

Case study on financial engineering the enron fraud

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At one clip Enron was one of the universe 's largest manufacturers of natural gas, oil, and electricity. A It besides appeared to be one of the most profitable companies, taking stockholders from \$ 19. 10 in 1999 to \$ 90. 80 by the terminal of 2000. A Enron 's top direction answered to a Board of Directors whose duty was to inquiry and disputenew partnerships, ventures, and determinations within the company. A On several occasions, Andrew Fastow, the company 's Chief Financial Officer approached the board of managers with new investing partnerships which the board approved with really small oppugning. A Some of these partnerships created a struggle of involvement due to the fact that Fastow was non merely pull offing the partnerships, but he was besides an investor in an outside entity that took portion in purchasing and selling assets with Enron. A Fastow was able to make and pull off several of these partnerships while still keeping his function as CFO of Enron. A This was due to the regulation set in topographic point by the Financial Accounting Standards Board (FASB) which states, `` if an outside investor puts in 3 per centum or more of the capital in a partnership, the corporation, even if it provides the other 97 per centum, does non hold to declare the partnership as a subordinate. A Therefore, assets and debt in the partnership can be withheld from the corporation 's balance sheet. " A With this regulation and the many partnerships Fastow created, Enron did non hold to declare the assets and debts from these partnerships, hence concealing 100s of 1000000s of dollars in losingss and debt. A The board of managers nevertheless did non see Fastow 's interaction with the partnerships to be a serious job due to the fact that the fiscal addition potency to Enron was great. A In fact Enron had a 65 page

codification of moralss that was given to all employees. Enron was a kid of the deregulated energy markets in the late eightiess. Before so, most public-service corporations were publically provided, and Enron realized it could turn a net income by selling and merchandising these public-service corporations. Sometime around 2000, Enron began merchandising through the cyberspace, a revolution in the industry. The job was that this scheme required a perpetually high portion monetary value. Thus, Enron 's scheme shifted from energy trading to portion monetary value as the company 's primary focal point. Most experts believe that it was around this clip that Enron began utilizing fiscaltechnologyto maintain its portion monetary values high and keep a high net income on the books.

To make this, Enron in kernel `` leveraged itself through debt, which it used to turn its non-core sweeping energy operations and service concern by maintaining most of this debt from looking on the balance sheets with luxuriant fiscal technology. When the stock monetary value began to fall, though, these same off balance sheet entities ended up downgrading Enron 's recognition evaluation. Suddenly, Enron was in over its caput -- it could non borrowmoneydue to its low recognition evaluation, nor could it utilize its ain money to transact concern, because it did non really have any. In fact, Enron had kept such a monumental sum of debt off the books -- plenty to restrain every plus Enron claimed and so some -- that the company merely imploded under its ain weight.

Enron: The Nigerian Barge Deal

Enron Corporation was an energy company based in Texas and created when InterNorth
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acquired Houston Natural Gas Company in 1985. Enron 's growing was fast, it was named

America 's Most Advanced Company " for six back-to-back old ages and it shortly became the

7th largest company in the United States, until its bankruptcy was declared in 2001.

Accounting fraud, money laundering and confederacy are some of the charges which Enron

stood accused of in a series of dirties that eventually came to a caput in the largest bankruptcy

in history. One of these dirties was named the Nigerian Barges instance ([Fleischer1, 2005]) . Enron tried to sell an involvement in three power-generating flatboats in the seashore of Nigeria unsuccessfully. When Enron failed to sell it by December of 1999, Merrill Lynch, one of the universe 's taking fiscal direction and consultative companies, agreed to purchase that involvement. That dealing was closed at the terminal of December 1999, and hence Enron could book about 12 million dollars in net incomes that twelvemonth and meet gaining marks. But the dealing was a fraud ([Kirkendall, 2005]) . The chief job with this trade was that Merrill Lynch acted merely as a temporal purchaser to assist Enron look more profitable than it truly was. Enron 's Chief Financial Officer Andrew Fastow promised verbally to Merrill Lynch that Enron would purchase back the flatboats at a determined net income within six months, or Enron would happen a 3rd

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company to make so. This fact turned the dealing to be a simple loan, and not a true sale, as Enron claimed. Enron's nonsubjective with this dealing was no other than doing its fiscal statements look better so that it could better the income statement and so, for case, borrow money from Banks and the populace at a lower involvement rate, or merely pay the executives in Enron indefensible fillips. The thought, announced in 1999, was that Enron would construct gas-fired power works near Lagos. Estimated costs put the undertaking at about \$ 500 million. Before the chief works was built, Enron would get down providing power from three 30-megawatt barge-mounted works firing either oil or gas, harmonizing to a 1999 article in Global Power Report, mentioning an Enron spokesman. The flatboats were to get down operation every bit early as the autumn of 1999, though programs had not been finalized. The initial study was that Enron would get down building, likely in the first half of 2000, and finish the undertaking in 22 months.

For Nigerians, the undertaking was of import because, though Africa's largest state is rich in energy resources, it faced relentless power crises and blackouts. By September, the cost estimation for the new power composite was up to \$ 800 million. Enron was committed to financing it and to putting in an associated 175 mile-long, 24-inch diameter, offshore natural gas pipeline to provide the works. By February 2000, seemingly before any building, the trade was already confronting political jobs, harmonizing to Global Power Report. The contracts were called into inquiry by the World Bank, Nigeria's national public-service corporation, the National Electric Power Authority and other Nigerian provinces. The World Bank reportedly

said the trade should hold been competitively command and that the concluding contract was excessively favourable to Enron.

Even before anything happened in the manner of providing energy, Enron was selling pieces of its trade to Merrill Lynch. That dealing and Merrill 's speedy sale of its involvement back to an Enron-related entity is at the bosom of the condemnable allegations. Industry deregulating besides caused new jobs for Enron which, for the first clip, needed to hold a strong competitory focal point. Enron knew that it could win in a deregulated environment merely if it were the lowest cost manufacturer or if it could separate its merchandise from the competition. The latter would look to be a frustrating end, when the merchandise is defined as a trade good like natural gas. Enron 's direction was fighting with how to explicate a scheme that would give clients what they wanted and develop a sustainable advantage in this new environment. They needed to happen a manner to `` box '' natural gas molecules, dependable bringing, and predictable monetary values such that it could specify a clear merchandise line and pass on the company 's alone accomplishments.

Ques: 1 What are the ethical issues involved in this instance?

Ques: 2. What are the exposure profile for Enron 's clients with regard to natural gas monetary values?

What are the exposure profiles for Enron?

Ques: 3. What suggestions do you hold for Enron?

Summary OF THE CASE:

The Financial Engineering encompasses the design, analysis, and building of fiscal contracts to run into the demands of endeavors. " Thus we can state that Financial technology is the phenomenon which facilitates the process/merchandise invention in the fiscal industries which will assist in heightening the stockholders ' wealth. The basic motivations in traveling for fiscal technology are as follows:

Reducing liability on the balance sheet, or

Reducing disbursal on income statement, or

Increasing gross on income statement, or

Increasing tax write-offs on revenue enhancement returns

Companies normally go for fiscal technology to cut down their hazard liability and accretion of debt in the balance sheet.

The range of fiscal technology includes the followers:

Investing Banking

Corporate Strategic Planning

Hazard Management

Primary and Derivatives Securities Evaluation

Fiscal Information Systems Management

Portfolio Management

Security Trading

The instance that we have chosen here will be explained from one facet out of the many countries covered under the range of fiscal technology that is "Corporate STRATEGIC Planning". This construct shall be explained in the context of Enron's, which has been regarded as the biggest fraud in history. Under Corporate Strategic Planning Scope the company has used Financial Engineering to be-fool the the stakeholder of the company. In corporate strategic be aftering one really of import determination includes "Strategic ALLIANCE" which the companies follow for carry throughing their strategic every bit good as fiscal motivations. Enron has excessively did the same thing.

Enron was created by a merge between Houston Natural Gas and Inter north. Houston 's Natural Gas 's CEO Kenneth Lay headed the amalgamation of the two companies. Kenneth Lay became the CEO of Enron. Enron was originally entirely involved with the distribution and transmittal of electricity and gas in the United States. In the amalgamation, Enron incurred a big sum of debt, and as a consequence of deregulating, no longer had sole rights to its grapevines. The company had to happen a manner to bring forth net incomes and hard currency flow. Kenneth Lay hired Jeffrey Skilling to work for Enron as an comptroller. Skilling suggested the pattern of purchasing gas from a web of providers and selling it to consumers at a fixed monetary value with a contract. Enron was interested in the enlargement, edifice, and operation of grapevines, power workss, and other substructure worldwide.

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After merely a twelvemonth of operation Enron merged with a company called Spectrum Seven, a company whose president and CEO is the former president of the United States, George W. Bush. In 1999, Enron tried to spread out their company by making the Azurix Corporation, a H2O public-service corporation company. Enron was named "America's Most Advanced Company" by Fortune magazine from 1996 to 2001. Enron was on Fortune's "100 Best Companies to work for In America" in 2000. The company's hereafter appeared to be bright and assuring continued success.

One of the really of import issue which led to the ruin of Enron was Nigerian Barge trade which was chiefly done to victimize the Govt and the stakeholders. Enron had promoted that it is come ining into a trade with the Nigerian Barge Fieldss of supplying energy human dynamos at that place. For Nigerians, the undertaking was of import because, though Africa's largest state is rich in energy resources, it faced relentless power crises and blackouts. The trade was a strategy to "park" Enron's assets to bolster its net incomes and that no hazard was transferred to Merrill Lynch in the trade because of an "unwritten 'handshake' side trade" by Enron to buy back the flatboats back from Merrill or happen another suited purchaser. It was a fake that allowed Enron to illicitly book about \$ 12 million in pretax net income, when in fact there was no existent sale and no existent net incomes. The function of Merrill Lynch in this whole thing has been questionable since they have deviated from their basicresponsibilityand helped them in indulging into deceitful activities. Alongwith this instance and many others Enron had to atlast file for bankruptcy and it has been a affair of great

concern for the US Govt. since one of its major investing bankers were involved in the instance.

Question:

Ques: 1 What are the ethical issues involved in this instance?

Autonomic nervous system: Enron showed a dainty image in forepart of the Nigerian Govt. Nigeria had abundant resources but lacked in expertness to use them expeditiously. Enron promised them to supply them expertise but it was merely a manner to "park" their assets. They wanted to conceal their earlier frauds and unethical manner of net incomes (black money). The most unethical portion was that they were playing with their codification of behavior and putting a bad illustration for the remainder of the corporate. But one of the board members of Merrill Lynch blew the whistling and the aureate image of Enron was tarnished.

Ques: 2. What are the exposure profile for Enron 's clients with regard to natural gas monetary values?

Ans. It has been identified that Enron 's jobs were non in its energy operations, but from "dot com" investments and in some foreign subordinates. Enron was originally entirely involved with the distribution and transmittal of electricity and gas in the United States. But after the amalgamation and the deregulating in the US, people could now entree gas at subsidised rate. This reduced its monopoly over the distribution of natural gas. But it had a strong political backup. The company 's connexion to George W. Bush, and Houston 's local political relations has received much attending in the recent yesteryear. In 1986, Enron was involved with Bush 's

company in joint boring for oil. It has been said that George Bush and Kenneth Lay even shared good friendly relationship dealings. That is why the company ever enjoyed some kind of shelter even after making unethical patterns. The clients did not hold any pick except for buying at the monetary values offered by Enron.

Ques: 3. What suggestions do you hold for Enron?

Ans. The lone suggestion that we have for Enron is that it should accept its error and apologise for its fraud. This can be one manner of recovering its image. Another option would be to counterbalance the Nigerian Barge Govt. so that it may experience that Enron is truly atoning on its error of working the abundant resources of Nigeria which remained unutilized.

SWOT ANALYSIS OF THE CASE

Strength

Strong political backup (Bush & A ; Houston Govt.)

Good reputation with fiscal establishments (Merrill Lynch)

Failing

Certitude and extra dependence on its dependable resources

Lack of support from top direction executives in strategic planning determinations (window dressing of the histories at in-between degree)

Opportunity

Recover their lost energy because of clients assurance in them

Promoting themselves in such a manner that the trade was fundamentally done to supply the client services at lower rates and non to conceal any corporate dirt.

Menace

It becomes hard to recover the lost image even if the company goes for `` n " no of CSR as the expression goes `` 1 dissatisfied client will state 30000 people whereas 1 satisfied client will state merely 3 " . So the company functionaries can good conceive of in what quantum their image or trade name equity has tarnished.

CRITICAL APPRAISAL

This is non the first cozenage or fraud for which Enron has been alleged. Previously it had been into spotlight when it created a bogus SPV (SPECIAL PURPOSE VEHICLE) to pull strings their histories. They have created a false SPV (Particular Purpose Vehicle) to reassign all their losings to that entity. It was fundamentally done to change over their ruddy balance sheet into a rose-colored one. Strong political backup and everlasting support from the taking fiscal establishments urged Enron to go on these frauds since they believed that Govt will come to its deliverance in instance it faces any job. Enron had non merely misused the options available through fiscal technology for their ain motivations but in a manner destroyed the state 's image besides because they were stand foring US Corporate civilization in Nigeria. So the state 's unity besides was at interest. The approaching companies can larn a lesson in two ways - 1. They may be encouraged to make such kind of frauds since Govt come for deliverance (negative

motive) 2. It may put an illustration for them non to reiterate such an act in future. (positive motive) . In Indian context it is really of import to larn a lesson because we have been top ranked in Corporate cozenage this twelvemonth.