

CRS Report for Congress

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The Enron Collapse: An Overview of Financial Issues

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Summary

Only months before Enron Corp.'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. Investigations of wrongdoing may take years to conclude, but Enron's failure already raises financial oversight issues with wider applications. 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 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, ranking it seventh on the Fortune 500. It now appears that Enron's problems did not arise in its core energy operations, but in other ventures, particularly in "dot com" investments in Internet and communications businesses and in certain foreign subsidiaries. The company used

accounting techniques involving unconsolidated partnerships and “special purpose entities” to prevent significant losses from appearing on its financial statements and to conceal the extent of its indebtedness. When these dubious accounting tactics came to light, nearly all the profits reported since 2000 disappeared and Enron quickly collapsed.

The unraveling began in August 2001, when CEO Jeffrey Skilling resigned for undisclosed reasons. On October 16, Enron reported its first quarterly loss in 4 years, taking a charge against earnings of \$1 billion for poorly performing businesses. On November 8, the company announced in a Securities and Exchange Commission (SEC) filing that it was restating its earnings since 1997 – reducing them by \$586 million. The coup-de-grace came on November 28, when the major bond rating agencies downgraded Enron’s debt to below-investment-grade, or junk bond status. The company filed for Chapter 11 bankruptcy on December 2, 2001.

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 overarching issue raised by Enron is how to improve the quality of information available about public corporations. Several aspects of this central issue are briefly sketched below, with references to CRS products that discuss the issues in 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 indicted on criminal obstruction of justice charges, related to destruction of documents..

One issue is whether Andersen’s extensive consulting work for Enron may have compromised its independence and its judgment in determining the nature, timing, and extent of audit procedures and in asking that revisions be made to financial statements, which are the responsibility of Enron’s management. Oversight of auditors has primarily rested with the American Institute of Certified Public Accountants (a nongovernmental trade group) and state boards of accountancy.

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 SEC would exercise direct oversight of the regulatory process and that a majority of the new body’s governing board would be from outside the accounting industry. Bills to establish a new auditor oversight body include H.R. 3763, H.R. 3795, H.R. 3818, H.R. 3970, and S. 2004.

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. Several bills before the 107th Congress would limit the provision of non-audit services by auditors to their clients, including H.R. 3617, H.R. 3693, H.R. 3736, H.R. 3763, H.R. 3818, H.R. 3795, H.R. 3970, S. 1896, S. 1921, and S. 2004. The Big Five accounting firms have agreed to impose (or support) a prohibition on provision of internal audit and information technology services to their audit clients. A crucial issue will be whether tax services, a major component of accounting firms' revenues, are included in the services deemed to compromise independence.

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

CRS Report RS21173, *Auditor Oversight: Proposals for a New Regulator*, 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. 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.)

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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.

Legislation before the 107th Congress would, among other things, require that account information be provided more often to plan participants; set a limit on the amount of employer stock that 401(k) plans can hold; allow participants to sell stock contributed

by employers after three years; improve plan participants' access to financial advice; or prohibit executives from selling company stock while a plan is "locked down." For summaries of related legislation, see CRS Report RL31319, *Employer Stock in Retirement Plans: Bills in the 107th Congress*, by Patrick Purcell.

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 H.R. 3763, H.R. 3769, H.R. 3818, H.R. 3840, and S. 1897. Several of the auditor reform bills cited above would require the audit committee of a corporation's board of directors to take a more active role in the selection and supervision of outside auditors.

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. 3671, H.R. 3818, and S. 1895 would mandate disclosure of ties between analysts’ firms and the companies they cover, or otherwise address conflicts of interest. H.R. 3763 directs the SEC to study stock analyst issues.

For additional information contact 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?

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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 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.

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.