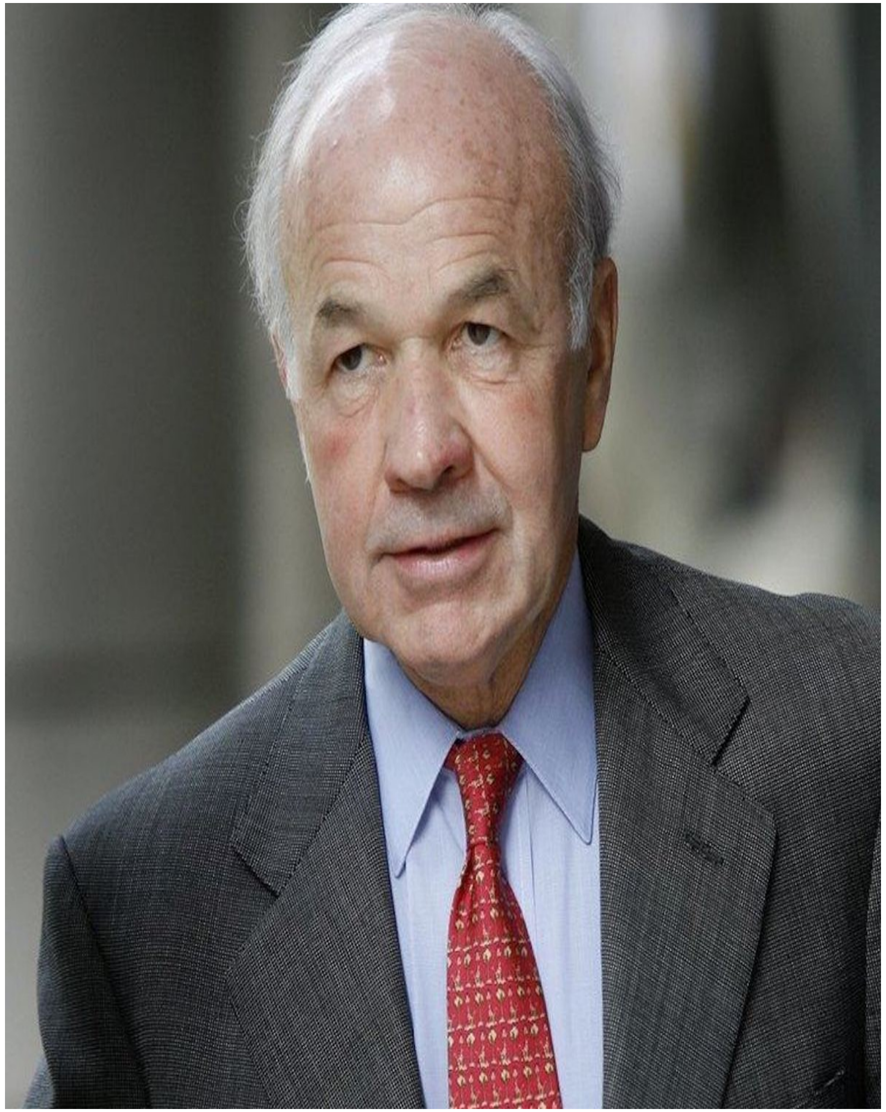
ENRON SCANDAL: THE FALL OF A WALL STREET DARLING

ENRON'S ENERGY ORIGINS

Enron was formed in 1985 following a merger between Houston Natural Gas Co. and Omaha, Neb.-based InterNorth Inc. Following the merger, Kenneth Lay, who had been the chief executive officer (CEO) of Houston Natural Gas, became Enron's CEO and chair. Lay quickly rebranded Enron into an energy trader and supplier. Deregulation of the energy markets allowed companies to place bets on future prices, and Enron was poised to take advantage. In 1990, Lay created Enron Finance Corp. and appointed Jeffrey Skilling, whose work as a McKinsey & Co. consultant had impressed Lay, to head the new corporation. Skilling was then one of the youngest partners at McKinsey

MARK-TO-MARKET

One of Skilling’s early contributions was to transition Enron’s accounting from a traditional historical cost accounting method to a mark-to-market (MTM) accounting method, for which the company received official U.S. Securities and Exchange Commission (SEC) approval in 1992.

MTM is a measure of the fair value of accounts that can change over time, such as assets and liabilities. MTM aims to provide a realistic appraisal of an institution’s or company’s current financial situation, and it is a legitimate and widely used practice. However, in some cases, the method can be manipulated, since MTM is not based on “actual” cost but on “fair value,” which is harder to pin down.

MARK-TO-MARKET

In Enron’s case, the company would build an asset, such as a power plant, and immediately claim the projected profit on its books, even though the company had not made one dime from the asset. If the revenue from the power plant was less than the projected amount, instead of taking the loss, the company would then transfer the asset to an off-the-books corporation, where the loss would go unreported. This type of accounting enabled Enron to write off unprofitable activities without hurting its bottom line.

The MTM practice led to schemes designed to hide the losses and make the company appear more profitable than it really was. To cope with the mounting liabilities, Andrew Fastow, a rising star who was promoted to chief financial officer (CFO) in 1998, developed a deliberate plan to show that the company was in sound financial shape despite the fact that many of its subsidiaries were losing money.

Enron's 2000 Reported Revenue vs. Similarly Sized Companies: Too good to be true?

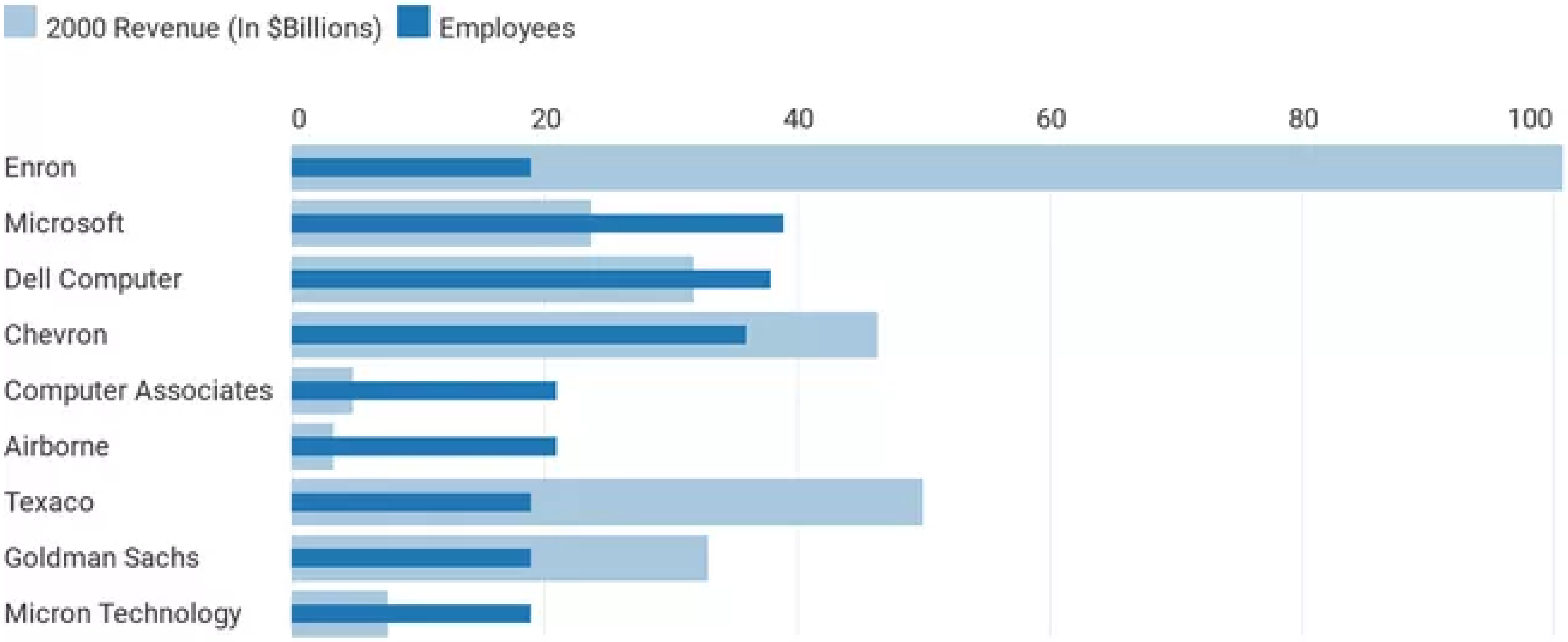


Chart: Investopedia • Source: Forbes • Get the data • Created with Datawrapper

HOW DID ENRON HIDE ITS DEBT?

Fastow and others at Enron orchestrated a scheme to use off-balance-sheet special purpose vehicles (SPVs), also known as special purposes entities (SPEs), to hide Enron's mountains of debt and toxic assets from investors and creditors.

SPEs—sometimes referred to as SPVs (special purpose vehicles)—can take several legal forms but are commonly organized as limited partnerships. In most cases, SPEs were used to finance the acquisition of an asset or fund a construction project or related activity. Regardless, the underlying motivation for creating an SPE was nearly always "debt avoidance."

SPECIAL PURPOSE VEHICLES (SPV)

That is, SPEs provided large companies with a mechanism to raise needed financing for various purposes without being required to report the debt in their balance sheets. The most important guideline that the authoritative bodies implemented for SPEs, the so-called 3 percent rule, proved to be extremely controversial. This rule allowed a company to omit an SPE's assets and liabilities from its consolidated financial statements as long as parties independent of the company provided a minimum of 3 percent of the SPE's capital. Almost immediately, the 3 percent threshold became both a technical minimum and a practical maximum. That is, large companies using the SPE structure arranged for external parties to provide exactly 3 percent of an SPE's total capital. The remaining 97 percent of an SPE's capital was typically contributed by loans from external lenders, loans arranged and generally collateralized by the company that created the SPE.

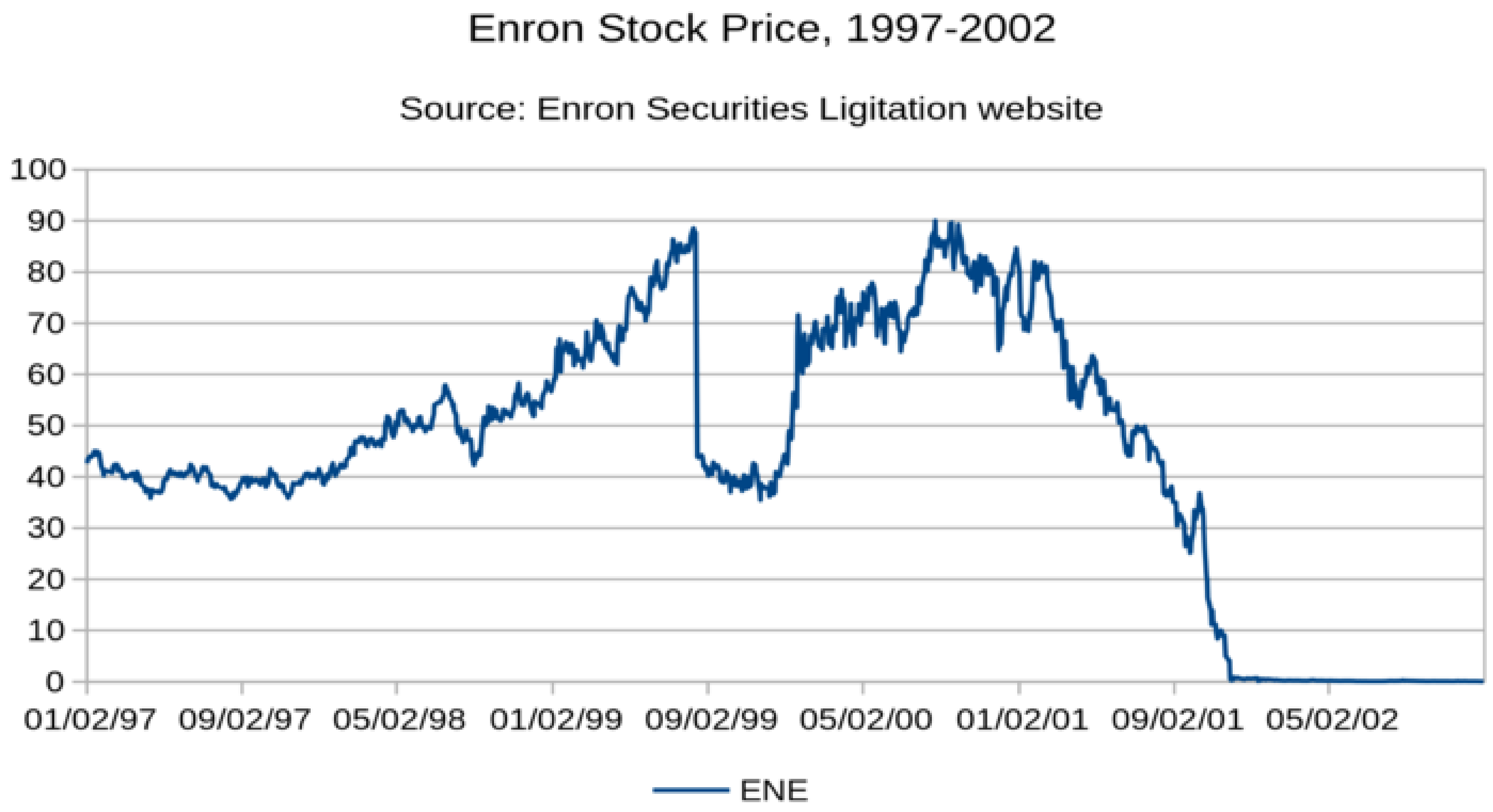
SPECIAL PURPOSE VEHICLES (SPV)

Throughout the 1990s, many companies took advantage of the minimal legal and accounting guidelines for SPEs to divert huge amounts of their liabilities to off balance sheet entities. Among the most aggressive and innovative users of the SPE structure was Enron, which created hundreds of SPEs. Unlike most companies, Enron did not limit its SPEs to financing activities. In many cases, Enron used SPEs for the sole purpose of downloading underperforming assets from its financial statements to the financial statements of related but unconsolidated entities. For example, Enron would arrange for a third party to invest the minimum 3 percent capital required in an SPE and then sell assets to that SPE. The SPE would finance the purchase of those assets by loans collateralized by Enron common stock. In some cases, undisclosed side agreements made by Enron with an SPE's nominal owners insulated those individuals from any losses on their investments and, in fact, guaranteed them a windfall profit. Even more troubling, Enron often sold assets at grossly inflated prices to their SPEs, allowing the company to manufacture large "paper" gains on those transactions.

THE SHOCK FELT AROUND WALL STREET

By the summer of 2001, Enron was in freefall. Lay had retired in February, turning over the CEO position to Skilling. In August 2001, Skilling resigned as CEO, citing personal reasons. Around the same time, analysts began to downgrade their rating for Enron's stock, and the stock descended to a 52-week low of $39.95. By Oct. 16, the company reported its first quarterly loss and closed its Raptor I SPV. This action caught the attention of the SEC.

A few days later, Enron changed pension plan administrators, essentially forbidding employees from selling their shares for at least 30 days. Shortly after, the SEC announced that it was investigating Enron and the SPVs created by Fastow. Fastow was fired from the company that day. Also, the company restated earnings going back to 1997. Enron had losses of $591 million and $690 million in debt by the end of 2000. The final blow was dealt when Dynegy, a company that had previously announced it would merge with Enron, backed out of the deal on Nov. 28. By Dec. 2, 2001, Enron had filed for bankruptcy



Enron Stock Price, 1997-2002
Source: Enron Securities Ligitation website
100
90
80
70
60
50
40
30
20
10
0
01/02/97
09/02/97
05/02/98
01/02/99
09/02/99
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BANKRUPTCY

Once Enron's Plan of Reorganization was approved by the U.S. Bankruptcy Court, the new board of directors changed Enron's name to Enron Creditors Recovery Corp. (ECRC). The company's new sole mission was "to reorganize and liquidate certain of the operations and assets of the 'pre-bankruptcy' Enron for the benefit of creditors."

The company paid its creditors more than $21.7 billion from 2004 to 2011. Its last payout was in May 2011.

CRIMINAL CHARGES

Arthur Andersen was one of the first casualties of Enron's notorious demise. In June 2002, the firm was found guilty of obstructing justice for shredding Enron's financial documents to conceal them from the SEC.

The conviction was overturned later on appeal; however, the firm was deeply disgraced by the scandal and dwindled into a holding company.

Several of Enron's executives were charged with conspiracy, insider trading, and securities fraud. Lay, Enron's founder and former CEO, was convicted on six counts of fraud and conspiracy and four counts of bank fraud. Prior to sentencing, he died of a heart attack in Colorado.


THANK YOU
FOR YOUR ATTENTION