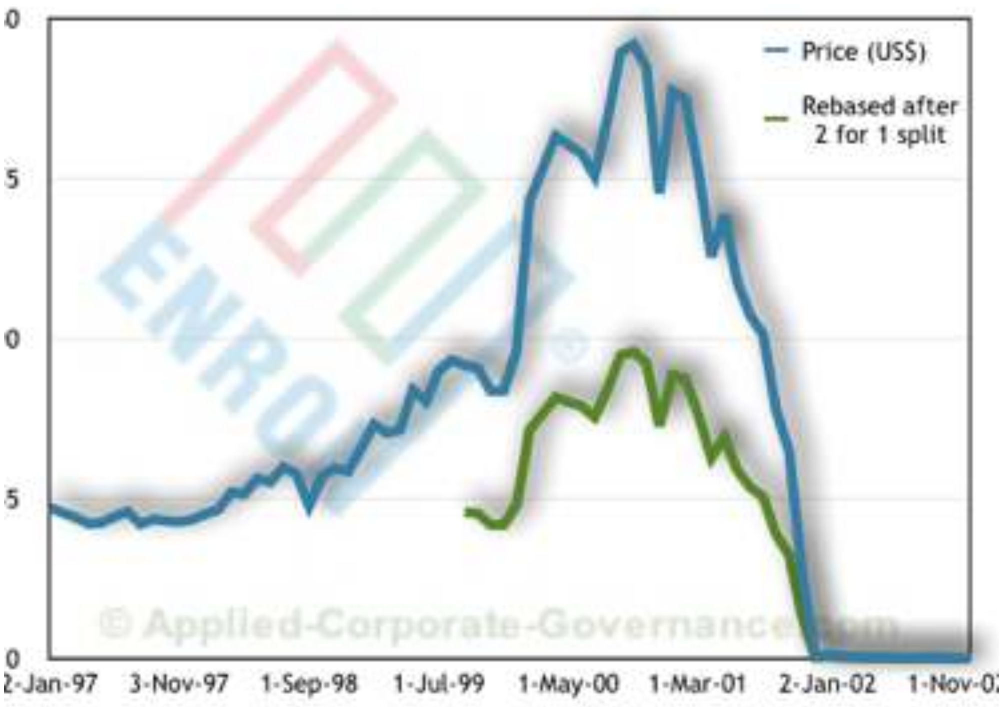
Applied Corporate Governance

People Planet Profit

Enron: a Case Study in Corporate Governance



History, ethics and governance failures explained and commented, with guidance for students

Nigel Kendall

www.applied-corporate-governance.com

Applied Corporate Governance™ is a trading name of Tangley International Ltd (registered in the UK). We are dedicated to helping organisations and indeed nations achieve long-term sustainability and growth through training, research, entrepreneurship and implementation of good corporate governance.

The Applied Corporate Governance brand has two arms:

- the ACG website, dedicated to informing, campaigning and improving culture across all sectors and regions. It is a recognised thought leader in its field.
- Corporate Governance Training: a private organisation offering a range of standard and tailored training programmes and online learning, often in partnership with local organisations.

For more information please visit the website or contact us at info@applied-corporate-governance.com*.

*Note: while our methodology was originally designed for commercial organisations, the principles apply equally to not-for-profits and non-governmental organisations (NGOs). This is because of the holistic nature of the methodology and view that all organisations, commercial or otherwise, should be guided by the same principles. If you are a non-commercial organisation, contact us for **special terms**.*

*Please note: the first time you email us you will receive a mail delivery warning asking you to add your address to our whitelist; this avoids us receiving spam to this address which can be easily guessed by spammers.

Preface

This Enron case study presents our own analysis of the spectacular rise and fall of Enron. A summary was first published on our website in 2015, opening a series of case studies assessing organisations against ACG's Golden Rules of corporate governance and applying our proprietary rating tool.

As we say throughout the site, the first and most critical rule is an ethical approach, and this should permeate an organisation from top to bottom. The way this creates the culture determines the performance in relation to the other four Rules.

Culture is, ultimately, determined by leadership. A strong board committed to the principles of corporate governance will encourage a healthy, ethical culture. The reader is therefore encouraged to read the case study with the role the board played in mind. The directors, and no-one else, have the ultimate responsibility for the Company to its stakeholders. Their role is to:

- define the Company's business and long-term objectives and identify strategic opportunities
- make sure the Company has access to the right quality of people, technology and organisation
- set the cultural and moral tone of the Company
- evaluate and monitor the chairman and the chief executive and if necessary replace them
- evaluate the internal controls to ensure the protection of the stakeholders and to evaluate the financial statements issued by the Company
- take care that the Company has effective management processes for making sure that its resources are applied to the profitable exploitation of business opportunities
- oversee the process of management development to provide an adequate succession

There are two critical factors in carrying out these roles. The first is a creative and stimulating chairman who carries weight and respect throughout the Company, not just at board level. His or her role is key – to build a team and to weld it together. To do that, the chairman also needs a second factor, namely the vision and independent perspective of directors who are not part of the operating management of the business.

Contents

"Dictators ride to and fro upon tigers which they dare not dismount. And the tigers are getting hungry."

Winston Churchill

Introduction

Why pick Enron? The answer is that Enron is a well-documented story and we can apply our approach with the great benefit of hindsight to show how the end result could have been predicted. It is also a good example to illustrate how ethics drives culture which in turn pushes the ethical boundaries and is a key influence on all the four other key elements of good corporate governance.

Hence, in advance of using our own membership for the survey input we can apply the very detailed findings from the post crash dissection of Enron. Readers who are interested can go to Wikipedia and burrow into the history of Enron and its major players. They can also study the various accounts that have been written and which are referred to in Wikipedia. We particularly commend "The Smartest Guys in the Room", the story of Enron's rise and fall, by Bethany McLean and Peter Elkind, and we gratefully acknowledge the valuable insights we have drawn from this fascinating book in producing our Enron case study.

This is the story of a business created by visionary people, initially to serve an anticipated major change in the supply of natural gas to the US consumer – namely deregulation - and extended later into other forms of energy supply as further deregulation loomed. It is a story of an industry-changing transformation of the way natural gas was bought and sold and the subsequent growth of the trading cuckoo in the Enron nest to dominate the culture of the whole business.

Early success blinded the eyes of the super-intelligent people leading the business to the need to maintain a robust ethical culture and the obsessive focus on revenue growth was not matched by an equivalent concern for cash generation. The geniuses heading Enron were too visionary to concern themselves overmuch with the mundane tasks of building the organisation and administrative structures necessary to underpin the global corporation they were creating.

Progressively more rewards-driven, senior managers started to stretch the accounting rules to produce the earnings required to crystallise their bonuses and options. In parallel, the rapid expansion of a business which was generating insufficient cash meant that they were always borrowed to the hilt and in constant need of massive new funding. But being progressively more obsessed with the stock price and hence restricted from tapping the stock markets for further, price-diluting equity finance, top management resorted to semi-hidden off-balance sheet funding.

Hubris, which took them disastrously into wildly ambitious new projects, coincided catastrophically with key current businesses turning out to be very much less profitable than earlier massaged earnings figures had implied. This put unbearable pressure on the rickety off-balance sheet financing vehicles and the whole edifice suddenly collapsed in the last quarter of 2001.

In the following Case Study of Enron's growth to a global business and its rapid demise, we are setting out to show the student of good corporate governance how the warning signs appeared early on and were readily apparent for those who wished to see them throughout Enron's dramatic history. We have annotated the chapters at various points with our Comments to draw the student's attention to the clear warning signs and we invite students to draw their own conclusions at the end and compare them with our own. We also invite students to use the Total Corporate Governance Survey tool to imagine the views of the key stakeholders at various stages in Enron's development and form their own view about how a responsible Board would have reacted if presented with the results of such a survey at those times. As an example, we have completed such a survey at the key time of summer 2000.

1. Enron's early days

In 1986, Ken Lay, then chairman and CEO of Houston Natural Gas (HNG) created what later became Enron out of effectively a reverse takeover of a much larger company, InterNorth, which was a significant player in the pipeline business.

His business plan was to create a giant pipeline network to be in pole position for the deregulation of the natural gas industry that he saw coming. He located Enron in Houston, breaking promises to InterNorth to keep it based in Omaha, and set out to build a coast to coast pipeline network. His rapid expansion plans ran into trouble early on as he built up debt, and a glut of gas drove down prices, while he was faced with expensive contract commitments with producers. By 1987 they were downgraded by Moody to junk status.

Comment 1.1 Despite the rapid expansion, problems were emerging early on with poor profitability and unmanageable debt – this was observed by the outside world. Any student of Enron should have noted this early cavalier attitude to the need to generate and manage cash.

There was a small oil trading operation in New York, which they renamed Enron Oil. This had made money in the year when the rest of the business was losing money. But in reality, the traders were not under tight enough control and in 1987 Enrol Oil was caught shifting profits into the next year, supposedly at the request of Enron management ,with the purpose of smoothing earnings. An internal auditor reported these fictitious transactions and Enron's external auditor, Arthur Andersen investigated them. Andersen produced a highly critical report, drawing attention to the breaking of trading limits and the destruction of Daily Position Reports on trading. The board, however, decided that these were normal practice in the oil trading world and allowed the results to stand. Andersen, surprisingly, accepted this. A different decision would have led to the need to restate the accounts and drawn the attention of the Securities and Exchange Commission (SEC). Presumably neither Enron nor Andersen relished the thought.

Comment 1.2 Management here acquiesces in wrong accounting to boost profits despite an internal audit report and Andersen accept this despite their own report. The board is clearly weak in its ethics and sloppy in its control over management even at this early stage. Andersen are showing an unprofessional approach already.

A senior trader in Houston was suspicious of the size of the profits being declared by Enron Oil and suspected that they were secretly ignoring trading limits. He reported this to his boss and to Ken Lay, but they seem to have been happy looking at the profits and took no action. Then the next year the traders made a disastrous wrong bet which threatened to bankrupt Enron itself, running up an exposure with a potential $1bn liability. Word got out into the marketplace that Enron might have a problem and things could have become dangerous. The chief trader lost his nerve at this point and confessed his wrong-doing to senior Enron management and by clever trading the potentially catastrophic position was transformed quietly into a manageable loss. However, in the subsequent investigations it transpired that not only were they breaking trading limits, they were also transferring money to their personal accounts. Having denied there was a problem for many months, Lay, as CEO, now had to accept the trading loss publicly but dismissed it as a one-off. As it happened, Enron had just concluded a big new financing just before this announcement, and on learning about the loss, the banks concerned were very unhappy. Lay maintained he had known nothing about it at the time.

Comment 1.3 Rumours in the market about Enron's reliability; Lay and the board raising money on the back of fictitious profits. Surely to the suspicious mind Enron wouldn't pass the sniff test.

2. The Gas Bank – a brilliant innovation

A tough lawyer, Rich Kinder, progressively took over operational control and made Enron profitable over the next few years. But though deregulation, the whole raison d'être for the business, was happening, Enron's business model wasn't generating significant profits. Enron had set up Enron Gas Marketing in 1988 to lock in long term contracts with their pipeline customers but Enron was carrying the risks regarding purchase price and transmission logistics. Jeff Skilling, at that point a young partner in management consultants McKinsey, was working for a large part of his time on a consulting assignment with Enron. As such he was specialising in the natural gas business. His ideas coming out of this assignment eventually revolutionised the whole natural gas industry. He introduced the idea of a Gas Bank to address the uncertainties of gas trading, drawing lessons from the financial services sector. His idea was that producers would sell to a "bank" (Enron) and consumers would buy from that "bank". Enron would make profits from the margin between the purchase price and the sale price. Both buyers and seller would have reliability and predictability. It seemed to have huge potential and it certainly appealed to Enron.

They adopted the idea, but couldn't make it work well and eventually, in 1990, they proposed to Skilling that he leave McKinsey and run the Gas Bank as CEO of the newly created Enron Finance. Skilling managed to solve the sticking points in the business model by offering cash advances to producers to get deals, and the

Gas Bank started to perform. This led naturally to the critical next step which was to set up a trading operation in gas contracts and thence into derivatives. This, Skilling felt, would free Enron from having to own physical assets and ought to require less capital. The industry progressively came to see the logic of what Skilling was talking about and Enron was soon at the centre of this new gas trading world and making lots of money. Skilling's characteristics of intellectual brilliance and vision inspired his early team and enabled him to sign a deal with Bankers Trust to help develop the derivatives business. This became so successful, however, that they soon fell out over the profit shares and Bankers Trust pulled out of the arrangement. By then though, Enron knew enough to carry on and it soon became dominant in the industry.

Comment 2.1 Enron is now embarked on huge expansion into trading and derivatives – a major move away from the management of pipelines. Can it manage traders more successfully now? Those looking at Enron's earlier experience would want to examine the future performance rather carefully.

One very significant decision Skilling persuaded the board to take was to apply for, and duly get, SEC approval to use mark to market accounting for its trading. It managed to persuade Andersen that this was an appropriate accounting policy and having got SEC sanction to use mark to market in 1992, it promptly backdated its application to the, as yet unpublished, 1991 results.

Comment 2.2 Mark to market needs very careful supervision and applying it to a previous year's figures, not yet published, contrary to the submission to the SEC is not a good sign. Remember the need to watch carefully how the published results are reached.

Skilling rapidly expanded Enron Finance, recruiting very bright MBAs rather than experienced managers who knew the old industry. He was showing profits, albeit resulting from his mark to market accounting. In 1991 Skilling's division and its traders had been merged with Enron Gas Marketing which had the regular customers for gas, and later he was given the Houston Pipeline, which gave the traders valuable inside information. The business was renamed Enron Capital and Trade Resources (ECT). Skilling and his people were given free rein to ignore Enron's HR policies on pay and they introduced extraordinarily generous contracts for their traders. His philosophy, based on the McKinsey principle of "up or out" was to motivate high flyers with the opportunity to earn vast sums and let survival of the fittest be the rule. Since he was not personally interested in management per se, one might conclude that this was unlikely to lead to a well-managed organisation in a big commercial operation such as ECT was becoming, attractive though it might have been in a consultancy partnership.

Comment 2.3 Skilling is building a big business with a management style based on valuing intellect and trading performance while apparently disregarding practical management issues; trouble surely looms

Skilling's managerial approach seems to have exhibited extreme loyalty to his good performers coupled with a tendency to turn a blind eye to their periodic failures or improper behaviour. He seems to have beeen afraid of losing them and unwilling to confront bad behaviour. Thus he appointed as his lead trader, a person, Lou Pai, who was a great trader but a man of very questionable morality.

In due course, Skilling contrived to turn trading from a service department into a profit centre. But then the gas marketers, incentivised by generous bonus schemes and using mark to market accounting, were allowed (encouraged?) to declare immediately the expected profits on long term deals.

As far as organisational issues were concerned, Skilling kept this responsibility to himself until the mid-nineties when, working so hard that his marriage was breaking up, he appointed a co-CEO to help him run ECT. The co-chief was an able manager from the pipeline division, but Skilling soon viewed him as intellectually weak and quickly replaced him with his lead trader, Lou Pai.

Comment 2.4 Skilling's operational head of trading was a frightening bully, and morally and ethically terrible. What was Enron's HR function doing accepting this management appointment and how could they allow their pay policies to be blatantly ignored. Also, what was Andersen doing about reviewing the profits declared on these long term deals under mark to market? The board was clearly looking only at earnings and seeming to have no handle on any other operational measures

3. Trading takes over as do the traders' ethics

From the beginning, Skilling had been pushing his traders to sign a really big deal and in 1992 they achieved this with a 20 year supply deal with a plant developer, Sithe Energies, for a 1000MW plant in New York State. Skilling's lead negotiator was Ken Rice who became one of his key executives in subsequent years. Using mark to market accounting ECT was able to declare profits before the plant even started operating. Skilling had negotiated a "phantom equity" deal for himself in ECT, which Enron bought out in 1992 at a price which valued the two year old business at $650m.

Comment 3.1   Why didn't the board look carefully at the super profits coming out of trading and the astonishing valuation of ECT? Again, where were Andersen? There must have been industry benchmarks which could have been applied here.

As the business grew, the traders became progressively more important in supplying the gas for the supply contracts. This led to fierce internal conflict over rewards, and the traders would regularly cheat the people who had signed up the supply deals when quoting prices. This was, if anything, made worse by the Performance Review Committee which Skilling had set up and which was supposed to assess individual performance biannually. This rapidly became abused with people sitting on the panel assessing those with whom they were effectively doing business. The result was that divisional heads pushed the interests of their own staff and people were likely to be penalised for crossing senior staff in other divisions. This later had an fatally adverse impact on vital areas such as risk assessment.

Comment 3.2   A good idea, the Performance Review Committee, becomes a source of organisational dysfunction through bad management and everyone knew this. What was Lay as CEO doing to ensure such an important function was working properly?

From its early days, Rich Kinder had told Skilling he wanted ECT to find its own finance. Growing rapidly, Skilling needed lots of finance, and while mark to market could be manipulated to produce profits, it didn't produce cash. Since Enron was already heavily borrowed, he turned to securitisation to meet his needs. He signed an early deal packaging money ECT was committed to advancing to gas producers against the related supply contracts, and selling the package to big investors, including such names as General Electric. This took the borrowing off Enron's balance sheet. He then persuaded pension giant, CalPERS, to join a partnership financing deal called JEDI which was created by a young finance executive called Andrew Fastow. This arrangement and its successors freed ECT to grow rapidly and by 1996 it was indirectly contributing 20% of Enron's earnings.

Comment 3.3   The focus on earnings and lack of concern with the deficiency in cash generation should have been picked up by the top finance people in Enron and it should have been a key performance measure for the board. Instead of which they went down the primrose path of creating off balance sheet vehicles to raise debt finance.

From the early days Skilling had recruited the brightest people to the trading floor. Over time they built up such a strong culture of self-belief and arrogant contempt for the rest of Enron that they became out of control, even by Skilling. Increasingly money-driven and able to earn huge sums, they created an unethical set of values which was not kept in check by top management. Also, the wholesale trading operation, part of Enron North America, as ECT had been renamed, was taking on an increasing amount of risk – by the end, they had up to $3bn over the course of a year. And there were increasingly frequent violations of limits by traders, with no meaningful consequences when these were discovered. They created Enron Online, EOL, an energy trading platform which became widely used by the industry and by some estimates, at one stage they were involved in up to 50% of the gas trades in the US. This was very profitable but its hidden cost was the great increase in capital requirement of the trading business. This became a dramatic problem later. Meanwhile, it gave Enron the opportunity to manipulate the market.

Comment 3.4 The trading mentality took the business out of control and everyone internally understood that it was trading that made most of the money, though Skilling insisted that Enron was about “logistics” as the p/e multiples on traders were much lower. Also the fairness of the profits declared was open to question as the market values to which they marked were often their own estimates, unverified by any outside party. Andersen should have been well aware of the dangers and so should the board. As with Barings around that time, the board didn’t understand how the profits were being made but were delighted to let the traders go on producing them, ultimately with fatal results

Carried away by their success, ECT then tried to get into trading all manner of different things and some, like metals, were a disaster as they knew nothing about them though they spent huge sums to get into the field. They had forgotten that it was their huge information base in natural gas that enabled them to dominate energy trading.

Overall, mark to market profit was all that counted. No-one was concerned about cash flow. They could always raise finance somehow.

Comment 3.5 Their cost base was huge and growing and the profits declared weren’t reflected in cash coming through the door. Some perceptive analysts were already drawing attention to this, though most were plugging Enron as a great growth stock.

4. Enron International and global expansion

Lay's chief negotiator in the merger with InterNorth was John Wing, his head of strategy at HNG. In the next few years Wing got Enron into several very profitable co-generation plant deals (selling electricity coupled with heat for steam). He arranged a very profitable deal for himself with a small slice of each project, but, crucially, his rewards were dependent on the projects delivering the promised returns. As domestic competition grew stronger, Wing looked overseas for expansion, and lighted upon the UK which was planning deregulation. He negotiated to build a giant gas-fired co-generation plant at Teesside and signed a big deal, partnering with chemicals giant, ICI. He negotiated supply deals with the oil companies drilling in the North Sea, and by 1990 had signed up electricity companies to buy the power. The plant came on stream in 1993 and was very profitable initially. Wing was a powerful character who made many demands of Enron, resigning and being rehired several times on increasingly favourable terms. Eventually in 1991, he overreached himself and the board decided to let him go, albeit signing a lucrative new contract with him as part of his termination terms.

Comment 4.1 Enron recruits very able people but its board shows consistent inability to control the strong figures they had created and is careless in dispensing huge sums of money in remuneration to very senior people – similar story to the trading side

After Wing left, Enron Power became the more public face of Enron, and was split into three divisions: the Enron Power US business, Enron Europe and Enron Development, addressing emerging markets. Rebecca Mark, one of Wing's early recruits, a glamorous figure and a powerful, charismatic personality who was full of self-confidence, got the job of creating a business that focused on building power plants and pipelines in emerging markets. She reported to the CEO of Enron Europe but rapidly became the public face of Enron around the globe. Generally disregarding organisational protocol, she operated very independently and quickly put together a series of deals in a very ambitious, high profile programme all round the world but, with a particular interest in South America. Her reputation grew inside Enron and in 1996 she was put in charge of all the overseas power divisions in what was called Enron International.

However, problems were arising under the surface. Firstly, profitability. The rapid expansion – from 25 employees in 1991 to 10,000 in 1996 - wasn't accompanied by an adequate administration, and the controls on the deals became lax. In the pressure to sign deals, very optimistic assumptions were made about long term profitability. This was exacerbated by a compensation scheme which rewarded dealmakers on the present value of the projected earnings, without regard for the eventual actual profitability of the deals. This was a similar arrangement to the mark to market arrangement that Skilling's traders had negotiated for their own compensation. Secondly it was becoming a very expensive operation to run, with huge travel costs and long times to bring deals to maturity. This was coupled by costs Enron had agreed to bear before the projects started to generate cash.

The original intention was to bring in partners who could carry most of the financing burden, but the need for speed meant that increasingly Enron itself was left to provide the finance. Worse, costs of failing bids started to be carried forward as assets, through deeming the bids to be still potentially live, instead of being prudently written off.

Comment 4.2 Here was a business clearly out of control and gobbling up cash. Also the accounting treatment to produce profits was clearly suspect. This would have been plain to any concerned outside observer. How much plainer to the board, if it had chosen to see, and to Andersen, who seem to have gone along for the (very profitable, fee-rich) ride

The most high profile of all Rebecca Mark's deals to go wrong was in India at Dabhol, south of Mumbai. Here, a hugely ambitious project was commenced with the aim of starting to provide the answer to India's chronic power shortages (a problem which persists to this day). Essentially, Enron committed itself through a deal with the local state authorities to building a huge plant in a $20bn scheme to provide the state with all the power it needed for the next twenty years. Negotiations began in 1992 and construction eventually started in 1995. However, a change of state government and local politics eventually brought the project to a halt with the state refusing to pay for all the power it was committed to. Mark managed to get the project restarted by negotiating another contract in which Enron cut its charges but left the state with a bigger commitment. By 1999 the plant was producing power and Phase 2 was started. However, the state then said it couldn't afford, and didn't need, all that power and refused to pay any more. The plant was closed down after Enron had spent $900m.

Comment 4.3 Any sensible risk assessment would have rung all the warning bells loudly on this one. The problems of politics and their disastrous effect on India's infrastructure development are notorious and persist to this day. What were the board thinking of.

As the nineties progressed, the other big disaster unfolding was the Teesside deal which was going bad through a misjudged take and pay contract in the North Sea.

Wing's former deputy had signed this agreement in 1993 to double the supply of gas to fill Enron's reserved pipeline capacity and the contract had started to go disastrously wrong in 1995 when spot prices fell well below the price Enron had agreed to pay, making it impossible to sell the gas at a profit. Unbeknown to Wall Street, Enron was eventually facing a potential loss of nearly $2bn against its stock market value at the time of $5bn.

After Skilling had taken over as CEO of Enron, he was faced with sorting out this potentially fatal situation. He ended up negotiating a deal with Phillips Petroleum in 1997 which resulted in a charge of $675m, knocking profits down to just $105m. Skilling and Rebecca Mark had long been bitter rivals and, in his new role as COO, Skilling was attacking Mark's empire. She was still doing deals which Skilling reluctantly financed, but he gradually stripped her of her responsibilities to the point where by 1998, she handed over her CEO post and became an Enron vice-chairman. After she left, Mark's old empire continued to do deals, but more and more were going wrong. At one point, they nearly sold 80% of Enron International to Arab interests, a solution which would have helped Enron's cash position enormously, but the sheik got very ill and the deal fell apart.

Comment 4.4 Here was a business supposedly generating 15% of Enron's earnings by 1996 but clearly the underlying profitability was suspect, it was out of control and it was absorbing lots of cash; this should have been clear to the Enron top finance people and to the board. What were Andersen doing to highlight this? Dazzled by Mark and happy to take things at face value? Skilling fought a battle with Mark, which was well recognised internally, not to sort out the business but to close it down regardless.

5. Water

After resigning as CEO of Enron International, Rebecca Mark came up with the idea of getting into the water industry with the argument that there was a worldwide shortage of pure water and a great opportunity for Enron to provide an answer. She persuaded the board to kick off the business by buying the UK company, Wessex Water, for which they paid a premium price. They renamed the new business Azurix.

By then Skilling, as COO, was keen to move Mark as far away from his own operations as possible and to this end had supported the proposal. However, he wasn't prepared to allocate any future finance and it was left to Andrew Fastow to set up a complicated funding arrangement to pay for the acquisition. This kept the debt off both Enron's and Azurix's books but, in reality, still left Enron ultimately liable for non-payment of the debt. In the process Enron stripped $1bn out of Azurix while leaving it with massive borrowings and no working capital. However, notwithstanding a complete lack of funds, Mark rapidly ran up costs building a big team of deal makers (young MBAs knowing nothing about water) and, travelling all over the globe, they quickly ran out of cash.

Comment 5.1 Skilling knowingly stripped most of the cash out of this new venture but allowed it to commit itself to building up a huge cost base. How could the board have allowed him to do something so commercially stupid? Mark had a track record of wild optimism coupled with wild spending

Having no Enron funding, far too soon, Mark felt they had no alternative but to go for an IPO. For the IPO to be credible at this early stage, they needed to be able to point to major progress and so, desperate to do another deal, they went after a big privatisation in Argentina. Their bid was successful, but at a price which turned out to be three times the value of the highest competing offer from water industry giants like the French company, Suez. On the strength of this deal, however, they were able to run the IPO shortly after, raising $700m. But Enron ended up taking out nearly $200m for its own purposes and Azurix, after paying off other debts, was left with just $300m, enough to pay for the new deal but no more.

Worse, the Argentina deal started to go wrong shortly after it was started, due to a carelessly written contract and lack of adequate due diligence by the negotiating team. Thereafter, progressively, everything started to go wrong. Deals failed to materialise, Wessex Water was hit by new regulation and the costly need to upgrade its facilities. And, dangerously for Enron itself, the regulatory requirement for quarterly reporting by Azurix quickly exposed the terrible position. Despite raising more money, the writing was on the wall. After a profit warning, Mark resigned and by the end of 2000, after a big write off of the Argentina contract, Azurix had lost $300m and it still owed $2bn. To resolve the disaster, Enron then bought in the publicly owned shares, but at less than half the flotation price. This solution also left Enron publicly liable for $1bn of debt. And short sellers started to look.

Comment 5.2 Lots of people inside Enron said that Skilling set up Mark to fail. This may well have been true, but even if not, by permitting the business to go ahead and then keeping it underfunded while exercising no control over costs, he was culpable as were the board for not having proper controls in place or reporting mechanisms. Moreover, by acquiescing in the IPO of a major part of the business Skilling was opening this new venture up to public scrutiny, and hence its potential impact on Enron itself

6. Enron's growing reputation and the pressures it brought

Enron's public reputation was outstanding during the nineties as it published profits rising from $387m in 1993 to $520m in 1995. Ken Lay was seen as a very bright, inspiring, visionary leader. As his public profile grew, however, he seems to have been progressively losing touch with the actual day to day operations of Enron. Regarding the two main business which were driving growth, he appears not to have really understood Skilling's gas trading which was assuming a larger and larger part of the corporate whole. And the high profile International operation seems to have been allowed great independence and used by him as a platform to him to build a personal presence on the world stage. His cultivating of the senior politicians and bureaucrats in Washington was designed to help Enron in its on-going efforts to push deregulation in energy but it also had the effect of making him a very well-known figure. During this time Lay was spending more and more time on his political and charitable activities, leaving the control of Enron to his tough number two, Rich Kinder, but ensuring that his own remuneration also rose rapidly.

Comment 6.1 For those who were looking, the writing was on the wall as the nineties progressed. Lay as CEO expected results but lost any natural feel and instinct for the business itself. Apart from the mantra of deregulation he seems to have lost any interest in what was going on under the shiny surface and clearly saw no need to have any personal benchmark checks to test the declared results, relying on Andersen (auditors) for the accounting principles and Vinson (corporate lawyers) for the legalities. Again, what were the board doing not noticing that their CEO was losing contact with the business?

He was seen by his staff as bit of a pushover when his senior managers demanded more pay and, in his public pronouncements about Enron's performance, he started to get a reputation, internally, for self-delusion. Kinder was the respected manager but hard driving and as time went on, he set the bar higher and higher for targets. And as these targets became harder to achieve consistently, managers started turning to aggressive accounting tactics. Enron was establishing itself as a growth stock so they set a target of 15% compound growth in earnings per share, incentivising senior people by granting big options packages which would let them receive millions if growth was achieved as forecast. However, to achieve this 15% growth out of slow growth businesses like pipelines, they started to turn more and more to mark to market to maximise published earnings. However, the board by then comprised people closely linked to Lay, conflicts of interest appear to have been fairly common, and they seem to have looked on Lay as all-knowing and never challenged things.

Comment 6.2 There were warnings from financial journalists in 1993 about the fact that using mark to market valuation of contracts would create the need to do an increasing number of deals to achieve the same growth rate. And in 1996 another journalist decomposed Enron's complex income statements to show that after adding back one-time gains the results weren't actually very good. But these criticisms were drowned out by favourable reviews and soon forgotten.

Rich Kinder had been angling for promotion to CEO, taking over from Lay, and in late 1996, when Lay contrived to deny this to him, he resigned. Inevitably he received a big pay-off which included a deal to buy a couple of pipelines. These formed the basis of a new business he founded with an old friend which quickly grew to the point where, by 2003, Kinder Morgan was worth $7bn. After Kinder had gone, Skilling was anxious that Lay might appoint someone other than him as Kinder's replacement, worst of all his rival Rebecca Mark. He threatened to resign if he wasn't made COO and, perhaps frightened of losing the driver of his fast growing trading business, Lay agreed and appointed Skilling as COO.

Unfortunately this key managerial role played to Skilling's weaknesses and would prove very damaging to Enron. Skilling still had the mind of a big-picture management consultant rather than a detail manager and Lay desperately needed a good manager as his COO to take over from Kinder. There were growing organisational problems to be fixed but Skilling was still very much focused on making trading the heart of Enron and very much not interested in understanding and sorting out managerial problems even in his own division, let alone in other parts of the $13bn revenue Enron group.

Comment 6.3 Enron loses its tough COO and replaces him with someone with poor management abilities. This was clear inside Enron but no-one was going to tell Lay. But what checks did the board make to ensure that the requirements of the key COO job were going to be met by appointing the best candidate for the job?

In 1995 Enron had disappointed Wall Street with its results and in 1996 it actually missed its forecasts. Missed forecasts always attract attention and now at least some parts of Wall Street were starting to look more critically at Enron.

7. The growth of Trading and Skilling's new ideas

With the success of his gas trading division behind him, Skilling progressively tried to turn the whole of Enron into something reflecting his own part of the business and put his own people into key positions. He started hiving off operations that were part of the traditional business like Enron Oil & Gas, the exploration and production arm which had grown rapidly and was itself a well-run, profitable and cash generating business. But the ECT business market itself was changing. Others were coming into the gas trading market and threatening Enron's commanding 20% share.

Comment 7.1 Getting rid of the reliable businesses that were the bedrock of Enron and turning it into a trading business – did the board understand what was going on? Certainly Wall Street were kept in the dark about the detail, except for those who enquired more closely who would fairly easily have found out about the hiving off of the traditional businesses

Retail electricity and Enron Energy Services

Lay and Skilling had for some years been preaching the benefits of the deregulation of retail electricity supply and Lay had been spending lots of money lobbying Washington to try to get this to happen. In anticipation of this, Skilling decided to move into trading electricity as part of a broadening of Enron's interests into trading power generally. To this end he set up Enron Energy Services (EES) with his man Lou Pai in charge and predicted that it would eventually be bigger than all the rest of Enron. Lay allowed Skilling and Pai big phantom equity stakes in EES.

EES depended for its success on the deregulation of retail energy at state level, but there was little prospect of this happening any time soon. Ken Lay saw it as a great cause for Enron to champion successfully and deliver huge savings to consumers by cutting out the utilities. But the idea made little progress in Congress. A few pilot programmes were started, but the only state to enact a law to deregulate energy at the retail level was California. In Skilling's enthusiasm to get into trading electric power, however, he seems to have forgotten that Enron's success in gas trading derived from their inside knowledge of the industry based on the pipelines they owned. Enron didn't know the electric power business the way they understood gas and pipelines. It was an outsider and it was soon clear that the established players were never going to let Enron in, so Skilling decided he had to buy a utility. He wanted one in the West to serve California, ready for its planned deregulation, and he eventually found a mid-sized one in Oregon called Portland General. This gave him the inside knowledge of the industry that he was looking for and access to California's grid.

Despite a big marketing campaign, however, Enron achieved barely 1% market penetration in California. And in 1996 an energy analyst perceptively wrote that EES had major potential but also carried big risk. Despite these shortcomings, in 1997 Enron contrived to sell 7% of EES to investors for $130m, enabling it to value the business at an astonishing $1.9bn, even though it wasn't really a business yet and nowhere near breaking even.

Comment 7.2 What on earth were these Wall Street analysts doing in the way of genuine research to arrive at a valuation like this? Supporting their colleagues who were making lots of money doing the placing to the mug investors!

In the event, Enron soon had to cut back on marketing EES in the face of the commercial realities and it lost most of its customers in the pilot programmes. Looking for a new offering, it then changed the focus to promising to handle business customers' total energy needs. This was a jump into the dark since Enron knew nothing about energy efficiency and wasn't used to dealing with day to day detail. Nonetheless, it started signing up big corporations with multi-year supply contracts, bundled with energy management services, and offering guaranteed savings. By the end of 1999, EES had signed up customers with a future commitment (dubbed total contract value) of $8.5bn. Total contract value was a new measure, invented to create a valuation of contracts which sounded very impressive but in practice bore no relation to revenues or profits actually achieved. EES was, in fact, making losses until it declared a $7m profit in Q4 of 1999, at which point Wall Street found it possible to value EES alone at an unbelievable $19bn.

Comment 7.3 Getting into a services business where it had no capability (detail management) and no interest at senior management level (nothing to do with trading) and contriving wild valuations for Wall Street, which they accepted. How many fatal errors here?

Traders were incentivised not on the basis of how much profit a contract actually generated over the contract's duration, but on what the forecast indicated at the date of signing, just like the international deal makers. And with poor controls, they also got into lots of bad deals, just like the deal-makers in Enron International. They were even offering customers cash to sign up to deals, structured as prepayments on future expected savings.

EES was consuming cash at a frightening rate. Having no expertise itself in this field, it had to buy in this capability from energy management and facilities companies. Despite this, lots of the big expenditure on cost savings still wasn't delivering savings to customers to the promised timescale, so as costs grew, EES tried to back out of these programmes. Meanwhile problems escalated, utility bills mounted up, its administration was hopeless and EES routinely made major billing errors. But Skilling was even more gung ho about prospects, referring to execution simply as a challenge and seeming to have had no idea of the realities of the business on the ground. By 1999 Andersen were warning Enron about the administrative problems at EES.

Comment 7.4 Andersen were drawing Enron's attention to administration being out of control – but at this stage top management ignored the warnings. EES customers and suppliers must have been very clear about Enron's incompetence and indeed suppliers complained about not being paid and customers complained about never getting accurate invoices

In early 2001 an internal forensic accounting team looking into EES contracts started to uncover very serious problems. EES was supposed to hedge all trading positions but Lou Pai, Skilling's long standing favourite, who was in charge, had ignored this. Pai, clearly operating almost entirely out of control by this time, was devoting most of his attention to his private activities. But he clearly was spending enough time to have made a huge speculative bet on energy prices going down, which turned out badly wrong (the wholesale traders had made the bet the other way and were making huge profits). As a result, Skilling eventually bit the bullet and moved Pai to a lesser job.

Comment 7.5 This is chickens coming home to roost. Skilling should never have appointed Pai and was guilty of gross dereliction in his duty to check on the management of the business he was praising to the skies to Wall Street

Pai's replacement discovered a chaotic administration, accounts out of control and big problems with credit risk on some important EES contracts. In total, under mark to market accounting, they should have booked losses of more than $500m. However, since Enron had just started reporting profits in EES and said how well things were going it would have been more than a little embarrassing to do that. So they decided to move the retail trading function out of EES and amalgamate it with the wholesale traders, thus covering the loss with the huge wholesale profits. EES, shorn of the loss-making traders, could then report a profit.

At this point a sales executive, Margaret Ceconi (who was also a qualified accountant) in EES, couldn't understand how EES hadn't reported a big loss and emailed a query to the SEC, without disclosing where she worked. The reply she got confirmed that Enron should have disclosed the loss. Meanwhile the investigation into EES contracts was halted. The new boss tried to correct the dire situation at EES but by early 2001 the whole business was in a terrible mess.

Comment 7.6 What was Andersen's reaction to this blatant fiddle to avoid showing losses in EES?

Enron North America and trading electricity in California

As we have said earlier, Skilling, Lay and Enron were totally committed to the idea of a deregulated energy market in California. Sadly the deregulation implemented in 1998 was only partial and very complicated. Also, delivering on contract commitments with electricity is logistically difficult regarding the transmission aspect. The complexity of the rules and difficulties in delivery left the system open to abuse. After some initial price reductions which benefited consumers, the suppliers started gaming the system.

Enron doesn't seem to have realised that their best interests lay in the California experiment being successful and that they should act to help achieve that goal. Intellectually, they despised the compromises in the new rules and at a trading level, they determined to game them. In an early experiment to test the system, they were fined for a trading experiment which was deemed to disregard the regulations' basic aim of creating efficient and fair markets. Yet Ken Lay still defended Enron's actions as ethical. This initial experiment was followed by more subtle trades which were totally artificial and designed to make money for Enron. The traders also progressively built undeclared deals with third parties in secret, to facilitate these unethical trades.

Comment 7.7 Intellectual arrogance led Enron's leaders not to understand what was in their best long term interests and to ignore the evidence in front of their eyes about blatantly unethical behaviour by their traders, even while Lay was lecturing the world on how ethical Enron was

This came to a head in 2000. An Enron trader had taken a long position on electricity prices in the belief that they would rise that year. Due to shortages, California suffered blackouts and prices went through the roof, netting large profits for Enron. The regulators and politicians concluded that the power companies were manipulating the market, in response to which Enron blamed poor regulation for creating a supply shortage. Legal experts called in by Enron were appalled at the unethical behaviour of the traders, even if it was technically justifiable as being strictly legal. Notwithstanding, the traders were still allowed to continue at this point. But, the supply situation in California was getting worse and by the end of 2000 the US Energy Secretary imposed a state of emergency.

California then reversed its earlier position and reimposed price caps, following which the situation rapidly improved, but the debate still raged over what had really caused the crisis. The politicians blamed the power companies but Skilling and Lay blamed the badly framed California deregulation. Skilling was even quoted as saying that Enron had been on the side of the angels.

But the fact was that the North American trading desk had generated $2.2bn for the year 2000, as a result of which Enron was very anxious not to disclose the huge profits they had made from their long position. So to hide these they secretly reserved 50% against what they described as potential Californian legal problems. Despite the growing crisis, the head of trading, whose manipulation and long position had both helped cause the problems and earned Enron hundreds of millions of profit, was promoted.

Comment 7.8 Lawyers were reporting dangerously unethical behaviour which was effectively condoned by management; top management were hiding profits - consciously misleading the markets. An ethical company?

Broadband and Enron Broadband

In the late 1990s Jeff Skilling saw the valuations being achieved in the tech dotcom field and decided to back a small Enron operation involved in laying fibre optic cables. He had the idea that, as expert traders, Enron could trade broadband width. As part of a plan to roll out a cross country fibre optic network, they then spent huge sums building up a team to implement this. This enterprise was to have the capacity to distribute TV-quality video and other content while creating a market in broadband trading. Skilling seems to have been looking at the way the dotcom boom was valuing ideas rather than actual profits, and the leveraged effect he could have on Enron's valuation by investing in a broadband trading operation. So they launched Enron Broadband.

Comment 7.9 Naively getting into broadband, about which Skilling knew nothing at all, as a means of ramping up Enron's market valuation. No apparent sense of the scale of the financial and resource commitment likely to be required

After the launch of Enron Broadband at the start of 2000, the market was given very bullish assurances about the progress already made in developing the business, and Enron's stock price rose sharply. But it was all really no more than just a plan, requiring major investment and new management expertise. The vision made the huge assumption that broadband could be traded like energy and that they could create the ability to deliver content in large volumes into an entirely new market. What they were trying to do was indeed, arguably, bold and visionary, but Skilling was trying to compress many man years of required development and testing into launching a finished business in eighteen months or so. This was plainly fanciful and quite unforgivable when his own team were warning him about the unfinished state of the product. But he was desperate to move on from the failure of the water venture, Azurix, and the decline of the International business. So he set targets which would preserve the share price but made life impossible for the broadband management.

Comment 7.10 What sort of oversight was the board providing to allow such a wild project?

For all Skilling's pronouncements about what they had already built, Enron Broadband Services (EBS) didn't have the capability to provide bandwidth on demand in its Enron network at this early stage and never got near achieving this. In fact, most of its features and components he said were already operational were still under development at this point. He had the idea of expediting the roll-out by linking with the other networks, not apparently appreciating that this was unlikely to be of interest to the existing players. Moreover, the idea of streaming programming for viewers was so far ahead of its time that few consumers possessed the necessary equipment to be able to receive this material and, in any case, Enron was placing itself in competition with the well-entrenched cable – television companies.

All in all, the whole project was grossly irresponsible. But EBS went ahead and was soon spending at the rate of $500m pa. While real development work was going on, it never really got beyond the demonstration stage. But that didn't stop the press releases implying that it was moving rapidly forwards. The time pressures on forecast results meant a requirement to deliver profits immediately, which was obviously impossible. They therefore started creative accounting. And for the first three quarters of 2000, they found ways to show a technical profit using Andrew Fastow's off-balance sheet Special Purpose Entities. But by the end of 2000 things were getting desperate if they were to meet the year-end forecast.

Comment 7.11 Where had commonsense gone?

The solution was a content deal with Blockbuster who would source movies for Enron to distribute. But even this never really got started due to Blockbuster having difficulty signing up the studios and Enron failing to tie up the phone companies to provide local delivery in time. The deal was clearly going to fall apart but to save the year-end results, Enron concocted a complex arrangement which purported to give it a significant value. They were then able to claim a $53m gain on the deal for the fourth quarter and meet their target for the year. A senior

Andersen accountant objected to the accounting treatment but at the end of the day Andersen approved the accounts unmodified.

Comment 7.12 Skilling was by now hooked on Fastow's off-balance sheet financing and fictitious accounting but Andersen who should have blown the whistle, didn't

At the Christmas party, however, the finance team produced a satirical presentation sending up the whole deal and making clear their awareness of the phoney nature of the results. A couple of months later the deal was ended with Enron publicly blaming Blockbuster for failing to produce the movies needed. They then, amazingly, declared a profit instead of a loss, on the basis that the business was worth more without the exclusive deal with Blockbuster. The boss of EBS, Ken Rice, unquestionably did a poor job of managing the business and was accused later of "pumping and dumping" as he talked up the value of a declining business and then sold his large Enron shareholding.

Comment 7.13 A chief executive who wasn't in control and the whole senior staff knew the thing was a sham

8. Impact on management behaviour and the culture

Skilling was painting a visionary picture for Wall Street of Enron being a well managed business that generated steadily growing profits. But underneath, it wasn't true, and by building expectations which couldn't be fulfilled he created unbearable pressures which would soon break the company.

Failings in the management and organisation were illustrated in the critical area of risk management, which was touted to Wall Street as superb but was, in practice, very poor. The Risk Management and Control (RAC) unit Skilling set up had a team of experts and a $30m budget which it said enabled Enron to understand risk superbly well and hence to be able to take on more risk than competitors. However, everyone in the company knew that the top man at RAC, Rick Buy, wasn't strong enough to stand up to the traders and deal originators. He interpreted his job as simply to present managers with an assessment of the risks and let them decide whether to proceed. So the dealmakers bullied the RAC over the assumptions in the deals they put forward for approval, which were often ridiculously optimistic. Worse, dealmakers sat on the performance review panels assessing the RAC staff, with all the conflict of interest that implied. Skilling himself, it seems, tended to opt out of direct responsibility by pointing to the high-powered RAC approval process.

Comment 8.1 Everyone at a senior level inside Enron knew that the Risk Management was not effective – how didn't this get communicated to Wall Street analysts? And did Andersen do its own checks into the RAC processes? Presumably not otherwise they would have written a critical report for the board.

Skilling's philosophy was that true business builders don't spend their time looking at costs. But the result was that costs got out of control and, to compound it, the whole bonus structure was focused on revenue generated, regardless of costs, aggravating the problem. In fact by the late 1990s Enron's entire corporate culture was changing fast to an aggressively money-driven one. Staff were encouraged to look for job transfers to parts of the organisation where they saw the most action – ie where the high fliers and the money were. The result was that team players left or were driven out. "Corporate killers", as they were called, dominated Enron and back-stabbing was rife. People focused on the process of bringing in deals and there was no incentive to look after the customer after the deal was signed. More and more big customers got disillusioned and mistrustful of the integrity of the Enron people they had to deal with.

Comment 8.2 Costs were out of control and any independent benchmarking of cost ratios would have shown this up. Skilling's disregard for costs and obsession with revenue would never have been allowed by a responsible board. A bad culture was developing and ethically Enron's reputation in the trade was starting to slide

9. Obsession with earnings and share price and the effect on ethical standards

Meanwhile the concern with Wall Street and the share price was becoming a company obsession. Employees were encouraged to acquire Enron stock and Skilling more and more looked to Enron's market capitalisation as the measure of his success. Jeff Skilling wanted Enron still to be valued as a logistics business, because a logistics business would be valued by Wall Street at a higher multiple of earnings than that of a trader. Moreover, Enron's share price had been hit a few years earlier by the scare that it might be facing a big trading loss and the market was still sensitive to Enron's trading activities. The result was that this led him to continually have to hide the progressive transformation of Enron into a giant trading business. In fact, by the late 1990s Enron had become primarily a trading operation with, by one estimate, 6000 out of its 18000 employees engaged in deals.

Comment 9.1 Dishonesty was creeping in at the highest level, but people saw what they wanted to see

Enron was announcing steady and increasing earnings. However, by its nature, a trading business can't produce steady, predictable earnings, and each year it became more and more difficult to transform the actual results into this steady progression. Hence the accountants had to resort to ever more complex mechanisms to achieve the desired result.

Skilling's forecast of Wall Street's next year expectations was becoming the key factor in the budgeting process. The inevitable result was that, in order to deliver the forecast earnings figures, there was an increasing use of accounting devices such as mark to market. This was coupled with a reluctance to accept necessary write downs, and the use of aggressive tax avoidance schemes. Unfortunately, pushing forward losses simply built up the problem, since most of Enron's businesses were not fundamentally very profitable, and not enough future profits were being generated to absorb the losses secretly carried forward. And underneath it all was the perpetual, and growing, shortage of cash. Earnings could be fiddled to show a better position, but a fundamental shortage of cash couldn't be disguised for very long.

Comment 9.2 Anyone with any experience knows that you can't fiddle figures forever and why wasn't Enron's auditor and adviser, Andersen, drawing attention to the increasingly unsound financial situation?

The situation was made catastrophically worse by Skilling's appointment of Andy Fastow as CFO in 1997. He had built his reputation by setting up the first off-balance sheet financing scheme, JEDI, but when Skilling promoted him to CFO at the age of 36, he wasn't a qualified accountant but simply had a narrow corporate finance background. Indeed, it was suggested that he couldn't properly read a balance sheet. Also, it was said that had no feel for risk control. To make up for these shortcomings, Skilling made Rick Causey, a 37 year old ex Arthur Anderson accountant, chief accounting officer. Causey was supposed to ensure that Fastow kept within the proper accounting conventions but, in practice, he seems to have ducked this responsibility. Instead of controlling him, he facilitated Fastow by showing him how he could stay within his interpretation of the rules. No-one seems to have been looking at the over-arching financial position and what the long term result of their actions was likely to be.

Comment 9.3 A bad management decision by Skilling putting the wrong person into a key job – how could he make such a key mistake? Answer, he knew nothing about management.

The other major weakness was the increasingly close relationship between the auditors, Arthur Andersen, and Enron. Over the years nearly 90 accountants had joined Enron from Andersen, and from 1997 onwards, Andersen's relationship partner with Enron was 37 year old David Duncan, a personal friend of Rick Causey. In the year 2000 alone, Andersen earned $52m from their work with Enron and to foster this relationship, Andersen's Houston office continually permitted Enron's aggressive interpretation of accounting rules, even defending Enron's practices to their Chicago bosses. The dangers here were eventually recognised by Andersen who internally categorised Enron as "high risk".

Comment 9.4 Obvious and unforgiveable conflict of interest here by Andersen, rewarding partners for making fee targets and turning a blind eye to professional integrity – and they knew what they were doing; going down the slippery slope to perdition

By 1999 the stock price had risen such that it gave its investors a 600% return and by the end of 2000 this was 1400%. The herd of Wall Street analysts regarded Enron as unbeatable, though this wasn't necessarily the case in the industry, as evidenced by the views of a friend of this author who said that no-one believed the declared profitability of Enron's deals.

The problem was that it was very difficult (though by no means impossible) to see through the incomprehensible financial statements. There were lots of people, inside the company and outside, who knew or should have known that the reality was different. But they chose to keep believing that it would all turn out right because the Enron people were all so clever. The fact that Enron was not generating enough cash was in the public domain and analysts were aware of the existence of Enron's huge off balance sheet debt, though this was hardly trumpeted about. As this author's friend says, too many analysts became marketers for stocks being pushed by their employer institutions.

Added to this was the fact that Skilling was a very convincing presenter. At the meeting to brief analysts in January 2000 about the launch of Enron Broadband, Skilling waxed eloquent about the Enron Intelligent Network which he (misleadingly) said already existed. He predicted that it would give Enron a 20% share of a bandwidth trading market in four years' time and that, together with its content business, the whole operation was already worth nearly $30bn. The share price was up by more than a quarter by the end of the day.

Comment 9.5 Everyone saw the trappings of success and assumed everything was as it seemed and all the stakeholders seem to have had their own reasons to ignore the underlying and growing problems. The markets lapped up the hype. What were the so-called industry expert analysts doing?

10. The inexorable pressure on finance and what it led to

Enron continued to need more and more finance as it grew. Both of Skilling's early stage "big ideas", EES and EBS were absorbing huge amounts of cash but producing meagre profits and causing Enron to have to rely on accounting tricks to produce earnings which would keep Wall Street happy. Since it was using accounting tricks, it wasn't generating enough cash to fund its expansion. In an honest world this might have been diagnosed as overtrading, where an expanding company running ahead of its cash resources often ends its days in financial collapse. Unwilling to issue more shares because of the negative effect the dilution would have on the share price, unable to increase its balance sheet debt, and not generating enough cash from its operations, Enron faced a real problem if it wished to fulfil its growth scenario.

Comment 10.1 The old problem of not generating cash, but expanding anyway, was getting rapidly much worse. Why was nobody reporting this?

Structured finance

The answer it found was to extend the off-balance sheet solutions created by Andy Fastow. With the support of Skilling and the board, from 1998 onwards, Fastow and his Global Finance Group used structured finance to raise up to $20bn pa. With his lieutenants Michael Kopper and Ben Glisan, he established a private team largely out of the control of anyone but Skilling, and turned Global Finance into a profit centre – effectively an internal investment bank. Becoming progressively more self-confident and arrogant, Fastow even boasted in an awards ceremony about his clever creations of off-balance sheet vehicles backed by Enron stock. These off balance sheet vehicles then refinanced themselves as the price of the Enron stock rose. The overall purpose was to enable Enron to borrow huge sums while hiding the true size of its borrowing.

The trouble was that, for all their complexity, in practice these transactions still left Enron ultimately responsible, and usually with triggers related to earnings or the share price which would cause instant repayment demands. Because of the unacceptable cost, there was no way to hedge against the share price collapsing, and a few years later this was to prove fatal.

Comment 10.2 These transactions were declared and open to consideration by analysts and the rating agencies; by and large the long term implications seem to have been ignored. Skilling himself cannot have understood the exposure. He certainly didn't understand the deal Fastow had created for himself

Artificial deals

Global Finance in 1999 also created transactions through an off balance sheet vehicle to generate $500m of artificial operational cash flow to disguise its inherent lack of cash, transactions which were to be reversed after the year end. Andersen objected and said the accounts would have to be restated if the transaction was later reversed. Early in the next year it was indeed reversed, but Andersen never demanded the promised restatement.

Comment 10.3 How could Andersen have sanctioned this? And how could they have let matters lie when the transaction was reversed?

Securitisation

Similar tricks were deployed using securitisation via Special Purpose Entities (SPEs). With as little as 3% of outside capital, these SPEs could transfer assets from the main company and raise 97% of new finance and the debt could be excluded from the transferor's balance sheet. In most cases Enron gave guarantees to look after the lenders to these SPEs. Progressively, Enron securitised everything it could, even the expected profits from its international power plants, "borrowing from the future till there was nothing left to borrow" as one ex employee put it. However, they contrived an accounting treatment to effectively report most of this new off-balance sheet borrowing as sales in Enron's books. By the end Enron had over $2bn outstanding in this form of finance.

Prepayment agreements

One way in which Enron focused on generating cash was via prepayment agreements. Enron would contract to supply gas or oil to an offshore SPE which had been up by a lender and the SPE would pay Enron in advance with funds provided by the lender. The lender, in turn, would contract to provide a similar amount of oil or gas over the same period of time to Enron, but Enron would make its own payments over a longer period. These were, ostensibly, separate transactions but, in reality, Enron was receiving finance and paying a fee equivalent to the difference in the value of the two transactions. Starting in 1992, Enron did over $8bn of these deals. Andersen signed off on the accounting treatment of these as commercial liabilities, not loans. The banks earned big fees, while knowing the purpose – to hide debt. These were kept very secret and grew to the point where at bankruptcy there was almost $5bn in outstanding prepayment agreements.

When it collapsed Enron owed $38bn but its balance sheet showed just $13bn. In all this, Global Finance saw themselves as being supremely clever financiers for keeping this off the balance sheet and avoiding conventional equity and debt finance.

Comment 10.4 A well-judged survey would certainly have brought out concerns from both employees and lenders about the growing exposure and permanent cash problem which these devices concealed

Acquiescence of auditors and bankers

To do all this Enron needed the acquiescence of its auditors, Andersen, and its banks, particularly Chase and Citi with whom the corporate relationships went back to the early days with Ken Lay. Enron was generating a vast number of deals, paying out $237m in fees in 1999 alone, and the banks were fighting for these deals. Enron had gained the reputation of being even sharper than the bankers so the banks were not too choosy about ethics in doing what was necessary to get a slice of the fees coming from Enron. One banker was quoted as saying “Can this deal get done? If it can and you’re not likely to be sued, then it’s a good deal”. The banking world was aware that Enron consumed an enormous amount of capital but it stopped very few bankers from doing business with them.

Comment 10.5 No-one in the banking world involved in these transactions was going to blow the whistle, but an independent survey would have highlighted the immorality of it all. All these banks wouild have complied with the necessary regulatory requirements!

Private deals by Fastow

On top of all this, Fastow and his close colleagues had for some years been taking a slice of some of these deals, unbeknown to the board. Progressively these became bigger and more important to Fastow. During this time Skilling signed off on one large deal involving CalPERS, which was a successor to the earlier participation of CalPERS in the JEDI partnership. This one involved a vehicle christened Chewco, in which Fastow’s private involvement was deliberately disguised. But the board asked no questions about it and Fastow got the credit for setting it up. He and Kopper subsequently drew huge sums from this arrangement.

After he was appointed CFO, Andy Fastow persuaded the board to let him set up a special scheme in which he himself managed an independent fund, in which he had a personal stake. This fund, for which he personally would raise independent finance, would provide funding to the SPEs that he was creating for Enron's off balance sheet finance. He promised that this would involve no more than three hours a week of his time, and justified its creation by promptly setting up a hedging arrangement to protect the value of Enron's investment in a new internet provider. Despite Andersen's disapproval on the grounds of conflict of interest, they ultimately raised no objection when the board eventually approved the scheme. The board gave Fastow an exemption from Enron's code of ethics regarding his manifest potential conflict of interest. The external partners in Fastow's first vehicle of this kind were banks CSFB and Greenwich NatWest.

Comment 10.6 The board allowed itself to be conned by Fastow and ignored the plain dangers here. Similarly Andersen; the big banks would have been quite clear about the ethical dangers

Over the next 18 months, Fastow set up his second private equity vehicle as a private equity source for Enron and did over 20 deals worth hundreds of millions of dollars. In selling the concept to Merrill Lynch, Fastow assured them about the attractiveness of the opportunity to their investors in view of his inside knowledge about the deals they would be offered. The bankers clearly understood the conflict of interest but accepted Fastow's assurances that it was sanctioned by the Enron board. The Chase banker involved also recorded in his note of the meeting his estimate of the size of the financial benefits that he felt would accrue to Fastow personally. But they were all chasing Enron's very lucrative banking and financing work, and contributing to Fastow's personal scheme was the price. In the end, this second fund raised capital commitments of $392m.

However, when the new fund got under way, far from putting the best deals into the fund as promised, Fastow allocated many of the worst deals. This way he got them out of Enron's books, and he made his investment returns work out well through secret, special arrangements with Enron, like agreeing that Enron would buy back these investments later at favourable prices. Clearly there was no serious attempt at oversight of Fastow's conflict of interest.

Comment 10.7 All this time, Fastow was supposed to be spending no more than 3 hours per week – surely this was observably untrue?

During the year 2000, a further set of special purpose entities, called Raptors, was set up to hedge against future losses on a huge scale. Of course, Enron's own shares again were being used as the ultimate security. But everyone went along with it. Fastow's company made huge profits, unbeknown to Enron, and Andersen approved all these schemes as Enron's auditor. These vehicles were progressively used during the year and increasingly were used to take known bad deals. By September one of the Enron lawyers was questioning this strategy on the basis that it might be seen as cooking the books. This, of course is exactly what it was. Fastow's Special Purpose Entities, with their complex transactions, were popular with Skilling and the board because, over their lifetime, they had shielded Enron from booking $1bn of losses!

Neither Skilling nor the board knew how much money Fastow was really making from these vehicles. Fastow represented to Skilling that he expected to earn a 25% return on his special purpose deals. However, this was hardly consistent with what he said to a meeting of his external investors in October 2000, which was convened to pave the way for a new, even bigger fund-raising. Fastow gave a presentation to the individuals and banks who had invested in his SPEs which, interestingly, included Enron's own bankers, Chase, and Merrill Lynch, who were closely involved with Enron. Fastow's own auditors, PricewaterhouseCoopers, and his lawyers were also present and they all heard Fastow boasting about the huge returns he had made for them. Taking what would appear to have been a huge risk, Fastow had invited Skilling to make a short presentation expressing support for him and the scheme, but apparently Skilling didn't see these figures. The investors wondered how Fastow could be making all this money without it being at Enron's expense but they were apparently comforted by Skilling's backing for him.

Comment 10.8 What Fastow was doing was in the public domain. What sort of lack of integrity or naivety allowed those present not to blow the whistle

Fastow's deals start to go wrong

The clever financing deals of Fastow through his Special Purpose Entities had been starting to go wrong towards the end of 2000, as their assets declined rapidly in value, meaning they had to pay money to Enron under the hedging agreements. But to be able to do this, they needed to draw on the Enron shares which were backing them. For there to be adequate value available in these shares required the continued growth in Enron's share price to provide the necessary funds. When the share price stalled, the value of the pledged shares was inadequate and several of the SPEs couldn't pay what they owed.

Enron was then faced with either having to issue more shares to cover the balance or having to declare losses, invalidating the whole point of these hedging vehicles. Enron's finance people then tried the trick of temporarily aggregating the positions of all the SPEs on the basis that, if the total was positive, they didn't need to show a loss. Andersen's Carl Bass initially refused to agree. However, senior Andersen's audit partners eventually agreed to cross-collateralise four of these vehicles for 45 days to bridge them through the year end and avoid Enron reporting $500m losses.

Comment 10.9 This was desperate measures. What on earth had happened to the ethos of Arthur Andersen?

11. Skilling is made CEO, problems mount and the bull market is over

In early 2001 Ken Lay handed over the CEO job to Skilling, and one of his early actions was to present to analysts Enron's 2000 results. These showed a doubling of the 1999 revenues to $100bn. Skilling sang Enron's praises and they talked of themselves as aiming to be the World's Leading Company. But the deep-seated problems were growing too big to hide, and becoming increasingly impossible for management to solve. The job he had long coveted was becoming a poisoned chalice.

Operational problems emerge into the open

International having failed to sell its loss-making assets to the Arab buyer, its management were trying to sell them piecemeal but without success. As mentioned earlier, the big Dabhol Indian power contract went catastrophically wrong, costing Enron its $900m investment and a stand-off with the state government which stopped paying bills.

Broadband, supposedly a business worth $36bn according to Skilling, by now had a huge overhead and in a collapsing tech market possessed no practical way to create earnings of any consequence.

EES's exposure to California was a real problem. A planned sale of the Portland General, the power utility, for $2.1bn fell through. Questions were being asked about how much money the Enron traders were making and Wall Street was asking how much EES was losing in California.

Comment 11.1 Now, at last, people were starting to question appearances against a darkening backdrop

Even Andersen were having second thoughts about their relationship. Early in 2001, Andersen partners discussed the issue of the conflicts resulting from Enron's use of Fastow's special purpose vehicles and formally considered resigning as auditors. However, weighing in the balance the possible $100m of fees pa they might earn from Enron, they decided not to resign. In a subsequent meeting Enron's chief accounting officer even managed to get their critic, Carl Bass, removed from the Andersen team dealing with Enron.

Comment 11.2 Most improper behaviour from the client and terrible weakness on Andersen's part

The stock market starts weakening and the sharks start circling

With the end of the bull market in Spring 2000, stocks had started falling and everyone was becoming generally more sceptical and downbeat. Enron's stock peaked at $90 in mid-August and was down to $65 in the autumn. Although it went back up, helped by the January 2001 analysts meeting with Skilling, the upward momentum had gone. Achieving forecasts was no longer enough to send the share price up. Worse, short sellers now started taking an interest. Mark to market accounting in energy companies was arousing attention.

A hedge fund manager, Jim Chanos, whose fund Kynikos specialised in shorting overvalued stocks, took an interest. In autumn 2000, following an article in the Houston supplement of the Wall Street Journal, he started looking at Enron. He had been very successful shorting telecoms stocks and knew how much trouble the industry was in. So he was puzzled by Enron's apparent success with its new broadband business. He also noted its very low return on capital and the huge amounts of capital held off balance sheet. They appeared to be consuming vast amounts of cash. Also he couldn't understand a declaration about dealings with a third party and decided they must be trying to hide something. Added to which the senior people were selling lots of shares. So he started shorting the Enron stock since he thought it looked as if the business could be in trouble.

Comment 11.3 At last someone with an interest started looking behind the veil. Of course, his interest was not in boosting Enron's shares but in driving them down.

After Skilling's 2001 press conference announcing the results for the year 2000,, the Kynikos team started looking closely at all the available figures from Enron and observed that while earnings had been growing smoothly, Enron wasn't generating cash. Moreover, debt was rising rapidly and Enron appeared to be selling assets but reporting the sales as recurring earnings. Chanos noted the high proportion of trading in the business mix and questioned the high multiple put on Enron's valuation. At this time, there was growing scepticism in the financial community about Enron, but few so far had voiced it publicly. Chanos spoke to Fortune magazine, and Fortune then conducted what turned out to be an unsatisfactory telephone interview with Skilling. To attempt to recover the situation, Enron decided to send CFO, Andy Fastow and Enron's senior PR man to Fortune to try to improve perceptions. This visit didn't achieve the desired outcome - Fortune wasn't convinced by the two executives and later ran a story which raised many questions about Enron.

Comment 11.3 Now, at last, the media smell a rat

Enron's stock, $82 after the analysts meeting in January, was down to $68.50 by the end of February. This caused the Special Purpose Entities to start going seriously wrong, so Fastow and his colleagues had to do another restructuring which resulted in these vehicles propping each other up on a permanent basis. Andersen were involved in agreeing this transaction at local partner level. In the process, Enron had to contribute more stock and derivatives, which put the SPEs in a position to give Enron another $828m in notes receivable. This then enabled them to cover $200m in losses for the quarter. Skilling later denied knowing about the detail of this restructuring, but understandably he wasn't believed. The board said no-one told them, though it was disclosed in Enron's financial statements.

Comment 11.4 Either Skilling and the board were lying or they were seriously and incompetently out of touch with the underlying business. Where were the controls and reports that they should have been receiving and indeed demanding?

On March 21 Enron's stock fell to $55.89 and the next day it touched $51.51. Skilling gave a conference call which talked the stock up and for a month it stayed around $60. Then they produced an excellent first quarter's results. At a conference to announce these, Skilling was challenged to produce a balance sheet by a short seller hedge fund manager. After refusing and being pressed, he ended up calling the hedge fund manager "Asshole". This extraordinary loss of control was the beginning of the end for Skilling's credibility and the analysts started to wonder about what he might be hiding.

Comment 11.5 Skilling was seen as obsessed with Enron's share price above all else, probably to the exclusion of honesty.

In May 2001 a respected short seller and analyst examined Enron's 2000 report and concluded that almost half the reported cash flow was in fact customer deposits which were potentially repayable and another quarter came from a one time sale of inventory. Gradually more and more people started writing negative articles.

Desperate measures as Enron starts to fall apart

Through the Spring of 2001, Enron Broadband Services was collapsing and having to offload lots of staff. To avoid having to admit to large-scale dismissals it tried to redeploy them elsewhere in the Group. A whistleblower wrote anonymously to Fortune magazine telling them that Skilling was lying when he denied that anyone was being fired. Internally, however, Skilling was losing credibility with staff as he kept saying how well they were all doing.

Comment 11.6 It was all coming out into the open though the market still probably had no idea of the scale of the potential problems

In June Skilling went to speak at a conference in California, to be greeted by a woman squashing a raspberry pie in his face. This was the way Enron was seen by the public in one of their main target markets for Enron Energy Services. And about that time Pai who was still running EES, and Rice who was still running Broadband, both left. The new boss of Broadband, who came from the trading group in Wholesale, quickly fired 50% of staff. They then merged Broadband into the Wholesale business to absorb the losses.

Comment 11.7 By now not only were the financial markets and their customers questioning Enron's credibility but they were starting to generate lots of disaffected former employees. Particularly when they realised how much some of the senior people had made over the years – like Lou Pai who made $250m from his stock options and Ken Rice who made over $70m.

In mid-2001 Jeff Skilling eventually felt he had to confront Andy Fastow over his conflicts of interest in regard to the SPEs. As a result, Fastow reluctantly decided that to remain as CFO of Enron, he would have to sell his interests in the SPEs, but he quietly sold them to his deputy. His deputy paid him $16m and left the company, while continuing to run the operations of the SPEs, and continuing to provide finance for Fastow in his capacity as CFO of Enron. This ostensibly enabled Fastow to clear the air, but neither the board nor the Enron shareholders were ever told who was the buyer or how much Fastow made from the sale.

Comment 11.8 Clearly the whole transaction was wrong and how it could have been carried out without the board understanding the details shows how incompetent and corrupt the top management had become by then

Enron made its second quarter earnings because the power traders' huge profits exceeded the gas traders' large losses. But cash was draining away. Despite Skilling's bullish presentation of the results, the share price stayed under $50 and investing institutions were starting to re-evaluate their positions on Enron and quietly selling and reducing their exposure to Enron's debt position. Credit derivatives on Enron, which had always been expensive, began to rise rapidly in cost. Astonishingly, J P Morgan Chase, one of Enron's key bankers, had nearly $900m of exposure to Enron at the time of the earnings announcement, but amazingly also had nearly $300m of short positions against it which it intended to add to.

Comment 11.9 Those in the know were starting to run for cover

A potential disaster loomed when an impending liability of $1bn arose from one of the off-balance sheet financing vehicles, where the underlying security looked likely to fall well short. This would require Enron to issue equity to cover it, and it was likely to fall due very soon, at the end of 2001. CSFB bank agreed to refinance this in a similar off balance sheet vehicle, even though it was increasingly clear that Enron would almost certainly have to pick up the tab sooner or later. The rating agencies didn't pick it up and the accountants signed it off.

Comment 11.10 The bankers presumably made a large fee from going along with this deception

12. Skilling and Lay under pressure

From early in his new role as CEO, Jeff Skilling seems to have started losing heart. The business was throwing up more and more problems and everything he had worked to build was going wrong. Ken Lay was really disengaged from the day to day running of the business and of no practical help and now that things were going wrong Skilling wasn't enjoying the situation. The business needed rapidly scaling back and managing in close detail, neither of which Skilling had ever had the ability or inclination to do. After the Q2 results were announced, Skilling told Lay he wanted to resign.

Comment 12.1 Skilling was the wrong man for this situation, but the board didn't realise this in time. In reality, the situation was probably beyond hope for anyone to repair by now though.

Despite wanting to resign, however, he continued to act like the CEO. He was as optimistic as ever at company presentations in August but staff weren't persuaded any more. After an explosion at the Teesside plant which killed several people, Skilling was badly upset. At what would be his last board meeting on August 13, he listened as the boss of risk assessment presented a disaster scenario:

Enron misses its quarterly targets, triggering a big sell off, which in turn leads to the collapse of the balance sheet because it forces the unwinding of the off balance sheet vehicles which were capitalised with Enron stock, which in turn prompts downgrades in the company's credit ratings, which triggers adverse changes in trading contracts. This causes trading partners to demand cash collateral, which Enron doesn't have. This wipes out liquidity and destroys investor confidence.

This prescient forecast was dismissed by Skilling and the finance team, saying they had plenty of sources of emergency cash. However, later in the meeting Skilling announced his resignation to the board, in a highly emotional state, and in the brief public announcements afterwards, Skilling said just that he had resigned "for personal reasons".

Comment 12.2 Was this self-deception or lying to run away from reality? Either way, the board should surely have followed up this board meeting with a check on Enron's true situation

13. Lay is CEO again for the Final Act

After Skilling's resignation, Ken Lay took over his former role as CEO and publicly stressed how strong Enron was and that there were no hidden issues. The outside world puzzled over the explanation of "personal reasons" causing the resignation of a hyper aggressive, alpha male CEO after just 6 months, concluding that there must be underlying problems. And the stock dropped to $40. The general perception of Enron was starting to change, even though most analysts stayed optimistic. Skilling admitted in an interview with the Wall Street Journal that he felt personally responsible for the stock price decline and if it had stayed up, he wouldn't have resigned.

Everything's fine; here's a raise for everyone

Shortly after Skilling's departure, Lay assured a big company meeting about the company's rosy future and awarded everyone new options amounting to 5% of salary. He also collected new options himself and sold two personal annuities to Enron for $10m cash. Surprisingly, his personal finances were getting into a bad state. He had borrowed huge sums to invest in a diversified portfolio, but most of these investments were illiquid and the borrowing was secured on Enron shares, often with triggers linked to the share price. So as the price fell, he got more and more pressured.

However, Lay gave a convincing presentation to Wall Street analysts and separately Skilling reiterated that Enron was in great shape.

Comment 13.1 Those listening heard what they wanted to hear. Once again, Lay was spending cash they didn't have.

Whistleblowers write to Enron top management and to Anderson

Just before Jeff Skilling left, an ex Andersen accountant, Sherron Watkins, was uncovering a frightening picture. She had wide experience of Enron, having originally been hired by Fastow, gone to Enron Gas Services, then to International, then to Broadband and back to Finance when Broadband collapsed. She was tasked with looking at Enron assets to see what could be sold. She saw and quickly understood how Enron had used SPEs to hide huge losses and that the value of the security, Enron shares, had fallen substantially and in many cases was insufficient to cover the losses, which would leave Enron having to issue millions more shares to cover the obligations. She wondered how all this could possibly have been agreed with Andersen and came to the conclusion that this was effectively a huge accounting fraud and that Enron was soon going to collapse.

While looking urgently for another job, she decided to alert top management in the hope that they would take steps to put the situation right. By then Skilling had left so she wrote to Lay anonymously before the scheduled employee meeting, expressing her fears that Enron would "implode in a wave of accounting scandals".

Comment 13.2 As often happens, the whistleblower first approaches the company's top management hoping they will act

However, Lay didn't raise this at the meeting, so she went to the head of HR who arranged for her to speak to Lay personally. When she talked to Lay, he expressed surprise but agreed to follow up the issues she had raised. He then arranged for an investigation by the same law firm which had been involved in setting up these SPEs, Vinson & Elkins, despite the clear conflict of interest. To conduct the investigation, Vinson & Elkins then appointed the Enron relationship partner who had billed $35m pa to Enron and as a reward was just about to become managing partner. They seem to have set the terms of reference of the preliminary enquiry so narrowly as to guarantee a whitewash. They also asked Vinson to advise on how to handle the whistleblower, Watkins.

Comment 13.3 Difficult to know whether Lay set up this arrangement to cover up the issues raised by the whistleblower but he should certainly have foreseen the result, as should the board

Another whistleblower was Margaret Ceconi, recently laid off by EES, who had written anonymously to the SEC some weeks earlier. At the end of August she wrote a long letter to the board warning of huge problems at EES. But the letter was never shown to the board, being treated as something one would expect from a disaffected employee who had been fired. Meanwhile, Ceconi had begun briefing an Enron-specialist analyst to put her in an informed position to ask probing questions of Enron. Again she reported her complaints to the SEC website, identifying Enron this time. However, no action resulted.

Comment 13.4 Again, the usual response when a whistleblower writes to top management, with the predictable consequences

By late September the Vinson lawyers gave Lay an oral report in advance of their official one, which told him there was nothing to warrant a full investigation. None of the Enron interviewees had challenged Andersen's judgements and while there was some concern about how Fastow's conflict of interest would appear if made public, they all praised the use of thc SPEs. Lay was delighted this cleared Fastow and considered the matter closed. He then decided to try to lock in all the senior staff by offering them generous new contracts. Even while Fastow was under investigation, Lay negotiated for him huge new cash incentives and options and a 50% increase in basic pay. In a board meeting on 9 October, the directors heard of the Sherron Watkins letter but the audit committee were assured that the preliminary investigation had shown there was nothing to worry about and they never even asked to see the letter.

Comment 13.5 Lay was either blind or desperate and the board should surely have smelled something fishy here

Sherron Watkins meanwhile contacted her old boss at Andersen, who wrote a long note to the audit partners. In fact, Andersen were already having to look at the SPEs as these were visibly in trouble again despite the earlier consolidation. To make matters worse, the World Trade Centre attack, which happened on 11 September, hit the markets hard, sending Enron shares down to $25 at one point. And to cap everything, the Andersen auditors realised they had made a mistake in the treatment of the SPEs in Enron's 2000 balance sheet. Correcting this would result in a charge to shareholders' equity amounting to $1.3bn.

Comment 13.6 Now Andersen themselves are in big trouble and a whistleblower has alerted them to worse things to come, but how do they handle it? What has happened to their own internal monitoring?

Coming clean? Up to a point

With the SPEs situation growing rapidly worse, a decision had to be taken by Enron management whether to choose this moment to bring everything into the open and take one big hit. In September, Lay had appointed Greg Whalley, head of trading, to take over as COO of Enron. As the new COO, Whalley was naturally keen to take all the write-downs as quickly as possible. Lay agreed and they started the process immediately to wind up the SPEs.

At this time, however, someone tipped off the Wall Street journalists who had previously looked at Enron, with inside detail about Fastow's partnerships in relation to the SPEs. They submitted a list of detailed questions, asking how much Fastow had made personally from the partnerships, but got a bland response from Lay. In reality, by the time Fastow sold his interest in the partnerships he had made more than $60m. But no-one in Enron knew this.

Comment 13.7 Now the cat is out of the bag but the board haven't realised it yet

During this time the accountants were wrestling with how to present the Q3 earnings in the best light when they would have to include $1bn of after tax losses and another $1bn of equity write down. Andersen, under pressure, agreed to go along with treating the equity write down as not material and with treating the losses as not requiring a restatement of previous published figures, even though the SPEs had been used to hide losses in previous quarters. Enron also wanted to report the losses as non-recurring but the Andersen partner objected. Enron called them non-recurring anyway.

Comment 13.8 Andersen were behaving in a completely unprofessional manner in first accepting this and secondly not blowing the whistle themselves and resigning

Lay handled the earnings announcement carefully and the share price actually rose a little. However, the next day the Wall Street Journal ran the story suggesting that the loss indicated a fundamental problem with Enron's business. Also it focused on Fastow's partnerships and the worrying conflict of interest. The story continued for three days, linking the equity write down to Fastow's off balance sheet vehicles and estimating how many millions he had made from his partnership dealings with Enron. Though some analysts still supported Enron, by now the stock was on the slide and was down 20% to $26 after the media reports. The SEC then began its own investigation into the partnerships and when Enron announced the investigation the stock dropped to $20.65.

Comment 13.9 The writing is on the wall by now. The media still don't know how big a disaster is unfolding but they are pulling at all the strands to unravel the mystery

On 23 October there was a disastrous conference call with analysts followed by an employee meeting in which Lay tried to empathise with staff over the falling share price and reassure them that he would turn things round. As he also expressed support for Fastow, this didn't go down well, and by now his own credibility was clearly evaporating.

Later that day the chairman of Enron's compensation committee arranged a conference call with Fastow in which they got him to admit to receiving $45m on two of the partnerships (in fact he made $60m) supposedly from working 3 hours a week on them. The next day Whalley fired Fastow (24 hours after Lay had expressed his support). That day the shares dropped to $16.41.

Comment 13.10 The right action but all far too late and still Lay isn't facing up to things

Meanwhile, as Enron's position rapidly worsened, Andersen in their Chicago headquarters woke up to the imminent mortal danger to the whole global partnership. Catastrophically, an in-house lawyer in Houston advised everyone to edit or destroy records which would show them in a bad light. She circulated a memo reminding people of the firm's policy on document retention, which was to discard anything that wasn't part of the audit file, indicating that this would be the opportunity to get rid of potentially damaging stuff. It was a particularly dangerous time since Arthur Andersen were already under a Cease and Desist order after they had been criticised by the SEC in regard to their work with another client. In early October, when the lawyer saw the possibility of an imminent SEC investigation in regard to Enron, she prompted the Enron audit partner to prune his files. After Enron's terrible conference call later that month, he duly ordered his team to apply the document retention policy urgently on the Enron files. Andersen's offices in London, Portland and Chicago all joined in and shredding went on till it had to be stopped when Andersen received a subpoena from the SEC.

Comment 13.11 The shredding, when it was made public, duly shredded Andersen's own reputation and was, like all attempted cover-ups, even more damaging than the failings in their relationship with Enron

To make matters worse, with Fastow now gone, Andersen's accountants were able to see things that had previously been hidden from them. These clearly meant restating accounts for 1997 and 1999. This would be awful both for Enron and for Andersen.

14. The end comes quickly

The next day after the disastrous call with the analysts on 23 October, the new CFO, Jeff McMahon, was faced with a cash crisis. No banks would extend the $2bn of overnight credit needed to roll over its commercial paper. In what would be seen as an act of desperation he had to draw down its $3bn in back-up credit lines. The share price collapse was already triggering potential paybacks of billions of dollars, and if the credit rating worsened the trading operation would be threatened. Now cash reserves were down to the last billion.

Ken Lay was calling his friends in Washington to try to get a rescue package, but to no avail. By the start of November, Enron had managed to raise $759m of new funding. But this led to the company having to open its books as never before. J P Morgan Chase sent a due diligence team to Houston. They looked at the core wholesale business and realised that it was funding lots of loss-making operations, like the retail business, hence the constant need for cash. By now there was an imminent liquidity crisis.

Comment 14.1 The board were clearly not receiving meaningful reports on the current and forecast cash position at least partly because the Finance function wasn't producing these even for its own use. They had been living from hand to mouth and month to month regarding cash and funding

As a possible way out, Enron explored the possibility of a takeover by its smaller rival, Dynergy, with the support of its deep-pocketed 26% shareholder, ChevronTexaco. There was a desperate attempt to close the deal before Enron was forced by the SEC to make full public declarations about Fastow's partnerships. Also, Andersen were belatedly pressing for an early announcement of the need to restate the accounts going all the way back to 1997. At that point, the rating agencies then downgraded Enron and the share price dropped below $10. Two days later on further bad news it dropped another 25% but recovered on a leak about the possible acquisition.

On 8 November everything was ready: the announcement of the agreed merger, the announcement of the restatements, writing off nearly $600m in profits and making a full declaration about Fastow's partnerships and that he had made $30m from them. But early that morning, credit agency Moody's called to say they were unhappy with the merger terms and were downgrading Enron to below investment grade. They were persuaded to hold fire while the deal was adjusted to meet their concerns. The next day the merger was announced and Moody's downgraded but kept above junk status.

Wall Street seemed to like the deal and the shares of both companies rose. Then doubts started to set in about the risks Dynergy were taking and whether they had done enough due diligence. Dynergy's boss, Chuck Watson, was confident he could shut down loss-making businesses, pay down debt and recapitalise Enron. But the Enron traders demanded big cash bonuses to stay working under the despised Dynergy, which after some reduction they were given. Then Lay's contract was found to include terms which would deliver him a $60m payout from the deal, but this caused such a furore that he agreed not to take it.

On 13 November more than $2bn was paid into Enron of which $1.5bn came from Dynergy. This was supposedly was more than enough to sort out the liquidity situation. However, four days later the CFO reported that liquidity was again very tight. Even after the Dynergy funds were paid in, cash continued to flood out. Trading partners were refusing to deal with Enron and the business performance was getting worse.

Comment 14.2 Dynergy is taking a very big gamble after only superficial due diligence. This looks like a death spiral.

When the 10-Q filing was released (quarterly balance sheet & cash flow) a few days later, it showed a significantly worse loss for the third quarter than the earlier guidance, and a poor forecast for Q4 reflecting the fact that business was now drying up. Also the assets in one of the early SPEs had dropped far below its obligations, leading to a $700m hit to earnings. And the ratings downgrade had triggered an unexpected obligation to pay $690m in eight days' time!

Even worse, Enron appeared to have burned through at least $1bn in six days and $2bn in less than a month. It no longer had adequate liquidity and the Dynergy CEO was now having serious doubts. He clearly hadn't been told about these issues by Enron and it was now damaging his and Dynergy's own credibility.

Comment 14.3 Interestingly, Dynergy's involvement with Enron as Enron started to unravel drew analysts' attention to Dynergy's own business, which was modelled on Enron, and this was to have severe consequences for Dynergy later on

By the weekend Enron's stock was down to $4.71 and the more Chuck Watson found out about the pay and other benefits and extravagant severance packages Enron's employees received, the more concerned he got. Eventually he decided that to save the deal and Enron, he had to put his own team in immediately to replace Lay and his top team, and subject to this, they then agreed a new deal at half the earlier valuation. However, the new deal depended on new capital being injected to enable Enron to regain its investment grade status, coupled with a successful rescheduling of all the debt that Enron was due to repay by the end of the following year. But, after initially making supportive noises, the banks were backing off. Then the rating agencies got concerned at the banks' lack of enthusiasm and the deteriorating trading situation.

Chuck Watson had come to the conclusion that the deal wasn't going to work, when the rating agencies downgraded Enron well into junk level. That triggered an immediate $3.9bn in debt to be paid and Watson immediately terminated the deal.

Comment 14.4 it was too late to save Watson's reputation. Dynergy was later accused of using similar financial devices to Fastow and manipulating the market like Enron and were fined. Watson lost his job and Dynergy nearly went bankrupt the next year

Enron shares closed the day at 61 cents.

Over the next few days Enron's cash drained away and its debt, both on and off the balance sheet, totalled $38bn. On 2 December 2001 they filed for bankruptcy – the biggest in US history.

Lessons for good corporate governance

What lessons can we draw from this Case Study about the corporate governance of Enron during its dramatic journey from boring pipeline company via global player in energy supplies to disaster. Let's apply our five Rules of Good Corporate Governance.

Ethical culture

Enron didn't start out as an unethical business. What introduced the virus was the pursuit of personal wealth via very rapid growth. This led to the introduction of quite extreme incentive schemes to attract and motivate very bright and driven people, which, in turn, led to an unhealthy focus on short term earnings. In this way, an amoral and unethical culture developed in Enron in which customers, suppliers and even colleagues were misled and exploited to achieve targets. And the top management, rewarding itself with even more outrageous incentives, boasted that a pure, market-driven ethos was propelling Enron to greatness and deluded themselves that this equated to ethical behaviour.

Clear goal shared by all key stakeholders

Lay and, particularly Skilling, engendered in all the staff of Enron the goal of driving up the share price to the virtual exclusion of all else. The goal of achieving a long term satisfaction from a stable customer base took a distant second place to signing up deals. In California, the customers were deliberately exploited by the traders to the maximum extent their ingenuity could achieve. Even internally, the Chief Finance Officer's funding scheme was designed to make him rich at his employer's expense.

Strategic management

As a McKinsey consultant specialising in strategy, Skilling had a very clear vision, at least initially, of what he wanted Enron to achieve. However, he wasn't interested in management per se and allowed operational management to wither. But his vision of a huge trading enterprise wasn't carried down to the next level of developing and implementing practical business plans, as evidenced by his crazy launch into broadband, a field in which he had no personal knowledge or experience and in which Enron had almost no capability or likelihood of raising the funds required to implement the project

Organisation resourced to deliver

Skilling became COO on the departure of a very tough and experienced predecessor. Even at that point, Enron had been expanding at a rate which outran its ability to set up appropriate and adequate administrative systems and controls. Added to which it had always been short of funds. Skilling's lack of interest in operational management meant that on his appointment at COO, he made a poor situation much worse by making bad managerial appointments. His focus on rapid growth incentivised by very generous compensation schemes, and with inadequate spending controls, created a totally dysfunctional organisation.

Transparency and accountability

From the early stages, Enron's focus on earnings and share price growth and the related financial incentives led to a necessary lack of transparency as the figures were fiddled. One could argue that Enron felt very much accountable to their shareholders for delivering consistent above average growth in Enron's market capitalisation. However, this growth was achieved by subterfuge and deception. Certainly the dealings in California were as far from transparent as it was possible to be.

Conclusion

It is clear with the benefit of hindsight that what started out as an imaginative and ground-breaking idea, which transformed the natural gas supply industry, rapidly evolved into a megalomaniac vision of creating a world-leading company. Intellectual self confidence mutated into contempt for traditional business models and created an environment in which top management became divorced from reality. The obsessive focus on driving the share price obscured the lack of basic controls and benchmarks and the progressive dishonesty in generating revenue and earnings figures in order to deceive the stock market led to the management deceiving themselves about the true situation.

Right up to nearly the end, Enron complied with all its regulatory requirements. The failings in these regulations led directly to Sarbanes-Oxley. But all the extra reporting in SarBox didn't prevent the global financial meltdown in 2008 as the banks gamed the regulatory system. Now we have Dodd-Frank.

The need for a Total Corporate Governance survey

What we actually need is independent Corporate Governance surveys and so we have applied our Total Governance Survey Model to this Enron case study, imagining what the results might have been from an independent survey conducted in mid-2000. The results are shown in the attached table and students can use the survey tool (click to download[1]) to do their own assessments as at different points in the Enron story. The purpose is to highlight the actions that a conscientious board of directors might have taken when informed by the results of such an independent Total Corporate Governance survey.

ENRON SUMMARY TOTAL CORPORATE GOVERNANCE SURVEY AT MID 2000

	Customers	Employees	Owners	Suppliers	Financiers	Average
Ethics	1.5	4.5	4.5	2.5	2.5	3.1
Goal	5.5	8.5	8.5	7.3	6	7.2
Management	4	7.5	6	6	6.5	6
Organisation	2.5	5	7	4	5.5	4.8
Accountability	3	7	6	3.5	3	4.5
Average	3.3	6.5	6.4	4.7	4.7	5.1
Sniff test	2	8	6	3	5	4.8

[1] This is a zip compressed Excel file and has been scanned by ClamXav anti-virus software. If the link doesn't work please go to http://www.applied-corporate-governance.com/support-files/ethics-governance-survey-worked-example-enron.xls.zip

Those surveyed would be asked to agree or disagree, on a scale of 1 – 10, with a series of statements to probe their views on Enron's performance in relation to the Five Golden Rules of Good Corporate Governance. When aggregated by our Total Corporate Governance survey tool, these have been expressed in the table above. What the Report to the Board would suggest is:

- customers and suppliers, Enron's trading partners, have a very poor view of Enron's ethics
- customers, in particular, but also suppliers, have a big problem with Enron's administrative processes
- employees, and to a lesser extent the investors, are still in thrall to the Enron inspirational reputation
- financiers don't trust Enron but are happy to do business with them

The figures themselves may not throw up the dangers lurking in the off-balance sheet vehicles, but anecdotal evidence gathered during the survey from the financiers and key staff almost certainly would.

What would give serious pause for thought is the poor light this sheds on Enron's behaviour towards its trading partners, and the bad ethical reputation they have in the industry. In fact this is borne out by the author's friend in his contacts with Ken Lay and Enron. Enron's published figures were simply not believed by those in the business.

Surely a conscientious board would hold Ken Lay and Jeff Skilling to account when presented with such an independent appraisal of Enron in its industry, notwithstanding Arthur Andersen signing off its accounts and the regulatory authorities accepting its filings without question.

ANNEXE

Some lessons to be borne in mind when setting up stakeholder research

There was ample information in the public domain for those who were prepared to use it. The questions or statements must cause the respondents to probe and avoid the herd mentality when answering. For instance, analysts (and board members) should have seen clear inconsistencies in accounting reports: growing earnings and growing assets but very poor cash flow and poor return on capital. What would it have taken to open their eyes?

Customers and suppliers, if asked, would have surely raised issues about the lifestyle of the senior company people. At the very least this wasn't healthy and at worst it would have pointed to a business which was out of control and would eventually blow up.

Bankers and others in the global finance world would have picked up the trade gossip about the international deals that gobbled up cash and would surely have brought these concerns out into the open through well-conducted research. What would it have taken for them to have seen through the hype?

Even in the high days of the dotcom boom, there were sensible people who would have rumbled the crazy broadband forecasts immediately. The research would have needed to tap into these impartial sources of opinion and to have taken them seriously.

All the key parties seem to have justified themselves on strictly narrow, legalistic interpretations of their actions. If it's not illegal it's OK. This suggests a need to set questions and answers in a context that shows up self interest in replies to standard questions.

So possibly an interesting point coming out of this is the need to have as a stakeholder someone who has a negative interest in the company (like short sellers). They will demand information that others would be happy not to ask for or to accept being fobbed off.

In the banking industry and its credit monitoring agencies, of course, despite the introduction of Sarbanes-Oxley as a direct result of Enron and other scandals, nothing was learned and 6 years later with Lehman's collapse the whole thing blew up. Surely this demonstrates the limitations of regulation and rules-based compliance and shows the need for a survey-based approach, avoiding the regulations altogether as these will be gamed.