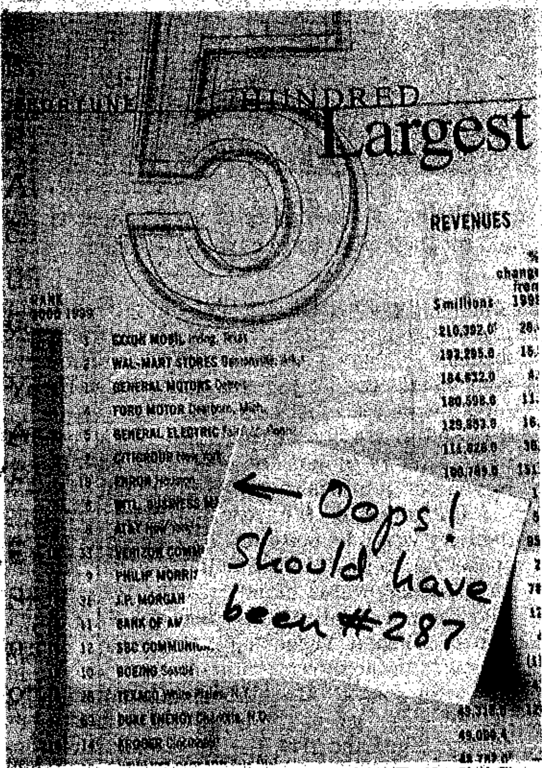
How 287 Turned Into 7: Lessons in Fuzzy Math

By GRETCHEN MORGENSON

FOR years, the Enron Corporation was known and admired as one of the nation's most innovative companies. Now, it looks as if the only innovations the company will be remembered for are the many labyrinthine schemes it used to mislead investors about its financial position.

It is not yet clear how early and often Enron substituted fantasy for reality in its reports to shareholders. But knowing the extent of the dishonesty is central to answering the question many people asked as they watched Enron implode. How could a company as big, profitable and powerful as Enron slide into oblivion so quickly?



Naum Kazhdan/The New York Times

Part of the answer is that Enron was neither as large nor as profitable as it claimed. But the company was a master of obfuscation in its financial statements, so investors were kept pretty much in the dark about its stature.

For example, the company said it was a highly profitable enterprise. But a determined investor looking closely at its financial statements would have found that even in the California power crisis, when energy costs were in the stratosphere and profits should have rolled in, Enron was earning only one-half of 1 percent on its sales.

Another half-truth concerned Enron's appearance last year at No. 7 on the Fortune 500 list of largest American companies. The company's $101 billion in revenue placed it between the powerhouses **Citigroup** and **I.B.M.** on the list. But rising to that level occurred only because energy trading companies can record as revenue the total amount of their transactions, rather than the profits made on each trade as is typical at brokerage firms. If viewed this way, Enron's revenue would have been $6.3 billion last year, pushing it to the bottom half of the list, at No. 287, wedged between **Automatic Data Processing** and **Campbell Soup.**

Adding credibility to the view that Enron was more ephemeral than real was last week's announcement that **UBS** was taking over the company's vaunted trading business, and paying nothing up front.

"We don't know where reality sets in at Enron," said Robert F. McCullough, an authority on the electric utility industry at McCullough Research, a consulting firm in Portland, Ore. "We know that the operational numbers as far as we can follow them don't scan. We have 4,000-odd special-purpose entities off the balance sheet. We're having very grave doubts about the overall honesty of the company. The question is, How far down did that dishonesty extend?"

It may take a team of forensic accountants months if not years to unravel all the Enron entities and see where the $12.5 billion that the company raised in the capital markets over the last 10 years went.

Nevertheless, for investors hoping to learn from the Enron wreck, a look back at its recent financial statements, fuzzy though they were, does show several warning signs of some of the company's woes well before the bottom fell out last fall. Investors concerned that other Enrons may be lurking in the stock market's shadows can sharpen their pencils and conduct a few tests on financial statements to allay or confirm their fears.

Michael J. Mauboussin, chief United States investment strategist at Credit Suisse First Boston, said Enron was, to some degree, a victim of its own growth promises. Even as the company was convincing investors that its impressive revenue growth would translate into extremely profitable businesses, Enron was unable to produce the returns that investors demanded.

"The reason people had enthusiasm for Enron was you could have made the case that they were in nascent markets that were going to develop into solid ones," Mr. Mau-

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bossin said. "But the economics were not there. As Enron needed more capital, the company went to more byzantine financial structures to try to achieve the growth it needed."

In Enron's days as a stock market darling, there was almost nothing it could say that investors wouldn't believe. One claim that caught the eye of Mr. McCullough well before Enron collapsed last year involved the commercial success of Enron Online, the company's online trading business. During 18 months that ended in the company's third quarter, even as other dot-coms went bankrupt, retrenched or simply vanished, revenue at Enron Online grew at an astonishing 12 percent a month.

A particularly doubtful assertion made by Enron Online was the so-called notional revenue it reported, Mr. McCullough said. For the first nine months of 2001, in news releases, Enron Online reported $544 billion in notional revenue, or the total amount of the underlying gas and electricity that the operation's trades covered. Yet, this contrasts greatly with the energy purchases and sales that Enron reported in its filings with the Federal Energy Regulatory Commission for the same period. Those reports show just $693 million in energy purchases and sales by the company. "We compare that $693 million against $544 billion and it's a surprising number," Mr. McCullough said. It is also a dubious number, he added. "A normal utility would have total electric revenues in the $1-to-$2-billion range, so the Enron number is roughly equivalent to the amount of electricity generated by 500 large utility companies. But they never put any of these numbers side by side so people would begin to question the numbers."

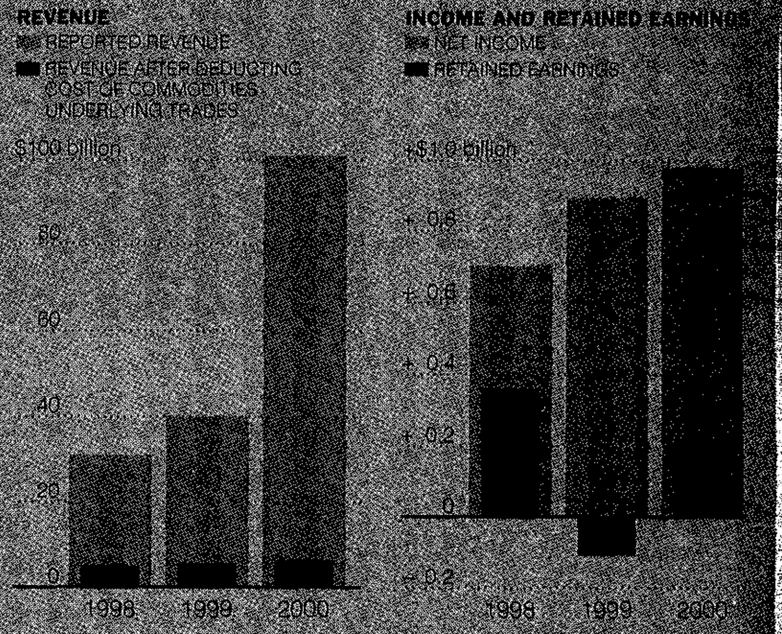
FEW investors can be expected to have done the extensive work Mr. McCullough did to uncover suspicious figures in Enron's reports. But by comparing two figures found in Enron's annual reports, even a novice could have found reason to doubt the earnings the company was reporting in recent years.

According to Enron's 2000 annual report, which does not reflect the four years of earnings restatements the company announced in October, net income rose to $979 million in 2000 from $703 million in 1998, an increase of 39 percent. Total earnings for the three years came in at $2.575 billion.

As is now known, these profits were almost completely manufactured. But even before the dire restatement of last fall, investors on the lookout for wide discrepancies between a company's reported earnings and its retained earnings — the profits that it made after all expenses and costs, like stock dividends, were paid — would have noticed a gulf at Enron.

Reality Check

Enron's revenue and earnings were impressive on the surface, but paled on closer scrutiny. Because energy trading companies report the entire amount of their trades as revenue, Enron became a $100 billion company in 2000. Under traditional accounting methods, the company's sales were $6.3 billion. And Enron's earnings totaled $2.575 billion from 1998 to 2000, but retained earnings, a better measure of what a company truly makes, totaled only $474 million.



Source: Enron's 2000 10-K report as filed with the Securities and Exchange Commission

The New York Times

For 1998 through 2000, Enron's net retained earnings, after subtracting losses from its trading activities, totaled just $474 million, roughly $2 billion less than its reported profits.

What this exercise illustrates is the amount of puffery that can go into a company's income statement.

Retained earnings, found in a company's statement of changes in shareholder equity, are not as closely watched by investors as are a company's net earnings, but they are less easily manipulated.

"This is the type of analysis anyone could have done on Enron one

10-K's: A Good Read for the Curious Investor

By DAVID CAY JOHNSTON

EVEN with the cynicism about corporate financial statements generated by the Enron collapse, investors can still learn plenty about a public company's performance, the known risks it faces in the future and its current problems. But that information almost certainly won't be found in the slick annual report mailed to shareholders.

Getting the substantive stuff requires examining the dry disclosure documents that most shareholders quickly pitch into the trash. The most important of these are the annual 10-K and the three quarterly 10-Q forms that companies are required to file with the Securities and Exchange Commission.

Access to those documents has become much easier since the mid-90's, when the S.E.C. embraced electronic filing and the Internet. These documents can be read online at the S.E.C.'s Web site (www.sec.gov), at the privately owned FreeEdgar (www.freeedgar.com) and other Web sites and, often, from links at a corporation's own Web site, usually in the area called "investor relations." (Edgar stands for Electronic Data Gathering, Analysis and Retrieval.)

Prof. Jerry Arnold, founder of the S.E.C. and Financial Reporting Institute at the University of Southern California, recommends that investors unaccustomed to the 10-K pay close attention to Item 1, the description of the enterprise; Item 3, legal proceedings; Item 6, selected financial data; Item 7, management's discussion and analysis of financial condition and operations; Item 7a, market risk; and Item 8, financial statements.

"The informed reader will also look at the index to exhibits near the end of the 10-K," Professor Arnold said, "especially items under Exhibit 10, which are material contracts." Employment agreements with executives are listed there, as well as important contracts like leases.

Investors examining the 10-K should look not just for bad news, like a warning that cash flow is so shriveled that management can no longer assure that the enterprise will continue.

"Management is supposed to disclose every material known event, trend or uncertainty that may cause the future to differ from the present," Professor Arnold said. He said those disclosures must deal with both the negative and the positive because, without positive disclosures, "investors might sell prematurely" and miss a run-up in a stock's price.

Whether Enron technically violated the full-disclosure requirement in Item 7 of its latest 10-K, filed last April 2, is a matter of debate. Enron's hidden liabilities in hundreds of partnerships that eventually led to the company's collapse were never mentioned, although a tortuous path through the footnote section acknowledges the existence of some of these partnerships.

Critics say Enron buried that information so completely, and omitted even more, that it was the same as a failure to disclose the truth. Henry T. C. Hu, a professor of banking and finance law at the University of Texas, said Enron was supposed to show "a real big-picture view of what could go wrong at a company."

Professor Hu said he thought "the likelihood is quite high" that regulators would now look into whether Enron had disclosed the risks adequately. □

year ago but nobody would have believed it," said an institutional money manager. "Shareholders can do it right now with other companies that have accounting issues or with any company that reports pro forma numbers."

UNDERSTANDING that Enron's profits were not nearly what the company had said they were helps to explain its quick demise. But plenty of uncertainty remains about why the company was so starved for cash that it had to borrow almost $6 billion in the six weeks after its third-quarter earnings bombshell and leading up to its bankruptcy filing.

Some of these borrowings may have been forced on the company by other lenders worried about the possibility of Enron's collapse. On Nov. 19, Enron disclosed that a downgrade on its debt rating required it to repay a $690 million note earlier than it had planned. Nevertheless, Mr. McCullough said, it is not clear that all $6 billion went to such payments.

Indeed, the company's financial statements show evidence of a cash squeeze early last year even as Enron was reporting growing profits. For example, in 2000, Enron said its net cash provided by operations totaled $4.8 billion. But Mr. McCullough pointed out that the total included $5.5 billion in deposits that Enron required of customers in California because of the spike in energy prices there, money that the company had to repay later. That put Enron's cash flow at negative $700 million. Deduct the proceeds from asset sales — one-time activities that were not part of the company's core business — and Enron's cash flow was a negative $2.56 billion in 2000.

In the first nine months of 2001, the company did a bit better, producing positive cash flow of $953 million. Even so, that is not a great showing when compared with Enron's revenue. "Against cumulative sales of $101 billion in 2000 and $138.7 billion in the first three quarters of 2001, this is an amazingly small amount of cash," Mr. McCullough said. "When you see one of the fastest growing corporations in a cash shortage, you have to ask: Where did that cash go?"

With a definitive answer to this question a long way off, Mr. McCullough is willing to make an informed speculation about why Enron unraveled as it did.

Based on Enron's financial statements, the company was obviously presenting a very strong picture on extremely weak fundamentals. Once executives had promised profitability, they had to worry about keeping up the appearances of a moneymaker. While its revenue was growing quickly, this was manageable. But when the growth tailed off, the promise of profitability became impossible to deliver.

For the first three quarters of 2001, revenue at the company increased 132 percent from the same period in 2000. Normally, cash flow from such impressive growth would be enough to cover any temporary cash shortfalls.

But isolating each period shows a different picture. Revenue growth at Enron in the second quarter flattened abruptly, and in the third quarter, revenue actually fell by $2.5 billion. Operations at the company's wholesale group for the Americas, which accounted for most of Enron's sales, were also slowing. Income before interest and taxes in this segment of the company declined to $582 million in the second quarter of 2001 from $661 million in the first quarter, Mr. McCullough said. Income rose again in the third quarter, to $717 million.

At the same time, Enron was returning $2.35 billion in deposits to its California customers.

"When we have four quarters of level revenues at wholesale Americas, one really does wonder whether

How investors can put the Enron debacle to use.

continued growth was needed to maintain the fiction of financial profitability," Mr. McCullough said. "It seems to be a situation where they are running twice as fast to stay where they are. Their financial problems might have been intervening in their day-to-day trading activities."

Enron may have found a way to paper over its problems, Mr. McCullough said, with an accounting technique known as "mark to market." That would have allowed it to realize immediately the earnings it forecast on energy deals even though the costs and revenue on those deals might stretch over long periods. A result would be high earnings but little actual cash coming in.

The inherent risk in such an arrangement is that the price of energy could fall. If that happened, the contract struck previously would become less valuable than the company had forecast, creating a loss on the deal. Salvation from having to show the loss could present itself, however, in an even bigger power contract at current prices.

The new contract, Mr. McCullough explained, would provide enough mark-to-market earnings to offset the loss on the contract struck when prices were higher. "With sufficient growth in volume, earnings can be positive in each year," he said, "while cash flows continue to deteriorate." But such an approach fails when sales growth falls, he said, "like any other pyramid scheme." □