Why Did Enron Fail?

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Introduction

From America's 7th most valuable company in December 2000, to a company in ruins by early 2002, Enron has been involved in one of the most incredible reverses of fortune ever. With shares riding high on Wall Street at $84.87 on the 28th December 2000, and awards such as "America's most innovative company" from Fortune Magazine 6 years running, and "Energy Company of the Year" from the Financial Times also in 2000, it looked as though Enron were promising to be one of the biggest American companies of all time.

Things started going drastically wrong. As large losses were being reported, share prices tumbled, and Enron, within the space of only a year, was on the verge of collapse. I shall be investigating the factors of this collapse, some of them due to business and economic factors, but mostly through deception and fraud.

Analysis

The timeline of events from when Enron were at the top to the bottom of the business world is quite outstanding. (See Figure 1, Appendix). The collapse seems to span a time of around 5 months, from August 2001 to January 2002. During this time, many scandals have come out, which suggest Enron has played a major part in its own downfall, through unsuccessful diversification to fiddling the accounts. As these things add up, it is no surprise Enron is now in the position it is.

In 2000 the company recorded record turnovers of $100m (See Figure 2, Appendix), a $60m increase from the previous year. Shares were selling at a high price, meaning that future expansion would have been possible due to high investment in the company. A collapse at this point seemed absolutely out of the question, it just seemed impossible, with future investment and high turnovers.

In October 2001, the third quarter results were published, showing a mysterious loss. This of course set the share price falling, as investors lost confidence about Enron's long term capabilities. This was the beginning of what was going to be a difficult few months for Enron, as different scandals and information was released.

The reasons for this loss have not been explained fully but there are many different possibilities, some through bad business decisions, some through bad accounting, and some from unnecessary purchases. All of these combined meant that Enron was facing debts of around $690m.

Enron consists of four main business units - Wholesale, Energy, transport and Broadband. The unit with the biggest problems was the broadband sector.

Organic growth was possible through high profits and high share prices, so Enron diversified into not only providing energy, but offering the up and coming broadband service. This was a decision that would cost them in the future. Enron were confident that it would be a success and so took a risk into a market that had not yet fully taken off. It was here eventually where Enron lost most of its money. They overestimated prices, and ended up losing $102m, with only $16m coming in. They bought up too many fibre optic cables (required to deliver the broadband internet service) of which only 2% were used.

The broadband service was also responsible for Enron using the wrong accounting techniques that actually made them look as though they were making money. They used a style known as “mark to market”, where money from contracts worth a certain amount of money over a long period (eg 5 years) were shown in the account straight away. Predictions were way out, as this accounting technique only works efficiently in a liquid market- where there are many buyers and sellers. By using it for assets that cant necessarily be seen - allocation of internet capacity, it didn’t work.

It is clear that this was a huge mistake. Using the wrong style of accounting meant that investors thought that Enron were making money, where in fact they were making huge losses. A former vice-president to Enron, Sherron Watkins, sent a letter to Kenneth Lay, the chief executive, warning him of the fact that their accounting procedures were wrong, and that something had to be done. If he’d taken the advice, he might have been able to save the company, but unfortunately Mr Lay didn’t have a business strategy in place to make a recovery. He failed to accept the fact that the financial accounts had been manipulated, and carried on as usual. With clear objectives and a strategy to make sure objectives were met, Enron at this point could have saved themselves.

By November 2001 news of the Enron disaster starting hitting the company hard as people lost confidence. Shares lost 23% in one day, hitting their lowest ever value. They were to fall 15% more to a value of $4.01 just six days later, and to just under $1 on the 28th. This all due to the fact investors had lost all confidence in a failing firm. Investors were not made fully aware they were buying into hidden debts, which were not present on balance sheets. It was discovered that Enron had fiddled the books by buying small companies to hide their debts. As long as they didn't own 3% of the company, debts didn't have to be shown on Enron's balance sheet. This way debts could be hidden in the small companies, but profits could be shown. Enron had fooled investors into thinking they were making huge profits and not losing money. In fact, they were losing millions. It is not hard to see why people were no longer investing in them after this news had broken out.

Enron were also guilty of wasting money. Not only had they lost a small fortune on the unsuccessful diversification, they wasted money on unnecessary items. Head offices included plasma screens to display share prices, 2000 chairs worth $600 each, a 33 foot Maplewood table, all contained in state of the art building and offices (www.bbc.co.uk, 27th Feb 2002). It seems as though this money was well spent at the time, as it looked good for potential investors who would visit the offices before deciding whether to put money in to the company. It also provided a good working environment for its 21,000 employees. Enron also allegedly spent money funding some of GW Bush's election campaign, as well as being involved in political bribery to influence governments. With losses so big, how were they still able to afford such things?

Being America's 7th largest company provided them with a financial economy of scale, bank were prepared to give them loans as they could see from profit and loss accounts that they were making huge amounts of money, not knowing that this was covering huge losses unaccounted for. Unfortunately as the scandal broke, banks lost confidence and recalled the loans.

As the scandal came about, Enron needed to gain capital, and a takeover by Dynegy was planned to relieve some of the debt. They pulled out of the deal at the last minute leaving Enron with debts near $700m and a very poor looking future.

Conclusion

It is clear to see that there are many factors involved in the Enron scandal. From diversifying into an unsuccessful market which lost money, to using the wrong accounting techniques, Enron can only blame itself for its downfall. With better business planning and strategies to overcome problems, they might not be in the position they are today. With independent audits, financial irregularities might have come to light sooner. Poor communications with share holders and potential investors meant they were unaware of the situation they were getting themselves in. Enron also spent a large amount of money on unnecessary items where perhaps better investment would have been a safer option.

Overall, the factors all combine to the failure of Enron, and at time of writing it is still unclear the exact reasons for the downfall, and how much of the information released by newspapers and the company itself is reliable. Based on the information available at the time, it is clear there are many deceptions and poor business decisions that have meant Enron have a very bleak future ahead of them.

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Appendix