The NewsHour with Jim Lehrer's segments back to 1996 are archived on the web at www.pbs.org/newshour.

"Explaining Enron" a series in four parts:

PART 1:
"Accounting Alchemy" – January 22, 2003 - http://www.pbs.org/newshour/bb/business/jan-june02/enron_1-22.html

TRANSCRIPT:

JIM LEHRER: The kind of magic behind the rise and fall of Enron. Our economics correspondent Paul Solman of WGBH-Boston reports on some of the ingredients.

The fantasy finance game

PAUL SOLMAN: Okay, you may know the basics about Enron already: A company called Houston Natural Gas becomes Enteron-- until told that name suggested intestines; becomes Enron; becomes politically-connected player in the new deregulated market of energy trading; becomes part of the Internet revolution; claims to become huge and profitable; is lying about both; fails. But how did Enron manage to fool the world? That's what the world is now trying to figure out. And here's what we seem to know of the company's magic act thus far.

The key was what you might call "accounting alchemy," miraculously turning lead into gold, water into wine, losses into profits, making debts and bad investments, or anything they wanted to simply disappear. Or to put it differently, Enron played the all-in-the-family fantasy finance game, manipulating hundreds of subsidiary companies with names out of "Star Wars," "Jurassic Park," medieval Scotland. So back here in the New York apartment where I played fantasy games growing up, let's see how they did it.

In the early '90s, Enron made money, with, for example, an oil partnership dubbed Jedi, after the "Star Wars" knights. One of its many subsidiaries, Raptor, which invested in Internet firms, was virtually minting money as its portfolio soared. And when Enron made a deal with Blockbuster Video to deliver movies on demand over the fiber optic cables it was installing across the country, Enron seemed to be making all the right connections.

Soon Enron was America's seventh largest company in terms of revenues. But from the beginning, something was kind of fantastic. It turns out, Enron got so big, so soon, with some audacious sleight-of-hand accounting-- call it "ledger domain." Enron recorded, as revenues, what on the stock market they simply refer to as volume. Accounting professor Doug Carmichael:

DOUGLAS CARMICHAEL, Baruch College: Enron was able to book its energy trading contracts at the full contract price. It would be like a stockbroker taking credit for the full sales price when a customer sold stock, instead of the commission that they earned on selling the stock, which gave them a much inflated earning figure.

PAUL SOLMAN: Or, since I'm back in my family apartment, if we tried this at home, it would be like setting up the brokerage firm Solman and Solman-- that's me and my dad-- get $1 million from you viewers to buy and sell stocks and bonds, then claim we're a multimillion dollar firm. Sadly, the accounting industry's board won't let us do that. Wall Street brokers can't either. But for companies like Enron, in this new industry, new regulations, or deregulations, applied. By the late '90s, however, with regulators otherwise engaged, Enron had begun to lose money.

But to keep its stock price and credibility as a trader from collapse, Enron needed to keep the game going. It started playing faster, looser. Take Enron's movies-on-demand deal with Blockbuster. That was a real partnership: To share profits 50/50 for 20 years. But before it could even go bad-- which it did-- Enron created a different company, code name: Project Braveheart. A Canadian bank invested $115 million in it, in return for the first decade of supposed future earnings from the Blockbuster deal.

Plus, Enron guaranteed the bank its money back if Braveheart fell. Then, get this, Enron recorded the bank's $115 million money- back guaranteed investment as Enron's profit! In most families, that would be outright fraud. Okay, how did they do it? Well, for one thing, their accounting alchemy was hidden in language even experts couldn't follow. Listen to a related deal, as read by Professor Carmichael.

More accounting tricks

DOUGLAS CARMICHAEL: Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day.

PAUL SOLMAN: Can anybody understand this stuff?

DOUGLAS CARMICHAEL: No. I think any objective evaluation would be that it's not transparent, it's not adequate disclosure.

PAUL SOLMAN: But this is literally officially what they've disclosed to the government.

DOUGLAS CARMICHAEL: Yes. In their filings with the SEC, that's all they disclosed.

PAUL SOLMAN: And now, nobody said, "wait a second," "what does this mean?"

DOUGLAS CARMICHAEL: Nobody, not the auditor, not the audit committee, no one.

PAUL SOLMAN: No... And not the SEC?

DOUGLAS CARMICHAEL: And not the SEC.

PAUL SOLMAN: Is that amazing to you?

DOUGLAS CARMICHAEL: It was shocking to me.

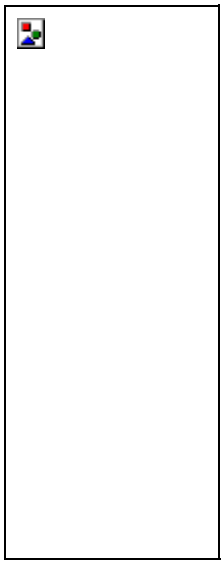
PAUL SOLMAN: Shocking?

DOUGLAS CARMICHAEL: Shocking.

PAUL SOLMAN: Now, a key to this scam was perhaps Enron's main alchemical tactic: The use of its so-called related parties companies like Raptor or Braveheart, companies created and owned almost entirely by Enron; subsidiaries, really, some of them run by its chief financial officer. Yet when it suited Enron's interests, these "related parties" were treated as independent, arms-length businesses.

In the case we just heard about, another related party had invested in something called New Rhythms Net Connections. This is our fanciful representation of it. (Beethoven's "Ode to Joy" playing.) Unfortunately, New Rhythms had crashed. So Enron entered into something called a derivatives contract with its own subsidiary. The contract increased in value as New Rhythm's stock price went down.

So if the stock rose, Enron would report profits from the stock because it was an asset of the subsidiary. If the stock dropped, Enron would report the profits from the New Rhythms derivative contract, neglecting to report that the related party-- the subsidiary-- was losing exactly the same amount.
This is like me claiming my daughters have a separate company, which lost $100 million in an Internet stock, but I made $100 million on the deal because I had a contract with them where they had to pay me a dollar for every dollar they lost. Meanwhile, who would make good their debts to me? Me, their father.
Bottom line: I lose $100 million, but report it as a $100 million profit, which is exactly what Enron did when the stock, in fact, tanked. By the way, Enron also pulled this with the related party known as Raptor, which had a whole portfolio of Internet losers. And then there was the old 1920s trick of watered stock, again with a related party.



Watered stock

DOUGLAS CARMICHAEL: They gave the related party 3.7 million shares of their common stock.
PAUL SOLMAN: Right.
DOUGLAS CARMICHAEL: And they disclosed that they, among other assets received, 1.2 billion in notes receivable.
PAUL SOLMAN: Notes receivable meaning just --
DOUGLAS CARMICHAEL: I Owe You's
PAUL SOLMAN: An IOU
DOUGLAS CARMICHAEL: And what they don't tell people is that was a one-for-one exchange. They gave their stock for a 1.2 million-note receivable.
PAUL SOLMAN: For an IOU from a company they owned.
DOUGLAS CARMICHAEL: From a company they owned.
DOUGLAS CARMICHAEL: And the SEC doesn't permit that. It's on its face a violation of SEC rules and accounting requirements. It's called watered stock, and it inflates the capital. It makes the company look like it has more equity than it really does.

Numerous abuses of SEC rules

PAUL SOLMAN: Back in the family, this is like pretending to sell $1.2 billion worth of my own company's stock to myself, giving myself my own IOU for $1.2 billion in return,

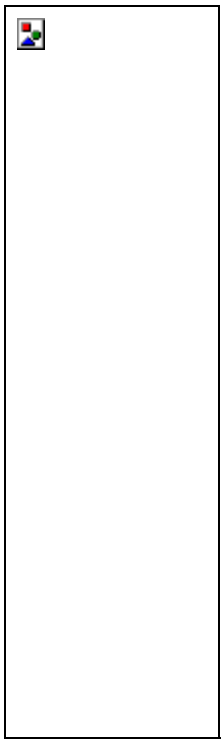
then recording the sale as if it were for cash. The SEC was literally established to prevent such abuses.
There were so many scams, we've almost run out of props. Enron borrowed money through related parties to hide its debts, sold off energy assets, then claimed the proceeds as pure profit, while never deducting the value of the asset it no longer had.
It sold now a nearly worthless fiber optic cable to one of its related parties, claiming a profit of $53 million, and then, without explanation, reported that same transaction again the following quarter with an additional $14 million profit, thereby just beating expectations on Wall Street.
And finally, remember that initially successful Jedi partnership in California? When Enron's partner took out its gains, Enron hid the fact by creating Chewco Investments-- after Chewbacca the Wookie, from "Star Wars"-- in a deal so complicated, the force would have to be with you to figure it out; so dark, Darth Vader would have shaken his head in admiration.
It all seemed like a fantastic game, and of course, that's the way we've played it here. But with billions gone, and thousands unemployed, you can say one last thing about Enron and its all-in-the-family accounting alchemy: It was no "Phantom Menace."

PART 2:
"Silent Watchdogs" – January 25, 2003 - http://www.pbs.org/newshour/bb/business/jan-june02/watchdogs_1-25.html

TRANSCRIPT:

JIM LEHRER: On Enron, earlier this week our economics correspondent Paul Solman of WGBH-Boston conjured up the magic behind Enron's accounting practices. Well, tonight, he tries to untangle the world of the financial watchdogs.
PAUL SOLMAN: If ever there were a maverick businessman on the go, it would be my old college classmate Peter Siris, professional New York investor, member of many boards of directors, former Wall Street analyst, and financial columnist who warned readers of his *New York Daily News* column that year that Enron was cruisin' for a bruisin'.
PETER SIRIS, Hedge Fund Manager: I had always thought that Enron was a fraud, and, and I'm on record in my newspaper as saying that.
PAUL SOLMAN: A year ago, though, no one was listening, perhaps because no one wanted to. And that leads to the big question: How representative is Enron of the whole system? Because in this case, the auditors, boards of directors, and stock analysts, the private sector watchdogs, didn't blow the whistle, because they were arguably better off not blowing the whistle. It's something Siris says he saw years ago as an analyst, when he denounced a particular stock.
PETER SIRIS: And I talked to friends and they would say to me, why did you do something stupid like that? I said the company was a house of cards. It was going to fall apart. I wanted to bring to it people's attention. They said, "You're an idiot. We're not

doing business with you anymore." Now the company did fall apart. It was a house of cards, and they never did business with me again.
PAUL SOLMAN: Really?
PETER SIRIS: Because if you don't own a stock, you don't care that somebody says, "Don't buy it." You own ten million shares of a stock and somebody says, "This stock is a fraud," and the stock goes down, you hate that person. They made your stock go down, okay? So one of the reasons you don't see analysts put out "sell" recommendations on stocks is it only makes enemies.
PAUL SOLMAN: Today, amidst government hearings and daily revelations, it seems the Enron empire had no clothes. But even last fall, analysts were still touting Enron's stock because, given the cozy relationships that can develop in a successful company, the naked truth might have been antisocial. After all, friendships can be involved, and often are-- with board members, for instance.
PETER SIRIS: They're friends of the company, and they go out there and they have... They go out and they have parties together and they have meetings -- four, six, twelve times a year with a group of people, and it's a very collegial atmosphere, you don't want to rock the boat. We're going to Enron Field to see the Astros play today. Who wants to sit here and talk about, you know, talking about some sort of partnership when we can see the Astros and sit in the dugout?
PAUL SOLMAN: We're not talking about all boards, of course. It's just that there is a danger in the cozy collegiality with management evident at Enron. And, says *Fortune* Magazine's Bethany McLean, who last March became one of the first to write negatively about Enron, there was a similar coziness between the company and its auditor, Arthur



Andersen.

Where were the watchdogs?

BETHANY MCLEAN, *Fortune* Magazine: A number of Andersen partners went on to get very high-profile jobs at Enron. Enron's chief financial officer, current chief financial officer, Jeff McMann, came from Arthur Andersen. Enron's chief accounting officer came from Arthur Andersen.
PAUL SOLMAN: So you've got... So you've got an auditor essentially compromised.
BETHANY MCLEAN: Mm-hmm.
PAUL SOLMAN: Compromised, that is, by relationships that were anything but arm's length, as McLean has written, in an atmosphere of heady enthusiasm. Moreover, enthusiasm tends to feed on itself, and spread. Last February, McLean's own publication crowned Enron America's "most innovative" company for the sixth year in a row, as voted by its peers. It came in second in quality of management, says the annual survey's editor, Lisa Munoz.
LISA MUNOZ, *Fortune* Magazine: They also scored quite high in employee talent, although they're not in the top three. They also scored quite high in any of the other categories-- social responsibility, quality of products and services, use of corporate assets, all of these things that, of course, are being called into question now.
PAUL SOLMAN: Thus, when it came to Enron, seldom was heard a discouraging word, and the bubble grew. But to put the Enron story in a larger context for a moment, bubbles can endanger an economy. The fact is that the U.S. brand of free-market capitalism, especially in an era of deregulation, depends on private sector watchdogs doing their job, and with Enron, they didn't. Columbia Law Professor John Coffee.
JOHN COFFEE, Columbia Law School: The system of corporate governance we have assumes that there are going to be a series of watchdogs-- auditors, audit committees, securities analysts, outside directors, bond-rating agencies -- that are going to examine and test the credibility of your statements. All of them failed in this case.
PAUL SOLMAN: The importance of such failure is arguably profound. It's one thing to see crony capitalism in Indonesia and even Japan, where relationships seem to drive investment instead of open competition; it's quite
another to bring it all back home.
JANICE FARMER, Enron Pensioner: I trusted the management of Enron with my life savings. Senators, I won't mince words here. They betrayed that trust.

Board and management intertwined

PAUL SOLMAN: So many investors ruined, and you start to wonder about the fabled transparency of U.S. firms, which brings us back to a second aspect of the watchdogs' failure at Enron: They weren't just cozy with the company; they also had genuine economic incentives to look the other way, or so claims Peter Siris, again citing how the firm handled its board.
PETER SIRIS: They gave big fees to the directors, and they also greased the directors' charities. I mean, for a lot of these people, it's big compensation.
PAUL SOLMAN: Enron's board ranked seventh in the nation in compensation, nearly $400,000 in cash and stock, which raises the issue of "you scratch my back, I'll scratch yours."
PETER SIRIS: Just remember, the board votes on the compensation of the management, okay? Now, who votes on the compensation of the board?
PAUL SOLMAN: The management.
PETER SIRIS: Hey! So let me ask you-- you're the president of the company; I'm on the board. I say, "Look, Paul, you know, don't you think you should give us board members an extra $50,000 a year in compensation this year? What do you think?"
PAUL SOLMAN: "Yeah, my own compensation is coming up as well."
PETER SIRIS: "I think, I think... Let's put it this way: I think you should deal with the board first. Then I'm sure the board will be happy to deal with your compensation." This is... Hey, this is a good system.
PAUL SOLMAN: Technically, directors represent shareholders, but they're picked by management, as are the auditors.
JOHN COFFEE, Columbia Law School: I think the basic story of what's happened over the last five to ten years is that, for the auditors, the costs of acquiescing to management-- that is, the possible liabilities-- have radically diminished while at the same time the benefits of acquiescing to management have radically increased.
You can now make a great deal of money by being very cooperative because you can sell management very lucrative consulting business that is much more profitable than being a staid, old-fashioned auditor. A study has been done by, of all people, Arthur Andersen that finds that the rate of earnings restatements by publicly reporting companies has increased 47 percent over the last three years.
I think that's a proof that the old system isn't working, that the auditors are not deterred, and that they are also much more seduced by the benefits of being able to sell consulting and other services to the company.

Compromised analysts

PAUL SOLMAN: Then, again, there are the Wall Street analysts, and here, Siris may shock you.
PETER SIRIS: The economics are very simple: You get paid for being a cheerleader if you're an analyst.
PAUL SOLMAN: Now, analyst meetings can be rah-rah rallies, as we saw at Enron's Houston neighbor and rival, El Paso, last year. But more important, the analysts work for the same big Wall Street firms-- Merrill Lynch, Goldman Sachs, Morgan Stanley-- that get huge fees for doing deals with firms like El Paso and Enron, which in turn wants the analysts to pump their stock price.
PETER SIRIS: So, you know, who are you going to give investment banking business to, the guy who says "sell" or the guy who says "you're geniuses, we love your company"?

PAUL SOLMAN: Now put yourself back in the analyst's shoes: Do you say, "sell Enron" and make a normal salary?
PETER SIRIS: Or do you join the chorus, put a "buy" out on stock, and your firm gets $5 million of fees from doing a secondary, and you get your million dollars for your cut?
PAUL SOLMAN: Your cut, as a salary or bonus or something.
PETER SIRIS: As a bonus for bringing in investment banking business into the firm.
PAUL SOLMAN: Really? And that's actually how it works?
PETER SIRIS: Yeah. I mean, you think I'm... We went to school together; you think I'd make up a story like this for your benefit?
PAUL SOLMAN: That is...
PETER SIRIS: That's how... That's how it works.

Fraud hard to pinpoint

PAUL SOLMAN: I asked Siris, who can be a little sweeping in his indictments, if he had evidence of this. As usual, he was not at a loss for words.

PETER SIRIS: When I was in industry and I was a senior financial executive at two New York Stock Exchange companies, then the analysts would always say to me, "you've got to put us in the deal because, you know, my compensation depends on getting a piece of this sale." I used to say to the analysts, "You want to be in the deal? We're going to earn $1.35 next year-- this is what each division is going to make, this is what the company is going to do. And if you write or say anything different from what I'm telling you, you won't be in our next offer."
PAUL SOLMAN: You mean, "Your company, your bank, will not get a piece of the action."
PETER SIRIS: When I was in industry and then...
PAUL SOLMAN: You would actually say that to them.
PETER SIRIS: Absolutely. Why are you looking at me like it's strange? I wanted one story out there. I wanted every analyst to have the same story, and if they weren't willing to go along with exactly the way I wanted that story managed, I wouldn't take their phone calls.
PAUL SOLMAN: Now, speaking of stories being managed, where were we, the media, in all this? One *Fortune* reporter did blow the whistle, but in general, desirable as juicy exposes are, on the business beat they're very hard to come by.
BETHANY McLEAN: If you have a company, like in the case of Enron, where the auditors, the management, the board, the Wall Street analyst community, portfolio managers have signed off on the company, and you're the one who doesn't get it, there is a major disincentive to continue to ask questions in the hope of arriving at something that's contrary in wisdom. In some cases it may not be there.
It's not always obvious. Every company doesn't have fraud at the core of it. Every company isn't careening toward bankruptcy as Enron is. So when do you keep asking the questions in hoping that there is something there and that you might be missing something, or when do you stop and say ok, I've talked to 100 people and I've heard all of this and this is the story?
PAUL SOLMAN: There is one private player with an incentive to sniff out flimflam. The unpopular Wall Street analysts short sellers, those who hope that the stock will go down,

like Jim Chanos, who bet heavily against Enron. And although he profits by getting bearish news first, he's worried that America's investors are increasingly vulnerable.
JAMES CHANOS, Hedge Fund Manager: At the end of the day, if corporate management is willing to look you straight in the eye and lie to you, a lot of people will believe them. And there's a growing subset of companies in the United States where corporate managements are willing to look you right in the eye and lie to you. And I think it's an outrage. And it continues.
PAUL SOLMAN: Growing.
JAMES CHANOS: Growing. Growing number.
PAUL SOLMAN: Isn't this... Aren't they all going to be chastened by what's happened here?
JAMES CHANOS: We'll see. I mean, there have been a number of debacles where you would think-- Sunbeam, Waste Management, Cendant, multibillion-dollar frauds; not the size of Enron, certainly-- where you would think someone should have been led off in handcuffs and wasn't.
PAUL SOLMAN: Now, perhaps, with all the attention being given to Enron, government will take a more active watchdog role, but in the end, for an economy that has long prided itself on getting investor money to the most efficient users of it, there may be nothing worse than a generation of executives who may be able, in effect, to "take the money and run" - or should we say - "Enron."

PART 3:
"Trading Risks" – March 19, 2003 - http://www.pbs.org/newshour/bb/business/jan-june02/trading_3-19.html

TRANSCRIPT:

PAUL SOLMAN: Enron. Its reputation has gotten so bad, people now routinely call it the crooked "E." But before it was known for its financial finagling, Enron had become famous as a business pioneer, blazing new trails in the market for trading risk.
FRANK PARTNOY: They ended up as a derivatives trading firm, something very different from what they had started with, which was essentially a traditional energy firm where they could buy and operate pipelines, and ship natural gas to customers.
PAUL SOLMAN: Law Professor Frank Partnoy is writing a book on Enron and derivatives.
PAUL SOLMAN: Explain derivatives markets.
FRANK PARTNOY: Derivatives are financial instruments whose value is linked to something else. They're basically fancy instruments that have evolved over the last ten years that enable investors and institutions to bet on virtually anything, from interest rates or exchange rates to commodities.
PAUL SOLMAN: Now, to make things a little clearer, let's go down on the farm to give you one of our typically oversimplified, but we hope helpful, demonstrations.

Old MacDonald here has a problem. He's fattening his hogs today, but they won't be ready to sell for six months. A hog like Wilbur will cost, say, $100 to keep and feed till slaughter time, when, if there's a God in hog heaven, Mac will get $150 for Wilbur-- a fat profit.
But now suppose the worst: A bumper crop of pigs comes to market just when Wilbur does, or people suddenly lose their taste for pork. At any rate, Wilbur and kin fetch only $50 apiece when they have to be sold. Big Mac here could go broke. But not if he hedged his bets on the commodities market.
SPOKESMAN: 11 on five! 11 on five!
PAUL SOLMAN: Yes, those human pens that provide the backdrop for movies like "Trading Places," the stock footage for stories like this one. They're marketplaces where farmers can sell their pigs, corn, wheat, what-have-you, at a date in the future, at a locked- in price.
So in Mac's case, if Wilburs are going for $150 today, he can enter into a contract that promises him, say, $150 per pig six months from now. It's really a bet on the future price of pigs, but for Mac, it's kind of like insurance against the risk that the future market price will go down.
FRANK PARTNOY: So Old MacDonald can enter into one of these contracts to lock in a future price. He no longer has to worry about whether the price goes down.
PAUL SOLMAN: Now contracts in this market don't just protect producers of pork, or any other commodity. Think about someone who needs to buy pork, like Kevin Bacon here, for his hot dog business. The risk to him is that the price will rise. So he could take the other side of a contract like Mac's, and lock in a price of no more than $150.
In effect, the parties would be swapping risks at a minimal cost-- basically the commission the market takes for brokering deals like these.
FRANK PARTNOY: Both sides love this agreement. It's great because it eliminates risk for the farmer. It eliminates risk for Kevin Bacon.
PAUL SOLMAN: And the market thrives because it charges something for doing this.
FRANK PARTNOY: There's always an intermediary putting these two together, and that intermediary, whether it's the market or an exchange, makes a few pennies off of both people so that everybody is happy.
PAUL SOLMAN: These contracts are essentially bets on the price of something in the future. You can use them to lower the price risk of something you make or buy, or anyone can just gamble with them-- speculate.
So there's another set of players, speculators, whose incarnation for us is specs, who thinks he can see the future, and wants to bet on his vision. In his mind's eye, perhaps, he sees Mad Cow Disease sweeping the land, killing the cattle industry, and thus forcing desperate meat eaters to switch to pork, driving the price way up. So he can take the other side of the Big Mac contract, just like Kevin Bacon did, promising to pay $150 six months from now, and rooting for the price to rise. That's speculation. But whether it was producers and consumers hedging their risks, or speculators taking risks, the commodity markets evolved to enable such trades, making a commission on each.
FRANK PARTNOY: And that's what makes markets efficient.
PAUL SOLMAN: What do you mean, "efficient"?
FRANK PARTNOY: Because the price will reflect all information that's available in the market. The speculator has certain information that the farmer and Kevin Bacon might

not have. As long as you allow speculators to come in and participate in the market, all the information that the speculators have will be reflected in market prices.
PAUL SOLMAN: "Okay," you may be asking, "what's this have to do with Enron?" Well, since commodity markets proved so useful for transferring risk and for predicting prices, they began to expand, trading more kinds of commodities: Metals like gold and silver, and energy products like crude oil, home heating oil, to name just a few.
And in the 1980s, when natural gas, long subject to strict price controls, was deregulated, Enron, a natural gas company, decided to transform itself by pioneering new trails in the commodities business. Deregulated, the price of natural gas could now go down and up, which meant producers and consumers were suddenly at risk.
FRANK PARTNOY: So customers are exposed to changes in the price of natural gas, and they like to hedge those risks. But they're very limited in terms of where they can go. The New York Mercantile Exchange offers them a hedge, but it's a limited hedge.
PAUL SOLMAN: Why would you want to hedge against different prices of natural gas?
FRANK PARTNOY: Well, as people probably know, prices of commodities can vary by region. So for example, the price of a gallon of gas in San Diego is a lot higher than the price of a gallon of gas in the Midwest. And so Enron said, "we'll enter this market and we'll supply custom-tailored contracts for these customers' needs. We'll deliver natural gas, or agree to deliver natural gas, to any location in the U.S. at any time."
PAUL SOLMAN: Of all the new kinds of contracts Enron began trading, none seemed more obscure or complex than weather derivatives, where there's no tangible commodity like hogs or gas at all. But weather derivatives are simply bets on the weather.
So we're going to try to keep the basic idea grade-school simple. Say the children's author Roald Dahl had a daughter, Barbara, who owns a ski resort in the Rockies. Barbara Dahl's worried about global warming. Suppose it keeps up for the next decade or two: No snow, no customers-- a total meltdown in her business.
Meanwhile, her twin sister, Barbara Dahl II, owns a golf resort in Colorado. For her, global warming might mean more business-- just what the weatherman ordered. A weather derivative would be a long-term contract Barbara I could enter into with anyone-- a speculator, Enron, or another businessperson. They would pay her money in the event of warmer weather-- above normal years for, say, 15 years.
But according to the contract, she'd have to pay if the weather was below normal. She would be then be protected against global warming, and if there were global cooling, she could afford to pay, since she'd be making money on all those extra skiers the snows would bring.
And you might be able to see why Barbara II would want to take the other side of such a contract: Getting paid in the event of global cooling, paying if the weather warmed up, since she'd be making lots of money from the flood of warm-weather duffers.
Finally, as always, specs the speculator could simply bet by entering into a contract with either of the Barbaras.
FRANK PARTNOY: A few years ago, you couldn't bet on the weather, and Enron came in and did what economists call "completing the market." If you were worried about changes in the weather, you could go to Enron and hedge those risks. They supplied a series of bets on the weather in the same way they had supplied a series of bets on natural gas.
PAUL SOLMAN: So what went wrong?

Well, for one thing, Enron's position in the trading business may have been highly profitable, but not for long. Think about it. If you're the only market in town, you can charge sizable commissions. Plus, you know more than everyone else, so you get to see price discrepancies-- essentially bargains in the market-- before others do, others like Enron's Houston neighbor and rival, El Paso, whose trading floor this is. But where there are profits, there's soon competition. Wall Street firms like Goldman Sachs and Morgan Stanley started competing with Enron, charging less for commissions, learning as much about price discrepancies as Enron did. Inevitably Enron's trading operation became less profitable. And experts now suspect it was losing money in nearly every other part of its business.

FRANK PARTNOY: Where Enron went wrong is it abandoned its core business. It made money every year, trading derivatives on natural gas and power. But as it expanded to other investments-- water, a power plant in India, telecommunications, Internet stocks, broadband-- it started losing billions of dollars on each of those investments. And the further it moved from its core business of trading, the more money it lost.

PAUL SOLMAN: But if Enron appeared to be in trouble, who would trade with it anymore? Would any of these folks use a market, or buy insurance from a company that made promises a decade or more away, but might not be able to keep them? Would you?

FRANK PARTNOY: As Enron continued to lose money in these other businesses, it had to hide those losses, and it started entering into all sorts of bizarre financial contracts in order to hide those losses.

And in the end, when people saw that, in fact, Enron was essentially a shell game-- that it had lost these huge amounts of money-- they withdrew their credit. They said, "We're not lending you any more money." And at that point, Enron went into a death spiral, and bankruptcy was inevitable.

PAUL SOLMAN: Of course, in the wake of disasters like the California energy crisis, some people draw a different moral from the Enron debacle: That when markets are deregulated, the price swings they're suddenly subject to can be a business opportunity for some, and a catastrophe for others, like California, which found itself at the mercy of price volatility that threatened the state's economy and quality of life.

Did companies like Enron, El Paso, and others manipulate the market to drive prices up? The jury's still out on those charges.

But one thing's for sure: They don't call it market risk for nothing.

PART 4:
"Stretching the Dough" – April 2, 2002 - http://www.pbs.org/newshour/bb/business/jan-june02/street_4-2.html

TRANSCRIPT:

PAUL SOLMAN: The end of winter, and time for an American ritual.

The quarterly earnings report -- and the quarterly pressure on corporations to please investors by showing growth: Higher profits than in the previous three months of the year.

The pressure to show rapid growth increased dramatically, it seems, during the boom 1990's on Wall Street and seems to have influenced the accounting antics at Enron, Global Crossing, Qwest and the like that have made these firms infamous.

No one's accusing all of corporate America, of course, but in recent years, more and more companies seem to have used more and more gimmicks to boost their reported profits....pushing the envelope of honest accounting.

Now please allow us a little poetic license, since we're about to explain some of those gimmicks as they might be used by a fictional firm we've named, Tortillas Flat, in honor of writer John Steinbeck's 100th birthday.

We're doing this at a real tortilla factory -- thus the hairnet legally required by the FDA. The factory is run by the country's top tortilla maker, Mission Foods, which was nice enough to lend us their facility in Pueblo, Colorado, for the occasion.

But before we demonstrate the gimmicks, a word about what drives them: the need to report ever higher earnings, to reassure investors about our company's future.

PAUL SOLMAN: John Karns is a professional investor.

JOHN KARNS: So we're looking at what's happening currently to give us a window into what's going to happen in the future. What we're really looking at, we're paying for is the future earnings potential of that company.

PAUL SOLMAN: Because that's where the share of stock is worth.

JOHN KARNS: Sure, sure.

PAUL SOLMAN: Okay, a brief explanation. A company is worth no more or less than all the profits --- the dough -- it's expected to earn in the future.

A share of Tortillas Flat, then, depends on how profitable we're going to become: very -- not very.

If investors think we're a Mexican food Microsoft-in-the-making, that is, that our profits will keep expanding, a share today, our slice of the total will be worth more.

Tricks of the accounting trade PAUL SOLMAN: But, if our profits look like they'll be small, then our share -- or cut of them, even if it's the same percentage of the company -- will be worth a lot less.

Thus, the question behind this story: How do we keep reporting higher profits... to keep investors hopes and our stock price up?
LYNN TURNER: What are some of the aggressive practices that you think are out there that we as auditors would have to keep our eyes on…
PAUL SOLMAN: The Securities & Exchange Commission's former chief accountant, Lynn Turner, shared some of the most popular techniques with his college accounting class, and with us.
LYNN TURNER: There is a culture of gamesmanship going on where people really do try to game the number.
PAUL SOLMAN: One common way of hiking profits is called "stuffing the channels." Say Tortillas Flat's top customer, a fast food chain we'll call "The Big Enchilada," cuts back on its tortilla orders -- our sales will drop and profits will be flat.
But, if "The Big Enchilada" can be persuaded to take delivery of the tortillas it was expected to buy and stow them away for later use, the folks at Tortillas Flat can claim them as sales, even if they haven't been paid for yet.
After all, they shipped them out the door.
On the other hand, it's a short-term fix, according to Lynn Turner.
LYNN TURNER: What that means is if The Big Enchilada's got so many tortillas sitting out there, they aren't going to need as many next quarter and the chances are that sooner or later, you're going to fall short and the investors are going to be surprised.
PAUL SOLMAN: Now if your customer won't store your product, there's an alternative: pay a warehouse to do it.
But says money manager John Karns, its the same short term fix, which comes with the same problem.
JOHN KARNS: They could just ship pallets and pallets of, of tortillas and recognize the revenues and have a great revenue quarter. The problem is they all sit somewhere in the warehouse, they go bad, they get returned...

Asset dumping, pension manipulation, and swaps

PAUL SOLMAN: And you're in deeper trouble next quarter. So maybe-- for us here at Tortillas Flat, how about another widely used trick?
We sell something we own, like one of our factories and every piece of machinery in it. But instead of candidly reporting it as a one-time windfall, we use the proceeds to make ourselves seem more profitable.
Specifically, we deduct the sales price from our corporate overhead account. So reported overhead goes down, implying we've cut costs, and are therefore operating more efficiently, more profitably.
PAUL SOLMAN: Forbes Magazine explains how IBM has been doing this for years, again, to keep its profits growing, smoothly and regularly. And money manager John Karns says Coca-Cola has managed its reported profits by buying and selling it's bottling companies.
Not that there's anything wrong with it legally, but this technique has troubled the SEC enough to clamp down on it, suggesting that at Tortillas Flat we shouldn't so asset sales as profits.
So how about copying yet another widely used practice: companies puffing up their bottom lines with -- get this -- stock gains from the pension money they've invested to pay their retired employees?

LYNN TURNER: They've invested heavily in the stock markets. And because the stock markets have done so well in recent years, 20, 25 percent returns, they've actually, instead of showing expense, shown an income from all the money that they've made on the stocks that are going to be used to pay off those pensions in the past.
PAUL SOLMAN: This form of financial flexibility -- or manipulating the dough – was used in the old economy and in the new one, as Lynn Turner discovered when he was at the SEC, investigating Qwest, whose only profits, it turned out, came this way.
LYNN TURNER: All of the profit that the bottom line of Qwest, had come from the pension income.
PAUL SOLMAN: All of it?
LYNN TURNER: All of it.
PAUL SOLMAN: When the stock market sank, of course, the profits disappeared; the trick was useless.
Now at this point, you may have the same question we did: who comes up with all these techniques? Cunning consultants? Slippery CEO's?
No, says Lynn Turner, the same folks who supposedly audit the company.
LYNN TURNER: All the Big Five accounting firms have a group of accountants within their organizations that do nothing, quite frankly, but work with Wall Street, trying to figure out how to get around the rules.
PAUL SOLMAN: Small wonder, then, that Enron's auditor, for example, approved of Enron innovations like its so-called SPE's - the "Special Purpose Entities" with the playful names -- Raptor, Chewco, Hawaii 125-0 -- partnerships Enron controlled, but treated, for reporting purposes, as independent companies, to boost its profits, hide its debts.
Arthur Andersen may actually have concocted many of them, to stay a step ahead of the rules being written to keep things on the up-and-up.
LYNN TURNER: Before the ink dries, they've got a new way to manufacture these financial transactions that really hide things from investors.
PAUL SOLMAN: We tried to come up with our own SPE, "Tomatoes of Wrath" salsa company, but decided in the wake of Enron it may be too dicey.
So here's one last technique we might try: the swap.
PAUL SOLMAN: This is a trick practiced by the telecoms, Qwest and Global Crossing. They'd both laid miles of fiber optic cable that wasn't being used. So they sold the idle lines to each other.
That's right, it was really a swap, but both companies reported the sales as profits, the expense of buying the other guy's cable would be written down slowly over years.
JOHN KARNS: So, I presume you plan to sell flour to somebody. They're going to sell it back to you.
PAUL SOLMAN: Actually lard -- a tub of lard.
That is, if we were stuck with some idle investment, say too much lard, one of the key ingredients in tortillas, we'd try to find another tortilla maker with too much lard, sell tubs of lard to each other, report the sales as profits, but amortize the cost over time as an investment.
And we could claim almost any price at all for selling lard....
JOHN KARNS: Which is, which is not a commodity that really is priced in the open market.

PAUL SOLMAN: Which is good for me.

The long-term damage of short-term fixes

JOHN KARNS: Yeah, absolutely it is good for you.

You know what? If you do that, it would probably be hard for me to discover it outright. But it will show over time -- because it will have to unravel over time eventually. Either you've got a lot of lard on your books or something starts to show up.

PAUL SOLMAN: "Something starts to show up." That is -- once again the same problem looms -- with channel stuffing, asset dumping, pension pinching, special purpose entities, swaps. You're buying time by fudging this quarter's results.

LYNN TURNER: But what do you do next quarter then when the business is still off? You start playing games with the numbers and you manage the numbers rather than managing the business.

And the very problems in the business that create those shortfalls in the numbers never get addressed.

PAUL SOLMAN: On the other hand, the pressure's on to perform this quarter. It's on the companies and on those who invest in them, like John Karns.

When he joined West Corp Funds a decade ago, mutual fund managers looked at earnings over a period of a year or two, he says.

JOHN KARNS: But it's become such that it was half a year and it was quarterly and you can even press it down to weekly.

There are companies who give weekly indications on what their sales are doing or give weekly indications on their business. But what tends to happen with the market is the market is so focused on what are you going to make next quarter and then once you get there, what are you going to make the next quarter that it has a very hard time of saying, what's going to happen over time?

Pressures on corporate executives

PAUL SOLMAN: There's a clear and present danger here. the value of our company depends on its cumulative, long-term profits.

But if Wall Street's best indicator of long term profits is short term profits -- rising every quarter -- but in fact rather precariously -- then the pressure on executives is to look good short term at a possible cost of the underlying, long term health of the company and thus the real value of its shares.

LYNN TURNER: It's not just Enron. But it's one after the other: Cendant, Rite-Aid, Xerox, Lucent, W.R. Grace. It goes on and on.

PAUL SOLMAN: Don't you have any sympathy for the managements of these companies that have to report higher and higher numbers?

LYNN TURNER: I have a tremendous amount of sympathy for the executives.

It's always, what have you done for me this quarter? And if the executives don't make it next quarter, they're gone. The average CEO today only has a three- or four- year life span as that before their turn around and, and gone. It's phenomenal, phenomenal pressure on them.

PAUL SOLMAN: Phenomenal pressure on executives, which had caused some -- perhaps more and more of them-- to go over the line.

It may have been bad for American business. On the other hand, consider this: The U.S. has been criticized for short-term thinking since at least the 1970s. And yet, you could argue we've outperformed every economy on earth.

If you run an operation like Tortillas Flat, then, you could play it safe and never stretch the truth about your business, as so many others seem to -- or you could keep investors happy by accentuating the positive, reporting ever higher earnings, and -- please forgive us -- letting the chips fall where they may.