Exclusive Outlook

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Enron: Who Is The Greater Fool?

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In his legendary book *"Adventures In The Screen Trade,"* novelist and screenwriter William Goldman emphasizes that an aspiring screenwriter cannot rely on truth alone, but must convey a "believable reality." Some events are simply too ridiculous for an audience to believe, however true they may be. He cites the example of Michael Fagen, who scaled a fence at Buckingham Palace in broad daylight, wandered around for quite a while in sight of guards, set off alarms that no one heeded, found conveniently unlocked windows, and eventually wandered into the Queen's bedroom as she slept, while her bodyguard was coincidentally out walking the dogs and her maids were cleaning another room. If you put it in a movie, no one would believe it. But it happened.

Likewise, if you hear the story of Enron, you will find it hard to believe that anyone could prosper from such horrible business practices, such brazen accounting misrepresentations, such utterly inhumane management habits, and such massive reserves of utter incompetence and unblinking arrogance. Most of all, you will find it hard to believe that many of the key figures in this massive fraud that cost billions and hurt thousands of people may have done nothing illegal.

To some extent, the dubiousness of Enron's outrageous behaviors prolonged their success; the 1990s produced a "stranger than fiction" ethos on Wall Street that led to many absurd behaviors, including investments in technology companies that made no money and had no plans to make money. Instead of treating Enron's empty promises as "too good to be true," Wall Street felt they were too bold to be false.

As we read the details of Enron's malfeasance in Bethany McLean and Peter Elkind's excellent book, *"The Smartest Guys In The Room,"* our emotions roller-coastered between anger and disbelief. How could a company that was generating little cash rack up $38 billion in debt? The web of deceit that fueled Enron's rise and fall betrays a logic so twisted that only cartoon character Homer Simpson could capture the essence of it. As Homer once explained to his wife, "Marge, it takes two to lie: one to lie and one to listen." Enron's leaders may have perpetrated a huge fraud, but they appear to have done so in broad daylight, in front of oblivious guards, through conveniently open windows.

The Anti-Culture

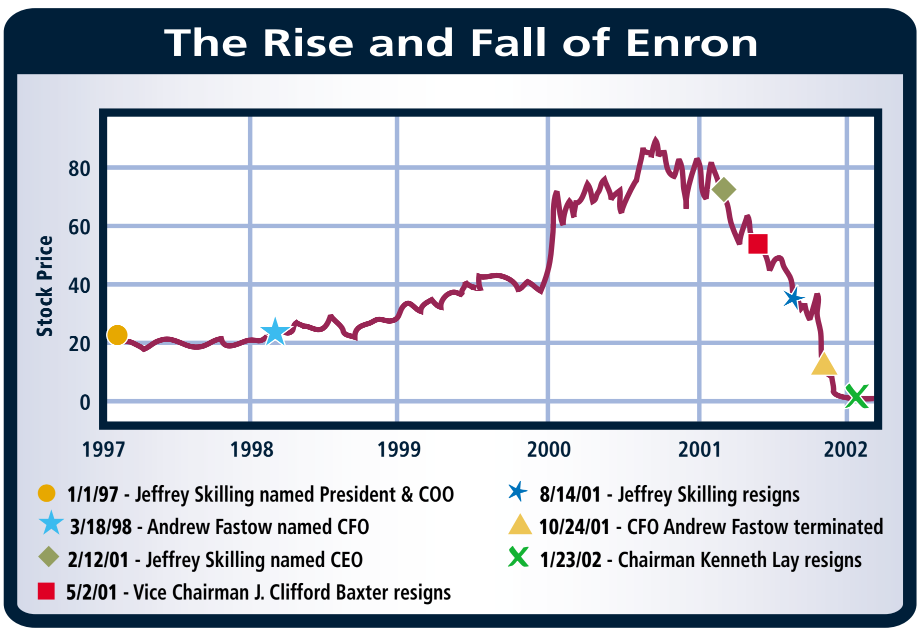
We cannot capture in this article the details so gruesomely documented in McLean and Elkind's book, so we recommend it to anyone who wants to truly understand how Enron disguised debt as income, claimed profits from deals that were losing money, kept huge amounts of debt off of their balance sheet, bullied and/or deceived banks, analysts, regulators and credit ratings agencies, paid lavish salaries and bonuses, and did so without ever quite explaining how they made money. Unbelievable? Not to the investors who lost everything.

But the heart of Enron's malfeasance may be the fact that the company was run by people who could not care less about those who lost everything. The company's leaders built a culture based on greed, machismo and unhealthy competition, dedicated to the proposition that looking out for number one was all that mattered. Enron's culture, conceived by President/COO Jeff Skilling and endorsed by Founder/CEO Ken Lay, presented the foulest possible face of capitalism, a veritable culture of sociopaths.

In the beginning, Enron was a real business with real assets (natural gas pipelines). It had a real business plan (providing a cost-effective fuel in newly deregulated markets) with real profits, and was run by a real manager (President Rich Kinder). But when Jeff Skilling joined the company, he brought his own vision, honed in the ultimate sociopath factory, McKinsey and Company, a consultancy renowned for its intellectual prowess, and equally famous for its ruthlessness. McKinsey habitually reduces every business to an academic exercise, where people matter only to the extent they can be exploited. McKinsey trades in ideas, and cannot be bothered with the details, or consequences, of their execution.

Skilling turned Enron into an energy trading company, pioneering the use of "risk-management" products, also known as derivatives, in the natural gas industry. Unfortunately, he seemed to have had no patience for management controls or strategic planning. As long as he was getting richer, he didn't particularly care how. And he hired in his own image. The success of his trading enterprise gave him power, and he used the power to reshape the company around his own values (or lack thereof).

John D. Rockefeller said that he cared little for wealth; his ambition was to build. Enron's ethos was quite different; they saw money to be made in the wake of deregulation, and they set out to take it. Unfortunately, Skilling's management skills were so weak, and Lay's understanding so limited, that they soon built a monster they could not, or did not wish to, control. Energy traders and dealmakers at Enron earned huge commissions and bonuses with virtually no oversight. The incentive for abuse was tremendous, and not just for the abusers.



Enron's philosophy seemed to be "game anything that can be gamed." Whether they were exploiting accounting rule loopholes, California's electricity system, or their own performance appraisal system, many of the people at Enron seemed to believe that anything not specifically and expressly prohibited by law was okay. We once heard a fiercely competitive salesperson say, "if you're not cheating, you're not trying." He would have fit in well at Enron.

When he joined Enron, Skilling insisted that his division be allowed to use "mark-to-market" accounting, which was a dramatic departure for the company. In a nutshell, "mark-to-market" accounting lets a company take full credit for a long-term deal, such as a ten-year contract, immediately. As McLean and Elkind describe it, "When you use conventional accounting, you book the revenues and profits that flow from the contract as they come through the door. But under the mark-to-market method, you can book the entire estimated value for all ten years on the day you sign the contract. Changes in that value show up as additional income—or losses—in subsequent periods." The value of the contracts is based on a company's "best estimates," and Enron tended to be, shall we say, optimistic. This instantly inflates a company's earnings, but you can see that it would be hard to sustain growth under such a system. Of course, the method appeals to those who draw commissions based on these projected profits, particularly if they determine the assumptions on which those projections are based.

Partners in, um, Accounting

Mark-to-market accounting, eventually adopted throughout many of Enron's various divisions, paved the way for unprecedented misrepresentation. Enron CFO, Andy Fastow, currently in prison, brilliantly illustrates the ultimate expression of Enron's culture. His actions demonstrate how far intelligence and ambition can go when unfettered by scruples or ethics. You see, at some point after Skilling's trading innovation excited Wall Street, many of the key players at Enron started getting rich on stock options. From that point forward, the company was in the "raising the stock price business," not in the gas or "logistics" business, to use Skilling's term. They became obsessed with managing Wall Street's perception, and Andy Fastow was the right genius for this very wrong direction.

Fastow and his chief aides invented numerous complex mechanisms that enabled Enron to meet Wall Street expectations, quarter after quarter, despite reality. He created "prepay" partnerships that disguised debt as cash flow. He built entities that bought assets from Enron (sometimes with their own borrowed money) when they needed to book revenues. He bullied and bamboozled banks, credit ratings agencies, and Wall Street Analysts; he always found a way to help the incompetently-run divisions show a profit. While all this was happening, no one seemed to be managing the actual business units, whose deals were getting worse and worse.

Although he was richly rewarded for his creative solutions to Enron's constant problems, that was not enough. Fastow eventually created numerous schemes for personal enrichment, including running several investment funds that took advantage of his inside knowledge and control of Enron's deals. It remains to be seen if anyone else will join Fastow in prison. In fact, as we said above, it's not entirely clear that Skilling and Lay, however despicable they are, did anything illegal. Besides, nothing this big (at the time of its bankruptcy, Enron's debt was $38 billion) happens in a vacuum; accountants, regulatory agencies, credit ratings agencies, banks and major investment firms are not exactly rubes. After the collapse, the finger of blame pointed in many directions; possibly they were all correct.

Experts at playing close enough to the rules to argue their case, Enron disclosed many of their bizarre accounting practices in required forms. Granted, the disclosures were sometimes vague or complicated or tucked away in small print, but they were there. Astute observers could also find clues to the company's many woes that were not fully disclosed.

Whether they were conmen or merely incompetent, Skilling, Fastow and Lay leveraged the conman's greatest asset: his victim's insecurity. Their accounting mechanisms were absurdly complex; no top-tier accountant wants to admit that he doesn't understand something, especially when it is presented as patently obvious. Skilling and Fastow viciously berated analysts who dared to question Enron's business model because they "didn't get it." They embarrassed critics into acquiescence.

Of course, it helped that Enron doled out huge fees to investment bankers, consultants and other "enablers" throughout the course of their massive charade. The men at the heart of Enron's leadership did not prosper simply because of their intelligence. Rather, they prospered by ruthlessly exploiting the insecurity, laziness, greed and stupidity of others. Apparently, there was plenty to go around. But, in a hopeful sign for capitalism, the emperor was not able to walk around naked forever.

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Fans of Harry Potter know that he is famous as "the boy who didn't die" when the evil wizard Voldemort tried to murder him. Understanding why Harry didn't die is one of the key mysteries in the popular novels. Jim Chanos of Kynikos Associates is "the man who didn't buy" - The Enron story, that is. Understanding why is simple: He read the 10-K filing and most importantly, the cash flow statement, and it didn't add up. Moreover, he knew what he knew, which was telecom, and he recognized Enron's Broadband story for a pack of lies (the entire industry was falling apart, but Enron claimed outrageous opportunity in their venture, which had yet to make a dime).

He was also surprised by Enron's low return on capital, its high debt (despite the billions in debt that was hidden in "off-balance-sheet" entities), its insider deals, and the incomprehensibility of certain sections of the third quarter 2000 filing. He sounded the alarm, and shorted the stock. Said Chanos, "As soon as anyone looked, they could see the stuff we saw." To us, that sentence is the most important lesson of the entire Enron story.

Chanos spoke to Fortune reporter Bethany McLean, co-author of *"The Smartest Guys In The Room."* Her February 19, 2001 article asked some very basic questions, such as "How exactly does Enron make its money?" Tough questions, scandal and bankruptcy followed. That article was not only the beginning of the end for the Enron company, but also for Arthur Anderson, their accountants. Much has yet to be decided in the courts, and many books are already in print, covering the lurid details of graft, deception, inter-office affairs, and sadly, the suicide of Cliff Baxter - one of Jeff Skilling's top aides.

We opened with the advice of a screenwriter, so let us end with a movie quotation. Andy Fastow named most of his schemes after elements from Star Wars. We recall that the great Jedi Knight Obi Wan Kanobi asked Luke Skywalker, as we now ask our readers, "Who is the greater fool? The fool, or the fool who follows him?" ▲