Order Code RS21135
Updated January 30, 2003

CRS Report for Congress
Received through the CRS Web

The Enron Collapse: An Overview of Financial Issues

Mark Jickling, Coordinator
Specialist in Public Finance
Government and Finance Division

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 and bond raters who failed to warn investors of 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 summarizes the Sarbanes-Oxley Act (P.L. 107-204), the major response by the 107th Congress to Enron's fall, and will be updated as the 108th Congress addresses related financial issues.

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

Enron: What Went Wrong?

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 Wall Street professional – 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's problems did not arise in its core energy operations, but in other ventures, particularly "dot com" investments in Internet and high-tech communications businesses. Like many other firms, Enron saw an unlimited future in the Internet. During the late 1990s, it purchased on-line 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, revenues 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 politics blocked 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. (For an Enron timeline, see CRS Report RL31364.) 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 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 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 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 laid bare by Enron and other corporate 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 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 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 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.

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. Many employees' retirement accounts were wiped out. 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 (107^{th} Congress), which passed the House on April 11, 2002, would have, among other things, required that account information be provided more often to plan participants; improved access to investment planning advice; allowed the sale of 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. The 108^{th} Congress is expected to revisit the issue.

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

In the wake of Enron and other scandals, corporate executives and boards of directors were subject to critical scrutiny. At Enron, WorldCom, and elsewhere, top management sold billions of dollars worth of company stock while serious financial problems were being hidden from the public. Several provisions of Sarbanes-Oxley were intended to remind CEOs of their duties to their firms and their public shareholders. Stock trades by corporate insiders must be reported in a matter of hours, rather than weeks or months. CEOs must personally certify the accuracy of their companies' financial statements. Criminal penalties for securities fraud offenses were increased.

The Sarbanes-Oxley Act also strengthened the oversight role of corporate boards. Any nonaudit services provided by a firm's outside auditor must be approved by the board. The board's audit committee, which must have a majority of independent directors (who are not affiliated with management), will now be responsible for hiring, firing, overseeing, and compensating the firm's outside auditor. The audit committee must include at least one director who is financially expert, able to evaluate significant accounting issues and/or disagreements between management and auditors.

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. In December 2002, 100 investment banks reached a settlement with securities regulators and agreed to take steps 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 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, 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?

The Sarbanes-Oxley Act (P.L.107-204) requires the SEC to study the role of investment banks in accounting deceptions and to report to Congress.

See also: CRS Report RS21188, *Enron's Banking Relationships and Congressional Repeal of Statutes Separating Bank Lending from Investment Banking*, by William D. Jackson.

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.

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.

See also: CRS Report RS21401, *Regulation of Energy Derivatives*, by Mark Jickling.

CRS Report RS20560, *Derivatives Regulation: Legislation in the 106th Congress*, by Mark Jickling.