

Enron Scandal: The Fall of a Wall Street Darling

The story of [Enron](#) Corp. is the story of a company that reached dramatic heights, only to face a dizzying fall. Its collapse affected thousands of employees and shook [Wall Street](#) to its core. At Enron's peak, its shares were worth \$90.75; when it declared [bankruptcy](#) on December 2, 2001, they were trading at \$0.26. To this day, many wonder how such a powerful [business](#), at the time one of the largest companies in the U.S, disintegrated almost overnight and how it managed to fool the regulators with fake holdings and off-the-books accounting for so long.

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

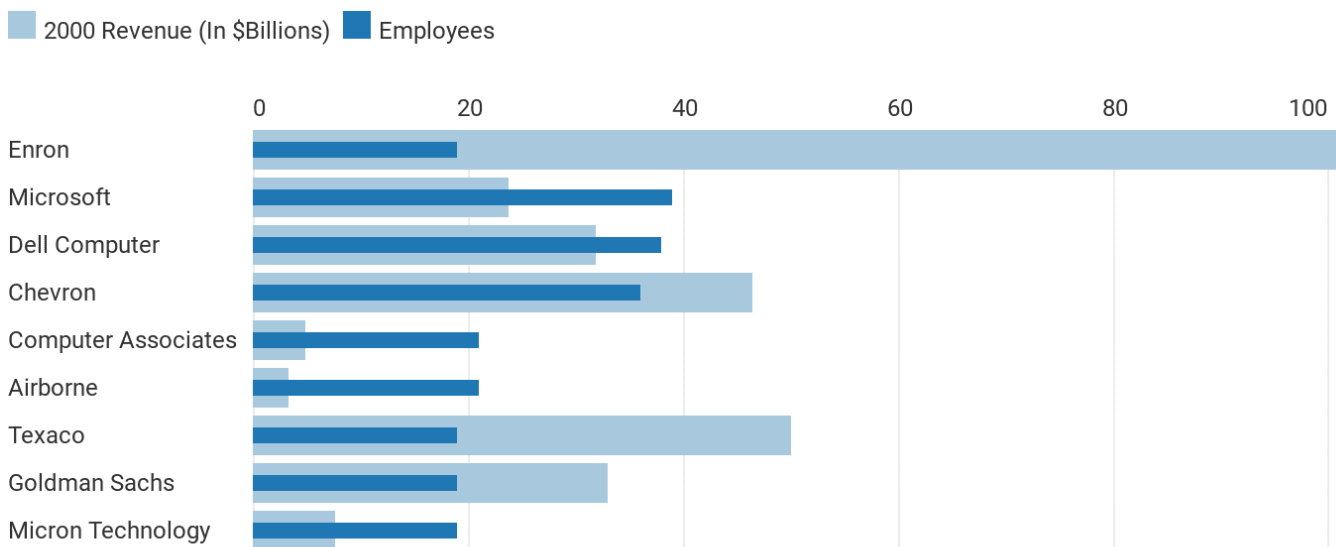


Chart: Investopedia • Source: Forbes • [Get the data](#) • Created with [Datawrapper](#)

Enron's Energy Origins

Enron was formed in 1985, following a merger between Houston Natural Gas Co. and Omaha-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 chairman and 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 the Enron Finance Corp. To head it, he appointed Jeffrey Skilling, whose work as a McKinsey & Co consultant had impressed Lay. Skilling was at the time one of the youngest partners at McKinsey.

Why Enron Collapsed

Skilling joined Enron at an auspicious time. The era's regulatory environment allowed Enron to flourish. At the end of the 1990s, the [dot-com bubble](#) was in full swing, and the [Nasdaq](#) hit 5,000. Revolutionary internet [stocks](#) were being valued at preposterous levels and consequently, most investors and regulators simply accepted spiking share

prices as the new normal.

Mark-to-Market

One of Skilling's early contributions was to move Enron from a traditional historical cost accounting method to a [mark-to-market \(MTM\)](#) accounting method, for which the company got official SEC approval in 1992. MTM is a measure of the fair value of accounts that can change over time, such as assets and liabilities. Mark-to-market aims to provide a realistic appraisal of an institution's or company's current financial situation. It is a legitimate and widely-used practice. However, in some cases it can be manipulated, since MTM is not based on "actual" cost but on "fair value," which is harder to pin down. Some believe MTM was the beginning of the end for Enron, as it essentially started logging estimated profits as actual ones.

"America's Most Innovative Company"

Enron created Enron Online (EOL) in October 1999, an electronic trading website that focused on commodities. Enron was the [counterparty](#) to every transaction on EOL; it was either the buyer or the [seller](#). To entice participants and trading partners, Enron offered up its reputation, credit, and expertise in the energy sector. Enron was praised for its expansions and ambitious projects, and named "America's Most Innovative Company" by *Fortune* for six consecutive years between 1996 and 2001.

Blockbuster Video's Accidental Role

One of the many unwitting players in the Enron scandal was Blockbuster, the formerly juggernaut video rental chain. In July 2000, Enron Broadband Services and Blockbuster entered a partnership to enter the burgeoning VOD market. Probably a sensible sector to pick, but Enron started logging expected earnings based on expected growth of the VOD market, which vastly inflated the numbers.

By mid-2000, EOL was executing nearly \$350 billion in trades. When the dot-com bubble began to burst, Enron decided to build high-speed broadband telecom networks. Hundreds of millions of dollars were spent on this project, but the company ended up realizing almost no [return](#).

When the [recession](#) hit in 2000, Enron had significant exposure to the most volatile parts of the market. As a result, many trusting [investors](#) and [creditors](#) found themselves on the losing end of a vanishing [market cap](#).

The Collapse of a Wall Street Darling

By the fall of 2000, Enron was starting to crumble under its own weight. CEO Jeffrey

Skilling had a way of hiding the financial losses of the trading business and other operations of the company; it was called [mark-to-market accounting](#). This is a technique where you measure the value of a [security](#) based on its [current market value](#), instead of its [book value](#). This can work well when trading securities, but it can be disastrous for actual businesses.

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 it hadn't made one dime from it. 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 mark-to-market practice led to schemes that were designed to hide the losses and make the company appear to be more profitable than it really was. To cope with the mounting [liabilities](#), Andrew Fastow, a rising star who was promoted to [CFO](#) in 1998, came up with a deliberate plan to make the company appear to be in sound financial shape, despite the fact that many of its subsidiaries were losing money.

Enron's shares skyrocket to an all-time high of \$90.56.



Feb.12, 2001

Jeffrey Skilling replaces Kenneth Lay as CEO. However, Lay remains a member of the board of directors.

Aug.14

Skilling resigns suddenly, and Lay takes over once again. Enron's broadband division also reports a massive \$137 million loss.

Analysts became weary of the company and subsequently drop their ratings for Enron's stock.

In turn, the company's share price dives to \$39.95, a 52-week low.

Oct.12

Arthur Andersen legal counsel tells auditors to destroy all Enron files, except Enron's most basic documents.

Oct. 16

Enron reports a \$618 million loss and \$1.2 billion value write off. Enron's stock drops further to \$33.84.

Oct. 22



How Did Enron Use SPVs to 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 its mountains of [debt](#) and [toxic assets](#) from investors and creditors. The primary aim of these SPVs was to hide accounting realities, rather than operating results.

The standard Enron-to-SPV transaction would go like this: Enron would transfer some of its rapidly rising [stock](#) to the SPV in exchange for [cash](#) or a [note](#). The SPV would subsequently use the stock to [hedge](#) an asset listed on Enron's [balance sheet](#). In turn, Enron would [guarantee](#) the SPV's value to reduce apparent [counterparty risk](#).



Although their aim was to hide accounting realities, the SPVs weren't illegal, as such. But they were different from standard debt [securitization](#) in several significant – and potentially disastrous – ways. One major difference was that the SPVs were [capitalized](#) entirely with Enron stock. This directly compromised the ability of the SPVs to hedge if Enron's share prices fell. Just as dangerous was the second significant difference: Enron's failure to disclose [conflicts of interest](#). Enron disclosed the SPVs' existence to the investing public—although it's certainly likely that few people understood them—but it failed to adequately disclose the non-[arm's length deals](#) between the company and the SPVs.

Enron believed that its stock price would keep [appreciating](#) — a belief similar to that embodied by [Long-Term Capital Management](#), a large [hedge fund](#), before its collapse in 1998. Eventually, Enron's stock declined. The values of the SPVs also fell, forcing Enron's guarantees to take effect.

Arthur Andersen and Enron: Risky Business

In addition to Andrew Fastow, a major player in the Enron scandal was Enron's accounting firm Arthur Andersen LLP and partner David B. Duncan, who oversaw Enron's accounts. As one of the five largest accounting firms in the United States at the time, Andersen had a reputation for high standards and quality [risk management](#).

However, despite Enron's poor accounting practices, Arthur Andersen offered its stamp of approval, signing off on the corporate reports for years – which was enough for investors and regulators alike. This game couldn't go on forever, however, and by April 2001, many [analysts](#) started to question Enron's [earnings](#) and their [transparency](#).

The Shock Felt Around Wall Street

By the summer of 2001, Enron was in a free fall. CEO Kenneth Lay had retired in February, turning over the position to Jeffrey Skilling; that August, Skilling resigned as CEO for "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" SPV so that it would not have to distribute 58 million shares of stock, which would further reduce earnings. 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 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 had \$628 million in debt by the end of 2000. The final blow was dealt when Dynegy (NYSE: DYN), a company that had previously announced would merge with the Enron, backed out of the deal on Nov. 28. By Dec. 2, 2001, Enron had filed for bankruptcy.

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 2004-2011. Its last payout was in May 2011.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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: **Chapter 11 Case No.**
: **In re**
: **ENRON CORP.**
: **01-**_____
: **()**
: **Debtor.**
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EXHIBIT "A" TO VOLUNTARY PETITION

1. If any of debtor's securities are registered under Section 12 of the Securities Exchange Act of 1934, provide SEC file number: 1-13159
2. The following financial data is the latest available information and refers to the debtor's financial condition on October 31, 2001:
 - (a) Total Assets \$24,759,295,677.00
 - (b) Total Debts (including debts listed in 2.c. below) \$13,151,751,966.00¹
 - (c) Debt securities held by more than 500 holders: -0-
 - (d) Number of total shares of preferred stock 1,570,934.568509
 - (e) Number of shares of common stock
 - (i) 743,905,381 outstanding shares of Enron Corp. common stock;
 - (ii) 85,479,162 shares of Enron Corp. common stock reserved for issuance upon exercise of outstanding options;

Criminal Charges

Arthur Andersen was one of the first casualties of Enron's prolific 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. A group of former partners bought the name in 2014, creating a firm named Andersen Global.

Several of Enron's execs were charged with a slew of charges, including conspiracy, [insider trading](#), and [securities fraud](#). Enron's founder and former CEO Kenneth Lay was convicted on six counts of fraud and conspiracy and four counts of bank fraud. Prior to sentencing, though, he died of a heart attack in Colorado.

Enron's former star CFO Andrew Fastow plead guilty to two counts of [wire fraud](#) and securities fraud for facilitating Enron's corrupt business practices. He ultimately cut a deal for cooperating with federal authorities and served more than five years in prison. He was released from prison in 2011.

Ultimately, though, former Enron CEO Jeffrey Skilling received the harshest sentence of anyone involved in the Enron scandal. In 2006, Skilling was convicted of conspiracy, [fraud](#), and insider trading. Skilling originally received a 24-year sentence, but in 2013 it was reduced by 10 years. As a part of the new deal, Skilling was required to give \$42 million to the victims of the Enron fraud and to cease challenging his conviction. Skilling remains in prison and is scheduled for release on Feb. 21, 2028.

New Regulations As a Result of the Enron Scandal

The Enron scandal resulted in other new compliance measures. Additionally, the [Financial Accounting Standards Board](#) (FASB) substantially raised its levels of ethical conduct. Moreover, company's boards of directors became more independent, monitoring the audit companies and quickly replacing bad managers. These new measures are important mechanisms to spot and close the loopholes that companies have used as a way to avoid accountability.

The Bottom Line

At the time, Enron's collapse was the biggest corporate bankruptcy to ever hit the financial world (since then, the failures of WorldCom, [Lehman Brothers](#), and Washington Mutual have surpassed it). The Enron scandal drew attention to accounting and corporate fraud, as its shareholders lost \$74 billion in the four years leading up to its bankruptcy, and its employees lost billions in pension benefits. As one researcher states, the Sarbanes-Oxley Act is a "mirror image of Enron: the company's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act." (Deakin and Konzelmann, 2003).

Increased regulation and oversight have been enacted to help prevent corporate scandals of Enron's magnitude. However, some companies are still reeling from the damage caused by Enron. Most recently, in March 2017, a judge granted a Toronto-based investment firm the right to sue former Enron CEO Jeffrey Skilling, Credit Suisse Group AG, Deutsche Bank AG and Bank of America's Merrill Lynch unit over losses incurred by purchasing Enron shares.