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Accounting 2600-001
Case Presentation

The Enron Scandal

By 2001 Enron was one of America's largest corporations, so large in fact, that its reach was felt by most of America. At its peak, it held over $60 billion in assets and held influence over a large portion of the nation's energy production (Healy & Palepu, 2003). During the last few years of operations, it was able to achieve astonishing growth and reported massive profits. This was due in large part to the company's leadership. However, the same leadership responsible for the growth brought the company to bankruptcy within months of reaching its peak. Many key individuals later faced criminal convictions.

Enron's bankruptcy had a wide impact. The leadership's criminal convictions were a very small when stacked against all the families that lost their entire retirement savings. Many hardworking, blue-collar families lost everything, thousands of people lost their jobs, and the banking and accounting industry were exposed for placing their greed ahead of the wellbeing of the public. In response to the fall of Enron, congress passed the Sarbanes-Oxley Act of 2002. This act established regulations targeted at preventing a similar incident from happing. While the act takes important an important step in the right direction, there is not a single practice that can be pointed to as the cause of Enron. The downfall was rather a culmination of many thing including a culture of greed perpetuated by leadership.

The founding of Enron can be traced back to 1985 when Kenneth Lay merged two natural gas pipeline companies. The pipelines owned by these companies transported natural gas from the production site to the end user, utility companies. In the beginning, the natural gas industry was well regulated and the cost of natural gas was often fixed as result of long-term contracts. However, this soon changed with deregulation. The price for natural gas became more flexible and spot market transactions became common. Spot market transactions created price volatility and as the owner of the nation's largest interstate network of pipelines, Enron was able to profit off this volatility (Healy & Palepu, 2003).

It was during this time of deregulation that Jeff Skilling joined Enron. During his tenure, Skilling was able to enact major change and drove a complete shift in the business model. Even before he started working for Enron, he was able to influence its operations. At the time, he was working for McKinsey a consulting company Enron hired to improve profits on their natural gas contracts. Lay saw potential in Skilling and hired him away from McKinsey. He immediately put him to work establishing natural gas banks.

The opening of the natural gas banks allowed Enron to buy from the producers and sell to the consumers. This shift in business operations opened the door to the use of energy derivatives. Enron quickly grew this market and soon became the largest player. This shift toward derivatives would eventually lead Enron away from the pipeline industry and into the trading industry. Within a few short years, Enron would almost completely shift operations away from pipeline operations and into the trading market.

By the mid 1990's Enron began to envision that its success in natural gas trading market would be able to transfer to other industries and began to branch out into electricity. Skilling lobbied for the deregulation of electric energy and in 1997 Enron acquired Portland General Electric, a major electric company serving the Western United Stated.

In addition to changing to the scope of operations for Enron Skilling instituted a new corporate cultural that placed profits or the appearance of profits above all else. Changing corporate cultural is in general not an easy task but was made easier due the rate of Enron's growth. In order to facilitate the change Skilling to instituted performance measures. These measures were designed to place performance ahead of all else. To enforce the new measures Skilling formed the performance review committee. The role of this committee was to rate everyone on a scale from 1 -5 based on their performance. A one meant the employee received large bonuses and promotions while a five meant the employee would be fired. This performance review placed everyone into a survival of the fittest mindset and rewarded the individual rather than the overall performance of the division. It was this mindset that helped foster a culture of greed. This new cultural culminated in a series of actions that would eventually bring the company from its highest stock value to bankruptcy within months.

One aspect of the new corporate cultural at Enron was to reward the closing of a deal rather than the success. This incentive lead Enron to construct an unsuccessful power plant in India. At the time India was not willing or able pay the cost for electricity that would allow a power plant to operate at a profit. Despite this fact, Enron went forward with their plan anyway. Billions of dollars were poured into the construction. Once construction was complete, Enron was not able to operate the plant and lost all the invested funds. Despite the failure of the project, the employees responsible walked away with large bonuses.

The new cultural had other effects on the corporation as well. It encourage profit at all costs and lead to Enron taking advantage of an accounting practice called mark-to-market. Mark-to-market allows companies to recognize future profits in the present year. This practice would allow Enron to book the profit for an entire multi-year contract into a single year. While mark-to-market does serve a legitimate purpose Enron implemented it in a fashion it was never intended. Mark-to-market involves projecting potential costs and revenues far into the future. Projecting far into the future quickly becomes very subjective and Enron was later found to have inflated projected revenues in order to boost earnings.

Mark-to-market had additional side effects as well. Each year would start fresh as the revenues relating to the current contracts were already recognized. This fact combined with the pressure of the not meeting performance expectations resulted in Enron traders manipulating the energy market. This possible due to deregulation in California. Traders would contact energy producers and convince them to shut their power plants down. With all of the plants up and running California produced more than enough electricity. However, once the traders convinced plants to shut down they were able to produce an artificial shortfall. This shortfall enabled traders to take advantage of the skyrocketing price of electricity. This activity produced large profits for Enron.

Based on the profits the traders were realizing, Enron started to expand their business model with the creation of Enron Online an electronic trading website. Enron also became willing to expand their trading into almost any market and even attempted to trade the weather. One notable area of expansion was into broadband internet. Enron began pouring millions into broadband and even collaborated with Blockbuster to provide video-on-demand services to consumers. At the time, investors viewed this growth positively and the stock value jumped. Despite the initial indications, these ventures also failed.

Due to the failure of a number projects in the late 1990's Enron experienced massive loss. Enron's response was to promote Andrew Fastow to CFO. In order to hide the losses and make Enron appear profitable Fastow created a number of special purpose entities. Using these entities Fastow was able to transfer Enron's assets and then borrow funds using the assets as collateral. This allowed Enron to recognize the revenue but not the debt. He was also able to take advantage of these entities by transferring failing assets in order to keep the losses from appearing on Enron's balance sheet. Using these methods Fastow was able to hide billions in debt.

While use of special purpose entities by a corporation is not illegal, the manner in which Fastow and Enron took advantage was. The entities listed Fastow as primary, violating the law that states ownership must be less than 3% in order to keep the financial reporting separated. Fastow also paid himself millions of dollars in management fees for his role with the entities.

During the early 2000's Enron's illusion of success began to fade. Fortune magazine published an article on March 05, 2001 titled "Is Enron Overpriced?". This article questioned the value of Enron's stock price (McLean, 2015). Outside analysts also started to ask questions even commenting that Enron was black box of information. Around the same time, Enron's CEO Lay resigned and was replaced by Skilling. This same year a number of transactions became known. Enron reduced earnings from 1997 to 2000 by $613 million and increased liabilities by $628 million Equity was then reduced by $1.2 billion. Azurix, a company previously acquired by Enron received after tax charges of $287 million. While other investments lost $724 million. Enron sold Portland General Corp that same year for a loss of $1.1 billion (Healy & Palepu, 2003). All this happened in a very short period of time and Enron's stock fell from a high of around $80 at the beginning of the year down to $0.26 when it declared bankruptcy in December 2001 (Thomas, 2002).

The culture of greed that eventually brought down Enron extended beyond the corporation itself. Arthur Andersen, one of the largest accounting firms, was making millions in fees and the bigger and more complex Enron became the larger the fees for Andersen. In additional to the accounting work Andersen held contracts with Enron for consulting work. The desire to keep Enron as a client motivated Andersen to look the other way on a number of accounting issues. They failed to hold Enron accountable for their faulty accounting and misleading financial notes. Once the problems were uncovered, Andersen started shredding thousands of documents. It was for this act that Andersen was later convicted of obstruction of justice. The conviction however, was later reversed. In addition to the criminal charges, the firm surrendered their CPA licenses and closed operations.

Sell side analysts also looked the other way and recommended strong buys on Enron despite a number of flaws. Enron had become a black box of information and failed to produce common reports issued by other corporations. In addition, Enron did not have a history of returns on equity that would justify such a high stock. Even after the accounting problems had been announced there were still a number of analyst who continued their positive recommendations (Healy & Palepu, 2003).

The analysts were motivated to produce positive reports for a couple of different reasons. If an analyst produced a positive report, they were better able to maintain a positive relationship with the company and receive inside information. A number of analysts also worked for firms that ran investment banking deals with Enron and analysts received bonuses for supporting that relationship. Investment banks continued to loan Enron funds through the special purpose entities despite the fact that they should have been aware of Enron hiding debt and assets.

In the end, the downfall of Enron was a combination of events both inside the company and out. After the company declared bankruptcy and the details of what had occurred became public, a number of criminal investigations took place. Kenneth Lay was convicted of six counts of securities and wire fraud. However, he died of heart attack prior to being sentenced. Jeffrey Skilling was convicted of 19 counts of securities and wire fraud. A federal judge later reduced his sentence by 10 years. Andrew Fastow cooperated with prosecutors and later plead guilty to two counts of wire and securities fraud. In addition to the top executives over 20 others including former Merrill Lynch employees pleaded guilty for crimes involving Enron.

Based upon the size and scope of the Enron scandal, the US government took action and passed the Sarbanes-Oxley Act of 2002. This act was aimed at preventing the behavior that took place at Enron from repeating. This act involved a number of key pieces. One of those pieces is that management must now certify the financial disclosures and have internal controls in place to ensure accuracy. Another section dictates that the external auditors must review the corporation’s internal controls and external auditors are no longer able to engage in consulting services with the clients they audit. Auditor partners are also required to rotate. In addition to separating the auditors consulting work, the sell analysts must be separated from the investment banks investing operations. The act also established the Public Accountancy Oversight Board. This board is tasked with the oversight of accounting rules and auditing standards. In addition, the board also inspects audit firms ensuring compliance with the rules and regulations (Hall, 2003). Overall Enron had a massive effect upon the United States both in terms of the changes the Sarbanes-Oxley Act would bring to the business world and at the individual level.

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