

CRS Report for Congress

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The Enron Collapse: An Overview of Financial Issues

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Summary

The sudden and unexpected collapse of Enron Corp. was the first in a series of major corporate accounting scandals that has shaken confidence in corporate governance and the stock market. Only months before Enron's bankruptcy filing in December 2001, the firm was widely regarded as one of the most innovative, fastest growing, and best managed businesses in the United States. With the swift collapse, shareholders, including thousands of Enron workers who held company stock in their 401(k) retirement accounts, lost tens of billions of dollars. It now appears that Enron was in terrible financial shape as early as 2000, burdened with debt and money-losing businesses, but manipulated its accounting statements to hide these problems. Why didn't the watchdogs bark? This report briefly examines the accounting system that failed to provide a clear picture of the firm's true condition, the independent auditors and board members who were unwilling to challenge Enron's management, the Wall Street stock analysts who failed to warn investors of trouble ahead, the rules governing employer stock in company pension plans, and the unregulated energy derivatives trading that was the core of Enron's business. This report also summarizes the Sarbanes-Oxley Act (P.L. 107-204), the major response by the 107th Congress to Enron's fall, and related legislative and regulatory actions during the 108th Congress. It will be updated as events warrant.

Other contributors to this report include (name redacted), (name redacted), (name redacted), and (name redacted).

Enron: What Went Wrong?

Enron Corp., the first nationwide natural gas pipeline network, shifted its business focus during the 1990s from the regulated transportation of natural gas to trading in unregulated energy markets. Until late 2001, nearly all observers — including Wall Street professionals — regarded this transformation as an outstanding success. Enron's reported annual revenues grew from under \$10 billion in the early 1990s to \$139 billion in 2001, placing it fifth on the Fortune 500. Enron continued to transform its business but, as it diversified out of its core energy operations, it ran into serious trouble. Like many other

firms, Enron saw an unlimited future in the Internet. During the late 1990s, it invested heavily in online marketers and service providers, constructed a fiber optic communications network, and attempted to create a market for trading broadband communications capacity. Enron entered these markets near the peak of the boom and paid high prices, taking on a heavy debt load to finance its purchases. When the dot com crash came in 2000, revenue from these investments dried up, but the debt remained.

Enron also recorded significant losses in certain foreign operations. The firm made major investments in public utilities in India, South America, and the U.K., hoping to profit in newly-deregulated markets. In these three cases, local politicians acted to shield consumers from the sharp price increases that Enron anticipated.

By contrast, Enron's energy trading businesses appear to have made money, although that trading was probably less extensive and profitable than the company claimed in its financial reports. Energy trading, however, did not generate sufficient cash to allow Enron to withstand major losses in its dot com and foreign portfolios. Once the Internet bubble burst, Enron's prospects were dire.

It is not unusual for businesses to fail after making bad or ill-timed investments. What turned the Enron case into a major financial scandal was the company's response to its problems. Rather than disclose its true condition to public investors, as the law requires, Enron falsified its accounts. It assigned business losses and near-worthless assets to unconsolidated partnerships and "special purpose entities." In other words, the firm's public accounting statements pretended that losses were occurring not to Enron, but to the so-called Raptor entities, which were ostensibly independent firms that had agreed to absorb Enron's losses, but were in fact accounting contrivances created and entirely controlled by Enron's management. In addition, Enron appears to have disguised bank loans as energy derivatives trades to conceal the extent of its indebtedness.

When these accounting fictions — which were sustained for nearly 18 months — came to light, and corrected accounting statements were issued, over 80% of the profits reported since 2000 vanished and Enron quickly collapsed. The sudden collapse of such a large corporation, and the accompanying losses of jobs, investor wealth, and market confidence, suggested that there were serious flaws in the U.S. system of securities regulation, which is based on the full and accurate disclosure of all financial information that market participants need to make informed investment decisions. The suggestion was amply confirmed by the succession of major corporate accounting scandals that followed.

Enron raised fundamental issues about corporate fraud, accounting transparency, and investor protection. Several aspects of these issues are briefly sketched below, with reference to CRS products that provide more detail.

Auditing and Accounting Issues

Federal securities law requires that the accounting statements of publicly traded corporations be certified by an independent auditor. Enron's auditor, Arthur Andersen, not only turned a blind eye to improper accounting practices, but was actively involved in devising complex financial structures and transactions that facilitated deception.

An auditor's certification indicates that the financial statements under review have been prepared in accordance with generally-accepted accounting principles (GAAP). In Enron's case, the question is not only whether GAAP were violated, but whether current accounting standards permit corporations to play "numbers games," and whether investors are exposed to excessive risk by financial statements that lack clarity and consistency. Accounting standards for corporations are set by the Financial Accounting Standards Board (FASB), a non-governmental entity, though there are also Securities and Exchange Commission (SEC) requirements. (The SEC has statutory authority to set accounting standards for firms that sell securities to the public.) Some describe FASB's standards setting process as cumbersome and too susceptible to business and/or political pressures.

In response to the auditing and accounting problems at Enron and other major corporations scandals, Congress enacted the Sarbanes-Oxley Act of 2002 (P.L. 107-204), containing perhaps the most far-reaching amendments to the securities laws since the 1930s. Very briefly, the law does the following:

- creates a Public Company Accounting Oversight Board to regulate independent auditors of publicly traded companies — a private sector entity operating under the oversight of the SEC;
- raises standards of auditor independence by prohibiting auditors from providing certain consulting services to their audit clients and requiring preapproval by the client's board of directors for other nonaudit services;
- requires top corporate management and audit committees to assume more direct responsibility for the accuracy of financial statements;
- enhances disclosure requirements for certain transactions, such as stock sales by corporate insiders, transactions with unconsolidated subsidiaries, and other significant events that may require "real-time" disclosure;
- directs the SEC to adopt rules to prevent conflicts of interest that affect the objectivity of stock analysts;
- authorizes \$776 million for the SEC in FY2003 (versus \$469 million in the Administration's budget request) and requires the SEC to review corporate financial reports more frequently; and
- establishes and/or increases criminal penalties for a variety of offenses related to securities fraud, including misleading an auditor, mail and wire fraud, and destruction of records.

See also CRS Report RL31554, *Corporate Accountability: Sarbanes-Oxley Act of 2002: (P.L. 107-204)*, by Michael Seitzinger; and CRS Report RS21120, *Auditing and its Regulators: Proposals for Reform After Enron*, by (name redacted).

Pension Issues

Like many companies, Enron sponsored a retirement plan — a "401(k)" — for its employees to which they can contribute a portion of their pay on a tax-deferred basis. As

of December 31, 2000, 62% of the assets held in the corporation's 401(k) retirement plan consisted of Enron stock. Many individual Enron employees held even larger percentages of Enron stock in their 401(k) accounts. Shares of Enron, which in January 2001 traded for more than \$80/share, were worth less than 70 cents in January 2002. The catastrophic losses suffered by participants in the Enron Corporation's 401(k) plan have prompted questions about the laws and regulations that govern these plans.

In the 107th Congress, the House passed legislation (H.R. 3762) that would have required account information to be provided more often to plan participants, improved access to investment planning advice, allowed plan participants to diversify their portfolios by selling company stock contributed by employers after three years, and barred executives from selling company stock while a plan is "locked down." (The latter provision was enacted by the Sarbanes-Oxley Act.) Similar legislation has not advanced in the 108th Congress.

See also CRS Report RL31507, *Employer Stock in Retirement Plans: Investment Risk and Retirement Security*, by (name redacted) (7...); and CRS Report RL31551, *Employer Stock in Pension Plans: Economic and Tax Issues*, by Jane Gravelle.

Corporate Governance Issues

In the wake of Enron and other scandals, corporate boards of directors were subject to critical scrutiny. Boards, whose chief duty is to represent shareholders' interests, utterly failed to prevent or detect management fraud. Several provisions of Sarbanes-Oxley were designed to boost the power of independent directors and the audit committee of the board to exercise effective oversight of management and the accounting process. Under Sarbanes-Oxley, the board's audit committee must have a majority of independent directors (not affiliated with management or the corporation) and is responsible for hiring, firing, overseeing, and paying the firm's outside auditor. The audit committee must include at least one director who is a financial expert, that is, able to evaluate significant accounting issues and/or disagreements between management and auditors.

In 2003, the New York Stock Exchange and the Nasdaq adopted rules requiring listed corporations to have a majority of independent directors (not affiliated with management or the corporation) on their boards. In 2004, the SEC is considering a rule that would facilitate the nomination of directors by shareholders.

Securities Analyst Issues

Securities analysts employed by investment banks provide research and make "buy," "sell," or "hold" recommendations. These recommendations are widely circulated and are relied upon by many public investors. Analyst support was crucial to Enron because it required constant infusions of funds from the financial markets. On November 29, 2001, after Enron's stock had fallen 99% from its high, and after rating agencies had downgraded its debt to "junk bond" status, only two of 11 major firm analysts rated its stock a "sell." Was analyst objectivity — towards Enron and other firms — compromised by pressure to avoid alienating investment banking clients?

The Sarbanes-Oxley Act directs the SEC to establish rules addressing analysts' conflicts of interest; these were issued in 2003. In December 2002, 10 major investment banks reached a settlement with state and federal securities regulators under which they agreed to reforms to make their analysts independent of their banking operations, and to pay fines totaling about \$1 billion.

See also CRS Report RL31348, *Enron and Stock Analyst Objectivity*, by (name redacted).

Banking Issues

One part of the fallout from Enron's demise involves its relations with banks. Prominent banking companies, notably Citigroup and J.P. Morgan Chase, were involved in both the investment banking (securities) and the commercial banking (lending and deposit) businesses with Enron. In 2003, the SEC fined the two banks \$120 and \$135 million, respectively, for their roles in Enron's accounting frauds.

Several aspects of Enron's relations with its bankers have raised several questions. (1) Do financial holding companies (firms that encompass both investment and commercial banking operations) face a conflict of interest, between their duty to avoid excessive risk on loans from their bank sides versus their opportunity to glean profits from deals on their investment banking side? (2) Were the bankers enticed or pressured to provide funding for Enron and recommend its securities and derivatives to other parties? (3) Did the Dynegy rescue plan, proposed just before Enron's collapse, and involving further investments by J.P. Morgan Chase and Citigroup, represent protective self-dealing? (4) What is the proper accounting for banks' off-balance-sheet items including derivative positions and lines of credit, such as they provided to Enron? (5) Did the Enron situation represent a warning that GLBA may need fine-tuning in the way it mixes the different business practices of Wall Street and commercial banking?

See also CRS Report RS21188, *Enron's Banking Relationships and Congressional Repeal of Statutes Separating Bank Lending from Investment Banking*, by (name redacted).

Energy Derivatives Issues

Part of Enron's core energy business involved dealing in derivative contracts based on the prices of oil, gas, electricity and other variables. For example, Enron sold long-term contracts to buy or sell energy at fixed prices. These contracts allow the buyers to avoid, or hedge, the risks that increases (or drops) in energy prices posed to their businesses. Since the markets in which Enron traded are largely unregulated, with no reporting requirements, little information is available about the extent or profitability of Enron's derivatives activities, beyond what is contained in the company's own financial statements. While trading in derivatives is an extremely high-risk activity, no evidence has yet emerged that indicates that speculative losses were a factor in Enron's collapse.

Since the Enron failure, several energy derivatives dealers have admitted to making "wash trades," which lack economic substance but give the appearance of greater market volume than actually exists, and facilitate deceptive accounting (if the fictitious trades are

reported as real revenue). In 2002, energy derivatives trading diminished to a fraction of pre-Enron levels, as major traders (and their customers and shareholders) re-evaluate the risks and utility of unregulated energy trading. Several major dealers have withdrawn from the market entirely.

Internal Enron memoranda released in May 2002 suggest that Enron (and other market participants) engaged in a variety of manipulative trading practices during the California electricity crisis. For example, Enron was able to buy electricity at a fixed price in California and sell it elsewhere at the higher market price, exacerbating electricity shortages within California. The evidence to date does not indicate that energy derivatives - as opposed to physical, spot-market trades — played a major role in these manipulative strategies. Numerous firms and individuals have been charged with civil and criminal violations related to the manipulation of energy prices in California and elsewhere.

Even if derivatives trading was not a major cause, Enron's failure raises the issue of supervision of unregulated derivatives markets. Would it be useful if regulators had more information about the portfolios and risk exposures of major dealers in derivatives? Although Enron's bankruptcy appears to have had little impact on energy supplies and prices, a similar dealer failure in the future might damage the dealer's trading partners and its lenders, and could conceivably set off widespread disruptions in financial and/or real commodity markets.

Legislation proposed, but not enacted, in the 107th Congress (H.R. 3914, H.R. 4038, S. 1951, and S. 2724) would have (among other things) given the CFTC more authority to pursue fraud (including wash transactions) in the OTC market, and to require disclosure of certain trade data by dealers. In the 108th Congress, the Senate twice rejected legislation (S.Amdt. 876 and S.Amdt. 2083) that would have increased regulatory oversight of energy derivatives markets by the CFTC and FERC.

See also CRS Report RS21401, *Regulation of Energy Derivatives*, by (name redacted); and CRS Report RS20560, *The Commodity Futures Modernization Act (P.L. 106-554)*, by (name redacted).

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