Enron and the domino effect

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Abstract: *This paper aims to present the effects of Enron's 2001 collapse has had on the business environment looked upon systemically, analyzing the interdependencies the American giant had with other components of this environment especially those that should have played and important system control role such as audit firms, financial analysts and investment banks. The premises from which we start are that exactly the failure of these control instruments has led to the escalation of the situation up to the point in which the fall becomes inevitable. I believe that this analysis can offer relevant lessons for the key on how the current situation of Greece must be judged, a subject of utmost importance.*
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If you look closely at the situation in which Greece is in, a subject of major topicality in the European context, we notice many similarities with the Enron bankruptcy case in 2001; although fundamentally different, both structures falling in the same trap of "sweeping something under the rug", of embellishing financial reports in the ridiculous hope that this will pass by unnoticed and that the method would work indefinitely. In both cases, a major fault for the current situation falls on the shoulders of the socio-economic systems who although having developed control tools did not use them only rarely for that they endangered their political interests. The manner in which they have acted shows that they have fully deceived the confidence invested in them by the stakeholders in the market, causing them damage of tens of billions of dollars and triggering a wave of mistrust that calls into question even the basic assumptions upon which the contemporary economic system is built.

In early 2001 few could have imagined what would happen with Enron in just a few months. Things seemed to go as good as it gets for the company: if between 1990 and 1998 Enron's stock share quotation increased by about 300% (a not so staggering percentage), 1999 had marked a turning point, things starting to have an accelerated upward trend, the exchange quotation of the company increasing by 56% in 1999 and by 87% in 2000; the share price stood at around 82 U.S. dollars; the market capitalization exceeded 60 billion dollars (more than six times the book value of assets); Enron won six consecutive years the title of world's most innovative company in the prestigious ranking Forbes top rated companies; in brief, investor's confidence and public opinion was at its peak. [1]

Since its creation in 1985, by Kenneth Lay through the merger of two natural gas transmission companies, Enron grew almost continuous activity. Its main field of activity, natural gas transportation has encountered and important growth along with the U.S. market liberalization that took place in the 80s, and one of the main beneficiaries of this growth was Enron, which had at that time the largest network of pipelines.

This was and remained for a long time the main "cash cow" of Enron, a business based on solid assets (the pipeline network that the company owned), on a steady market that did not promise any dramatic nor present major challenges, natural gas demand being if not steady then at least constantly increasing. As long as the company has kept focusing attention on this sector, it did not encounter any financial problems regarding neither the development of the owned pipeline nor concerning providing liquidity for the current activity.

In the 90s Enron decided to change their strategy even more, in the attempt to get a more accelerated growth than the natural gas distribution could provide. Thus, the company began to replace the focus on this sector by diversifying their activities through different market entries. Firstly, in the sector they were already activating, they have ceased to be only a carrier in order to become a major trader of natural gas by creating the Enron Online platform as well. Over time this platform was extended, becoming a complex tool for online commodity trading. It should be noted that the development model chosen was based on the creation of numerous special purpose entities which led to the increase of the financial reporting system complexity and has made the real situation of the company more difficult to track. It is hard to say whether fraud was originally one of the reasons for applying this model, but it is clear that it was made possible by this type of organization.

Enron also aimed at increasing its international presence, in this respect starting various projects in Europe, South America, Asia and the Caribbean, ranging from construction and operation of power plants, to various other infrastructure projects. All these projects regardless of their success or failure, have required significant financial resources and, because of long construction periods of time (during which they would only absorb funds without generating any income), have brought the company into an almost chronic liquidity crisis.[2]

To address this challenge, the company has resorted to two methods that have hastened its end. Enron was at this point

[1] Data source: *The Fall of Enron*, **P. M. Healy, K. G. Palepu**, Journal of Economics Perspectives, American Economic Association, Vol 17, No. 2, pp 3-26

[2] „**The Other Enron Story**", Mack, Toni, (2002-10-14), Forbes.com

dependent on public perception; as long as it was seen as a solid company with a rising equity price and growth prospects, things could be controlled, Enron being able to access funding which would enable "rolling debts" until some of the projects in progress could be completed, starting to generate income, which in turn could be used to settle debts. Public perception is mainly dependent on financial reports that a stock exchange listed company is required to publish periodically, upon which their performances are judged by the public. Taking advantage of nontransparent accounting practices that they already have been using3 and of the existing loopholes in the financial reporting system that publicly traded companies are required to comply4, Enron's top management decided to embellish reports so that they would provide a positive image of the results achieved.

Because such a maneuver can only work as long as it ensures complete secrecy, and once rumors about such practices reach the market reaction is immediate and devastating, we can consider this as the first capital mistake.

In the rush to ensure enough liquidity to allow the continuous operation of the business and debt roll, Enron began to sell a part of their held assets. Of course the most popular thus the easiest to sell from all their owned businesses were the ones that had the most potential to ensure a potential buyer a higher profit, in a quick and safe manner. For this reason Enron sold its "cash cows", which denotes a combination of downright shocking panic and lack of vision on the behalf of the top management, thus committing the second capital mistake.

It has to be stated that at least at a theoretical level, even at that last hour, Enron could have been saved. A truly inspired management which ensured activity restructuration based on solid arguments, exiting projects that had proven to be financial failures, combined with continuing debt rolling until seemingly viable projects were completed, could perhaps have saved the giant.

Instead of such an approach that could have probably saved at least some of the tens of billions of dollars lost by investors and tens of thousands of jobs dissolved, Enron CEO Jeff Skilling started the domino effect, giving the fatal blow to the company on 14 august 2001, just six months after taking office, he resigned sold all the shares he held. This was, for Enron, the point of no return.

The end of the illusion cam pretty unspectacular. In its report to customers from August 23rd, 2001, Daniel Scotto, a financial analyst at BNP Paribas changed the Enron recommendation from BUY to NEUTRAL5, suggesting that Enron's shares could be considered source of funds which, in specific terms, means that they must be sold because they do not longer posses growth potential. It is hard to know if Scotto's recommendation was based on a very deep analysis of Enron for which the resignation of Sklling could have represented a good opportunity to expose the fraud, or if, as in many cases from

[3] *The Fall of Enron*, **P. M. Healy, K. G. Palepu**, Jurnal of Economics Perspectives, American Economic Association, Vol 17, No. 2, pp 3-26

[4] *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value* (PDF), **Bratton, W. W.** (May 2002). Tulane Law Review

[5] *Ex-Analyst at BNP Paribas Warned His Clients in August About Enron*, **Rebecca Smith,** The Wall Street Journal , 29 January , 2002

the Wall Street financial analysts worlds, was based on some information leaked from inside Enron.

The latest variant seems to be supported by the fact that Enron Vice-President Sherron Watkins was, at that same time, expressing concerns regarding the company's accountancy situation, first through an anonymous email sent to the CEO of that time, Kenneth Lay, then through a conversation with a former colleague who was back then working for the audit firm Andersen. 6

One of the questions which are obsessively addressed when the Enron case is in question is how nobody realized for so long what was really going on. I believe that one possible explanation deals with financial analysts; although highly trained and motivated to see the essence beyond the illustrated image the listed stock companies want to provide and hired to provide the best possible investment advice, they often find themselves in interest conflicts because the banks they work for have commercial relations with companies they should objectively evaluate. Fear of losing a large account can often be a serious self-censorship reason. It is in this sense at least curious why BNP Paribas decided to dismiss Daniel Scotto at the end of 2001, under the circumstances that, regardless of his source of "inspiration", he saved his clients huge sums of money by his August recommendation7.

Another victim of the Enron scandal was the auditing company Arthur Andersen, which as it turned out over the investigation, has destroyed incriminating documents pointing at Enron. For this reason and based on records found, Andersen was accused and found guilty for obstructing justice. Under U.S. law, a convicted person or entity may not audit other companies, so that Arthur Andersen was forced to surrender their license. Although it was eventually declared innocent by the U.S. Supreme Court, the scandal created was enough for losing the most customers and went bankrupt. This side of the scandal shows us how another system component that had both the means and obligation to discover and report Enron's serious irregularities, failed in its mission.

Taking this into consideration, I think the image of the Enron scandal is now complete: greed, cowardice, conflicts of interest, inoperative control instruments, total lack of ethics. Here are the ingredients that made possible the largest U.S. bankruptcy until its time and the malignant components attacking the modern economic system. If you replace greed with clinging to power, we could probably declare the same statement in the case of Greece and other EU countries. It becomes clear that a fundamental change of paradigm is necessary for the recovery of the global economic system and that this is necessary to be based on the notion of morality, this being in no way antithetical to the idea of profit.

It is clear that forms of synchronizing real economy with the monetary economy have to be found. Also, the tax collection system should be improved because budget deficits cannot be mitigated only through loans but they can be rather minimized by improving business results, through actions made in order to dissolve the black economy and through policies aiming to increase gray

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[6] *The Fall of Enron,* **P. M. Healy, K. G. Palepu**, Exibit 1

[7] *Ex-Analyst at BNP Paribas Warned His Clients in August About Enron,* **Rebecca Smith,** The Wall Street Journal, 29 January , 2002

economy contribution to the state. We are referring to the tax system quality, the consistency of the tax collection system and about motivating economic agents to pay taxes, thus avoiding tax evasion. System reliability is not only the image casted by decision makers but by their actual performance.

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