Dr. Renuka Bakshi et .. al Journal of Management Research and Analysis (JMRA)
Available online at http://jmraonline.com
ISSN: 2394-2770, Impact Factor: 6.303, Volume 6 Issue 02, February -2019, Pages:190-200

CASE STUDY ON ENRON – THE FALLING STAR

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INTRODUCTION: -

The case of Enron Corporation (USA), biggest failure of America was related to the accounting problems of WINDOW DRESSING, the NEGLIGIENCE OF THE CORPORATE GOVERNANCE and the NEGLIGIENCE OF CORPORATE FINANCIAL REPORTING. These terms are crucial for every Organization. Window Dressing is basically improving the appearance of company's financial statements that are Profit and Loss Account, Balance sheet, Cash flow Statement and various other reports before presenting it to its Shareholders and Stakeholders. This was against the rule of corporate financial reporting as it says that there must be TRUE and FAIR view of all the Financial Statements of an organization. Principles of corporate financial reporting include going concern, Materiality and Objectivity. While, these principles were ignored by the Corporation. Moreover, Corporate Governance is a bundle of Rules, Regulations, Codes, Practices and principles regarding the rights and responsibilities of all the people working in an Organization such as Directors, Managers, Shareholders and other Stakeholders. It works to protect the interest of the shareholders as well stakeholders. Therefore, it is important for every organization to follow these practices to survive in the economy otherwise it will face a severe downfall like Enron Corporation.

Downfall of ENRON CORPORATION was also related to the ignorance of some Accounting standards. Those ignored Accounting standards were: -

1. AS-1: Disclosure of Accounting policies.
2. AS-9: Revenue Recognition
3. IAS-27: Consolidated Financial statements and accounting for investment in subsidiaries

AS-1: Disclosure of Accounting policies

IAS-1 deals with Presentation of financial statements as to how should they include the contents of the financial presentation, their structure etc. The objective of this IAS is to define and prescribe the basis of the presentation of general purpose financial statements to ensure comparability of financial statements of previous years and with that of financial statements of other entities.

With ENRON's case, the financial statements of the organization were tampered at the hands of those who prepared the accounting rules Financial Accounting Standards Board. Not only did they capitalize on the loopholes of in the standards but they also fabricated the presentation of the financial statements of the company. The income statements showed a drastic increase in the revenue of the organization from $40112 in 1999 to $100789 in 2000.

Not only that, there were contradictions as to what cash flows and balance sheet displayed. The company had been falsifying and manipulating its accounts since years.

AS-9: Revenue Recognition

The particular IAS describes as to when the revenue is to be recognized from the sale of goods and services, rendering of royalties and dividends. It provides the framework for recognition of revenue that implies incorporating an item income statement that meets the definition of revenue. Enron used to provide services such as wholesale trading and risk management in addition to energy building and maintaining energy power plants. Enron, through this process chose to report the entire value of the trades as their revenue that lead to a multifold growth in the company's revenue by more than 750%.

Not only that, Enron used mark to market method of accounting, which implied that once a contract was signed, the income was estimated as the present value of net future cash flows.

Hence, the accounts were again falsified to show a rosy picture of the organization.

IAS-27: Consolidated Financial statements and accounting for investment in subsidiaries

This Indian Accounting Standard came into effect from 1987 and stated that the Financial Statements of parent and subsidiary companies will be prepared or presented in a consolidated manner. Obviously, it will be presented or prepared by the parent or holding company. In addition to this, Investments made in subsidiary company by parent company must be disclosed in the accounts of Parent company.

But, the problem occurred when Enron formed various Special Purpose Entities and invested in them hugely to hide its debt. It never disclosed this fact to any its shareholders and other stakeholders. Also, it didn't give any hint regarding this in its Financial Statements

OVERVIEW OF ENRON COMPANY

Enron was a Public company incorporated in 1930 as northern natural gas company in Omaha. In 1947, the company was listed on New York Stock Exchange. The company's name changed to Internorth Inc in 1980 and in 1985 a merger with Houston Natural Gas Corporation took place. Then finally company's name was changed to Enron which headquartered in Houston.

The key persons of the company were Kenneth lay (Founder, chairman and CEO), Jefferey Skilling (Former President, COO, CEO), Andrew Fastow (Former CFO). Arthur Andersen was appointed as company's auditor. By 1992, the organization became the largest seller in North America. It earned $122 million through its gas contracts. Growth of the company was on its peak. To achieve further growth, it adopted diversification strategy. The company owned various assets such as gas pipelines, electricity plants, pulp and paper plants, water plants, and broadband services.

Enron built its first overseas power plant in Teesside, England, in 1991. During the 1990s Enron aggressively invested in building power plants all over the globe, including such places as Italy, Turkey, Argentina, China, India, Brazil, Guatemala, Bolivia, Columbia, the Dominican Republic, Poland, and the Philippines. Enron made a major commitment to the construction of a massive power plant in India, the largest foreign investment in the country, but Enron took a significant loss from the project.

By 2000, following were the signs of growth: -

1. Employees increased from 15076 to 30000 in 20 countries around the world.
2. Stocks increased by 311%.
3. Stock price was $83.13.
4. Revenues generated $139 billion.
5. Total assets acquired equaled $62 billion.
6. Fortune named it 'America's most innovative company.
7. It was the 7th giant corporate organization in the world.

But, on December,2001, Enron filed for bankruptcy. Shareholders were getting confused due to complex financial statements of the company. Sherron Watkins, an employee of the company complained in 1991 about the accounting practices of the company but she was shifted to another department and here complaints and allegations were ignored. But she again raised the matter of excessive funds and complex financial statements in 2001. Then this scandal came to light and was taken as the biggest corporate failure in America's history. This downfall was complex enough that the judges and other people were not able to understand the financial statements of the company. Its failure is one of the biggest accounting and auditing practices failure to be recorded in American Corporate history.

REASONS FOR ENRON SCANDAL

Enron's scandal led to its bankruptcy in 2001. A huge organization was blown to smithereens. Enron's shareholders filed a $40 billion lawsuit after company's stock price nosedived. But what really caused such a mishap?

The financial statements of the organization were extremely complex to the shareholders and the analysts. Even the business model of the organization was arduous. Unethical practices were been conducted in the organization.

The corporation used accounting limitations to misrepresent earnings and modify the balance sheet to indicate a rosy picture of actually far from favorable performances.

The various reasons for Enron's scandal are:

1)**REVENUE RECOGNITION:**

In addition to building and maintaining energy power plants, Enron provided services like wholesale trading & risk management. At the time of acceptance of buying and selling risk of the products by merchants, they were allowed to report and products' cost as Cost of Goods Sold and the selling price as revenues. But when an agent provides service to the customers, he does not take same risks. While acting as an agent, the service provider were able to report trading and brokerage fees as revenue, although not for the full value of the transaction.

Enron chose to report the entire value of each of its trades as revenue. This led to an increase in company's revenue multifold by more than 750% rising from $13.3 billion in 1996 to $100.8 billion in 2000, just within 4 years. This placed the company at sixth spot on Fortune Global 500 index.

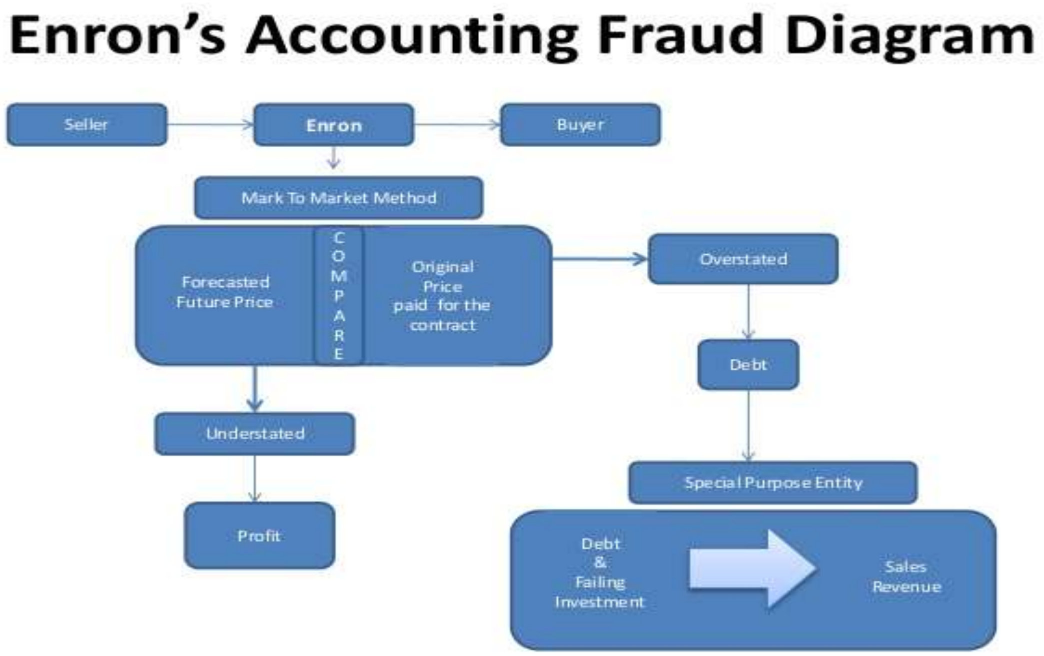
2) **MARK TO MARKET ACCOUNTING:**

Mark to market method requires that once a long-term contract was signed, income is estimated as the present value of net future cash flow.

ISSN: 2394-2770, Impact Factor: 6.303, Volume 6 Issue 02, February -2019, Pages:190-200

Prior to Jeffery Skilling joining the corporation, Enron's accounting was fairly straightforward. Post his appointment he demanded the trading business to be conducted on mark to market model. Investors were often given false and misleading reports. Using this method, income of the projects could be recorded even if the money hasn't been received as of yet. Enron later expanded this method to other areas of the company to help it meet Wall Street projections.

A contract with *Blockbuster video* was signed as a 20-year agreement to introduce on demand entertainment to various U.S. cities by year-end. Enron estimated the profits at $110 million even when the technical viability of the deal was questioned. The deal failed eventually and blockbuster video withdrew from the contract but Enron continued to recognize future profits.



3**)** **<u>SPECIAL PURPOSE ENTITIES</u>**:

Special purpose entities are the legal entities created to fulfill narrow, specific or temporary objectives. They are basically used to isolate companies from financial risks. Enron used hundreds of SPE's to hide its debt.. The shareholders were disclosed that the organization hedged downside risk in its own illiquid investments using SPE's when in reality these SPE's were using company's own stock and financial guarantees to finance the hedges.

4) **<u>CORPORATE GOVERNANCE</u>**:

The corporate governance model of Enron was complicated. It had a model board of directors comprising predominantly of outsiders with significant stakes and a talented audit committee. The business model of the organization was complicated still it attracted a large sum of capital.

The overall corporate governance of Enron was weak. The board of directors comprised of people who lacked moral character. This was one of the crucial reasons why Enron collapsed.

FINANCIAL AUDIT

Various CPA's and accountants were hired by Enron who had worked on developing accounting rules with Financial Accounting Standards Board. The accountants basically searched for the loopholes in the standards and capitalized on it. Enron's management pressurized Anderson's auditors to defer recognizing the charges from SPE's as its credit risks became known. The SPE's never returned the profit, but the organization was required by the accounting standards to be written off and removed from balance sheet at a loss. Arthur Anderson was accused of not performing its moral, ethical and professional responsibilities in connection with Enron's financial statements. Even the board wasn't informed of the contracts of internal management.

Both the organizations shook hands to do something that would result in a total disaster.

6) **AUDIT COMMITTEE**:

Enron's audit committee was inadequate and wasn't functioning properly. The members of the committee did not have the power and knowledge to question the auditors on matters relating to company accounts of the organization. Pressure was put onto the committee by the company.

The conflicts of interests of Enron's committee were regarded with suspicion once the issue became public.

7) **RISK MANAGEMENT**:

Enron was appreciated for its sophisticated risk management tools.

These causes have done serious complexities in the financial statements of the company. This can be concluded by understanding the statements. So, statements are as under.

BRIEF EXPLANATION RELATED TO FINANCIAL STATEMENTS

In income statements revenue is drastically increasing from $40112 in 1999 to $100789 in 2000. This is because of adopting the merchant model of revenue recognition instead of agent model. Cost and expenses are also increasing from $39310 to $98836. This is because the company was spending aggressively. In addition to this, executives were also focusing on the short-term earnings but they had large expense account.
The cashflow statement of the company showed a positive cash inflow of the company. By bifurcating it showed that from investing activities there was a cash outflow of $4264 which has even increased from $3507 in 1999. By comparing two consecutive years 1999 and 2000, financing activities also showed a decrease in cash inflow of the company from $2456 to $571. That means all the cash generated was from operating activities.
As the cash inflow from financing activities was showing a decline in 2000 that means there was a decrease in cash raised from different sources. But in balance sheet long term loans/debts were increasing even by double amount from $6471 to $13759 and shares issued were also increased from $6637 to $8348. This was a contradictory situation in the financial statements of the company.
Total cash used in 1999 was $(1000) but is drastically increased to $1769 in 2000 which was even more than double. Whereas, company was focusing on the short term earning but they had a large expense account and were spending excessively. Despite all the following facts,

- An outflow of cash in financing activities.
- A decrease in the cash inflow of investing activities.
- An increase in the long-term debts of the company.

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- Purchase of non-current assets.
- Too much spending.

Still there was a continuous rise in the cashflow of the company. So, here main question arose that after excessive spending and investments in the assets from where all the cash was generating. So, it came into the consideration that company was falsifying or manipulating its accounts since years and was showing only profits and incomes to the shareholders and investors. It was doing this to increase the returns and stock prices of the company. In year 2000, cumulative total return of the company was 1415% and stock price of the Enron was $99.95. Even directors and executives of Enron earned $1.1 billion by selling 17.3 million shares. But, from 2000 to 2002 stock prices of Enron started declining. In 201, it started incurring losses and in 2002 it come to an end.

This can be seen in the following chart showing the different phases of stock prices of the Enron from year 2000 to 2002. As at point (A), Enron was at its peak it was the time of year 2000 when it was recognized as the most innovative company. At point (B), company earned $1.1 billion by selling 17.3 million shares. In the first quarter of the 2001, it was earning some profits which was shown by point (C) but in the second quarter of the 2001, it started incurring loss as shown from

points (D) to (F). Eventually, in third quarter of 2001 it incurred a huge loss which amounted nearly $618 million shown by point (G). At point (I), it came to a shut down point and filed for bankruptcy.

AFTERMATH OF ENRON SCANDAL

Enron's scandal is still known as one of the biggest corporate scandals in the US history.

1. It is since been studied by management and corporate students. The scandal resulted in a loss of $74 billion of its shareholders. Around 4500 of its employees lost their jobs.

2. Since a lot of investors' money was tied with the pension and retirement schemes, the pension fund of the employees was destroyed. They lost some $60 billion in their age-old security.
3. Enron owed nearly $67 billion to its creditors. The stakeholders of the organization received very limited, if any assistance from the organization.
4. American citizens' trust in the country's economic system was obliterated.
5. Arthur Anderson lost its accreditation. Around 85,000 of its employees lost their jobs. The organization that was one of the largest auditing firms, lot all its reputation. Even its former big shot clients terminated their respective contracts and instead shifted to the other big fours i.e. Deloitte, PwC, KPMG and E&Y.
6. The accounting reporting standards for the organizations were sharpened.
7. The banks were suspected of collusion. Citigroup and JP Morgan Chase lost a significant amount leading to Enron's bankruptcy.

RECOMMENDATIONS TO AVOID SIMILAR FRAUDS

1. **Presence of Independent and external auditors** will help in avoiding frauds in companies. In this case, Andersen did not play any role in avoiding the fraud, rather He indulged in the mischief and that led to a disastrous scandal.
2. **Financial disclosures** must be made mandatory for all the companies. As full disclosure is the basic principal of corporate financial reporting, Enron didn't disclose their accounts and financial statements and that led to fraud.
3. **Worker's protection council** must be there in every organization which can protect workers from the consequences of fraud. As after this Enron case almost all the workers lost their jobs and livelihood.
4. **Pension security scheme** should be in every organization to protect the pension fund of workers. Because of absence of such kind of schemes many employees lost their pension fund.
5. **Presence of Strong whistle blower system** is important in every organization. In 1996, Sherron Watkins, an employee of the company was shifted from one department to another due to the absence of whistle blower system.
6. **Carrot and stick approach** can also help in preventing frauds. Instead of transferring Employees like Sherron Watkins, they should be rewarded for their honesty. Rewards will encourage employees to keep an eye on all over the organization.
   Stick should be used in the terms of penalty and conviction.
7. **Reduction in the time period of director's appointment** may also help in this.

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Book

CORPORATE GOVERNANCE BOOK BY C.B.GUPTA

Annexure

INCOME STATEMENT OF THE COMPANY

Enron Corp. and Subsidiaries Consolidated Income Statement

(In millions, except per share amounts)	Year ended December 31, 2000	1999	1998
Revenues			
Natural gas and other products	$ 50,500	$19,536	$13,276
Electricity	33,823	15,238	13,939
Metals	9,234	-	-
Other	7,232	5,338	4,045
Total revenues	100,789	40,112	31,260
Costs and Expenses			
Cost of gas, electricity, metals and other products	94,517	34,761	26,381
Operating expenses	3,184	3,045	2,473
Depreciation, depletion and amortization	855	870	827
Taxes, other than income taxes	280	193	201
Impairment of long-lived assets	-	441	-
Total costs and expenses	98,836	39,310	29,882
Operating Income	1,953	802	1,378
Other Income and Deductions			
Equity in earnings of unconsolidated equity affiliates	87	309	97
Gains on sales of non-merchant assets	146	541	56
Gains on the issuance of stock by TNPC, Inc.	121	-	-
Interest income	212	162	88
Other income, net	(37)	181	(37)
Income Before Interest, Minority Interests and Income Taxes	2,482	1,995	1,582
Interest and related charges, net	838	656	550
Dividends on company-obligated preferred securities of subsidiaries	77	76	77
Minority interests	154	135	77
Income tax expense	434	104	175
Net income before cumulative effect of accounting changes	979	1,024	703
Cumulative effect of accounting changes, net of tax	-	(131)	-
Net Income	979	893	703
Preferred stock dividends	83	66	17
Earnings on Common Stock	$ 896	$ 827	$ 686
Earnings Per Share of Common Stock			
Basic			
Before cumulative effect of accounting changes	$ 1.22	$ 1.36	$ 1.07
Cumulative effect of accounting changes	-	(0.19)	-
Basic earnings per share	$ 1.22	$ 1.17	$ 1.07
Diluted			
Before cumulative effect of accounting changes	$ 1.12	$ 1.27	$ 1.01
Cumulative effect of accounting changes	-	(0.17)	-
Diluted earnings per share	$ 1.12	$ 1.10	$ 1.01
Average Number of Common Shares Used in Computation			
Basic	736	705	642
Diluted	814	769	695

Enron Corp. and Subsidiaries Consolidated Statement of Comprehensive Income

(In millions)	Year ended December 31, 2000	1999	1998
Net Income	$ 979	$ 893	$ 703
Other comprehensive income:			
Foreign currency translation adjustment and other	(307)	(579)	(14)
Total Comprehensive Income	$ 672	$ 314	$ 689

The accompanying notes are an integral part of these consolidated financial statements.

BALANCE SHEET OF THE COMPANY

Enron Corp. and Subsidiaries Consolidated Balance Sheet

December 31, (In millions, except shares)	2000	1999
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,374	$ 288
Trade receivables (net of allowance for doubtful accounts of $133 and $40, respectively)	10,396	3,030
Other receivables	1,874	518
Assets from price risk management activities	12,018	2,205
Inventories	953	598
Deposits	2,433	81
Other	1,333	535
Total current assets	30,381	7,255
Investments and Other Assets		
Investments in and advances to unconsolidated equity affiliates	5,294	5,036
Assets from price risk management activities	8,988	2,929
Goodwill	3,638	2,799
Other	5,459	4,681
Total investments and other assets	23,379	15,445
Property, Plant and Equipment, at cost		
Natural gas transmission	6,916	6,948
Electric generation and distribution	4,766	3,552
Fiber-optic network and equipment	839	379
Construction in progress	682	1,120
Other	2,256	1,913
	15,459	13,912
Less accumulated depreciation, depletion and amortization	3,716	3,231
Property, plant and equipment, net	11,743	10,681
Total Assets	$65,503	$33,381

The accompanying notes are an integral part of these consolidated financial statements.

BALANCE SHEET OF THE COMPANY

December 31,	2000	1999
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 9,777	$ 2,154
Liabilities from price risk management activities	10,495	1,836
Short-term debt	1,679	1,001
Customers' deposits	4,277	44
Other	2,178	1,724
Total current liabilities	28,406	6,759
Long-Term Debt	8,550	7,151
Deferred Credits and Other Liabilities		
Deferred income taxes	1,644	1,894
Liabilities from price risk management activities	9,423	2,990
Other	2,692	1,587
Total deferred credits and other liabilities	13,759	6,471
Commitments and Contingencies (Notes 13, 14 and 15)		
Minority Interests	2,414	2,430
Company-Obligated Preferred Securities of Subsidiaries	904	1,000
Shareholders' Equity		
Second preferred stock, cumulative, no par value, 1,370,000 shares authorized, 1,240,933 shares and 1,296,184 shares issued, respectively	124	130
Mandatorily Convertible Junior Preferred Stock, Series B, no par value, 250,000 shares issued	1,000	1,000
Common stock, no par value, 1,200,000,000 shares authorized, 752,205,112 shares and 716,865,081 shares issued, respectively	8,348	6,637
Retained earnings	3,226	2,698
Accumulated other comprehensive income	(1,048)	(741)
Common stock held in treasury, 577,066 shares and 1,337,714 shares, respectively	(32)	(49)
Restricted stock and other	(148)	(105)
Total shareholders' equity	11,470	9,570
Total Liabilities and Shareholders' Equity	$65,503	$33,381

Enron Corp. and Subsidiaries Consolidated Statement of Cash Flows

	Year ended December 31,		
(In millions)	2000	1999	1998
Cash Flows From Operating Activities			
Reconciliation of net income to net cash provided by operating activities			
Net income	$ 979	$ 893	$ 703
Cumulative effect of accounting changes	-	131	-
Depreciation, depletion and amortization	855	870	827
Impairment of long-lived assets (including equity investments)	326	441	-
Deferred income taxes	207	21	87
Gains on sales of non-merchant assets	(146)	(541)	(82)
Changes in components of working capital	1,769	(1,000)	(233)
Net assets from price risk management activities	(763)	(395)	350
Merchant assets and investments:			
Realized gains on sales	(104)	(756)	(628)
Proceeds from sales	1,838	2,217	1,434
Additions and unrealized gains	(1,295)	(827)	(721)
Other operating activities	1,113	174	(97)
Net Cash Provided by Operating Activities	4,779	1,228	1,640
Cash Flows From Investing Activities			
Capital expenditures	(2,381)	(2,363)	(1,905)
Equity investments	(933)	(722)	(1,659)
Proceeds from sales of non-merchant assets	494	294	239
Acquisition of subsidiary stock	(485)	-	(180)
Business acquisitions, net of cash acquired (see Note 2)	(777)	(311)	(104)
Other investing activities	(182)	(405)	(356)
Net Cash Used in Investing Activities	(4,264)	(3,507)	(3,965)
Cash Flows From Financing Activities			
Issuance of long-term debt	3,994	1,776	1,903
Repayment of long-term debt	(2,337)	(1,837)	(870)
Net increase (decrease) in short-term borrowings	(1,595)	1,565	(158)
Net issuance (redemption) of company-obligated			
preferred securities of subsidiaries	(96)	-	8
Issuance of common stock	307	852	867
Issuance of subsidiary equity	500	568	828
Dividends paid	(523)	(467)	(414)
Net disposition of treasury stock	327	139	13
Other financing activities	(6)	(140)	89
Net Cash Provided by Financing Activities	571	2,456	2,266
Increase (Decrease) in Cash and Cash Equivalents	1,086	177	(59)
Cash and Cash Equivalents, Beginning of Year	288	111	170
Cash and Cash Equivalents, End of Year	$ 1,374	$ 288	$ 111
Changes in Components of Working Capital			
Receivables	$(8,203)	$ (662)	$(1,055)
Inventories	1,336	(133)	(372)
Payables	7,167	(246)	433
Other	1,469	41	761
Total	$ 1,769	$(1,000)	$ (233)

The accompanying notes are an integral part of these consolidated financial statements.