

# Enron's Demise Were There Warning Signs Harvard Case Solution & Analysis

John Clifford Baxter

**In class References to Accounting Improprieties**  
 Revenue Recognition Principle - states that revenues can be recorded in the books in advance of the transaction.  
 Revenue being recognized - a long-standing accounting principle that means accounting for a business expense based on recognizing the benefit of the sale of the business.  
 Matching period - each expense item included in the period must be recorded in the same or the following period to ensure a correct balance.

**Avoiding Future Accounting Improperities**  
 The Enron scandal is responsible for the creation of the Sarbanes-Oxley Act, which was passed in 2002. This act was designed to prevent future accounting improprieties by requiring more transparency and accountability from companies.  
 A key provision of the act is the requirement that companies must disclose any financial information that could be considered misleading or deceptive.  
 The act also requires companies to have internal controls in place to ensure the accuracy of their financial statements.  
 It prohibits any act of fraud or other illegal activity in connection with the preparation or maintenance of financial statements.


**Who did the Enron scandal affect?**  
 Enron's downfall resulted in the ripple effect spreading its reaction to others such as the shareholders and Arthur Andersen, the banks and investors.  
 The Enron scandal affected not only companies but the financial world as well.

**EMPLOYEES & ARTHUR ANDERSEN**  
 - Over 40,000 employees lost their jobs  
 - Many lost their savings and investments  
 - Arthur Andersen lost its status as a public company  
 - Many employees lost their homes and cars  
 - Many employees lost their retirement funds  
 - Many employees lost their health insurance  
 - Many employees lost their life savings  
 - Many employees lost their families  
 - Many employees lost their lives


**INVESTORS & BANKS**  
 - Enron's collapse caused a loss of confidence in the company  
 - Many investors lost their money  
 - Many banks lost their deposits  
 - Many banks lost their credit ratings  
 - Many banks lost their ability to lend money  
 - Many banks lost their ability to attract new customers  
 - Many banks lost their ability to compete in the market

**WHO WAS ENRON CORPORATION?**


- Enron was established in 1985 by Kenneth Lay and Jeffrey Skilling.
- The Enron company was the 7th largest corporation in America.
- They were named "America's most innovative company" 6 years in a row.
- One of the largest companies to produce electricity, natural gases, and other communication initiatives such as internet bandwidth, risk management, weather derivatives (weather insurance), etc.
- Created markets where people could trade energy, gas futures, etc.
- The Enron scandal surfaced in the October of 2001, leading to the bankruptcy of the Enron Corporation.
- Enron's net worth valued at over 70 billion dollars before the bankruptcy.




**Revenue recognition**



**Enron Paper Sales**



**Enron's Revenue**



**But how did they manage to get away with it for so long?**



**Parties Involved**

<p><b>Kenneth Lay</b>                  - From 1985 to 2001, Lay was chairman of Enron and CEO of the company.                  - Lay was convicted of securities fraud in 2003.                  - Lay received a 12-month suspended sentence and a \$10 million fine.                  - Lay died in 2005.</p>	<p><b>Jeffrey Skilling</b>                  - Skilling was CEO of Enron from 2001 to 2004.                  - Skilling was convicted of securities fraud in 2006.                  - Skilling received a 24-month suspended sentence and a \$10 million fine.                  - Skilling died in 2009.</p>	<p><b>Andrew Fastow</b>                  - Fastow was CFO of Enron from 1992 to 2001.                  - Fastow was convicted of securities fraud in 2003.                  - Fastow received a 6-month suspended sentence and a \$10 million fine.                  - Fastow died in 2009.</p>	<p><b>Arthur Andersen</b>                  - Arthur Andersen was Enron's auditor from 1985 to 2002.                  - Arthur Andersen was convicted of securities fraud in 2002.                  - Arthur Andersen received a 5-year suspended sentence and a \$10 million fine.                  - Arthur Andersen was later merged with EY.</p>
---	---	---	---

# Enron's Demise Were There Warning Signs Harvard Case Solution & Analysis

John Clifford Baxter

**In class References to Accounting Improprieties**  
 Revenue Recognition Principle - states that revenues can be recorded in the books as soon as they are earned.  
 Revenue recognition - a long-standing accounting principle that states accounting for a business enterprise should be done according to the nature of the underlying business.  
 Matching period - each expense must be recorded in the same period as the revenue that it is related to.

**Avoiding Future Accounting Improperities**  
 The Enron scandal is responsible for the creation of the Sarbanes-Oxley Act of 2002, which established the Public Company Accounting Oversight Board (PCAOB).  
 A public company is one that is registered with the SEC and is required to disclose financial information to the public.  
 Sarbanes-Oxley Act of 2002 - a law that was passed in response to the Enron scandal and other corporate accounting scandals. It was designed to prevent similar incidents from happening again by requiring companies to be more transparent and to have better oversight of their financial reporting.


**Who did the Enron scandal affect?**  
 Enron's downfall resulted in the ripple effect spreading its reaction to others such as the shareholders and Arthur Andersen, the banks and investors.  
 The Enron scandal affected not only companies but the financial world as well.

**EMPLOYEES & ARTHUR ANDERSEN**  
 - Over 40,000 employees lost their jobs  
 - Many lost their savings and investments  
 - Arthur Andersen lost its status as a public accounting firm  
 - Many employees lost their homes and cars  
 - Many employees lost their retirement funds  
 - Many employees lost their health insurance  
 - Many employees lost their life savings  
 - Many employees lost their families' financial security


**INVESTORS & BANKS**  
 - Enron's collapse caused a loss of confidence in the company  
 - Many investors lost their money  
 - Many banks lost their deposits  
 - Many banks lost their credit ratings  
 - Many banks lost their ability to lend money  
 - Many banks lost their ability to attract new customers

**WHO WAS ENRON CORPORATION?**


- Enron was established in 1985 by Kenneth Lay and Jeffrey Skilling.
- The Enron company was the 7th largest corporation in America.
- They were named "America's most innovative company" 6 years in a row.
- One of the largest companies to produce electricity, natural gases, and other communication initiatives such as internet bandwidth, risk management, weather derivatives (weather insurance), etc.
- Created markets where people could trade energy, gas futures, etc.
- The Enron scandal surfaced in the October of 2001, leading to the bankruptcy of the Enron Corporation.
- Enron's net worth valued at over 70 billion dollars before the bankruptcy.




**Revenue recognition**



**Enron Paper Sales**



**Enron's Revenue**



**But how did they manage to get away with it for so long?**



**Parties Involved**

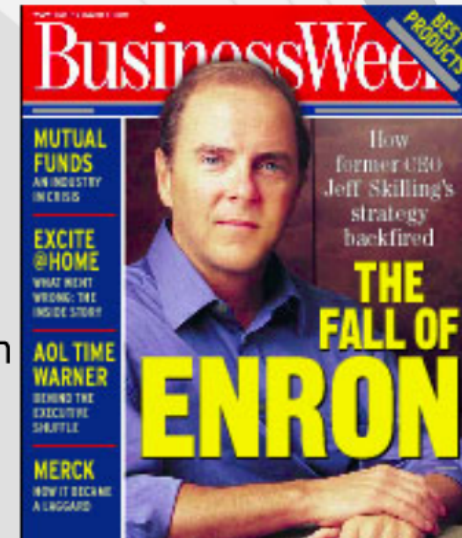
<b>Kenneth Lay</b> - From 1985 to 2001, Lay was chairman of Enron. - Lay was convicted of 11 counts of fraud in the Enron case. - Lay received a 2-year suspended sentence. - Lay was fined \$5 million. - Lay was ordered to pay \$10 million in restitution.	<b>Jeffrey Skilling</b> - Skilling was CEO of Enron from 1999 to 2001. - Skilling was convicted of 11 counts of fraud in the Enron case. - Skilling received a 24-year sentence. - Skilling was fined \$100 million. - Skilling was ordered to pay \$100 million in restitution.	<b>Andrew Fastow</b> - Fastow was CFO of Enron from 1999 to 2001. - Fastow was convicted of 11 counts of fraud in the Enron case. - Fastow received a 2-year sentence. - Fastow was fined \$10 million. - Fastow was ordered to pay \$10 million in restitution.	<b>Arthur Andersen</b> - Andersen was Enron's auditor from 1985 to 2001. - Andersen was convicted of 11 counts of fraud in the Enron case. - Andersen received a 5-year sentence. - Andersen was fined \$100 million. - Andersen was ordered to pay \$100 million in restitution.
---	---	---	--



You **Tube**

# WHO WAS ENRON CORPORATION?

- Enron was established in 1985 by Kenneth Lay and Jeffrey Skilling.
- The Enron company was the 7th largest corporation in America.
- They were named "America's most innovative company" 6 years in a row.
- One of the largest companies to produce electricity, natural gases, and other communication initiatives such as internet bandwidth, risk management, weather derivatives (weather insurance), etc.
- Created markets where people could trade energy, gas futures, etc.
- The Enron scandal surfaced in the October of 2001, leading to the bankruptcy of the Enron Corporation.
  - Enron's net worth valued at over 70 billion dollars before the bankruptcy.



# Parties Involved



- Kenneth Lay was the founder, CEO and

**Kenneth Lay** Enron from 1985 to 2002

- Lay was convicted of 6 accounts of fraud .He faced 45 years in jail maximum.
- Lay passed away July 5th 2002, of an heart attack. There are many conspiracies about his death, many believe that he is still alive



**Jeffery Skilling**

- Skillings was the CEO a few month before the scandal
- Skillings was convicted of 19 accounts of federal felonies related to the financial problems at Enron
- He faced 24 years in prison



**Andrew Fastow**

- Chief financial officer of Enron
- Fastow plead guilty and got a lighter sentence than the others with 6 years in prison



- He was the chief strategy officer at Enron
- He committed suicide on Jan 25 2002, a year after he resigned from Enron.
- Before his death he said to skillings "They are calling us child molesters, that will never wash off."

## Revenue recognition

- To make Enron look like they had a LOT of money accountants falsified mark to market accounting for long term projects.

### So What is Mark to Market Accounting?

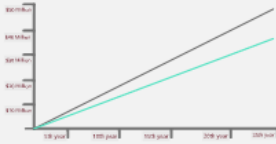
- So lets pretend... Enron signed a contract that lasts twenty five years
- They need to estimate how much money they will make out of this contract

- So they calculate the highest amount of revenue they can possibly make, and minimize the expenses amount it will cost them to do

- Enron calculates the total profit of 25 years to be \$50 million

- Every year Enron should have gone back to the contract and adjust the amount to what they really made

- Enron didn't deduct the losses making them look a lot more profitable



## Special Purpose Entities

- Enron used deception to manipulate its balance sheets to pose as a growing profitable and well financed company.

- Special purpose entities are company's that have one job and it is to hold assets which would not be shown in Enron's balance sheet.



- Enron sold their assets to special purpose entities, these assets were not shown in their balance sheet, covering up their debt.

- Enron owned other businesses but did not run them, just profited. (partnerships)

- By not claiming some their assets they were able to create a better balance sheet making their stock prices higher.



## Auditors

- The job of Auditors is to make sure the company accurately records all the accounts.

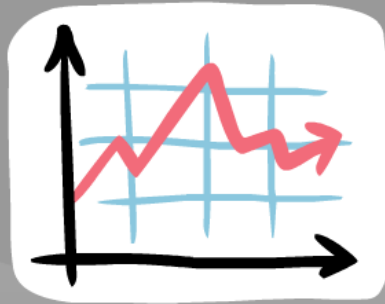
Enron hired Arthur Anderson to audit their work and also hired them for consulting work.

Arthur Anderson ignored all the accounting problems because they did not want to lose the multi million dollar consulting work.



# Summary of scandal

Enron was able to hide, manipulate and deceive official accounts and auditors for years. A reporter named Bethany McLean published an article called "Is Enron Overpriced?" bringing attention to Enron; exposing them. She was able to show how the company claimed to be a multi-billion dollar company when they were actually in mass amounts of debt. They were able to pull off this scandal by cheating and lying, the three of the methods that they used were, over revenue recognition, special purpose entities and false auditing.

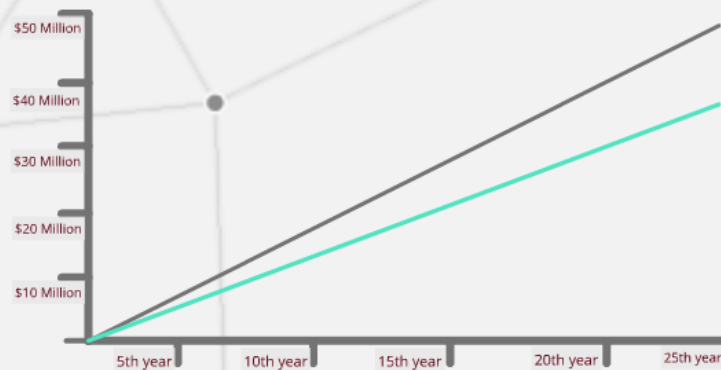


# Revenue recognition

- To make Enron look like they had a LOT of money accountants falsified mark to market accounting for long term projects.

## So What is Mark to Market Accounting?

- So lets pretend... Enron signed a contract that lasts twenty five years
- They need to estimate how much money they will make out of this contract
  - So they calculate the highest amount of revenue they can possibly make, and minimize the expenses amount it will cost them to do



- Enron calculates the total profit of 25 years to be \$50 million
- Every year Enron should have gone back to the contract and adjust the amount to what they really made
  - Enron didn't deduct the losses making them look a lot more profitable