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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. As firms become more transparent, the ability of corporate insiders to pursue their own interests at the expense of rank-and-file employees and public stockholders diminishes. Several aspects of this issue are briefly sketched below, with references 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 outside audits were clearly inadequate. When auditors saw accounting practices that would normally be regarded as improper, they turned a blind eye. Moreover, Enron's auditor was actively involved in devising complex financial structures and transactions that facilitated deception. The auditing firm, Arthur Andersen, has been convicted on criminal obstruction of justice charges related to destruction of documents.

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 ad 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 susceptible to business and/or political pressures.

In response to the auditing and accounting problems laid bare by Enron and other corporate scandals, Congress enacted the Sarbanes-Oxley Act of 2002 (PL 107-204),

containing perhaps the most far-reaching amendments to securities regulation since the 1930s. Very briefly, the Act does the following:

- Creates a new oversight board to regulate independent auditors of publicly traded companies – a private sector entity operating under the oversight of the Securities and Exchange Commission;
- 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 related parties, and other significant events that may require "real-time" disclosure;
- provides for the adoption of rules to prevent conflicts of interest that affect the objectivity of stock analysts;
- authorizes $776 million for the SEC in FY 2003 (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.

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

For additional information contact Bob Lyke (7-7355) or Mark Jickling (7-7784).

## 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 the sale of company stock contributed by employers after three years; and bar executives from selling company stock while a plan is "locked down." The latter provision was enacted by the Sarbanes-Oxley Act (PL 107-204). Two Senate bills with generally similar provisions have been reported out of committee: S. 1971 and S. 1992.

See also: CRS Report RL31507, *Employer Stock in Retirement Plans: Investment Risk and Retirement Security*, by Patrick Purcell (7-7571).

CRS Report RL31551, *Employer Stock in Pension Plans: Economic and Tax Issues,* by Jane Gravelle.

## 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, whose objectivity and loyalty to shareholders are not supposed to be swayed by personal or business ties to management. Should the way outside directors are selected be changed? 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.

The Sarbanes-Oxley Act (PL 107-204) requires prompt, electronic disclosure of stock trades by corporate directors, senior executives, and other insiders. The Act also gives the board's audit committee direct responsibility for hiring, compensating, and overseeing the company's outside auditor. New rules proposed by the New York Stock Exchange would require that a majority of directors be independent.

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 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." 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?

The Sarbanes-Oxley Act (PL 107-204) directs the SEC to establish rules regarding conflicts of interest, disclosure of analysts' (and their firms') holdings in the stock and other business relationships with the companies that the analysts cover.

See also: CRS Report RL31348, *Enron and Stock Analyst Objectivity*, by Gary Shorter (7-7772).

## 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?

The Sarbanes-Oxley Act (PL107-204) requires the SEC to study the role of investment banks in accounting deceptions and to report to Congress with recommendations for possible amendments to securities laws.

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 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 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 and utility 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 S. 2724 would give the CFTC more authority to pursue fraud (including wash transactions) and to require disclosure of transaction data by traders and certain over-the-counter energy derivatives markets.

See also: CRS Report RS20560, *Derivatives Regulation: Legislation in the 106th Congress*, by Mark Jickling (7-7784).