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Enron and Its Strange Accounting Practices: Common Misunderstandings

BY CHRIS TANNER

Most people have at least some idea of what Enron got wrong. Almost no one pays attention to what Enron got right. Most are not aware that the Enron Corporation was responsible for some of the most groundbreaking and innovative changes that ever occurred within the energy and natural gas industries. As counterintuitive as people find this, Enron did get some things right.

Meanwhile, the present economic and financial crisis is difficult to understand. Many experts suggest that the only hope of solving this crisis is to understand its origins. One way to clarify things is to look back at various factors that ruined Enron. Some of these factors, like the misuse of derivative securities, are part of the foundation for the present crisis.

Smartest Guys in the Room

To that end, the Murray State University College of Business showed the Enron documentary "Smartest Guys in the Room" in October 2009. The Enron crisis is suitable for this type of retrospective because most Murray students remember hearing about Enron, but at the time were not sophisticated enough to appreciate its significance. During the worst of the Enron crisis,

most Murray students were in elementary or junior high school.

Now that eight to nine years have passed and these students are enrolled in the College of Business or elsewhere within MSU, a lot of valuable lessons can be gained by taking a fresh look at this crisis involving that infamous company with the familiar name. The film served as a way to initiate a discussion about some of these lessons. One of the most interesting and often overlooked is that many of Enron's innovative concepts were perfectly legal and sensible when used properly. Several examples follow.

Special Purpose Entities

A Special Purpose Entity (SPE), a legal entity that a company can use to isolate itself from financial risk, can be useful and completely trustworthy. Prior to Jeffrey Skilling's tenure, Enron's CEO was an enterprising and very truthful individual named Rich Kinder, who left the company in 1996. When Kinder was CEO, Enron used SPEs only sparingly, but always to the benefit of Enron shareholders (Bryce, 2002).

Conversely, under the mismanagement of Skilling, Enron absurdly twisted SPEs to fall well outside the meaning intended by Internal Revenue Service (IRS) statutes and Generally Accepted

Accounting Principles (GAAP) standards. Of all the mistakes and abuses that contributed to the downfall of Enron, the distortions of SPEs may have been the most harmful and the most difficult for an average person to understand. However, what many people forget was that for many years, Enron utilized SPEs skillfully and effectively (Rapoport and Dharan, 2004).

Mark-to-Market Accounting

For certain types of commodities and financial instruments, mark-to-market is often the most accurate and reliable price indicator. For many years, Enron's use of mark-to-market accounting was perfectly legitimate, and actually an improvement over more antiquated existing accounting methods. This is because conventional accounting requires that an energy contract be booked (accounted for) at its sale price, and then depreciated over a set period of years (Rapoport and Dharan, 2004). Such treatment can be unrealistic and inaccurate for an energy contract. Enron officials lobbied the Securities and Exchange Commission (SEC) to be allowed to use this type of accounting. In 1993, notably while Kinder was still CEO, that lobbying was completed. Enron's worst accounting abuses did

not occur until 1997 and after (McLean and Elkind, 2003).

The principle behind “mark-to-market” is simple. Where a valid market exists, contracts that close on a particular day should be “marked” to the “market” conditions of that particular day. With a company like Goldman Sachs, which trades recognizable stocks, this treatment is easy. It’s very easy to determine the value of a stock on a particular day. For example, every day, five days of the week, Apple or Google stock closes at a certain price. When the stock market closes, the exact price is readily available.

Similarly, within energy markets, the actual value of most energy contracts is easily obtained. However, in Enron’s case, the troubles began in computing a value for some of their more exotic derivatives. Some complex derivatives are based on a rapidly shifting set of underlying principles, making the calculations to determine their value difficult. Even worse, those calculations are speculative, and unlike stock, difficult to reliably peg to a certain value. No matter what type of accounting is used, it can be difficult to determine accurate values for energy derivatives (Partnoy, 2002).

Connection to Today’s Crisis in Residential Real Estate

It is commonly accepted wisdom that part of the problem with residential real estate within the United States is that there is no way to achieve true and authentic pricing of houses. A big problem delaying our recovery is the accuracy of real estate pricing.

Repossessed houses sit and languish on the market for years because banks, stuck with foreclosed property, cannot get an accurate idea of “how low to go” or how much of a loss they can sustain without getting in trouble with their shareholders. Because accurate pricing is not available, it is safer for a bank to “do nothing” and just leave the house on the market indefinitely. This inaction is delaying a recovery in the real estate market. Meanwhile, the bank carries on its books the purchase price of the prop-

erty, even though the actual value of the property no longer has any connection to the purchase price. In this sense, mark-to-market is a more reliable indicator of what the house is worth.

Booking an energy contract’s value merely at its sale price is an oversimplification and does not provide an effective measure of the true intrinsic value of that contract. With the 1993 introduction of mark-to-market practices into their oil and gas contracts, Enron reduced opportunities for inaccurate pricing. Instead of using the sale price at the end of each trading day, Enron reconciled the books on every trade that occurred by “marking” each trade according to the current “market” conditions, a better value indicator than a contract’s sale price.

Had Enron stuck with the simpler forms of energy contracts, it could have done quite well. Instead, Enron, like housing investors in 2003–2009, got intoxicated by the tremendous profit potential in complex derivatives and made financial commitments that it could not back up with cash reserves. Also, Enron exploited the fact that certain complex contracts, such as those that would not be completed until 20 years in the future, are extraordinarily difficult to value. Even the most honest accountant would be required to wildly speculate in order to guess at a value for such a contract.

In the fallout after Enron’s collapse, many people blamed Enron’s abuse of mark-to-market accounting as part of the cause. However, this is an oversimplification. Mark-to-market was not the problem; instead, Enron’s use of wildly complicated derivatives was the problem, along with its unrealistic pricing of those derivatives. Where there is no readily ascertainable “market,” there can be no “marking.” Also, a properly supervised company with appropriate business protocols and safeguards would not have wanted to participate in these types of contracts, as they are too risky, even for a trading company. In the event of a downfall, their business liability insurance underwriters could refuse to cover their losses. Second, even in the instances

where Enron participated in risky contracts, they should have been more realistic and honest about the pricing of those contracts.

The result was that Enron was free to engage in extraordinarily high-risk gambling using derivatives, and was also free to price those derivatives in any way that was convenient, without concern that any government agency would be aware of it. Regardless of what kind of accounting was used, this was eventually going to catch up with them.

Almost the entire oil and gas industry now uses mark-to-market accounting for their energy contracts. Enron was the first to cross this precipice, despite considerable resistance from regulators as well as others within their industry.

Establishing a Derivative Market

Another example of an Enron practice that might have been beneficial was the forming of long-term and specialized energy contracts, securitizing them, and treating the contracts as a type of financial instrument, including establishing a derivative market. This was an extremely innovative practice and also a significant benefit to low-income energy customers. Producers of natural gas could participate in a stable market without having to sell their energy products on the highly volatile “spot” market.

The result was stability in an industry that was otherwise subject to jarring, roller-coaster boom-bust volatility. This stability was a benefit to smaller energy companies that provided service to sparsely populated areas. Previously, smaller energy providers had difficulty achieving success in the energy industry because of fears of being whip-sawed by an irrational market turn. Allowing smaller energy providers to safely enter the energy market resulted in a type of democratization of the energy industry, which in turn benefited low-income consumers.

Skilling introduced the practice of securitizing energy contracts and establishing a derivative market for Enron

based on course material he studied while getting his MBA from Harvard Business School (McLean and Elkind, 2003). At present, long-term specialized energy contracts, securitizing those contracts into financial instruments, and a limited derivative market for those securities are now well-established parts of the U.S. energy industry. Enron was the first to develop this.

Patents for Complex Financial Instruments

Some of Enron's financial mechanisms were so innovative that they were worthy of patent protection. However, for the most part, Enron did not file for patent protection in this area. This is partly because these concepts were so new that the U.S. patent system had not yet taken a position on whether these types of improvements constituted patentable subject matter or not (United State Patent Office, 2009). A watershed case, "State Street," which addressed the patenting of business methods, did not occur until 1998; Enron ceased operation in 2001. Most applications take at least three years and often four to work their way through the patent system. Any applications Enron had pending were likely abandoned as part of its 2001 collapse.

Since 2001, the U.S. Patent Office has established an entire Art Unit of Examiners dedicated to examining patent applications covering the types of financial instruments originally popularized by Enron. This is a complex area of patent law, and it is difficult to find people with sufficient expertise to understand the subject matter.

Enron was a leader and a pioneer in this area, and some of their advancements and innovations are now accepted standard industry practice.

Deregulation of Energy Utilities

California's Governor Pete Wilson strongly advocated for deregulation of

energy utilities beginning in the early 1990s, and he staked a considerable amount of his political capital on pushing deregulation through the California State Legislature (McLean and Elkind, 2003; Swartz and Watkins, 2003). Around that same time, Senator Phil Gramm (R-TX) pushed some portions of energy deregulation through the U.S. Congress.

In 2000–2002, deregulation resulted in an awful mess for California. Examples include \$2,900 utility bills for a single month for one home, extensive rolling blackouts, and, eventually, the embarrassing recall of Governor Gray Davis (McLean and Elkind, 2003). Such a recall of a sitting elected official is rare and unusual, and very traumatic, painful, and expensive for a state to go through.

Unfortunately, California's implementation of energy deregulation was egregiously flawed. Despite the fact that Enron stood to benefit enormously from the existing deregulation plans, company officials pleaded with the state to change the system. Enron officials, including Ken Lay and Jeff Skilling, repeatedly met with California regulators and warned them that California should not implement deregulation in the form contemplated, as they would regret doing so. And Enron was right.

This is not to say that Enron did not abuse the California utility system. Enron's manipulation of energy prices in California was criminal, and numerous Enron personnel went to jail for these abuses (Smith and Emshwiller, 2004). However, this is a separate issue. What many people overlook is that after picking up the pieces of the mess and firing their governor, California implemented a much more limited and controlled form of energy deregulation (McLean and Elkind, 2003). Interestingly, this wiser implementation utilized some of Enron's original suggestions.

Conclusion

Some of these examples show that Enron was not only correct, but also prescient. Observers should not be misled by Enron's crash. Yes, Enron was an egregiously criminal enterprise, but Enron also had several good progressive ideas. Everyone knows what Enron got wrong. Almost no one pays attention to what Enron got right.

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