

CRS Report for Congress

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The Enron Collapse: An Overview of Financial Issues

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

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 will be updated regularly as further reliable information about Enron's downfall – which is now extremely limited – becomes available.

Other contributors to this report include 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.

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. The reported third quarter loss was \$618 million, versus a \$292 million profit a year earlier. 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.

Several committees in the House and Senate have held or plan to hold 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 no one at Enron did anything improper, the swift and unanticipated collapse of such a large corporation suggests 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 financial issue raised by Enron is whether the quality of information available about public corporations needs to be improved. 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. While external audits do not prevent corporations from making financial mistakes, let alone bankruptcy, problems with recent Enron audits may have contributed to both the rapid rise and the sharp fall in its stock price. Outside investors, including financial institutions, may have been misled about the corporation's net income (which was subsequently restated) and contingent liabilities (which were far larger than generally known). The auditor, Arthur Andersen, has admitted some mistakes. Andersen fired the partner in charge of Enron audits on January 15, 2002, and Enron dismissed Andersen on January 17. One issue is whether Andersen's extensive consulting work for Enron may have compromised 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. Questions have also been asked about Andersen destroying documents and e-mails related to its audits. Oversight of auditors has primarily rested with the American Institute of Certified Public Accountants (a nongovernmental trade group) and state boards of accountancy. On January 17, 2002, the Chairman of the Securities and Exchange Commission (SEC) proposed a new oversight board that would be responsible for disciplinary actions.

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

CRS Report RS20707, *Auditor Independence: The SEC's 2000 Rulemaking*, 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 latitude allowed in valuing derivatives, particularly non-exchange traded energy contracts. 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.)

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. Should there be a limit on the amount of employer stock that a 401(k) plan can hold? Should companies be allowed to restrict the sale of stock that they contribute to the plans? Should the guarantees that the Pension Benefit Guarantee Corporation extends to traditional “defined benefit” plans also apply to 401(k)'s?

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

CRS Report RL30122. *Pension Sponsorship and Participation: Summary of Recent Trends*, 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. These partnerships appear to have concealed debts and liabilities 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? Should there be restrictions on indirect compensation in the form of, say, consulting contracts or donations to other institutions 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?

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)?

For additional information contact Gary Shorter 7-7772.

Derivatives Issues

The core of Enron’s business appears to have been 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. Did Enron earn money from dealer commissions and spreads, or was it actively speculating on future price trends? Speculative losses in derivatives, perhaps masked by “creative” accounting, could have contributed to the firm’s downfall. On the other hand, the trading operations may have been profitable and trouble-free, and Enron’s financial difficulties the result of other unrelated operations.

Enron’s collapse 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 might set off widespread disruptions in financial and/or real commodity markets.

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