

Enron

Arrogant management?
Failed business model?
(then) Fraud

Accounting front and center

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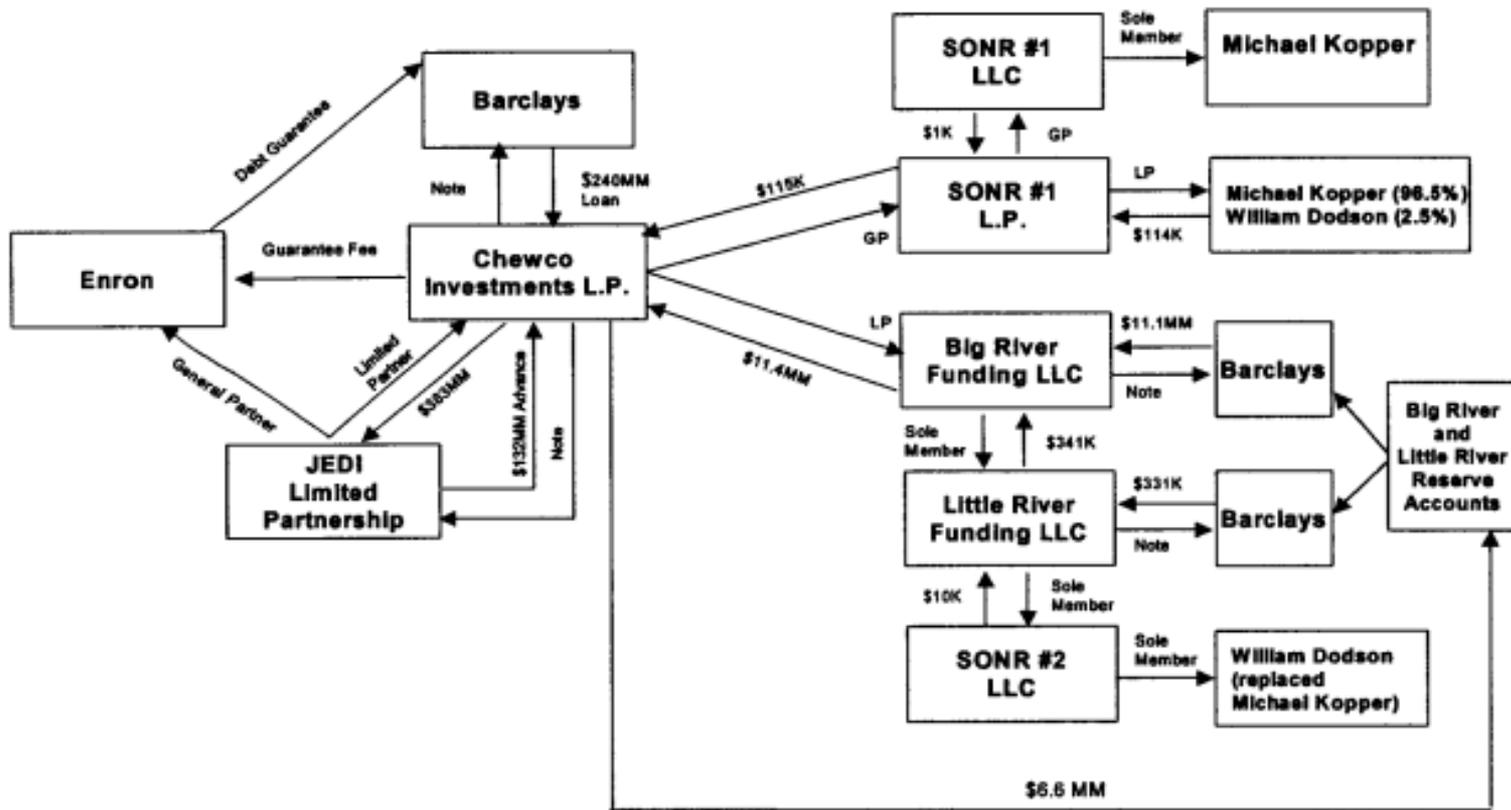
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Background

This presentation is simplified...

A diagram of the Chewco transaction is set forth below:



Background

Introduction

- Circa 1998-2001...the “dot.com” era
- 7th largest company by revenues in U.S.
- 25,000 employees
- Accolades:
 - Fortune magazine: most admired company
 - McKinsey: example of innovative company outperforming traditional rival
 - Several Harvard cases espousing Enron’s business model
 - Etc., etc., etc.

Background

Introduction

- **Business strategy (as articulated...maybe)**
 - Procure assets in deregulating industries
 - Glean knowledge from owning these assets with trading knowledge in gas markets
 - Create commodity contract that can be traded
 - Divest “heavy assets” when all knowledge gleaned
 - Changed Enron from a traditional pipeline company to more of a commodity trader (but didn’t like to advertise this...preferred to be called a gas supplier and electricity supplier, etc. (steadier, more permanent earnings)
 - Note: ENE traders were often taking 5X more risk trading than Morgan Stanley and other Ibank traders

Legal background

Legal events

- **Oct 16, 2001**
 - ENE announced \$1.01B after tax nonrecurring charge in 3rd Qtr and \$1.2 decrease to Shareholders' Equity (13% reduction to SE)
- **Oct 31, 2001**
 - ENE Board formed special investigative committee to recommend actions with respect to transactions between ENE and entities connected with related parties
- **Nov 8, 2001**
 - ENE announces intention to restate 1997 through 2001 Q2 financials to reduce NI by \$586M (and SE)

Legal background

Legal events

- Nov 19, 2001
 - ENE filed Q3 10-Q
 - Non-recurring charges related to structured finance deals and related entities
 - Total debt on balance sheet: \$12.978B
 - **The same day at the Waldorf Astoria, NY, NY presentation: Total debt: \$38.094B**
 - **(\$25.1B off balance sheet)**
- Dec 2, 2001
 - Chapter 11 bankruptcy filing...no cash...
- Thereafter...

Legal background

Legal events

- Dec 2, 2001
 - Chapter 11 bankruptcy filing:
 - Court appointed examiner spent \$88M trying to figure out just the off B/S accounting and its role in the bankruptcy
- Bankruptcy filing led to allegations of:
 - Securities fraud
 - Accounting irregularities
 - Energy market price manipulation
 - Money laundering
 - Breach of fiduciary duties
 - Misleading financial information
 - ERISA violations
 - Insider trading
 - Excessive compensation (top 200 exec's paid average of \$7.12M each in 2000)
 - **Wrongdoing by certain of Enron's bankers...**

Legal background

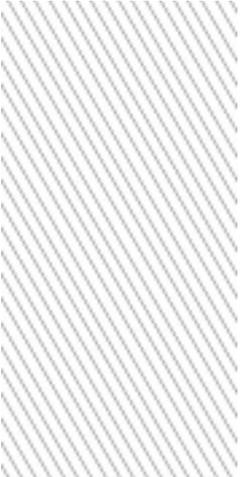
Legal events

- **Newby v. Enron (THE Enron class action lawsuit)**
 - Enron shareholders and other damaged parties sued Ibank's (jointly and severably) for \$40B+
 - New theory for class action lawsuits in U.S.
 - (Ibank's not directly responsible for ENE financial disclosures)
 - Court examiner concluded:
 - There is sufficient evidence...certain financial institutions...involved with SPE (Special Purpose Entities) transactions had actual knowledge of the wrongful conduct of these officers by participating in...SPE's
 - (LESSON: Watch what you say in email, phones (records kept), etc.)

Legal background

Legal events

- (My role at Analysis Group)
 - Damage estimates for JPMChase
 - Estimate and settlement was \$2.2B announced June 2005
- Estimating damages consists of:
 - Assume JPMC is guilty
 - Undo the fraud in the financial statements (this is an understatement)
 - Model how the financial statements influence stock price (e.g. like a P/E ratio but more complicated)
 - Use the “as if no fraud” set of financial statements to estimate an “as if no fraud stock price”
 - Find out or model who bought and sold the stock and at what prices...estimate damages



Failed business model?

Failed business model?

Accounting, compensation , arrogance and ruthlessness

- Arrogance
- Mark to market (M2M) accounting
- Excessive compensation divorced from performance
- Ruthlessness
 - **Created severe incentives AND ability to manufacture profits AND cash flow AND hide debt off balance sheet**
 - **Created severe incentives to SECURITIZE to divest of poorly performing assets AND raise cash to “feed the beast”**

Failed business model?

Arrogant leaders

- **Ken Lay**
 - Founder, Chairman, CEO
 - Disliked confrontation. Very “hands off” manager
 - Thought of ENE as his own (family regularly used Enron jets, one kid used it to have a new bed delivered)
- **Jeff Skilling, Blames R. Mark for Enron collapse.**
 - President and COO (CEO from Feb – Aug 2001).
 - No interest in details. Consultants’ mentality
 - Interview for Harvard Business School: Dean: Skilling, are you smart? Skilling, “I’m ****ing smart”
 - At McKinsey he was “sometimes wrong but never in doubt”

Failed business model?

Arrogant leaders

- **Andrew Fastow**
 - CFO (no experience as CFO but knew about securitization)
 - Colleagues in Chicago: “I don’t know that he ever had a moral compass”
 - Resume “Created and sold first security backed solely by senior LBO bank debt...directly responsible for pretax profit contribution of \$12.8 million” ...colleague at Continental bank: “Andy was the number two guy in a two-man group, but it was not his idea and he was the follower not the leader”
- **Rebecca Mark, Blames J. Skilling for Enron collapse.**
 - CEO of Enron International and then Azurix
 - Deal maker buying heavy assets, changed clothes 3x per day, disliked numbers. Colleagues: “Ego-driven empire builder” “worked hard at self-promotion

Failed business model?

Arrogant leaders

- **Example:**
 - Each hired smart MBA's, highly motivated by \$'s, without knowledge/experience
- **Example:**
 - Staged trading desk to fool analysts into thinking its retail energy business (EES) was running (it wasn't...yet...but everyone thought this was ok)
- Many more examples

Failed business model?

Mark to Market (M2M) accounting

- Enron celebrated when they received the AOK to use M2M accounting treatment from the SEC.
 - The basic methodology was simple. To create a merchant asset or “monetize” a deal, the trader would forecast the future price curve for the underlying product, calculate the future cash flows and apply a discount rate to compute the net present value which could either be sold to an SPE created for that purpose or kept on Enron’s books as a merchant asset. For some products, e.g. gas futures, market prices could be obtained from NYMEX but usually for a limited time horizon, say four years. Enron extended the mark to market principle to much longer contracts (10 years) for which it had to derive its own price curves.
- As one trader put it, for some products where Enron was the only supplier, it was more a case of “marking to Enron.”

Failed business model?

Mark to Market (M2M) accounting

- An Enron employee
 - OK, now that it's bust, I can tell you a little bit of what was going on—at least where I was. Imagine that you make a spreadsheet model of a business plan (in this case it was taking over the world). You discount it with Montecarlo simulations (more like Atlantic City, really), sensitize it to all possible shocks, but still make sure you obtain a huge NPV. Then sell this “idea” to a company that does not consolidate and which finances the purchase with debt guaranteed by Enron's liquid stock (remember no consolidation). You book all the NPV (profit) upfront.
- Many mark to market contracts were “tweaked” to generate extra profit
- Many apparently entered at an economic loss just to record profit (needed a utility company to agree to the transaction...no better way than to sell it at an economic loss then fudge the M2M accounting)

Failed business model?

Compensation incentives and ruthless performance evaluations

- **Compensation**

- Focus on completing deals, not long term profits and cash flows
- Idea:
 - Close deal (grease with cash, if needed)
 - Use wild assumptions so it appears profitable
 - Book (unlikely) profits now
 - Get bonus, move on

- Cash flow, if any, often years into the future

- Mark and Skilling BOTH made millions with mark to market accounting and a deal mentality

- Mark: Hard assets (Indian plant, Azurix water, Argentina deal)
- Skilling: Gas delivery contracts

- **Ruthlessness**

- Lower 10% typically fired. **“Rank and Yank”**
- Led to lots of backstabbing and lack of cooperation within ENE

Failed business model?

Compensation incentives and ruthless performance evaluations

- ...AND VIRTUALLY NO INTERNAL CONTROLS
- **To SUMMARIZE:**
- **Created severe incentives AND ability to manufacture profits**
- **Created severe incentives to securitize to divest of poorly performing assets AND raise cash to “feed the beast”**
- So performance was outstanding, right? ...wrong...

Failed business model?

Consider the following ratios...using the fraudulent numbers

- That is, ENE wasn't making itself look stellar...just making itself look like it wasn't unsuccessful
- Consider: An internal report: Enron's international assets were:
 - Carried at: \$10.1B (\$33B total assets at FYE99)
 - Internal estimated value: \$4.5 to \$6.9 Billion
 - Write down? ...NO. Used "sales to SPE's and M2M to show earnings, cash flows and hide debt

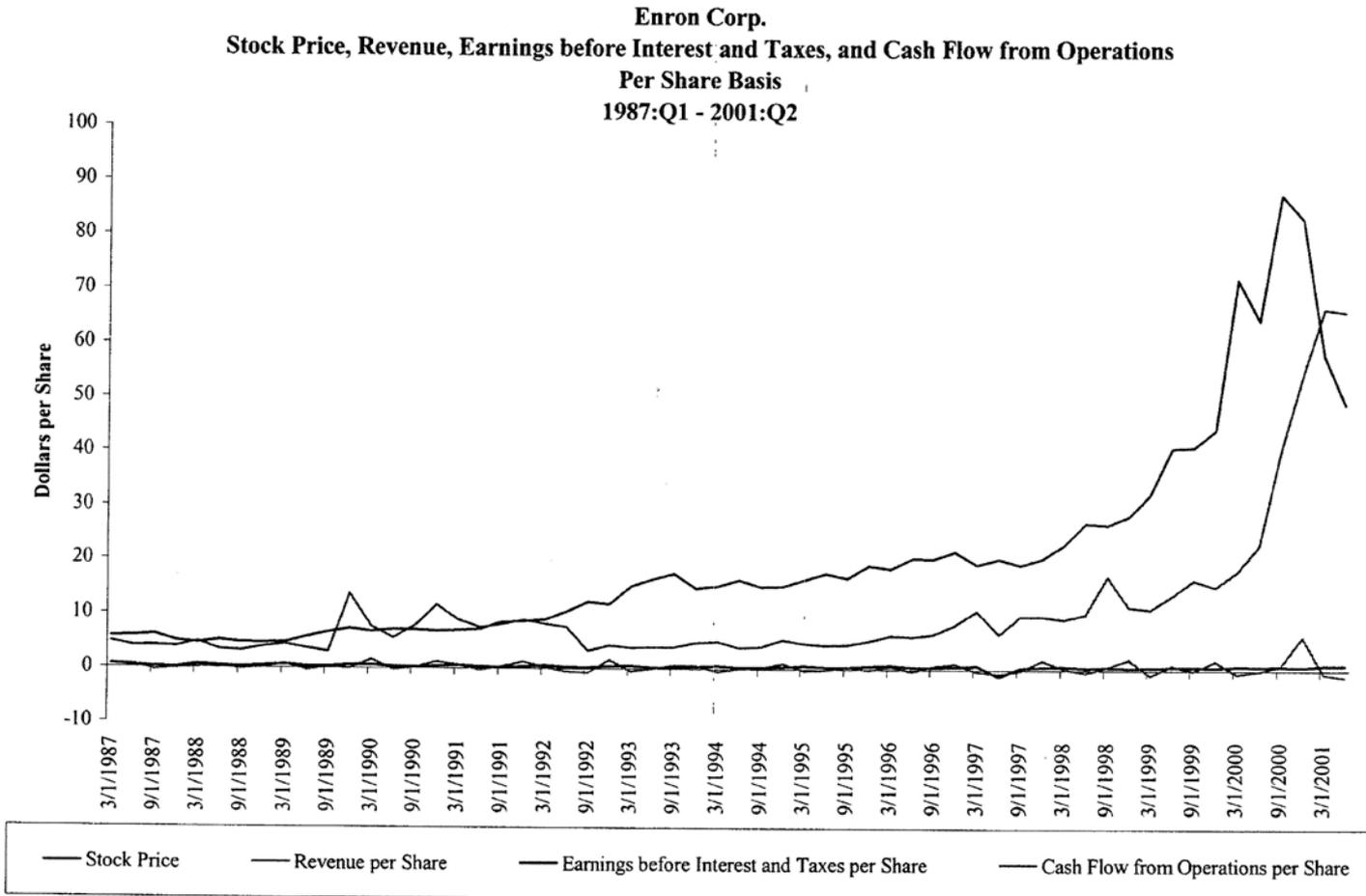
ENRON ROA and ROE Time Series:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
						(3)/(5)	(3)/(2)	(2)/(5)	(4)/(6)	(4)/(2)	(2)/(5)	(5)/(6)
			<i>Net</i>	<i>Total</i>	<i>Stock.</i>	<i>ROA</i>	<i>Margin</i>	<i>Asset</i>	<i>ROE</i>	<i>Net</i>	<i>Asset</i>	<i>Leverage</i>
<i>Year</i>	<i>Revenue</i>	<i>EBIT</i>	<i>Income</i>	<i>Assets</i>	<i>Equity</i>	<i>b4 tax</i>	<i>on Sales</i>	<i>Turnover</i>		<i>Margin</i>	<i>Turnover</i>	
1995	9189	1165	520	13239	3165	8.80%	12.68%	0.69	16.43%	5.66%	0.69	0.76
1996	13289	1238	584	16137	3723	7.67%	9.32%	0.82	15.69%	4.39%	0.82	0.77
1997	20273	565	105	22552	5618	2.51%	2.79%	0.90	1.87%	0.52%	0.90	0.75
1998	31260	1582	703	29350	7048	5.39%	5.06%	1.07	9.97%	2.25%	1.07	0.76
1999	40112	1995	1024	33381	9570	5.98%	4.97%	1.20	10.70%	2.55%	1.20	0.71
2000	100789	2482	979	65503	11470	3.79%	2.46%	1.54	8.54%	0.97%	1.54	0.82

Failed business model?

The market, perhaps, was NOT paying attention to earnings

- ...It was the “dot.com” go-go era

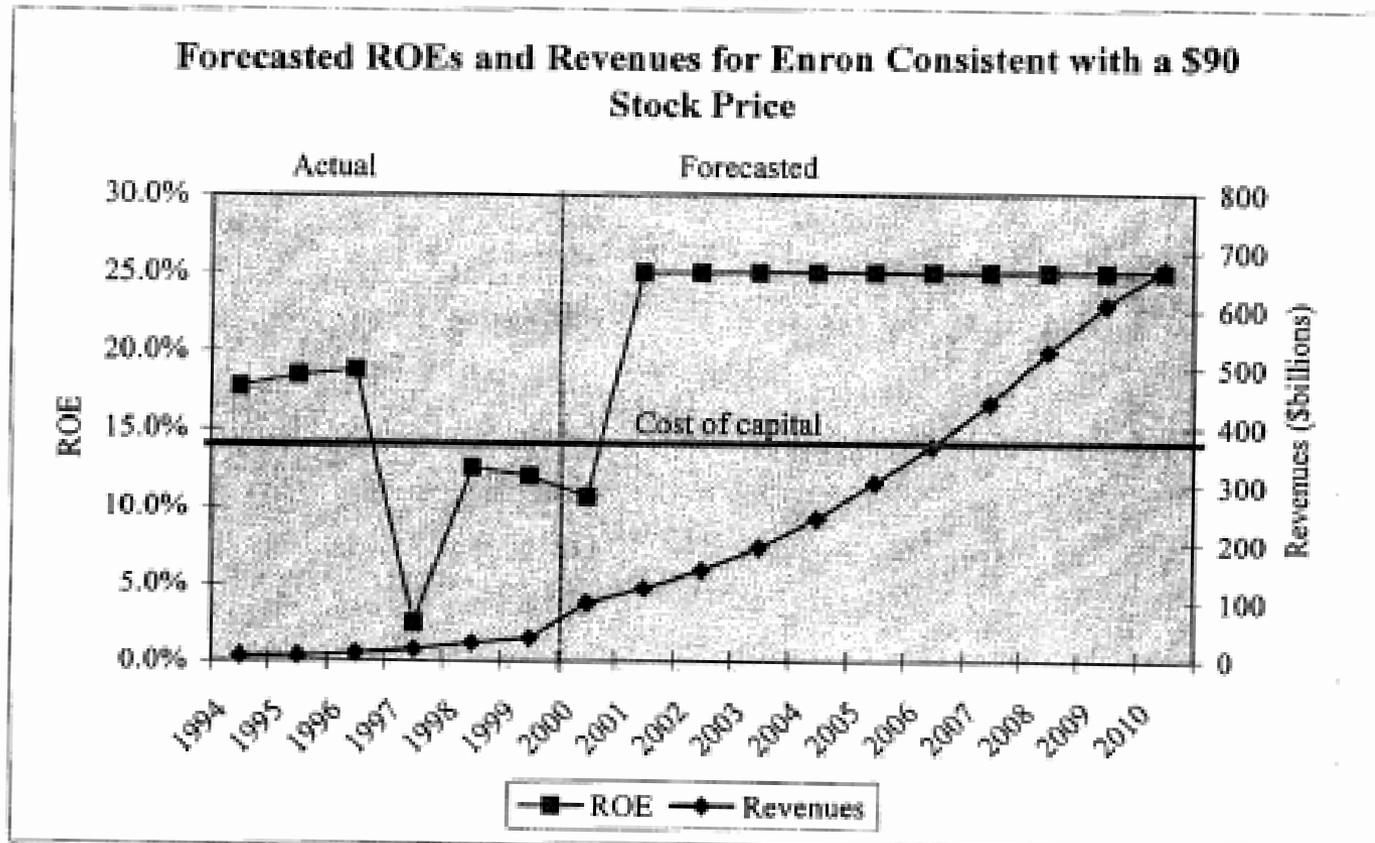


Sources: CRSP, SEC Filings.

Failed business model overpriced?

A standard valuation model used to forecast ROE and revenues

- Source: Healy and Palepu





Fraud and accounting misrepresentations

Accounting techniques

Six accounting techniques

- **1. FAS 140 Transactions (Not consolidating SPE's (Special Purpose Entities)**
 - Recorded as sales to SPE's although ENE assumed responsibility for repayment of debt of SPE to outside investors if assets sold to SPE didn't perform (therefore not an economic transfer of risk...not a sale)
 - Also supported performance of SPE equity owners by offering to give ENE stock if SPE assets didn't perform
 - See discussion of SPE's
- **2. Minority Interest Transactions**
 - Allowed ENE to obtain funds while showing proceeds as “minority interest” rather than debt
- **3. Prepay Transactions**
 - These were loans disguised as offsetting commodity trades.
 - See discussion

Accounting techniques

Six accounting techniques

- 4. Share Trust Transactions
 - SPE issued notes and equity (with guaranteed payouts) then purchased assets from ENE.
 - But repayment of notes and equity guaranteed by ENE. Therefore assets purchased from ENE NOT a sale.
- 5. Tax Transactions
 - Artificial transactions lacking bona fide business purpose. Allowed ENE to record income from future (speculative) tax deductions
 - In the Nigerian Barge transaction and “Cochise” transactions there were verbal understandings that ENE would reacquire the assets after they had been “sold” to generate the tax deductions.
- 6. Non-Economic Hedges
 - Raptor, LJM1 Rhythms. Hedged M2M investments by entering into derivative contracts with counterparties dependent economically on ENE...they were hedging their own risk.
 - Avoided recording losses because the losses were “hedged”

Accounting techniques

Six accounting techniques

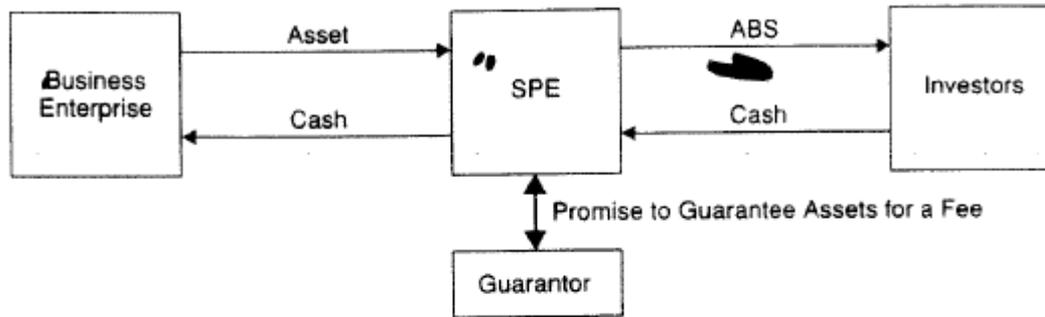
- For FY2000 (last audited financials) these 6 techniques generated:
 - 96% of NI
 - 105% of funds from operations (similar to CFO)
 - Enabled ENE to report \$10.2B debt rather than \$22.1B in debt
- For FY1999 11 such transactions were completed in last two weeks of FY
- Behind the scenes: M2M accounting and compensation incentives based on it
 - Under a “failed business model” view ENE wasn’t looking stellar, just trying to avoid looking like a failure

Accounting: Intro to SPE

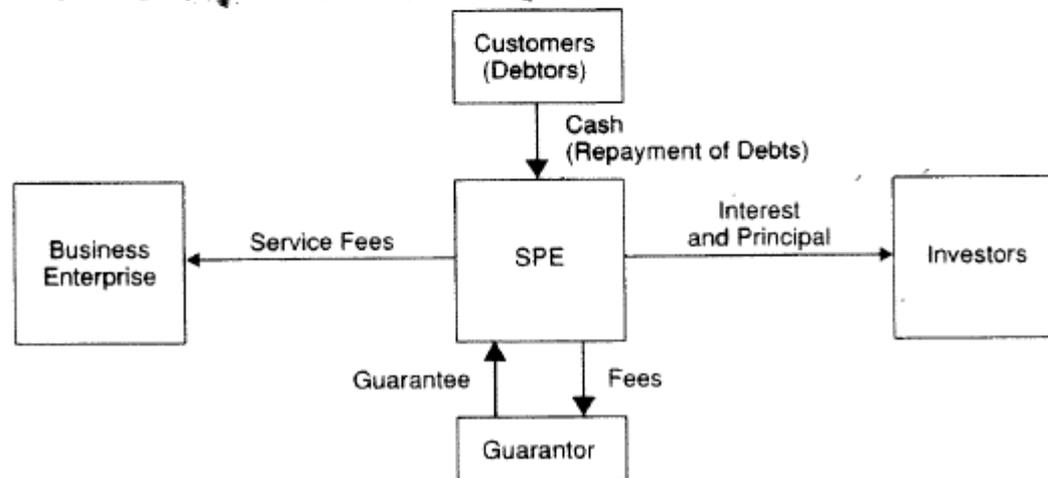
An SPE is a legal corporation set up for a special purpose

Exhibit 6.2 Generic Securitization

Panel A: At Creation



Panel B: Processing of Transactions



- E.g.
- Buy accounts receivables from the sponsor
- Then collect the cash
- Then use the cash to pay back any debt and interest
- Use remainder, if any, to pay a dividend to SPE owners
- If don't collect enough cash, use capital from equity owners to pay debt holders
- NOTE: SPE equity at risk

Accounting: Intro to SPE's

ENE violated the typical SPE transaction and accounting

- ENE was the guarantor for many of its SPE transactions
- To make a sale to an SPE (or other entity) the other entity must be independent...its equity must be at risk (otherwise not a sale)
 - ENE should have consolidated the SPE's showing lots of debt and lots of poor performing assets generating no earnings and no cash flows
- This enabled ENE to:
 - Sell to the SPE at an inflated price (avoiding losses or recording uneconomic gains)
 - Transfer large amounts of cash to ENE to “feed the beast”
 - Manage earnings (many of these transactions done at end of quarter/end of year)
 - Avoid disclosing debt that it was economically responsible for (since it guaranteed payment to the SPE investors)

Accounting: Intro to SPE's

ENE violated the typical SPE transaction and accounting

- In setting up the SPE's, Fastow was the managing partner, or his subordinates were
- Since he was dealing with himself, he:
 - Took large management fees
 - Paid cash to friends/family/colleagues who invested in the SPE's
 - Invested himself
- The ENE Board gave an exception to its employee code of conduct to allow Fastow to open his fund:
 - From “The Smartest Guys in the Room”: “In May 2000, the Enron board conducted a “review” of Fastow’s private fund. Fastow told the finance committee that the fund expected a modest annual return of about 17.95 percent. What Fastow didn’t mention was that *on that very day*, the Enron “investors” in his Southampton partnership were receiving wire transfers divvying up more than \$12 million.”
- How can the same person represent both sides and expect a fair outcome???

Accounting: Intro to SPE's

ENE violated the typical SPE transaction and accounting

- In other SPE transactions ENE “sold” its stock to an SPE and retained a non-controlling interest (50% ownership of the SPE)
 - When ENE’s stock increased in price the SPE M2M its ENE stock investment, increasing SPE income.
 - ENE, as non-controlling owner recorded its 50% of the SPE income as its own income
 - It is a violation of GAAP for a firm to record an increase in its own share price and show it as income.
 - Sometimes the SPE didn’t pay for the ENE stock immediately.
 - It is a violation of GAAP to accept a receivable (an IOU) in exchange for issuing stock

Accounting: Intro to SPE's

These various transactions had colorful names

- Whitewing
- Osprey
- LJM SPE (named after Fastow's family's first names)
- Raptors
- Rhythms hedges
- Chewco
- Jedi
- Bacchus
- Nakita
- Cochise
- Sundance (forest products)
- Mahonia and Yosemite prepay transactions
- Talon
- Nahanni

Accounting: Prepays were loans

Prepay Transactions

- In the Prepay Transactions, Enron obtained financing and accounted for its obligations as price risk management liabilities (short term operating liabilities) rather than debt.
- Moreover, the increase in the outstanding prepay balance from one reporting period to the next served to increase Enron's reported CFO.
- In substance, however, these transactions were loans because Enron transferred no commodity price risk, and the proceeds it received had to be repaid with interest at fixed maturity dates.
- The amounts due, interest rates accrued on the unpaid balances, schedule of maturities and portion of operating cash flow attributable to the transactions could not be discerned from Enron's financial statements or MD&A (and thus were misleading).

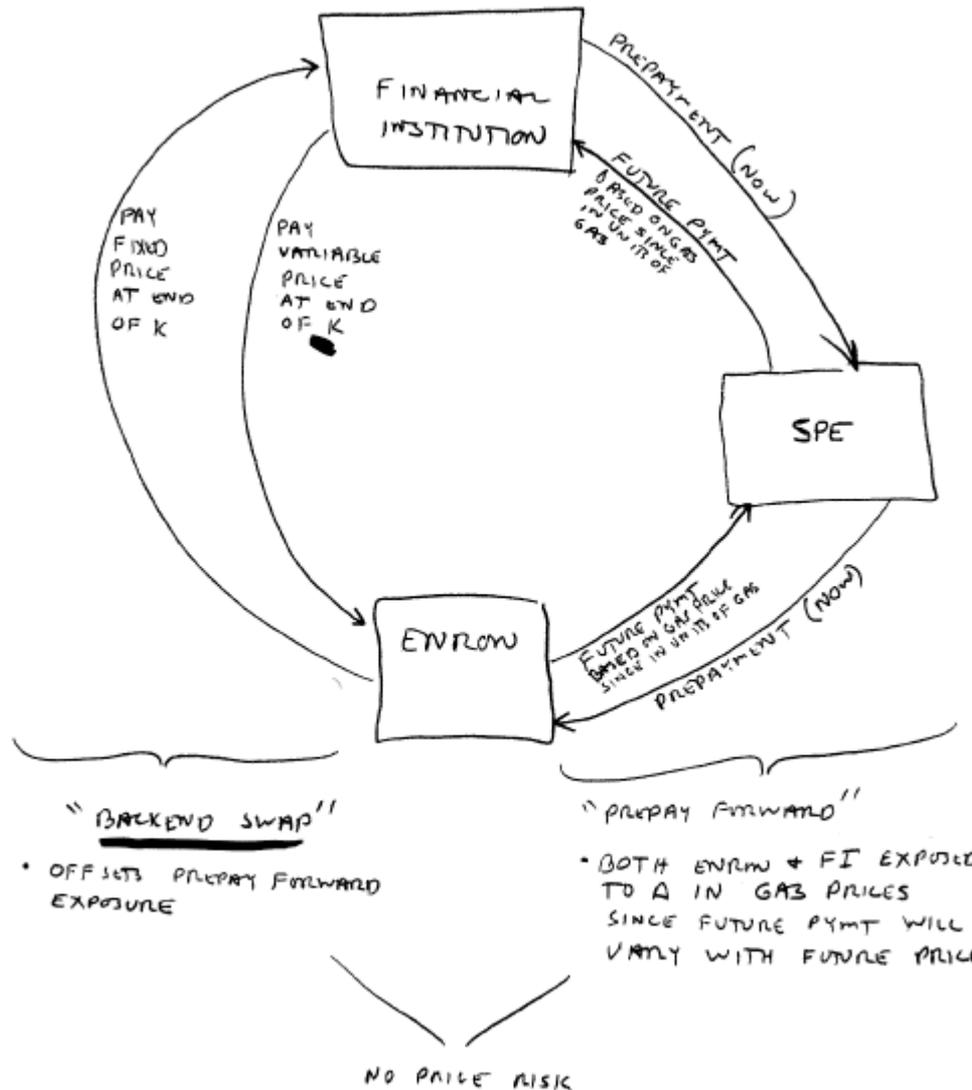
Accounting: Prepays were loans

Prepay Transactions

- As noted by Ibankers at Chase and Citibank in their INTERNAL emails:
- *“smoke and mirrors”*
- *“E gets money that gives them C flow but does not show up on the books as big D Debt”*
- The accounting...

Accounting: Prepays were loans

Prepay Transactions



- Notice that if the prepay and swap are set up at the same time, it is a loan... price changes for the commodity do not impact the net results.

Accounting: Prepays were loans

Prepay Transactions

- Accounting example for the Prepay Transactions:
- Qty: 10,000,000 MBTU at \$2.00

Date	Prepay		Swap	
1/1/xx	Cash	20,000,000	No Entry	
	Operating Liabilities	20,000,000		
	Recorded as CFO		Swap fixed @\$2.05	\$0.05 is Interest
3/31/xx	I/S	1,000,000	Operating Assets	500,000
	Operating Liabilities	1,000,000	I/S	500,000
	Price change to \$2.10		$(2.10-2.05)*10M$	
6/30/xx	I/S	200,000	Operating Assets	200,000
	Operating Liabilities	200,000	I/S	200,000
	Price change to \$2.12		$(2.12-2.10)*10M$	
6/30/xx	Operating Liabilities	21,200,000	Cash	700,000
	Cash	21,200,000	Operating Assets	700,000

Accounting techniques

Six accounting techniques

- Of the 6 accounting techniques, each involved some form of self dealing
 - 1. FAS 140 Transactions (Not consolidating SPE's (Special Purpose Entities)
 - 2. Minority Interest Transactions
 - 3. Prepay Transactions
 - 4. Share Trust Transactions
 - 5. Tax Transactions
 - 6. Non-Economic Hedges
- Behind the scenes...more self dealings with:
 - 7. **M2M accounting**

There were red flags!

Consider this analyst report available at:

http://www.offwallstreet.com/reports/NEW_ENE_5.6.01.pdf

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New Rec: Enron Corp. (ENE \$59.48) May 6, 2001

Position: Sell Target: \$30 Timing: 2 (1=aggressive; 5=cautious)

There were red flags!

Consider this analyst report

..."Because margins on Enron's incremental business are so thin, and **because it now takes about \$2.1B in additional revenues just to generate an additional penny of after tax earnings**, it probably should come as no surprise that Enron management appears to have resorted to a variety of transactions that are of questionable quality and sustainability to manage and to boost its earnings. **These transactions appear to be purposely obscured in Enron's public reporting. They include related party transactions whose total earnings impact is difficult to gauge, and they include gain on sale items that are of questionable quality and where the buyer appears to have recourse.** In the past, when Enron management has been questioned about some of these transactions, it has not been forthcoming."

Lessons?

Multitude of lessons

- Ethics, compensation design and internal controls matter
- Tendency to behave similarly to those immediately around us. Think about this when you are working
 - Many ENE employees were aware they were stealing from and lying to shareholders or aware that many others were doing so.
 - Very well documented throughout ENE
- Read annual reports, critically
- Learn accounting, critically. A lot of people lost a lot of wealth
- Diversify



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