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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 the stock market and perhaps the economy itself. 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 and bond raters who missed the 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. The report also describes related legislation that has received floor or committee action and will be updated regularly. An indexed list of all Enron-related bills is available on the CRS website.

Other contributors to this report include William D. Jackson, Bob Lyke, Patrick Purcell, and Gary Shorter.

Formed in 1985 from a merger of Houston Natural Gas and Internorth, Enron Corp. was the first nationwide natural gas pipeline network. Over time, the firm's business focus shifted from the regulated transportation of natural gas to unregulated energy trading markets. The guiding principle seems to have been that there was more money to be made in buying and selling financial contracts linked to the value of energy assets (and to other economic variables) than in actual ownership of physical assets.

Until late 2001, nearly all observers – including professional Wall Street analysts – regarded this transformation as an outstanding success. Enron's reported annual revenues grew from under $10 billion in the early 1990s to $101 billion in 2000, placing it seventh on the Fortune 500. Enron's problems did not arise in its core energy operations, but in other ventures, particularly "dot com" investments in Internet and communications businesses and in certain foreign subsidiaries. Rather than recognize these problems, the company engaged in dubious accounting tactics: it assigned business losses and near-worthless assets to unconsolidated partnerships and "special purpose entities" to inflate its reported bottom line, and may have disguised bank debt 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, nearly all the profits reported since 2000 disappeared and Enron quickly collapsed. (For an Enron timeline, see CRS Report RL31364, *Enron: A Select Chronology of Congressional and Government Activities*, by J. Michael Anderson.)

Nine committees in the House and Senate have held hearings related to Enron's fall. The Justice Department is conducting a criminal investigation. The challenge for financial oversight, however, does not depend on findings of wrongdoing. Even if Enron and its outside accountants and lawyers had done nothing improper, the sudden collapse of such a large corporation would suggest basic problems with 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 central issue raised by Enron is transparency: how to improve the quality of information available about public corporations. Several aspects of this issue are briefly sketched below, with references to CRS products that provide more detail.

Auditing Issues

Federal securities law requires that the accounting statements of publicly traded corporations be certified by an independent auditor. Enron's outside audits have received much attention. Outside investors, including financial institutions, may have been misled about the corporation's net income (which was subsequently restated) and its losses and liabilities (which were far larger than reported). The auditor, Arthur Andersen, has been convicted on criminal obstruction of justice charges, related to destruction of documents..

Oversight of auditors has primarily rested with the American Institute of Certified Public Accountants (a nongovernmental trade group). There have been several proposals – from the SEC, the Bush Administration, and in Congress – to create a new regulatory organization responsible for disciplinary, quality-control, and/or independence oversight of auditors. Common features of these proposals are that the board would review audits and discipline auditors, under the oversight of the SEC, and that a majority of the new body's governing board would be from outside the accounting industry. H.R. 3763, passed by the House in April 2002 and by the Senate (with an amendment in the nature of a substitute) in June, would create such an oversight body. The conference on H.R. 3763 began on July 19, 2002, and is expected to approve something like the Senate version, which gives the new board greater scope and authority than the House bill.

Another auditor issue is the provision of non-audit services to audit clients. Some believe that provision of such services is a conflict of interest that tends to undermine the arm's-length, watchdog posture expected of the outside auditor. Some non-audit services are prohibited by SEC regulations. H.R. 3763, as passed by the House, would direct the

SEC to expand its list of prohibited services to include the provision of information technology (IT) and internal audit services. The Senate version of H.R. 3763 includes the IT and internal audit services ban, makes current SEC auditor independence regulations a matter of statute, and requires the audit committee (or a delegated representative) of a corporation's board of directors to approve in advance the purchase of non-prohibited non-audit services, except in certain cases (where the non-audit services cost less than 5% of the total audit bill).

See also: CRS Report RS21120, *Auditing and its Regulators: Proposals for Reform After Enron,* by Bob Lyke.

CRS Report RL31483, *Auditing and accounting reform proposals: a side-by-side comparison,* by Mark Jickling.

Accounting Issues

The Enron controversy involves several accounting issues. One concerns the rules governing whether the financial statements of special purpose entities (SPEs) established by a corporation should be consolidated with the corporation's financial statements; for certain SPE partnerships at issue, consolidation is not required if among other things an independent third party invests as little as 3% of the capital, a threshold some consider too low. A second issue concerns the use of derivatives to manipulate accounting results. Third, there are calls for improved disclosure, either in notes to financial statements or a management discussion and analysis, especially for financial arrangements involving contingent liabilities. The SEC has proposed rules that would accelerate the filing of quarterly and annual reports. H.R. 3763, in both House and Senate versions, calls for calls for improved disclosure of transactions with unconsolidated subsidiaries and "related-party" transactions. The House version of H.R. 3763 calls for "real-time" reporting of certain events that are important to investors.

The overarching policy issue is whether current accounting rules 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 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 susceptible to business and/or political pressures. The Senate version of H.R. 3763 would require that FASB be funded by contributions from corporations that sell securities to the public (rather than the accounting industry) and would require FASB to adopt procedures to ensure prompt consideration of needed changes to accounting rules.

For additional information contact Bob Lyke (7-7355).

Pension Issues

Like many companies, Enron sponsors 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. Consequently, the company's bankruptcy has substantially reduced the value of its employees' retirement accounts. The losses suffered by participants in the Enron Corporation's 401(k) plan have prompted questions about the laws and regulations that govern these plans.

H.R. 3762, which passed the House on April 11, 2002, would, among other things, require that account information be provided more often to plan participants; improve access to investment planning advice; allow plan participants to sell company stock contributed by employers after three years; and prohibit executives from selling company stock while a plan is "locked down." The latter provision is also included in H.R. 3763, in both House and Senate versions.

See also: CRS Report RS21115, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, by Patrick Purcell.

Corporate Governance Issues

The role of a company's board of directors is to oversee corporate management to protect the interests of shareholders. However, in 1999 Enron's board waived conflict of interest rules to allow chief financial officer Andrew Fastow to create private partnerships to do business with the firm. Transactions involving these partnerships concealed debts and losses that would have had a significant impact on Enron's reported profits. Enron's collapse raises the issue of how to reinforce directors' capability and will to challenge questionable dealings by corporate managers.

Specific questions involve independent, or "outside" directors. (Stock exchange rules require that a certain percentage of board members be unaffiliated with the firm and its management.) Should the way outside directors are selected be changed or regulated? Directors are elected by shareholders, but except in very unusual circumstances these are "Soviet-style" elections, where management's slate of candidates receives nearly unanimous approval.

Should there be restrictions on indirect compensation in the form of, say, consulting contracts or donations to charities where independent board members serve? Should the personal liability of directors in cases of corporate fraud be increased? Do the rules requiring members of the board's audit committee to be "financially literate" ensure that the board will grasp the innovative and complex financial and accounting strategies employed by companies like Enron?

Several bills before the 107th Congress would require prompt, electronic disclosure of stock trades by corporate directors, senior executives, and other insiders – including both House and Senate versions of H.R. 3763.

For additional information contact Gary Shorter (7-7772).

Securities Analyst Issues

Securities analysts employed by investment banks provide research and make “buy,” “sell,” or “hold” recommendations for the use of their sales staffs and their investor clients. These recommendations are widely circulated and are relied upon by many investors throughout the markets. Analyst support was crucial to Enron because it required constant infusions of funding 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.” This performance added to concerns that were raised in 2000 in the wake of the “dot com” stock crash. Is analyst objectivity compromised by pressure to avoid alienating lucrative investment banking clients? Are regulations needed to require disclosure of analysts’ personal holdings or their employers’ dealings with the firms they cover, or to prohibit the linking of analyst pay to investment banking profits? Should analysts’ performance and qualifications be monitored by the SEC or by a self-regulatory organization such as the National Association of Securities Dealers (NASD)?

H.R. 3763, as passed by the House, directs the SEC to study stock analyst issues and to establish a confidential risk rating system for corporations that would determine how frequently the SEC reviews companies’ financial statements. The Senate version of H.R. 3763 requires the NASD to adopt rules to regulate analysts and reduce conflicts of interest.

See also: CRS Report RL31348, *Enron and Stock Analyst Objectivity*, by Gary Shorter.

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, and have suffered from Enron's collapse. The two activities had been separated by the 1933 Glass-Steagall Act, until P.L. 106-102 (the Gramm-Leach-Bliley Act) allowed their recombination. Observers have begun to question whether that 1999 repeal of Glass-Steagall encouraged conflicts of interest and unsafe bank lending in support of the investment banking business with Enron.

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 devised late in Enron's collapse, involving further investments of 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 William D. Jackson (7-7834).

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 speculative trading in derivatives is an extremely high-risk activity, no evidence has yet emerged that indicates that such losses were a factor in Enron's collapse.

Since the Enron failure, several energy traders have admitted to making "wash trades" which lack economic substance, but give the appearance of greater market liquidity than actually exists, and may facilitate deceptive accounting (when the fictitious trades are reported as real revenue). The energy derivatives market survived Enron's fall, but in mid-2002 appears to be shrinking, as major traders (and their customers and shareholders) re-evaluate the risks of unregulated energy trading.

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.

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. H.R. 3914 would amend 2000 legislation that exempted energy derivatives from Commodity Futures Trading Commission (CFTC) jurisdiction. H.R. 4038 proposes to regulate the currently unregulated over-the-counter derivatives market in a fashion similar to the current regulation of securities brokers and dealers by the SEC. S. 1951 and Senate Amendment 2989 (to S. 517) would authorize the CFTC to require disclosure of transaction data by traders in the over-the-counter energy derivatives market.

See also: CRS Report RS20560, *Derivatives Regulation: Legislation in the 106th Congress*, by Mark Jickling (7-778)