

Financial disasters: the enron scandal



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ENRON The Enron scandal was a financial scandal that was revealed in late 2001. After a series of discoveries involving irregular accounting procedures which could be turned in as fraud, went on throughout the 1990s, involving Enron and its accounting firm Arthur Andersen. Enron stood at the verge of falling into the largest bankruptcy in history by mid-November 2001. An attempt by a smaller energy company, Dynegy, was not feasible.

Enron filed for bankruptcy on December 2, 2001. As the scandal was shown, Enron shares dropped from over \$90.00 to just pennies. As Enron had been considered a blue chip stock, this was event came as a surprise to all and was an overall disaster in the financial world. Enron's downfall happened soon after it was revealed that the majority of its profits and revenues were the result of deals with special purpose entities (limited partnerships which it controlled). The result was that many of Enron's debts and the losses that it suffered were not reported in its financial statements.

In the early 1990s the Congress of the United States of America passed legislation deregulating the sale of electricity. It had done the same for natural gas some years earlier. The resulting energy markets made it possible for companies like Enron to thrive, while the resultant price volatility was often bemoaned by producers and local governments. [2] Strong lobbying on the part of Enron and others, however, kept the system in place. [3][4] By the late 1990s Enron's stock was trading for \$80-90 per share, and few seemed to concern themselves with the opacity of the company's financial disclosures.

In mid July 2001, Enron reported earnings of \$50. billion, almost triple year-to-date, beating analysts' estimates by 3 cents a share. [5] Despite this, Enron's profit margin had stayed at a modest average of about 2. 1%, and its share price had dropped by over 30% since the same quarter of 2000.

[6] However, concerns were mounting. Enron had recently faced several serious operational challenges, namely logistical difficulties in running a new broadband communications trading unit, constructing the Dabhol Power project, a large power plant in India, and criticism of the company for the role it allegedly had played in the power crisis of California in 2000-2001. By the end of August of 2001, his company's stock still falling, Lay named Greg Whalley, 39, president and chief operating officer of Enron Wholesale Services and Mark Frevert, 46, who was previously Mr. Whalley's superior at Enron Wholesale, to positions in the chairman's office. Some observers suggested that Enron's investors were in significant need of reassurance, not least because the company's business was difficult to understand (even "indecipherable"[14]) and difficult to properly express in a financial statement.

15] "[I]t's really hard for analysts to determine where [Enron] are making money in a given quarter and where they are losing money," said one analyst. [16] Lay accepted that Enron's business was very complex, but asserted that analysts would " never get all the information they want" to satisfy their curiosity. He also explained that the complexity of the business was due largely to tax strategies and position-hedging. [17] Lay's efforts seemed to meet with limited success; by September 9, 2001, one prominent hedge fund manager noted that "[Enron] stock is trading under a cloud. [18]

The sudden departure of Skilling combined with the opacity of Enron's accounting books made proper assessment difficult for Wall Street. In addition, the company admitted to repeatedly using "related-party transactions," which some feared could be too-easily used to transfer losses that might otherwise appear on Enron's own balance sheet.

A particularly troubling aspect of this technique is that several of the "related-party" entities were or had been controlled by Enron's CFO, Andrew Fastow. 19] Then, a few days later, on October 17, 2001, Enron announced that its third-quarter results were negative due to one-time charges of over \$1 billion. Enron management claimed the losses were mostly due to investment losses, along with charges such as about \$180 million in money spent restructuring the company's troubled broadband trading unit. "After a thorough review of our businesses, we have decided to take these charges to clear away issues that have clouded the performance and earnings potential of our core energy businesses," said Kenneth Lay in a statement.

[21] Some analysts were unnerved. What's next? ," asked David Fleischer at Goldman Sachs, an analyst called previously 'one of the company's strongest supporters' [22] asserting that the Enron "[m]anagement... lost credibility and have to reprove themselves. They need to convince investors these earnings are real, that the company is for real and that growth will be realized".

[23] Additionally Enron asserted that the broadband unit alone was worth \$35 billion, a claim also mistrusted. "I don't think anyone knows what the broadband operation is worth," said Todd Shipman, an analyst at Standard &

Poor's. 24] On October 22, 2001, the share price of Enron fell to \$20. 65, down \$5. 40 in one day, following the Securities and Exchange Commission's announcement that it was investigating several suspicious deals struck by Enron, called " some of the most opaque transactions with insiders ever seen".

[25] Attempting to explain the billion dollar charge and calm investors, Enron's disclosures spoke of " share settled costless collar arrangements," " derivative instruments which eliminated the contingent nature of existing restricted forward contracts," and strategies that served " to hedge certain merchant investments and other assets. Such arcane phraseology left many analysts feeling ignorant about just how Enron ran its business. [26] In addition, despite the crisis of confidence felt by many observers and Enron investors, the company refused to elaborate on its unusual investment and accounting practices. Jeffrey Skilling, while still in his capacity as CEO, went as far as to use an expletive against a participant in a conference call who was insistent that Enron release balance sheet numbers along with earnings. [27] Regarding the SEC investigation, chairman and CEO Lay said, " We will cooperate fully with the S.

E. C. and look forward to the opportunity to put any concern about these transactions to rest. "[28] A few days into November 2001 it became known that the Enron management had been aggressively pursuing new investment or an outright buyout.

[46] The efforts were reported to have been largely unsuccessful. Investor Warren Buffett was approached, but declined. [47] Other overtures were

made to prominent buyout firms such as Clayton, Dubilier & Rice, the Blackstone Group, and Kohlberg Kravis Roberts, all apparently fruitless efforts. 48] Sources claimed that Enron was planning to explain its business practices more fully within the coming days, as a confidence-building gesture. [49] Enron's stock was now trading at around \$7, as investors worried that the company would not be able to find a buyer.

After it received a wide spectrum of rejections, Enron management apparently found a buyer when the board of Dynegy, another energy trader based in Houston, TX, voted late at night on November 7 to acquire Enron “ at a fire-sale price”[50] or about \$8 billion in stock. Chevron Texaco, which at the time owned about a quarter of Dynegy, agreed to provide Enron with \$2.5 billion in cash, specifically \$1 billion up front and the rest when the deal was completed. Dynegy would also be required to assume nearly \$13 billion of debt, plus any other debt hitherto occulted by the Enron management's secretive business practices[51], possibly as much as \$10 billion in “ hidden” debt. [52] Dynegy and Enron confirmed their deal on November 8, 2001. Commentators remarked on the different corporate cultures between Dynegy and Enron, and on the “ straight-talking” personality of the CEO of Dynegy, Charles Watson.

[53] Some wondered if Enron's troubles hadn't simply been the result of innocent accounting errors. [54] By November, Enron was asserting that the billion-plus “ one-time charges” disclosed in October should in reality have been \$200 million, with the rest of the amount simply corrections of dormant accounting mistakes. [55] Many feared other “ mistakes” and restatements might yet be revealed. 56] November 9, 2001 brought with it another major

correction of Enron's earnings with a reduction of \$591 million over the stated revenue of years 1997-2000. The charges were said to come largely from two special purpose partnerships, called " Jedi" and " Chewco". The corrections resulted in the virtual elimination of profit for fiscal year 1997, with significant reductions every other year.

Nevertheless Dynegy was reported to have not lost interest in purchasing Enron despite this disclosure. 57] Both companies were said to be anxious to receive an official assessment of the proposed sale from Moody's and S (considered by some a " do or die"[58] deal for Enron) presumably to understand the effect on Dynegy and Enron's credit rating the completion of any buyout transaction. In addition, concerns were raised regarding antitrust regulatory hurdles leading to possible divestiture, along with what to some observers were the radically different corporate cultures of Enron and Dynegy. 59] Nevertheless both companies pushed aggressively for the deal, and some observers were hopeful; Charles Watson was praised for his vision in attempting to create the biggest presence on the energy market in one fell swoop. [60] " We feel [Enron] is a very solid company with plenty of capacity to withstand whatever happens the next few months," said Watson at the time.

[61] One analyst called the deal " a whopper [...] a very good deal financially, certainly should be a good deal strategically, and provides some immediate balance-sheet backstop for Enron. [62] Credit issues were becoming more critical, however. Around the time the buyout was made public, Moody's and S both lowered Enron's rating to just one notch above junk status.

Were the company's rating to fall below investment-grade, its ability to trade might be severely limited subsequent to a curtailment or elimination of its credit lines with competitors. [63] In a conference call, S affirmed that, were Enron not to be taken over, S would cut its rating cut to low BB or high B, ratings "not even at the high end of junk". [64] Furthermore many traders had limited their doing business with Enron, or stopped altogether, fearing more bad news. But Watson again attempted to re-assure, affirming during a presentation to investors in New York that there was "nothing wrong with Enron's business." [65] He also acknowledged that remunerative steps (in the form of more stock options) would have to be taken to redress the animosity of many Enron employees for management after it was revealed that Lay and other top officials had sold hundreds of millions of dollars worth of stock in the months leading up to the crisis. [66] The situation was not helped by the disclosure that Kenneth Lay, his "reputation in tatters" [67], stood to receive a payment of \$60 million as a change-of-control fee subsequent to the Dynegy acquisition, and this while many Enron employees had seen their retirement accounts, which were largely based on Enron stock, decimated as the price fell 90% in a year.

"We had some married couples who both worked who lost as much as \$800,000 or \$900,000," said an official at a company owned by Enron. "It pretty much wiped out every employee's savings plan. [68] Watson assured investors that the true nature of Enron's business had been made clear to him: "We have comfort there is not another shoe to drop. If there is no shoe, this is a phenomenally good transaction," he said at the time.

[69] Watson further asserted that Enron's energy trading part alone was worth the price Dynegy was paying for the whole company. [70] The long-term trials and implications of Enron's collapse are somewhat unclear, but there is considerable political fallout both in the U. S. and in the UK relating to the money Enron gave to political figures (around US\$7 million since 1990).

During Clinton's eight years in office, the company and Lay contributed about \$900, 000 to the Democratic Party. In 1999 and 2000, the company gave \$362, 000 in soft-money donations to Democrats. Since 1996, between 72% and 94% of yearly American contributions went to the Republican Party, including heavy contributions to George W. Bush's presidential campaign. Fallout from the scandal quickly extended beyond Enron and all those formerly associated with it. The trial of Arthur Andersen LLP on charges of obstruction of justice related to Enron helped to expose accounting fraud at WorldCom.

The subsequent bankruptcy of that telecommunications firm quickly set off a wave of other accounting scandals. This wave engulfed many companies, exposing high-level corruption, accounting errors, and insider trading. Though at the time of its collapse, Enron was the largest bankruptcy in history, this has been eclipsed by the collapse of WorldCom. Former Enron CFO Andrew Fastow, the mastermind behind Enron's complex network of offshore partnerships and questionable accounting practices, was indicted on November 1, 2002, by a federal grand jury in Houston on 78 counts including fraud, money laundering, and conspiracy. He and his wife Lea Fastow, former assistant treasurer, accepted a plea agreement on January 14, 2004.

Andrew Fastow will serve a ten-year prison sentence and forfeit US \$23. 8 million, while Lea Fastow will serve a five-month prison sentence and a year of supervised release, including five months of house arrest; in return, both will provide testimony against other Enron corporate officers. Ben Glisan Jr. , a former Enron treasurer, was the first man to be sent to prison in the Enron scandal.

He pleaded guilty to one count of conspiracy to commit security and wire fraud. John Forney, a former energy trader who invented various strategies such as the “ Death Star,” was indicted in December 2002, on 11 counts of conspiracy and wire fraud. His trial was scheduled for October 12, 2004. His supervisors, Timothy Belden and Jeffrey Richter, have both pled guilty to conspiring to commit wire fraud and currently are aiding prosecutors in investigating this scandal.

Jeffrey Skilling was arrested on February 11, 2004, by the FBI. Kenneth Lay was indicted by a federal grand jury on July 7, 2004 for his involvement in the scandal. He pleaded not guilty on July 9. On May 25, 2006, the jury in the Lay and Skilling trial returned its verdicts. Skilling was convicted of 19 of 28 counts of securities fraud and wire fraud and acquitted on the remaining nine, including charges of insider trading.

He was sentenced to 24 years, 4 months in prison. Lay was convicted of all six counts of securities and wire fraud for which he had been tried, and he faced a total sentence of up to 45 years in prison. [86] Lay died on July 5, 2006, before sentencing was scheduled. On July 12, 2006, a potential Enron witness scheduled to be extradicted to the US, Neil Coulbeck, was found

dead in a park in north-east London. 1] The US case alleges that Coulbeck and others conspired with former Enron CFO Andrew Fastow.

[2] All told, sixteen people pleaded guilty for crimes committed at the company, and five others, including four former Merrill Lynch employees, were found guilty at trial. Eight former Enron executives testified, the star witness being Fastow, against Lay and Skilling, his former bosses. [87] Another was Kenneth Rice, the former chief of Enron Corp. ' s high-speed Internet unit, who cooperated and whose testimony helped convict Skilling and Lay. In June 2007, he received a 27 month sentence.

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