



People like to blame politicians and regulators, but experts in accounting, economics, and trading agreed that deregulation wasn't responsible for Enron's fall. Instead, they blamed the uncertainty inherent in a new industry, irresponsibility on the part of Enron management and auditors, inefficiency in the way deregulation was carried out, and the willingness of investors to see only what they wanted to see.

What brought down **Enron?**

By Jennifer Vanasco Photos by Kevin Weinstein

In late January, before a large audience at Gleacher Center, professor Richard Leftwich, alumni Michael Polsky and David Vitale, and dean Edward A. Snyder examined the reasons for Enron's collapse. What worried the panelists was whether a new market that previously had little oversight might become overregulated. Without any government intervention, they agreed, market pressures will encourage other companies to come clean financially.

Enron was a player in a brand new field, one where there were no rules, according to Polsky, '87, a Chicago entrepreneur in the energy sector. "You can't expect Enron to get in a new market and start policing itself, saying, 'This is right, this is wrong,'" he said. "It's inevitable when we create a brand new industry that we have to have a pioneer like Enron—maybe in the bad sense of the word—to help us really understand what needs to be done to prevent this situation from happening again."

Even so, noted Snyder, public scrutiny should focus on Enron management, particularly the murky accounting and auditing practices that the company engaged in. "People on the outside who have followed Enron for quite a while have been complaining about the lack of transparency," Snyder said.

Richard A. Leftwich, Fuji Bank and Heller Professor of Accounting and Finance, pointed out that the Financial Accounting Standards Board (FASB) and the Securities and Exchange



Among the speakers was Michael Polsky, '87, principal of Invenergy.

Commission have been slow to respond to changing business practices, whereas investment bankers tend to exploit regulatory loopholes rapidly.

What Happened to Enron?

Using numbers the company reported, Leftwich showed that even as Enron's revenue grew dramatically, its profit margins shrank because costs kept increasing as well.

"Whether you measure margins in terms of earnings before interest and taxes to sales, or net income to sales, these were declining margins for Enron," he said.

Not only did Enron have a flat—perhaps declining—rate of returns on assets and equity, the firm was heavily in debt. Revenues were growing, but the need for cash was growing at an even faster rate.

"You can see that this was an enterprise that was consuming considerable amounts of cash," he said. "As far as transparency, there's an interesting number there in the final year—a \$4 billion cash inflow, cash from operations. That's a very healthy-looking number. Unfortunately, \$2 billion



Panelists also included David Vitale, '76, (left) president of the Chicago Board of Trade; professor Richard Leftwich (center), and dean Edward A. Snyder.



of that seems to be from 'other.' My reading of the financial statements makes it fairly difficult to penetrate what 'other' was."

Enron's price-to-book value was higher than that of its peers in the energy field—Reliant, Dynegy, Duke, and Williams—and even higher than that of trading companies like Morgan

where nearly as high as it was valuing Enron's, suggesting that the market had some very high growth expectations," he said.

Polsky wondered how the market value ever reached \$100 billion. "I like the remarks where people say, 'Oh, \$60 billion to \$100 billion of shareholder value was lost,'" he said. "My

Enron really an industry, or was it simply a Ponzi scheme?" He conceded Enron had interesting innovations but ultimately little value. "There were certainly legitimate parts of the business, but there was no value there from day one. I think they tried to create value from something that wasn't there."

The Future of the Markets

The aftershock from Enron's collapse left the business community wondering how the government would regulate markets in the future. Enron traded energy in the over-the-counter (OTC) market, a smaller, less formal exchange than those operated by the Chicago Board of Trade and the Chicago Mercantile Exchange. The OTC market may be more flexible and innovative and have lower costs, but the lower transparency and lack of government oversight make it "a 'buyer beware' market," said Vitale, '76, president and CEO of the Chicago Board of Trade and an expert on OTC trading systems.

"Enron filled all of the roles in the energy market they were in. They acted as principal, agent, and customer. They

"Market economies cannot undo risk and uncertainty. Those are features of life. Markets will adjust to them." —Edward A. Snyder

Stanley, Goldman Sachs, and Merrill Lynch, Leftwich pointed out. "Enron's market value was five or six times its book value, whereas the investment banks were selling at about three times book," he noted. Enron also racked up unusually high price-to-earnings ratios. "The market was not valuing the investment banking earnings any-

question is, was it ever created? In my opinion, it wasn't there."

Enron took advantage of its status as a player in a newly deregulated industry that few people understood— independent power trading. "Enron created an expectation that because of deregulation, money would suddenly grow on trees," Polsky said. "Was



A panel discussion on the fall of Enron drew a crowd to Gleacher Center.

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clearly had to be conflicted in running all of those roles. I would argue it caused some of their failure,” he said.

But the situation is likely to change significantly in the OTC market, Vitale predicted. The Enron collapse will bring on additional regulation and attendant costs that will eliminate its advantage over regulated markets. “I believe that the real cost of over-the-counter markets will rise because of additional government intervention, either by law or by regulation,” he said. “I think the biggest risk for our economy and for markets gener-

ally is that the consequences may drift into the regulated exchange market. That would be totally unjustified because it’s pretty difficult to identify any significant failures there,” he said.

Some people claim the Enron collapse shows the system failed, but Snyder said it’s important to note that the markets adjust well to such situations. “Market economies cannot undo risk and uncertainty. Those are features of life. Markets will adjust to them,” he said. “Over the next few weeks, the markets will be sorting out which companies are more

transparent, which earning streams are solid versus thin air, who’s doing the audits on the books, who’s doing the legal work.”

Too much government intervention could create unintended, unanticipated problems, and the market should be allowed to adjust on its own instead, Snyder said.

Panelists predicted the government won’t make specific laws regulating energy trading. Instead, they worried that any resulting legislation will cripple the entire marketplace. “I think we need to be concerned that [new]

regulations will constrain the ability of markets to work,” Vitale said. “I don’t think energy will be singled out.”

Energy Deregulation

Even if energy trading remains deregulated, the industry needs to become more self-policing to keep the government from stepping in, Vitale said. The problem lies in how electricity deregulation has been carried out, Polsky said, noting it has been done state by state and is half deregulated and half regulated. “Markets were different in every jurisdiction,” he said. “The situation as it exists is not stable.” The solution is to deregulate all energy trading because it will prevent another Enron-like collapse, Polsky said.

The Enron debacle steered public scrutiny away from California, which is under criticism because the wholesale market is deregulated while the

retail market is regulated, Snyder said. “I think Governor Davis ought to send all the Enron senior executives fruit baskets because he was let off the hook for California’s fundamentally flawed deregulation,” he quipped.

Accounting and Auditing

Vitale said the job of restoring confidence in the integrity of American businesses belongs to the accounting and auditing industry. “They need to respond rapidly; that’s clearly evident now,” he said. But it is a



Audience members had a chance to pose questions individually to panel members, including Polsky (above), after the forum.

Richard Leftwich

Richard Leftwich is Fuji Bank and Heller Professor of Accounting and Finance. A member of the faculty since 1979, he earned a Ph.D. in applied economics and finance and an M.S. in applied economics at the University of Rochester, where he also taught accounting. Leftwich was director of the Seminar on the Analysis of Security Prices (SASP) from 1985 to 1996 and director of the Center for Research of Security Prices for four years before being named to SASP. In 1994, he received the McKinsey Award for Excellence in Teaching. Early in his career, he lectured at the University of Queensland, Australia, and worked as an accountant and analyst for a mining concern in Brisbane and a financial analyst for a sugar refinery in Sydney. Leftwich currently is an editor of the *Journal of Accounting Research* and serves on the editorial board of the Bank of America *Journal of Applied Corporate Finance*.

David Vitale

David Vitale, ’76, has been president and CEO of the Chicago Board of Trade (CBOT) since 2001 and serves as president and CEO of the MidAmerica Commodity Exchange, an affiliate of the CBOT. Vitale is a member of the Council on the Graduate School of Business. He is former vice chairman and director of Bank One Corporation, where he was responsible for commercial banking in the United States and select international markets. Vitale also oversaw real estate and private banking as well as investment management and corporate investments. He joined First Chicago Corporation in 1968 and held several positions until it merged with Bank One in 1993.

Edward A. Snyder

Edward A. Snyder, M.A. ’78 (public policy), Ph.D. ’84 (economics), is dean and professor of economics. He spent 16 years on the University of Michigan’s business school faculty and served as the senior associate dean with responsibility for faculty matters and professional degree programs. He also was the founding director of the Davidson Institute, which focuses on such emerging markets as India, China, and Central Europe. In 1991–92, Snyder was the John M. Olin Visiting Associate Professor at the GSB’s George J. Stigler Center for the Study of the Economy and the State, and early in his career he was an economist with the antitrust division at the U.S. Department of Justice. Before joining the GSB in July 2001, Snyder was dean at the University of Virginia’s Darden School.

Michael Polsky

Michael Polsky, ’87, is principal of Invenergy, one of the leading independent power producers in the United States. Trained as an engineer in his native country, Ukraine, Polsky founded Indeck Energy Services in Buffalo Grove, Illinois, two years before earning his M.B.A. During his tenure at Indeck, *Inc.* magazine rated the firm one of the fastest-growing companies nationwide. In 1990, he started Polsky Energy, which he renamed SkyGen Energy. In October 2000, Calpine Corporation acquired SkyGen, and Polsky joined the firm’s board of directors and served as president of a subsidiary, SkyGen Energy Marketing. He left to launch his new venture, Invenergy, with other principals in October 2001.

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—Richard A. Leftwich

management problem as well, and boards of directors bear some responsibility. “I do believe this is an issue for everybody, not just auditors and accountants,” he said.

The government is unlikely to intervene in the auditing market, Leftwich said. “Even the most ardent of regulators recognize they just don’t have the resources to do it.” Still, the auditing/consulting marriage is under more stress now, he said. The likely result is that more firms will spin off their consulting business “because that’s where the litigation risk is. It’s not a cure,” Leftwich said, “but politically, it’s a likely outcome.”

Snyder said the real solutions will emerge because auditors want to salvage their own reputations. “Even if you do the separation, temptation will not fully go away. No matter what the role of government or the FASB is, there still has to be a reputation component. I think that’s what a lot of the market is going to be figuring out.”

Vitale added, “The auditors who come out of this process with a stronger reputation will be in a better competitive position.”

Don’t Blame Bush

Panelists agreed that the Enron collapse was due to internal factors.

Snyder said the Bush administration could not have been responsible for Enron’s decline, just as it was not responsible for its rise. “The fall of Enron is a second act. The first act is the rise of Enron, which got to be a \$100 billion market cap company before Mr. Bush and Mr. Cheney were even campaigning for the White House. I don’t mean to suggest that there aren’t political dimensions to this story, but the idea that the administration is central to the core of it just doesn’t match with the facts.

“I’m not really sure what Mr. Bush’s role could have been,” he added. “To make it go down faster?”



Audience members questioned everything from the impact on natural gas and power markets to challenges the accounting profession will face.

Better Oversight Will Keep Auditors in Line, Weil Tells Congress at Enron Hearing

There is no shortage of specific accounting rules to govern corporate financial transactions. But company managers sometimes use the list not for guidance but for its loopholes, Roman Weil told the House Committee on Energy and Commerce in February.

“Aggressive managers have been able to say, ‘Detailed accounting rules cover many transactions, but none of them cover the current issue so we can devise accounting of our own choosing,’” he said. “And they do.”

Weil, V. Duane Rath Professor of Accounting, was one of three business school professors summoned by Congress to explain the Enron bankruptcy. The problem lies with the way the Financial Accounting Standards Board (FASB) sets specific rules for specific

issues because of the litigious corporate culture, he said.

“The rules strengthen aggressive management’s belief that if a rule doesn’t prohibit something, then it’s allowed,” Weil said.

The other problem lies with the corporate auditing committees—members of the board of trustees charged with overseeing the auditor’s work. But the trustees usually have little accounting expertise and tend to defer to company managers, he said. Since the accountants hire the auditing firm, conflicts of interest are inherent. After auditors perform the audit, they take on a consulting role, a service they perform for an additional fee.

The solution, Weil said, is to empower the auditing committee to change firms every five to seven years.—P.B.

“You can’t expect Enron to get in a new market and start policing itself, saying, ‘This is right, this is wrong.’” —Michael Polsky, ’87

Panelists agreed that the Enron story is not finished. New regulations and closer oversight are likely to be implemented, and even more companies may be found to have murky accounting practices.

“I think there will be a few more Enrons coming up, especially in the energy industry, which is very heavily capital-intensive,” Polsky said. “There is a big drive to do creative financing.

There are a lot of new companies, and they have to maintain high growth. One way is to manipulate financial statements.”

He added, “It’s only a question of how quickly we can straighten up [the industry].”

Periods of trouble are part of economic history, Vitale said. “Frankly, when things are good and getting better, we get arrogant that we can do

no wrong. Regulation and supervision get more slack because people think, ‘Things can’t go bad. We’re never going to have a recession.’ We went through a decade where people began to think they couldn’t make a mistake. But market economies are cyclical. We go through periods where things are difficult, and that’s when adjustments are made.”

The industry will indeed straighten up, panelists agreed, partly because the problems of Enron were brought to public attention so quickly, and partly because of the power of the markets.

“The markets will adjust to this,” Snyder said. “I predict they will adjust well.” ■