# Enron Scandal

## Background

The year was 1985, and Enron was incorporated as the merger of Houston Natural Gas Company and Internorth Inc. In 1995, the business was recognized as the most innovative business by the Fortune, and it made it successful run for the next six years. In 1998, Andrew Fastow became the CFO of the business, and the CFO created special purpose vehicles (SPVs) to conceal the financial losses of the Enron. During the period of 2000, the shares of Enron traded at the price levels of $90.56.

## Beginning of Scandal

On February 12, 2001, Jeffrey Skilling came in place of Kenneth as a chief executing officer. On August 14, 2001, Skilling abruptly resigned, and Kenneth took over the role once again. Same period, the broadband division of the business reported a massive loss of $137 million, and the market prices of stock fell to $39.05 per share. In the period of October, the CFO's legal counsel instructed auditors to destroy the files of the Enron and asked to maintain only the utility or necessary information. The business reported a further loss of $618 million and a write off of $1.2 billion. The price of the stock deteriorates to $33.84.

## Downfall of the Company

On October 22, the business got into a probe from Securities and Exchange Commission. With this news, the stock of Enron further deteriorated and was reported at $20.75. In November 2001, the business for the first time admitted and made the revelation that it inflated its income levels by $586 million. Also that it has been doing so since 1997. On 2nd December 2001, the business files for bankruptcy and the stock prices end up flat at $0.26 per share. On January 9, 2002, the justice department ordered a criminal proceeding against the business. On January 15, 2002, the NYSE suspended Enron, and the accounting firm, along with Arthur Andersen was convicted on the grounds of obstruction of justice.

## Enron Scandal Causes

- The creation of a special purpose vehicle for concealing financial losses and a pile of financial debt;
- Mark-to-market accounting as an accounting concept is an excellent method to value securities, but such a concept becomes a disaster when applied to the actual business.
- Lapse of corporate governance in Enron Corporation.

## Enron Hiding their Debt

The Enron corporation and its management resorted to an unethical scheme and malpractice of off-balance sheet mechanism. It created a special economic vehicle to hide the massive debt from its external stakeholders, namely creditors and investors. The special purpose vehicle was utilized for concealing realities of accounting rather than focusing on the operating results.

The corporation transferred some portion of assets that had rising marketable value to the special economic vehicle, and in return, it took cash or note. The special purpose vehicle then utilized to such stock to hedge an asset present on the balance sheet of Enron. It ensured that a special purpose vehicle reduced the counterparty risk.

The formation of the special purpose vehicles cannot be termed as illegal, but in comparison with the securitization techniques relating to debt, it could be termed as bad. Enron disclosed the existence of special purpose vehicles to the investors and the public, but few people understood the complexity of transactions done using the special purpose vehicles.

Enron assumed that the prices of the stock would continue to appreciate and that it would not deteriorate or fail as hedge funds. The primary threat was that the special economic entities were capitalized with only the stock of the corporation. If the corporation was compromised, then the special economic entities won't be able to hedge the deteriorating market price of such stocks. Additionally, the Enron corporation had held significant conflicts of interest with respect to the special purpose vehicles.

## Mark to Market Accounting in Enron Scandal

The CEO of Enron Corporation Jeffrey Skilling transitioned the accounting practice of the Enron Corporation from a historical cost accounting method to mark to market accounting method. The transition of the accounting practice received approval from the Securities and Exchange Commission during 1992. Mark to market accounting is a practice that reports the fair market value of the liabilities and assets for a given duration or financial period.

The mark to market gives insights to an institution and is regarded as the legitimate practice. The method, however, is also exposed to some form of manipulation. The Mark to market is based on fair value rather than taking up the actual value. It caused the business to fail miserably as they were reported the expected profits as the actual profits.

## Why is the Enron Scandal Important?

The Enron scandal is significant in terms of learning perspectives for both new financial professionals and experienced professionals. The scandal tells us why strong corporate governance is the key to success for any business to sustain and drive profitable business. Additionally, it draws insights as to how accounting policies should not be used and applied. Any misuse can have drastic results or impacts on the health of the business.

Due to the bankruptcy of the business, employees lost several perks and pension benefits. Many came on the verge of the financial crisis. The crisis was so deep that the shareholders of the business lost an estimated value of $74 billion. Such corporate fraud should be taken as learning, and an understanding should be drawn as to why regulations and compliance are necessary.

## Conclusion

The Enron Corporation was formed as the merger of Houston's natural gas company and inter-north Incorporation. After the merger, it grew rapidly and was regarded as the most innovative company. However, it resorted to bad accounting practices. It was involved in the creation of special purpose vehicles, utilized to hide the rising debt of the Enron incorporation, and this led to the failure and downfall of the business.

Reference: www.wallstreetmojo.com