The Enron Scandal and Moral Hazard

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The Enron Scandal and Moral Hazard

- Enron, the 7th largest U.S. company in 2001, ***filed for bankruptcy*** in December 2001.
- Enron investors and retirees were left with ***worthless stock***.
- Enron was charged with ***securities fraud*** (fraudulent manipulation of publicly reported financial results, lying to SEC,...)
- **QUESTION:** In what ways are **security market moral hazard problems** at the heart of the Enron bankruptcy scandal?

Brief Time-Line of the Enron Scandal

- Enron was a Houston-based natural gas pipeline company formed by merger in 1985.
- By early 2001, Enron had morphed into the 7^{th} largest U.S. company, and the largest U.S. buyer/seller of natural gas and electricity.
- Enron was heavily involved in energy brokering, electronic energy trading, global commodity and options trading, etc.

Brief Time-Line of the Enron Scandal...Continued

- On October 16, 2001, in the first major ***public*** sign of trouble, Enron announces a huge third-quarter loss of $618 million.
- On October 22, 2001, the Securities and Exchange Commission (SEC) begins an inquiry into Enron's accounting practices.
- On December 2, 2001, Enron files for ***bankruptcy***.

Buying as the Ship Went Down : Oct – Dec 2001

On the advice of Alliance Capital Management, one of its investment managers, the Florida state pension fund bought Enron stock even as the company's troubles became known. A former Alliance executive, Frank Savage, is also a member of Enron's board.

PURCHASES OF ENRON STOCK SINCE OCT. 17

DATE	NUMBER OF SHARES	SHARE PRICE	PRICE PAID (MILLIONS)
OCT. 22	311,200	$22.82	$7.1
OCT. 24	302,500	16.30	4.9
OCT. 25	124,600	15.47	1.9
OCT. 29	373,900	14.51	5.4
OCT. 30	317,800	12.23	3.9
NOV. 13	581,900	9.37	5.5
NOV. 14	478,600	9.84	4.7
NOV. 16	209,500	9.02	1.9

NOV. 30 Pension fund sells its entire Enron holdings, 7.6 million shares, at 28 cents a share.

OCT. 17 Enron reduces shareholder equity by $1.2 billion to account for transactions involving certain partnerships.

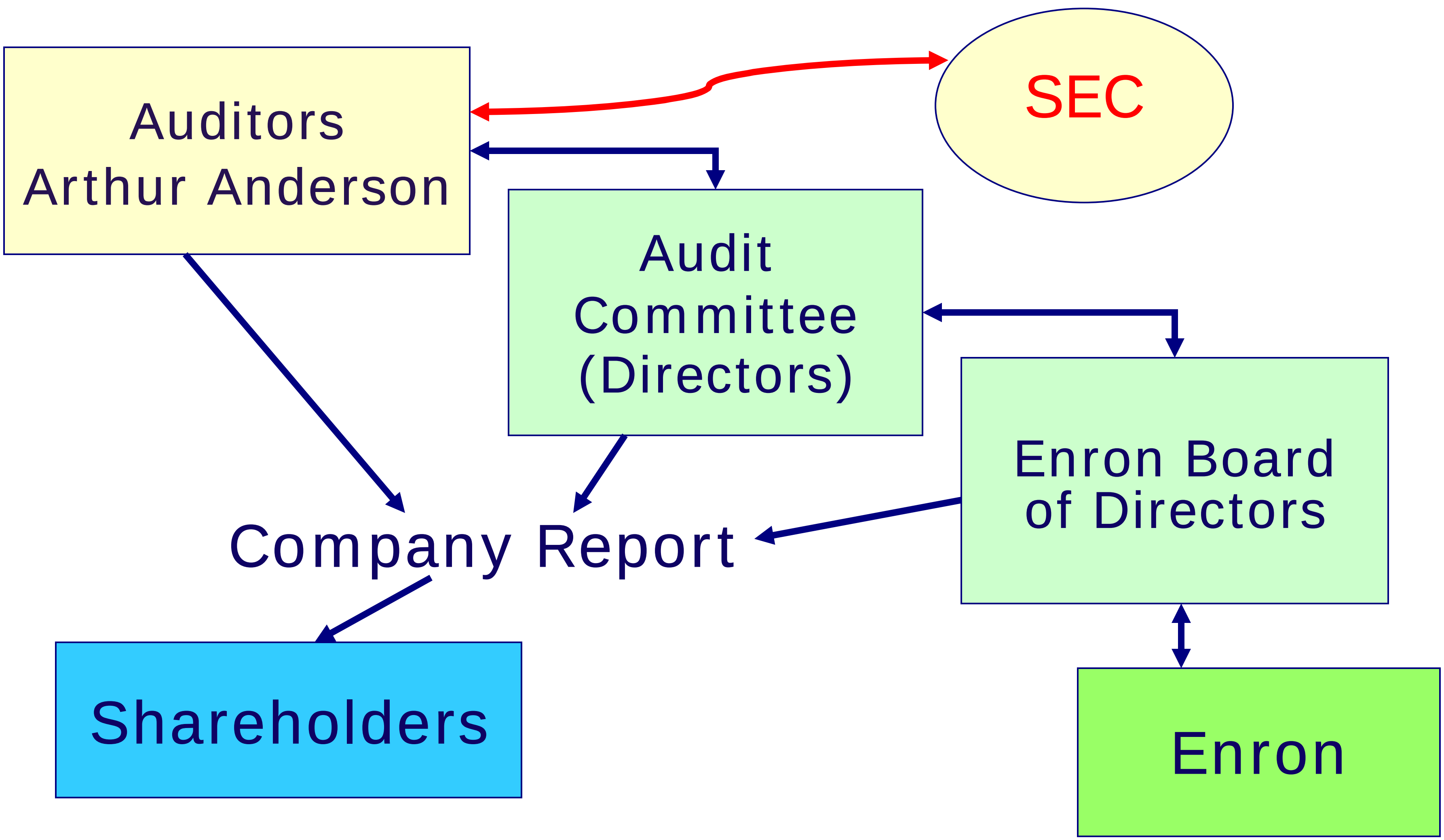
OCT. 22 Enron discloses that the Securities and Exchange Commission has opened an inquiry into the partnerships.

NOV. 8 Enron says it overstated profits for the previous five years by $586 million.

DEC. 2 Enron files for bankruptcy protection.

Sources: Dow Jones Interactive (stock price); Office of Senator Bill Nelson

Regulatory Oversight of Enron



Investigative Findings

- 1993-2001: Enron used **complex dubious energy trading schemes**

- **Example: “Death Star” Energy Trading Strategy**

  - Took advantage of a loophole in the market rules governing energy trading in California

  - Enron would schedule electric power transmission on a congested line from bus A to bus B in the opposite direction to demand, thus enabling them to collect a “congestion reduction” fee for seemingly relieving congestion on this line.

  - Enron would then schedule the routing of this energy all the way back to bus A so that no energy was actually bought or sold by Enron in net terms. It was purely a routing scheme.

Investigative Findings …

- 1993-2001: Enron also used **complex & dubious accounting schemes**

- *to reduce* Enron's tax payments;
- *to inflate* Enron's income and profits;
- *to inflate* Enron's stock price and credit rating;
- *to hide* losses in off-balance-sheet subsidiaries;
- to engineer off-balance-sheet schemes to *funnel money* to themselves, friends, and family;
- *to fraudulently misrepresent* Enron's financial condition in public reports.

WHY WASN'T ENRON STOPPED SOONER!

Case Study of One Accounting Scheme

(Based on WSJ site & Prof. S. Ravenscroft Notes)

- Enron’s rapid growth in late 1990s involved large capital investments not expected to generate significant cash flow in short term.

- Maintaining Enron’s credit ratings at an investment grade (e.g., BBB- or higher by S&P) was vital to Enron’s energy trading business.

Case Study … Continued

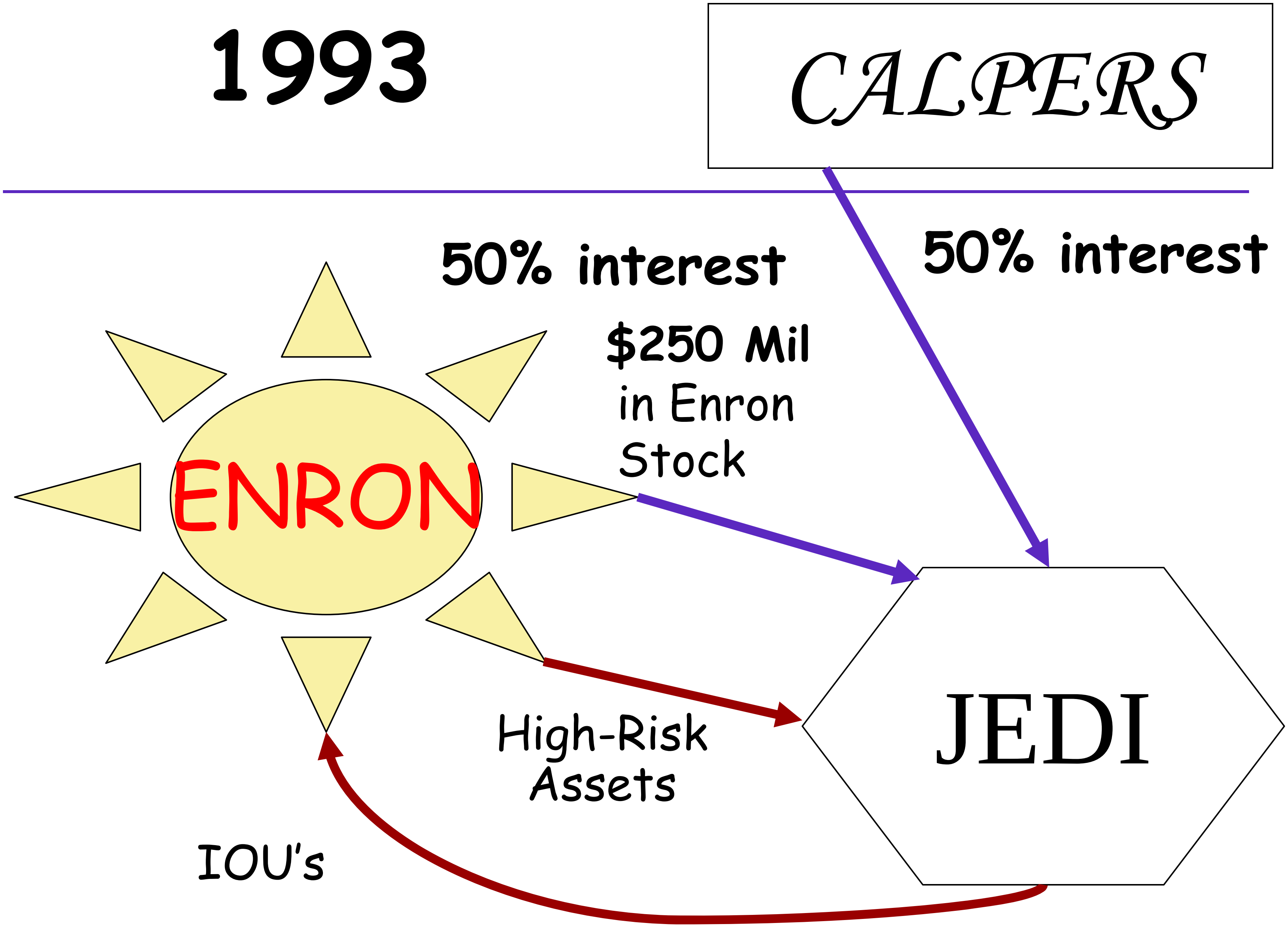
- One perceived solution: Create partnerships structured as ***special purpose entities (SPEs)*** that could borrow from outside investors without having to be consolidated into Enron’s balance sheet.

- ***SPE 3% Rule:*** No consolidation needed if at least 3% of SPE total capital was owned independently of Enron.

Case Study … Continued

- ***Enron's creation of over 3000 partnerships*** started about 1993 when it teamed with ***Calpers*** *(California Public Retirement System)* to create ***JEDI*** *(Joint Energy Development Investments)* fund.
- Enron initially thought of these partnerships as temporary solutions for temporary cash flow problems.
- **Enron later used SPE partnerships under 3% rule to hide bad bets** it had made on speculative assets by selling these assets to the partnerships in return for IOUs backed by Enron stock as collateral! (over $1 billion by 2002)

1993


CALPERS
50% interest
50% interest
$250 Mil
in Enron
Stock
ENRON
High-Risk
Assets
JEDI
IOU's

Case Study… Continued

- In Nov 1997, Calpers wants to cash out of JEDI.
- To keep JEDI afloat, Enron needs new 3% partner.
- It creates another partnership ***Chewco*** (named for the Star Wars character Chewbacca) to buy out Calpers' stake in JEDI for $383 million.
- Enron plans to back short-term loans to Chewco to permit it to buy out Calper's stake for $383 million.

This is the plan....

Case Study…Continued

- Chewco **needs** $383 million to give Calpers
- It gets.....
  - $240 mil loan from Barclay's bank **guaranteed by Enron**
  - $132 mil credit from JEDI (**whose only asset is Enron stock**)

•Chewco **still must get 3% of $383 million (about $11.5 million) from some outside source** to avoid inclusion of JEDI's debt on Enron's books (SEC filing, 1997).

Case Study…Continued

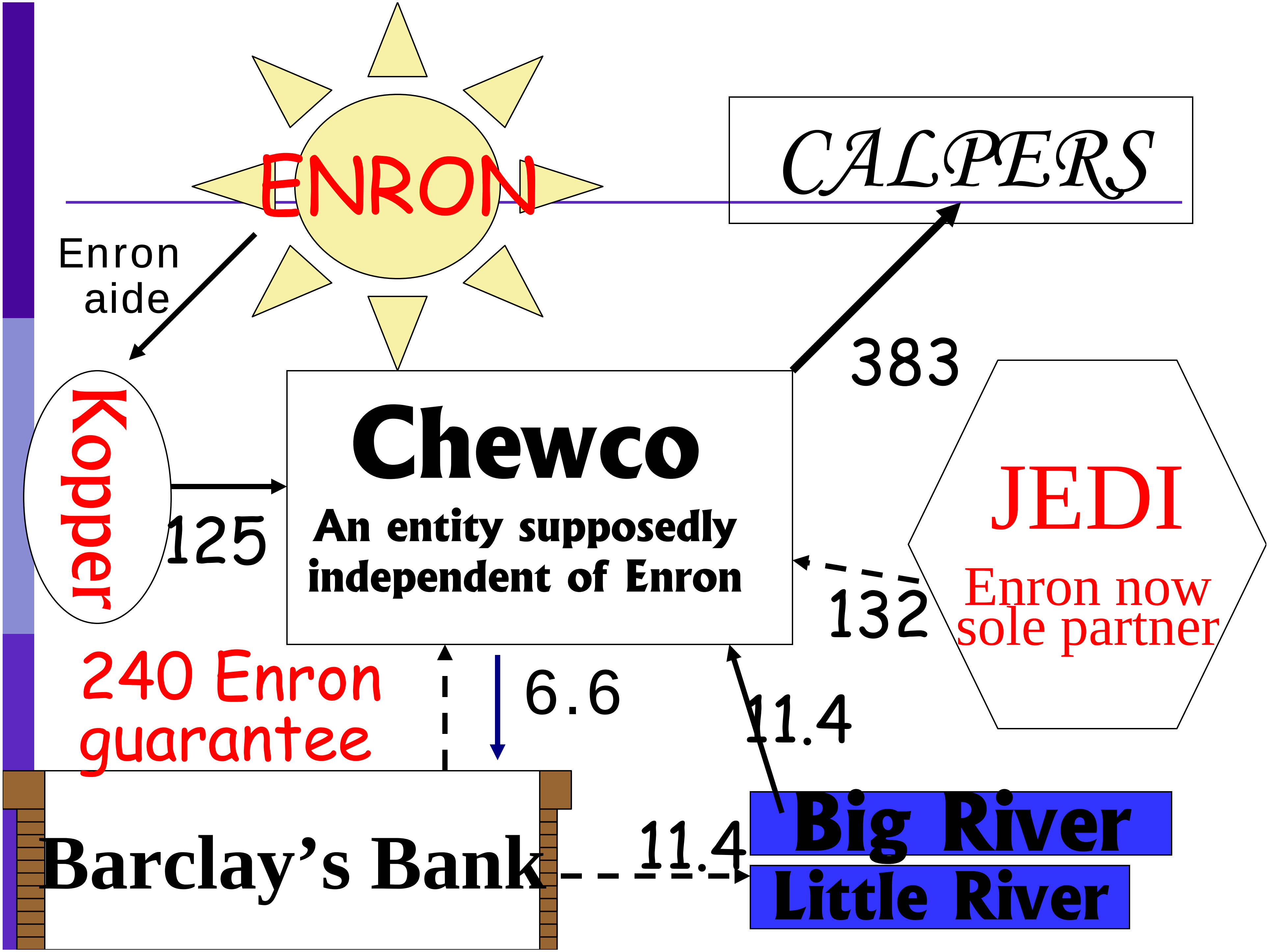
Chewco Capital Structure: Outside 3%

- $125,000 from William Dodson & **Michael Kopper** (**an aide to Enron CFO Fastow**)

- $11.4 mil loans from **Big River and Little River** (two new companies formed by Enron expressly for this purpose **who get a loan from Barclay’s Bank**)

More Complications for Enron!

- **Barclay's Bank** begins to **doubt** the strength of the new companies Big River and Little River.
- It **requires a cash reserve of $6.6 million** to be deposited (as security) for the $11.4 million dollar loans.
- This cash reserve is **paid by JEDI**, whose net worth by this time consists solely of **Enron** stock, putting **Enron** in the at-risk position for this amount (red arrow on the next slide.)


ENRON
CALPERS
Enron aide
Kopper
Chewco
An entity supposedly independent of Enron
383
JEDI
Enron now sole partner
125
132
240 Enron guarantee
6.6
11.4
Barclay's Bank
11.4
Big River
Little River

Case Study… Continued

"Oh, what a tangled web we weave when first we practice to deceive!"

Walter Scott, Marimon, VI

Profit to Enron from all this?

- Enron received $10 million in guarantee fee + fee based on loan balance to JEDI.

- Enron received a total of $25.7 mil revenues from this source.

- In first quarter of 2000, the increase in price of Enron stock held by JEDI resulted in $126 million in profits to Enron.

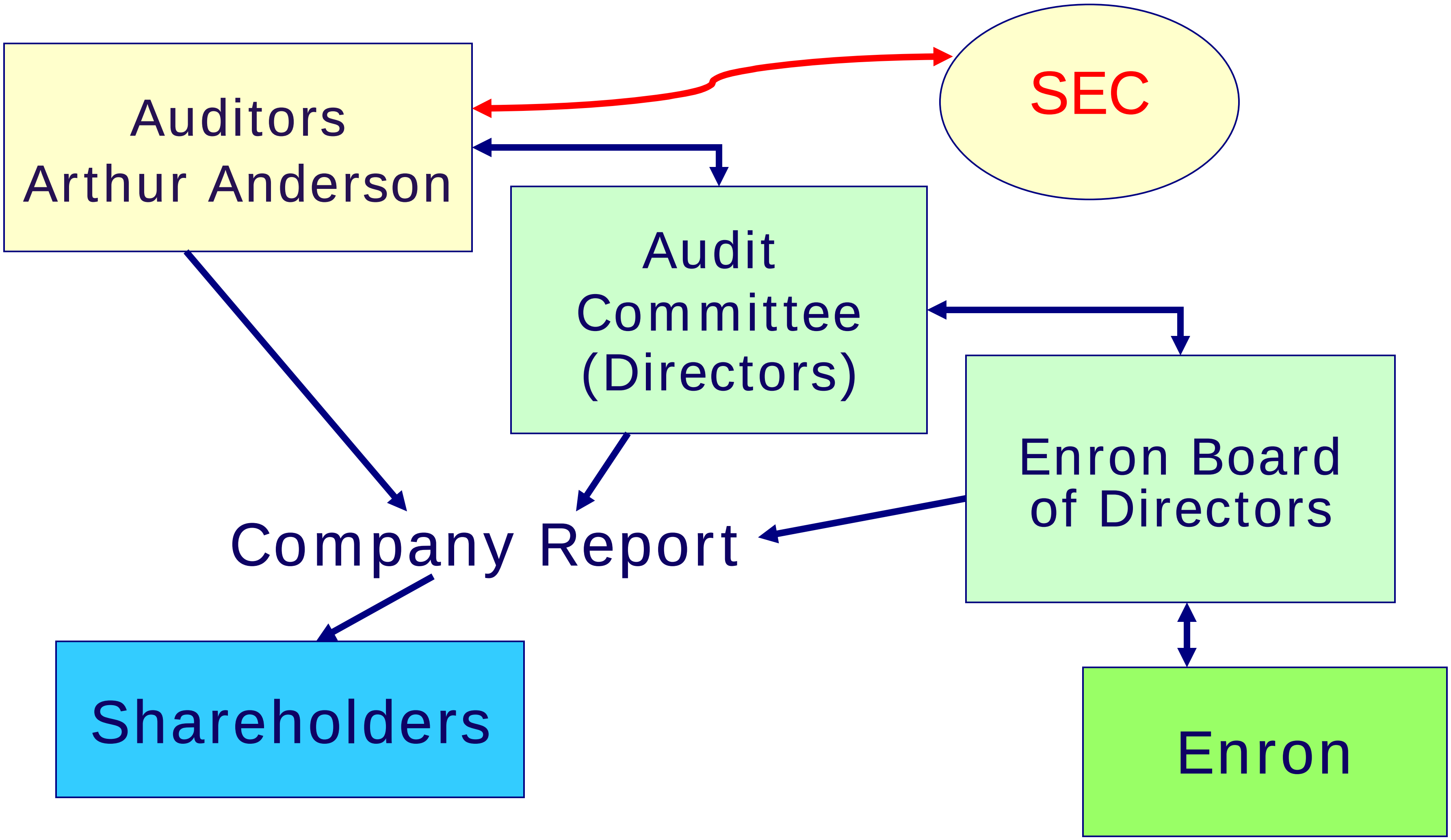
Profit to Enron from all this?

- **But everything fell apart when Enron's share price started to drop in Fall 2000 (dot.com bubble burst ↓).**

- In November 2001, Enron admitted to the SEC that Chewco was not truly independent of Enron.

- Chewco went bankrupt shortly after this admission by Enron.

Who is to Blame for the Enron Scandal?



Who is to Blame for Enron?

- **Lax accounting** by Arthur Anderson (AA) Co**?**
- **“Rogue” AA auditor David Duncan** (fired 1/15/02)?
- **Enron’s senior management** for hiding losses in dubious off-balance-sheet partnerships?
- **CFO Andrew Fastow** for setting up these partnerships (6 year prison sentence 9/26/2004)?
- **Timothy Belden** (trading schemes, 2yrs probation 2007)
- **CEO Jeff Skilling** (24 year prison sentence 10/23/06)?
- **CEO Kenneth Lay** (died 7/23/06 with charges pending)?
- **Media exaggeration and frenzy?**
- **Stock analysts** who kept pushing Enron stock?

Bad Accounting Practices?

Generally Accepted Accounting Practices (Prior to 2002):

- Auditing companies often **consult** for the companies they audit (conflict of interest).
- Audit company partners often later **accept jobs** from their client companies.
- Companies often retain the same auditing company for **long periods of time**.
- Auditing companies have been allowed to **police themselves**.

Bad Accounting Practices?

Generally Accepted Accounting Practices (Prior to 2002)… Continued

- Appointment of auditor company is ***in theory*** by shareholders but ***in practice*** by senior management
- Audit Committee members often are **not independent** of senior management - insiders are the ones with the most accurate understanding.
- Audit Committee members have typically been **required** to own company stock to align their incentives with those of company.

Other Dubious Practices?

- Board of Directors have traditionally been **paid largely in stock** to align their interests with shareholders.
- Directors **can sell out early** based on insider information.
- When senior executives are charged with failure to abide by SEC rulings, the **company typically pays the fine**.

Lessons from Enron Scandal

- Demonstrated the importance of “old economy” questions: How does the company **actually** make its money? Is it **sustainable** over the long haul? Is it **legal**!

- Demonstrated the need for significant reform in accounting and corporate governance in the U.S.

- Does this necessarily mean **government regulation** can fix the problem?

Sarbanes-Oxley Act (SOX) of 2002

- **U.S. legislative response** to recent spate of accounting scandals (Enron, WorldCom, Global Crossing, Adelphia Communications...)

- **Compliance with comprehensive reform of accounting procedures is now required for publicly held companies**, to promote and improve the quality and transparency of financial reporting by internal and external auditors.

Sarbanes-Oxley Act (SOX) of 2002

- Companies must **"list and track performance of their material risks and associated control procedures."**
- CEOs are required to **vouch for the financial statements of their companies.**
- Boards of Directors must have Audit Committees whose members are **independent** of company senior management.
- Companies can no longer make loans to company directors.

SOX Act of 2002 … Continued

- SOX Act Essentially a response to **one** cause of the financial irregularities: failure by auditors, SEC, and other agencies to provide adequate oversight.
- Not clear how SOX Act will prevent misuse of “off-balance-sheet activities” that are difficult to trace.
- SOX Act also does not address **other** key causes:
  - ***misaligned incentives*** (e.g., shift from cash to stock option compensation)
  - ***focus on short-run profits*** rather than longer-run profit performance.

Getting Rid of SPE 3% Rule

- ***SPE 3% Rule:*** Rule permitting Special Purpose Entities (SPEs) created by a firm to be treated as "off-balance-sheet" – i.e., no required consolidation with firm's balance sheets – as long as at least 3% of the total capital of the SPE was owned independently of the firm.

- Rule raised to 10% in 2003 following Enron scandal

- After more misuse of rule during Subprime Financial Crisis, Financial Accounting Standards Board (FASB) *replaced this rule in 2009 with stricter consolidation standards on all asset reporting (FASB 166 & 167).*

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