

**Enron**

What happened ?

1

**Enron And Growth**

During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan: buy or develop an asset, such as a pipeline or power plant, and then expand it by building a wholesale or retail business around the asset.

- This growth involved large initial capital investments
- not expected to generate earnings or cash flow in the short term.
- placed immediate pressure on Enron's balance sheet

Enron already had a substantial debt load.

- place pressure on Enron's credit ratings.
- Maintaining Enron's credit ratings at investment grade was vital to the conduct of its energy trading business.

2

**Enron – Off-balance sheet transactions**

Solution - find outside investors willing to enter into arrangements.

- joint investments typically were structured as separate entities
- in many cases a guaranty or other form of credit support was required from Enron.

Enron's treatment of the entities for financial statement purposes was subject to accounting rules that determine whether the entity should be

- consolidated in its entirety (including all of its assets and liabilities)
- or should instead be treated as an investment by Enron.

3

**Enron and SPE**

Enron preferred the latter treatment "off-balance-sheet" - because it would enable Enron to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies.

Enron used Special Purpose Entities in many businesses

- synthetic lease transactions: sale to an SPE of an asset and lease back (Enron's headquarters in Houston);
- sales to SPEs of "financial assets" (a debt or equity interest owned by Enron);
- sales to merchant "hedging" SPEs of Enron stock and contracts to receive Enron stock;

4

**SPE**

Hundreds of respected U.S. companies have trillions of dollars in debt in off-balance-sheet subsidiaries, partnerships, and assorted obligations, including leases, pension plans, and take-or-pay contracts with suppliers.

Potentially bankrupting contracts are mentioned vaguely in footnotes to company accounts

The goal - skirt the rules of consolidation

the bedrock of the American financial reporting system and the source of much its credibility.

Set in 1959, aim to make public companies give a full and fair picture of their business--including all the assets and liabilities of any subsidiaries.

5

**SPE and consolidations**

Accountants, lawyers, and bankers have learned to drive a coach and horses through them.

**Special-purpose entities (SPEs).**

the parent can bankroll up to 97% of the initial investment in an SPE (debt) without having to consolidate it into its own accounts.

Normally, once a company owns >50% of another, it must consolidate it under the 1959 rules. But parent companies own 0% of SPE equity.

The controversial exception: outsiders need invest only 3% of an SPE's capital

6

**SPE standards**

Fumbles by the Securities & Exchange Commission and the Financial Accounting Standards Board.  
 In 1990, accounting firms asked the SEC to endorse the 3% rule that had become a common, though unofficial, practice in the '80s.  
 The SEC didn't like the idea, but it didn't stomp on it, either.  
 FASB drafted two overhauls of the rules but never finished the job, and the SEC is still waiting.

7

**Enron**

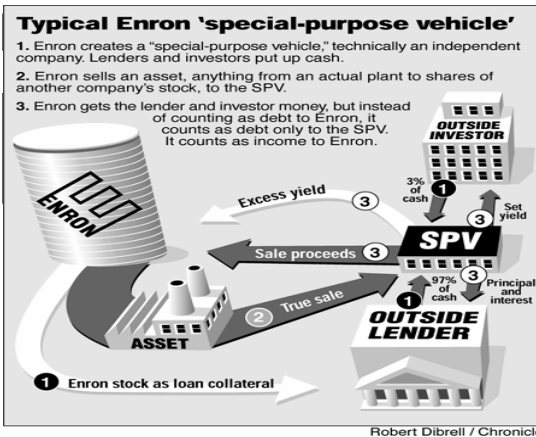
Accounting literature provides only limited guidance concerning when an SPE should be consolidated  
 - the context of synthetic lease transactions  
 SEC staff concerns that there was no standard practice  
 FASB Emerging Issues Task Force released several statements  
 If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SPE or its sponsor should consolidate the SPE..

8

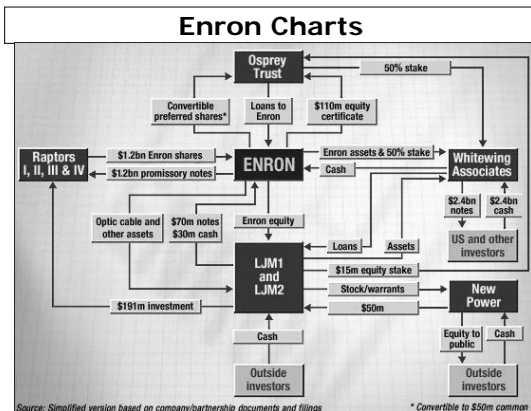
**SPE**

This presumption in favor of consolidation can be overcome only if two conditions are met:  
 First, an independent owner(s) of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction.  
 The SEC - 3% of total capital is the minimum acceptable investment  
 Second, the independent owner must exercise control over the SPE to avoid consolidation.

9



**Enron Charts**



**Chewco**

The first related-party transactions:  
 Chewco Investments L.P., a limited partnership managed by Kopper.  
 Led to inaccurate financial statements from 1997 through 2001, 1993 -1996, Enron and CalPERS - partners in \$500 million joint venture JEDI  
 Because Enron and CalPERS, had joint control.  
 So Enron did not consolidate JEDI  
 Enron would record its contractual share of gains and losses from JEDI on its income statement but would not show JEDI's debt on its balance sheet.

12

**Chewco 2**

November 1997, Enron wanted to redeem CalPERS' interest in JEDI so that CalPERS would invest in another, larger partnership. Enron assisted Kopper in forming Chewco to purchase CalPERS' interest.

Enron could only avoid consolidating JEDI onto Enron's financial statements if Chewco had some independent ownership with a minimum of 3% of equity capital.

Enron and Kopper, however, were unable to locate any such outside investor, and instead financed Chewco's purchase of the JEDI interest almost entirely with debt.

Kopper transferred his ownership interest ... to William D. Dodson.

13

**Chewco SPE**

The CEO of Andersen testified

-the firm had performed unspecified "audit procedures" on the transaction in 1997, was aware at the time that \$11.4 million had come from "a large international financial institution" (presumably Barclays), and concluded that it met the test for 3% residual equity.

- Andersen was unaware that, cash collateral had been placed in the reserve accounts at closing.

14

**Chewco SPE Revenues**

During the 12 months that the subordinated loan was outstanding, Chewco paid Enron \$17.4 million under this fee agreement. JEDI was the source of these payments to Enron. Revenue to Enron !

As of March 31, 1998, Enron recorded a \$28 million asset, which represented the discounted net present value of the "required payment" through June 2003, and immediately recognized \$25.7 million in income (\$28 million net of a reserve).

15

**Chewco SPE**

Enron did not consolidate Chewco (or JEDI) into its consolidated financial statements.

This mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or it was caused by Kopper.

AA Reviewed the transaction closely in 2001

- Chewco did not satisfy the SPE accounting rules

Enron announced that it would consolidate Chewco and JEDI retroactive to 1997.

- increased Enron's reported debt by \$711 million in 1997, by \$561 million in 1998, by \$685 million in 1999, and by \$628 million in 2000.

16

**Chewco SPE**

Kopper received \$2 million in "management" and other fees relating to Chewco.

The participation of an Enron employee as a principal of Chewco appears to have been accomplished without any presentation to, or approval by, Enron's Board of Directors.

Unlike Fastow, Kopper was not a senior officer of Enron, so his role in Chewco would not require proxy statement disclosure (but would require approval under Enron's Code of Conduct).

17

**JEDI Enron stock gains 1**

From 1993 through the first quarter of 2000,

Enron picked up its share of income from JEDI using the equity method of accounting.

Changes in fair value of the assets were recorded in JEDI's income statement. JEDI held 12 million shares of Enron stock, at fair value.

Enron and Andersen apparently developed a formula in 1996

first quarter of 2000 - Enron recorded \$126 million in Enron stock appreciation

third quarter of 2000 decision that income from Enron stock held by JEDI could no longer be recorded on Enron's income

18

**JEDI Enron stock gains**

In the first quarter of 2001  
Enron stock held by JEDI declined in value by approximately \$94 million. Enron share \$90 million.  
Enron's internal accountants decided not to record this loss based on discussions with Andersen.  
According to the Enron accountants, they were told by Andersen that Enron was not recording increases in value of Enron stock held by JEDI and therefore should not record decreases.

19

**LJM 1**

In 1999, two partnerships in which Fastow was the manager and an investor. LJM 1 and LJM 2  
LJM2 solicited prospective investors as limited partners using a confidential Private Placement Memorandum ("PPM") detailing, -unusually attractive investment opportunity" resulting from the partnership's connection to Enron. The PPM emphasized Fastow's position as Enron's CFO  
The transactions between Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense.

20

**LJM 2**

From June 1999 through June 2001, Enron entered into more than 20 distinct transactions with the LJM  
Two types:  
**Asset Sales.** Enron sold assets to LJM that it wanted to remove from its books.  
These transactions often occurred close to the end of financial reporting periods.  
Did they actually transfer the risks and rewards of ownership to the other party

21

**LJM 3**

Near the end of the third and fourth quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2.  
Legitimacy of the sales.  
(1) Enron bought back five of the seven assets after the close of the financial reporting period  
(2) the LJM partnerships made a profit on every transaction  
(3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, "earnings" to Enron of \$229 million in the second half of 1999

22

**Rhythms**

In three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against loss.  
**Hedging Transactions.** Enron transferred its own stock to an SPE in exchange for a note.  
The Fastow partnership, LJM1, provided the outside equity necessary for the SPE  
The SPE purported to take on the risk that the price of the stock of "Rhythms"  
If the SPE were required to pay Enron on the Rhythms options, the transferred Enron stock would be the principal source of payment.

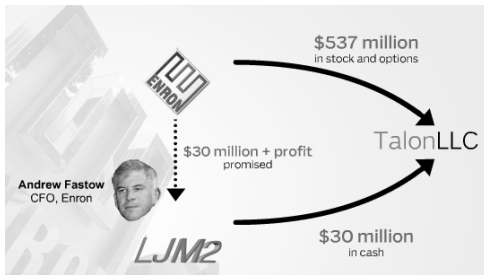
23

**Rhythms**

Enron received from Swap Sub a put option on 5.4 Enron could require Swap Sub to purchase the Rhythms shares at \$56 per share in June 2004. The put option was valued at approximately \$104 million.  
Enron obtained a fairness opinion from PricewaterhouseCoopers ("PwC") on the exchange of the 3.4 million restricted Enron shares for the Rhythms put and the \$64 million note.  
PwC opined that the range of value for the Enron shares was \$170-\$223 million, that the range of value for the Rhythms put and note was \$164-\$204 million, and that the consideration received by Enron therefore was fair from a financial point of view.

24

**Talon**



25

**Raptor 1**

Raptor vehicles. Extraordinarily complex structures. funded principally with Enron's own stock intended to "hedge" against declines in the value of a large group of Enron's merchant investments. Andersen approved the transactions, in fact the "hedging" transactions did not involve substantive transfers of economic risk. Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron.

26

**Raptor 2**

Enron used this strategy to avoid recognizing losses  
 In 1999, Enron recognized after-tax income of \$95 million from the Rhythms transaction, which offset losses on the Rhythms investment.  
 In the last two quarters of 2000, Enron recognized revenues of \$500 million on derivative transactions with the Raptor, which offset losses in Enron's merchant investments. "Earnings" from the Raptors accounted for more than 80% of that total.

27

**Raptor 3**

Hedging Enron's investments with the value of Enron's capital stock  
 Two of the Raptor SPEs lacked sufficient credit capacity to pay Enron on the "hedges."  
 In late March 2001, Enron would be required to take a pre-tax charge against earnings of more than \$500 million  
 Rather than take that loss, Enron "restructured" the Raptor vehicles by, among other things, transferring more than \$800 million of contracts to receive its own stock to them just before quarter-end.

28

**Raptor 4**

These efforts could not avoid the inevitable results of hedges that were supported only by Enron stock in a declining market. Ultimately, the SPEs were terminated in September 2001. - announcement on October 16, 2001, of a \$544 million aftertax charge against earnings - was the result of Enron's "hedging" its investments  
 Enron was required to reduce shareholders' equity by \$1.2 billion - result of accounting errors made in 2000 and early 2001,

29

**Watkins memo**

• The new Raptor structure transferred risk in the form of stock dilution

— Handwritten note from Sherron S. Watkins on an internal Enron presentation in the spring of 2001 about problems with the Raptor partnerships.

There it is!  
 That is the smoking gun.  
 You cannot do this!

risk assessment &

**Enron Issues**

**Consolidation Issues** In 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation.

This retroactive consolidation decreased Enron's reported net income by \$95 million (of \$893 million total) in 1999 and by \$8 million (of \$979 million total) in 2000.

**Self-Dealing Issues**

These related-party transactions facilitated

- accounting and financial reporting abuses by Enron
- extraordinarily lucrative for Fastow and others.

31

**Enron Fraud**

A partnership called "Southampton Place," provided spectacular returns. In exchange for a \$25,000 investment, Fastow received (through a family foundation) \$4.5 million in approximately two months. Two other employees, who each invested \$5,800, each received \$1 million in the same time period.

32

**Public Disclosures**

Very Little

10-K Note:

Note 16 RELATED PARTY TRANSACTIONS

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

33

**Is Enron Overpriced?  
Monday, March 5, 2001**

By Bethany McLean

In Hollywood parlance, the "It Girl" is someone who commands the spotlight at any given moment--you know, like Jennifer Lopez or Kate Hudson.

But for all the attention that's lavished on Enron, the company remains largely impenetrable to outsiders, as even some of its admirers are quick to admit.

**FORTUNE**

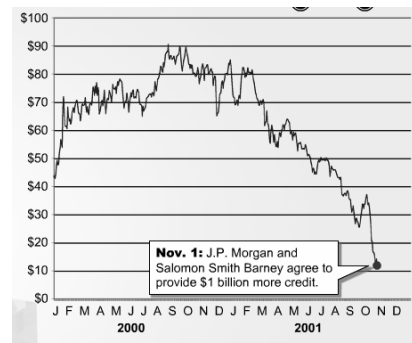
34

**New Books**



35

**Stock Price**



36

**Enron Note 16**

"Enron guarantees the performance of certain of its unconsolidated equity affiliates in connection with letters of credit issued on behalf of those entities. At December 31, 2000, a total of \$264 million of such guarantees were outstanding, including \$103 million on behalf of EOTT Energy Partners, L.P. (EOTT). In addition, Enron is a guarantor on certain liabilities of unconsolidated equity affiliates and other companies totaling approximately \$1,863 million at December 31, 2000, including \$538 million related to EOTT trade obligations.

37

**Arthur Andersen Is Convicted**

June 16, 2002 - On Obstruction-of-Justice Count  
 Duncan on Oct. 14: Andersen believed the company's third-quarter earnings news release was misleading.  
 Some items "non-recurring," or not  
 Enron ignored the advice  
 Corrupt persuader: Andersen in-house attorney Nancy Temple

38

**Arthur Andersen Is Convicted**

Oct. 16 2001: she sent him an e-mail that evening in which she recommended "deleting some language that might suggest we have concluded the release is misleading"  
 e-mail persuaded Mr. Duncan to alter a memo with the intent of keeping the original version from the SEC.  
 Andersen saved the original memo, in which Mr. Duncan raised concerns with Enron  
 Ms Temple wanted it to be changed to "aggressive"  
 May 2005 – Supreme court says jury instructions were wrong.  
 Arthur Andersen Is Conviction overturned

39

**Status – Nov 03 1**

**The Allegations:** Prosecutors and regulators say Enron created off-the-books partnerships and Used aggressive accounting methods to hide massive debt and inflate the firm's bottom line.

**Who's Who:**

- Kenneth Lay, former chairman, CEO
- Jeffrey Skilling, former CEO
- Andrew Fastow, former CFO
- Michael Kopper, former managing director
- Ben Glisan, former treasurer

**What's Happened:**

**Mr. Glisan** pleaded guilty to conspiracy, sentenced to 5 years in prison and ordered to surrender \$938,000  
**Wesley Colwell**, a former Enron accountant, settled SEC charges over inflated earnings - agreed to cooperate with probes.

**Status – 2006 Prosecution Scorecard**

Criminal charges Total: 34 Guilty pleas: 16

- Ben Glisan Jr. 5 years in prison.
- Lea Fastow 1 year in prison.
- Andrew Fastow Awaiting sentencing.
- Richard Causey Awaiting sentencing.
- Michael Kopper Awaiting sentencing.
- Mark Koenig Awaiting sentencing.
- Paula Rieker Awaiting sentencing.
- Timothy Belden Awaiting sentencing.
- Jeffrey Richter Awaiting sentencing.
- Lawrence Lawyer Awaiting sentencing.
- Dave Delainey Awaiting sentencing.
- Ken Rice Awaiting sentencing.
- Kevin Hannon Awaiting sentencing.
- John M. Forney Awaiting sentencing.
- Timothy Despain Awaiting sentencing.
- Christopher Calger Awaiting sentencing

41

**Status – 2006**

Jury conviction: 5

- Dan Boyle 3 years, 10 months.
- James A. Brown 3 years, 10 months.
- Daniel Bayly 2 years, 6 months.
- William Fuhs 3 years, 1 month.
- Robert Furst 3 years, 1 month.

Acquittal: 1

- Sheila Kahane Not guilty.

Conviction overturned: 1

- Arthur Andersen Government won't retry.

Case dropped: 1

- David Duncan Plea and charge withdrawn.

42



<b>Status – 2006</b>
----------------------

Others charged: 10

- Ken Lay • Jeff Skilling Currently on trial.

Broadband division

- Joe Hirko Going to trial in September.
- Rex Shelby Going to trial in September.
- F. Scott Yeager Going to trial in June.
- Kevin Howard Going to trial in May.
- Michael Krautz Going to trial in May.

British bankers

- Gary Mulgrew Fighting extradition.
- David Bermingham Fighting extradition.
- Giles Darby Fighting extradition.

43