FRAUD CASE ANALYSIS: ENRON CORPORATION

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Enron is known as the one of the largest fraud scandals in the United States history. As a result of the investigations, the company was forced to file for bankruptcy in December 2001. In May 2006, Enron’s former chief executive, Jeffrey Skilling was sentenced to 24 years in jail while the ex-chairman Kenneth Lay died of heart-attack in July 2006. The article gives an insight about the scandal and why it emerged, discussing the schemes and financial highlights of Enron Corp. as well as its fall.

Enron Corporation, bankruptcy, fraud, debt, trial

Enron Corporation – History

Enron Corporation represented one of the largest fraud scandals in history. As a result of the fraud investigations, the company was forced to file for bankruptcy in December 2001. Enron was “a provider of products and services related to natural gas, electricity and communications to wholesale and retail costumers” (Chary, 112).

Enron Corp. has its roots in Omaha, Nebraska (US). In 1985, Houston Natural Gas merged with InterNorth to form an energy company based in Huston, Texas (US). The company integrated several pipeline systems and hence created the first nationwide natural gas pipeline system. In 1986 Ken Lay, former chief executive officer of Houston Natural Gas, was named chairman and chief executive officer at the young energy company. It’s now when the company chose the name Enron Corp. In 1987, after discovering the oil traders in New York have overextended the company's accounts by almost $1 billion, the company works its loss down to $142 million. The loss immediately leads to Enron Corp. developing different services in order to reduce the risk of price swings.

A year later, Enron Corp. opened its first overseas office in England. In a gathering known as the “Come to Jesus” meeting, the company’s new strategy was revealed to the executives: pursue unregulated markets in addition to its regulated pipeline business.

Jeffrey Skilling joined Enron Corp. in 1989 and launch Gas Bank, a program under which buyers of natural gas could lock in long-term supplies at fixed prices. At the same time, the corporation started to offer financing for oil and gas producers.

In 1992, Enron Corp. expended to South America by acquiring Transportadora de Gas del Sur. In the same year, the company started to push to extend on the continent. A year later in England Enron’s Teesside power plant began operations. It would prove to be one of the first successes for Enron’s international strategy.

In 1994 the corporation made its first electricity trade which would turn into one of Enron’s biggest profit centers in the next years. With the establishment of a trading center in London, part of Enron Europe, in 1995, Enron entered the European wholesalers market.

In 1996, construction began on the Dahhol power plant in India. However, the project would be plagued by political problems and eventually Enron put the project up for sale in 2001.

A year later, Enron bought Portland General Electric Corp., the utility serving the Portland, Oregon (US), which would be sold in 2001 to Northwest Natural Gas Co. for about $1.9 billion. The same year, Enron Energy Services was formed to provide energy management services to commercial and industrial customers. Enron continued its policy of acquiring companies and in 1998 acquired Wessex Water in the United Kingdom which formed the basis for its water subsidiary Azurix. But a year later, when one-third of Azurix is sold to the public in a public offer, the company’s problems become apparent as the shares fell sharply after an early rise. The same year (1999), Enron Online, the company's commodity trading Internet site, started to operate. In the last quarter of the year, Enron Energy Services turned its first profit.

In 2000, Enron’s annual revenues reached $100 billion, more than double the year before, reflecting the growing importance of trading. However, the problems with Azurix continued and Rebecca Mark resigned from her position of chairwoman while Enron announced the intention to take the subsidiary private. The same year, The Energy Financial Group ranked Enron the sixth-largest energy company in the world, based on market capitalization.

In April 2001 Enron disclosed it had owned $570 million by bankrupt California utility Pacific Gas & Electric Co. While the top executives were likely aware of the debt and the illegal practices, the fraud was not revealed to the public until October 2001 when Enron announced that the company was actually worth $1.2 billion less
than previously reported. This problem prompted an investigation by the Securities and Exchange Commission¹, which has revealed many levels of deception and illegal practices committed by high-ranking Enron executives, investment banking partners, and the company’s accounting firm, Arthur Anderson.

At the end of the year Enron’s shares closed at $8.63 per share, an 89 percent drop since the beginning of the year.

The critical dates in the scandal are October 16, 2001 and November 8, 2001. On October 16, Enron disclosed that it had made a loss of $618 million that quarter, while on the second date it disclosed that it had overstated its earnings since 1997 by $586 million. In other words, Enron’s accounts for the previous four years had not shown the true state of its huge indebtedness.

### Analyzing the Fraud: Timeline and Financial Highlights

Enron Corp., which appeared very strong until December 2001, made the voluntary decision to restate its financial statements. This proved to be fatal and the corporation had to go for a bankruptcy. While the bankruptcy of a small company is taken as a routine, Enron’s case is different as the company was ranked seventh by *Fortune 500*².

During the 1990s, Enron expended quickly into several areas such as developing a power plant and a pipeline. This expansion, however, required large initial capital investments and long gestation period. By that time, Enron already raised a lot of debt funds from the market and hence any other attempt to raise funds would affect Enron’s credit rating. But Enron had to maintain the credit ranking at investment rate in order to continue business. On top of that, the company wasn’t making enough profits either, as it promised to investors. Hence, Enron began making partnerships and other special “arrangements” (Special Purpose Entity, or SPE). These companies were used to keep Enron’s debts and losses away from its balance sheets, therefore allowing it have a good credit rating and look good in front of the investors.

Enron’s ultimate goal was to overcome the rules of consolidation and, in the same time, still increase credibility. If a parent company (in this case Enron) financed less than 97% of an initial investment in a SPE, it didn’t have to consolidate in into its own accounts³. In order to achieve non-consolidation, according to GAAP⁴, two conditions must be met:

- the assets must be legally isolated from the transferor (i.e. sold to the SPE); and
- an independent third party owner has to make a substantive capital investment which should amount to at least 3% of the SPE’s total capitalization. The independent third party owner must exercise control over the SPE in order to avoid consolidation.

If properly done, the legal isolation and the third party control over the SPE, reduce the risk of the credit. Therefore, off-balance sheet treatment of such a SPE involves enough third party equity. The third party’s equity must be “at risk”, otherwise the transferor would be required to consolidate the SPE into its own financial statements.

Therefore, Enron thought that the solution was to find outside investors willing to enter into financial arrangements with them and started several structured entities in the name of SPEs. To allow the SPE to borrow from the market, Enron, in many cases, provided a guaranty or other form of credit support. Or, in other cases, the SPEs mutually supported among themselves. Since Enron’s accounting treatment of SPEs was subject to the test of accounting to determine whether the SPE should be consolidated or not, that’s how easily Enron achieved the off-balance sheet treatment of all its SPEs.

The corporation followed this policy in financing which ultimately would enable Enron to be valued more attractively by rating agencies and Wall Street analysts. Ever since, the huge debt took place into the subsidiaries and many obligations flew from US companies into Enron’s SPEs, while the contracts likely to end up in losses were mentioned vaguely in the footnotes of company accounts.

Enron used several related parties in rising of equity and structured its financial arrangements using the loopholes in laws, trying to not consolidate into its accounts by intentionally not fulfilling certain conditions.

Here is a graphical description of how SPEs worked:

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2. The Fortune 500 is a ranking of the top 500 American public corporations as measured by gross revenue, even though eligible companies are any for which the revenues are publicly available.

3. EITF (Emerging Issues Task Force) is “an organization formed in 1984 by the Financial Accounting Standards Board (FASB) to provide assistance with timely financial reporting” (from: http://www.investopedia.com/terms/e/eitf.asp , retrieved Sunday, March 25, 2007)

4. Generally Accepted Accounting Principles is the standard framework of guidelines for financial accounting in USA. “It includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of financial statements” (from: http://en.wikipedia.org/wiki/GAAP , retrieved Sunday, March 25, 2007)
Up to end of 2000, no one pointed fingers at Enron. For 2000, the corporation reported $101 billion revenue and the auditors gave a clean report. But, at this stage, Enron announced its intention that during the third quarter of 2001, it would book a loss of $1.01 billion and, at the same time, reducing shareholders’ funds by $1.2 billion as a result of correcting accounting errors in the past.

Dynegy Inc., Enron’s rival announced its intention to acquire Enron for about $9 billion which would have offered a “modest premium” for Enron shareholders, if the business would have taken place.

Then Enron disclosed it had initiated a plan for restructuring which would negatively impact the fourth quarter earnings as well. The company also disclosed that a note payable for $690 million payable to a partnership has been accelerated for payment because Enron’s debt rating was getting downgraded. As a result, several rating companies lowered Enron’s long-term rating below investment grade and Dynegy terminated the merger agreement, citing breaches of warranty and agreements in the merger agreement. At this point, Enron’s balance sheets came under federal investigation.

As a result, on December 2, 2001 Enron filed for Chapter 11 bankruptcy protection. At the same time, Enron sued Dynegy for $10 billion alleging breach of contract regarding Dynegy’s wrongful termination of it proposed merger. Enron announced that one of the reasons for filing the bankruptcy protection was termination of merger agreement with Dynegy and announced that despite their best efforts to insure a proper merger process, their financial condition has deteriorated significantly.

To understand Enron’s story, let’s look at the financial highlights table:

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<th>Table 1. Enron’s Financial Highlights</th>
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<td><strong>Year</strong></td>
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<td><strong>Revenues</strong></td>
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<td><strong>Long Term Debt</strong></td>
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Chapter 11 is a chapter of the United States Bankruptcy Code which governs the process of reorganization under the bankruptcy laws of the United States (from http://en.wikipedia.org/wiki/Chapter_11, retrieved Sunday, March 25, 2007)
The financials presented in the table above were to be restated by Enron. In 2000, the profitability was less than 1%, becoming clear that Enron’s profits were realizable only if the quality of the revenue is good.

Enron used SPEs (such as JEDI, Chewco, Raptors, so on) transactions to facilitate accounting and financial reporting abuses. No matter which SPE was used, the aim was non-consolidation. If any of the SPEs would have been consolidated, Enron’s true financial position would have been disclosed much earlier.

Opening new SPEs was considered necessary for Enron to mitigate market exposures on Enron’s investments, including investments in energy-related companies. The transactions in derivatives were intending to hedge Enron’s risk in certain investments in their subsidiaries or related parties. Therefore, as seen in Figure 1, Enron transferred its own equity to SPEs in exchange for a note payable immediately and a derivative contract later, in order to cover the risk of Enron’s investments. Hence, if the SPEs were required to pay Enron for loss of value in investments, the stock transferred by Enron earlier would be the principal source of repayment.

In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with Raptor which offset losses in Enron’s merchant investments. In total, Enron was having an aggregate amount of investments in related parties of up to $1.9 billion.

After a long trial, Andrew Fastow, the former Enron finance executive has been sentenced to six years in prison. Fastow pleaded guilty for fraud and money laundering in 2004 and also became the chief witness in the trial against Jeffrey Skilling and Ken Lay. His testimony helped convict Lay (who died in July 2006 after a heart-attack) and Skilling, who was sentenced to 24 years in jail. May 2006, the latter was found guilty on 19 counts of conspiracy, fraud and inside trading over Enron scandal. Skilling was found to have orchestrated a series of deals and financial scheme which later lead to loses as they hide debts from investors. Michael Kopper, former executive at Enron, was sentenced to 37 months in jail. Kopper pleaded guilty in 2002 to wire fraud and money laundering and his testimony helped convict Fastow. Michael Koenig, another former executive, served 18 months in jail as he helped present false accounts to investors.

**Conclusion**

The Enron Corp. case was the biggest in a series of scandals that damaged the reputations of corporations in US. As a direct result, the Congress passed a law, called the Sarbanes-Oxley Act which imposed stricter rules on auditors and made corporate executives criminally liable for lying about their accounts. The Enron scandal moved the balance of power away from the company boards towards the investors.

After the scandal there is more caution among corporate executives about spinning off accounts that might be inaccurate, as now they face criminal liability. However, the temptation to boost stock prices has been a feature of booming markets mostly when the rewards for executives are high.

**References:**
