that "Enron was able to push Andersen around." Because of Anderson's consulting work for Enron they were reluctant to jeopardize that relationship.[5]

Lay maintained the role of Enron's CEO until February 2001 when Skilling took the helm. By August, Skilling resigned due to "personal reasons" and Lay took over again. At this point Enron vice president Sherron Watkins sent Lay an anonymous memo warning about accounting scandals due to Fastow's partnerships.

By mid-2001 Enron's public financial statements were undergoing extensive analysis. In October, Enron announced losses of $638 million for the third quarter and a further $1.2 billion reduction in shareholder's equity. This attracted the attention of the federal Securities and Exchange Commission (SEC) and they began investigating transactions between Enron and its SPEs.

Revelations of Enron's fraud caused their stock price to plunge from a mid-2000 high of $90 per share to less than $12 per share in November 2001. Fastow was fired. (Bondarenko, 2021) Competitor Dynegy expressed interest in acquiring Enron, but dropped out of the deal within a few weeks, citing a lack of full disclosure of off-balance-sheet debt. (Thomas, 2002) This move prompted Enron's stock to drop to less than $1 per share. Such a precipitous decline obliterated the value of Enron employees' 401(k) pensions which were tied to the company's stock. (Bondarenko, 2021) Enron filed for Chapter 11 bankruptcy on December 2, 2001, at the time the biggest corporate bankruptcy in the history of the United States. (Smith, 2018)

Aftermath

Enron executives Lay, Skilling, and Fastow were convicted on charges of fraud and conspiracy. Lay died of a heart attack prior to his sentencing. Skilling served 12 years of a 24 year sentence while Fastow served six years in prison before his release in 2011. (Bondarenko, 2021)

Leader of the FBI's Enron Task Force in Houston, Supervisory Special Agent Michael E. Anderson said, "The Enron Task Force's efforts resulted in the convictions of nearly all of Enron's executive management team … Enron was a company where it was okay to lie; it was okay to cheat as long as you were making money for the company. And that attitude was permissible up to the top levels of the company."[6]

Employees received very little of their 401(k) accounts, and civil suits filed by investors did not allow them to recover their investments.

The US Department of Justice indicted Arthur Andersen for obstruction of justice following revelations that they shredded documents related to Enron audits. On June 15, 2002 they lost their license to engage in

[5] Curwen, L. (2021, August 3). *The collapse of Enron and the dark side of business*. BBC News. https://www.bbc.com/news/business-58026162
[6] *Enron*. (2016, May 18). Federal Bureau of Investigation. https://www.fbi.gov/history/famous-cases/enron

public accounting. Clients and employees fled the once-respected firm despite the fact that in 2005 the Supreme Court overturned the obstruction of justice verdict due to faulty jury instructions.

Following Arthur Andersen's 2002 collapse, the Sarbanes-Oxley Act was passed, prohibiting auditors from working for the same publicly traded business as consultants at the same time. It imposed penalties for companies for "destroying, altering, or fabricating financial records." (Bondarenko 2021) The act also required companies' chief executive officers and chief financial officers to vouch for the accuracy of their accounts. (Curwen, 2021)

Lessons Learned

1. Enron made high risk deals that sometimes fell outside their own typical risk control processes. Avoid greed and practice restraint during boom periods. A flourishing financial market led to an atmosphere of individual and collective greed and "corporate arrogance." (Thomas, 2002)
2. Lack of transparency combined with deliberate obfuscation of financial practices leads to disaster. Bethany McLean, one of the authors of *The Smartest Guys in the Room*, a bestselling book about Enron's fall, states that:

   > One of the core lessons from Enron is that a lot of what the company did wasn't actually illegal. It was a very difficult prosecution for that reason. What Enron really excelled in was using the existing rules and regulations as a roadmap of the possible. And I've described it as a "legal fraud," because so much of what they did was actually legal, even though it created this edifice where the financial statements had no bearing on economic reality.[7]

3. A business's environment leads to fraud. *The Journal of Accountancy* bases several "classic risk factors" that contributed to Enron's fall on the white paper by the American Institute of Certified Public Accountants called the Statement of Auditing Standards (SAS) 82, Consideration of Fraud in a Financial Statement Audit.[8] These risk factors include:
   - Unduly aggressive earning targets and management bonus compensation based on those targets.
   - Excessive interest by management in maintaining stock price or earnings trend through the use of unusually aggressive accounting practices.
   - Management setting unduly aggressive financial targets and expectations for operating personnel.
   - Inability to generate sufficient cash flow from operations while reporting earnings and earnings growth.
   - Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments such as … reliability of financial instruments.
   - Significant related party transactions. (Thomas, 2002)

[7] Brancaccio, D. (2021, September 30). *The Enron scandal: 20 years later, what's changed?* Marketplace. https://www.marketplace.org/2021/09/23/enron-scandal-revisited-20th-anniversary-legacy/
[8] Fogle, D. (1998). *SAS 82: Providing guidance in the hunt for fraud*. Office of Justice Programs. https://www.ojp.gov/ncjrs/virtual-library/abstracts/sas-82-providing-guidance-hunt-fraud

Timeline of events

1985 ....Federal deregulation of natural gas pipelines occurs; Houston Natural Gas Corporation and InterNorth, Inc. merge. Kenneth Lay takes over as CEO.
1986 ....Merged company renamed Enron.
1996 ....Jeffrey Skilling becomes Enron's chief operating officer.
1999 through
mid-2001 ....Two of Fastow's SPEs earn him $30 million plus in management fees.
Mid-2000 ....Enron's stock reaches high of $90 per share.
2001 ....Web-based trading division Enron Online launches and executes trades worth around $2.5 billion per day.
February 2001 ....Jeffrey Skilling takes over as Enron CEO.
August 2001 ....Skilling resigns as Enron CEO; Lay takes over again.
November 2001...........Enron shares tumble to less than $12 per share.
December 2, 2001......Enron declares Chapter 11 bankruptcy.
June 15, 2002.............Arthur Andersen loses license to engage in public accounting.
July 30, 2002 ....Sarbanes-Oxley Act of 2002 passes to help protect investors from fraudulent financial reporting by corporations.

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