

# The Enron Scandal and Moral Hazard

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Prof. Leigh Tesfatsion  
Department of Economics  
Iowa State University  
Ames, IA 50011-1070

<http://www.econ.iastate.edu/tesfatsi/>

# The Enron Scandal and Moral Hazard

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- 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 the **security market information problems** discussed by Mishkin Chapter 8 illustrated by the Enron bankruptcy scandal?

# Brief Time-Line of the Enron Scandal

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- Enron was a Houston-based natural gas pipeline company formed by merger in 1985.
- By early 2001, Enron had morphed into the 7<sup>th</sup> 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.

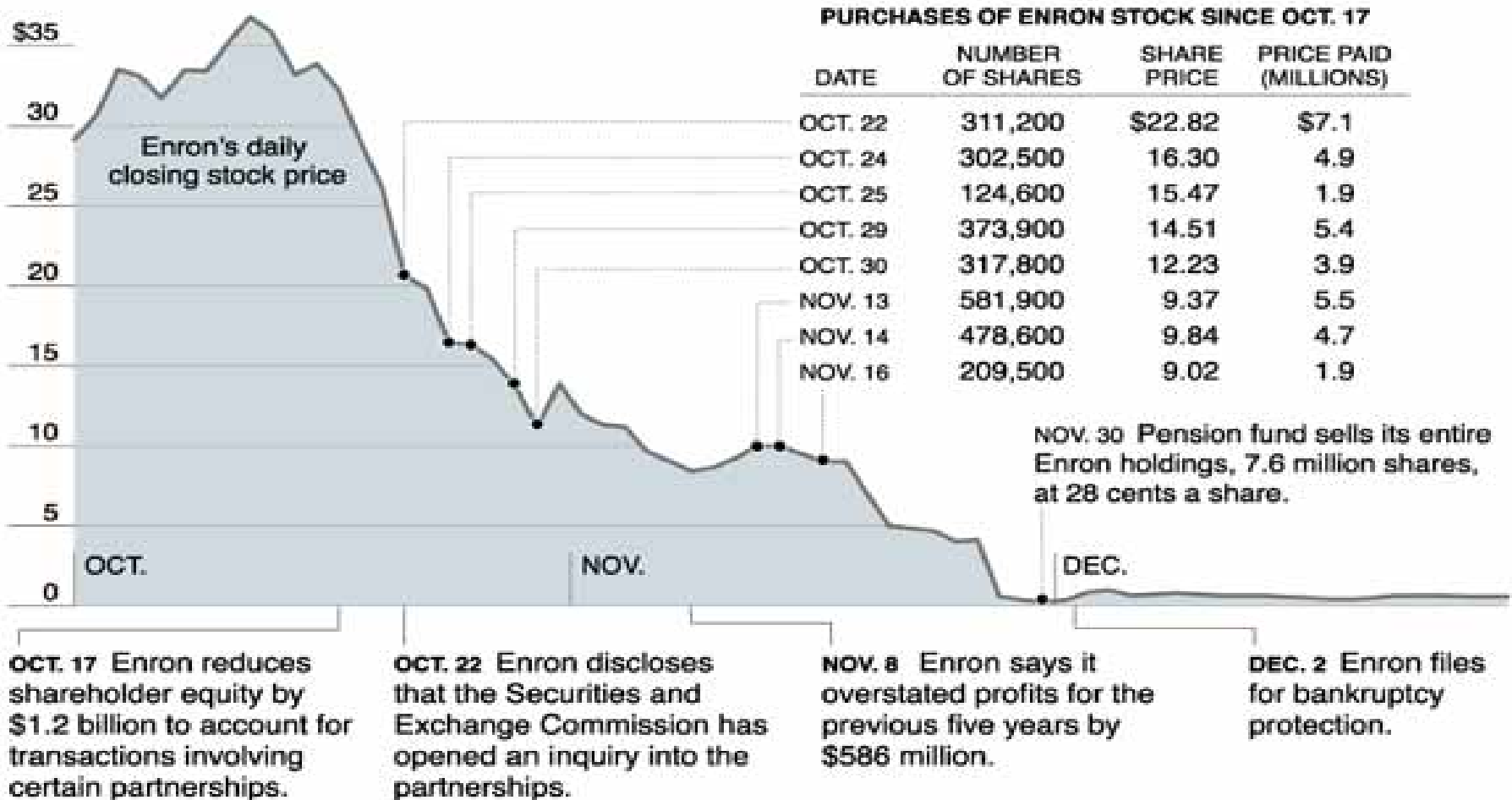
# Brief Time-Line of the Enron Scandal...Continued

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- 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

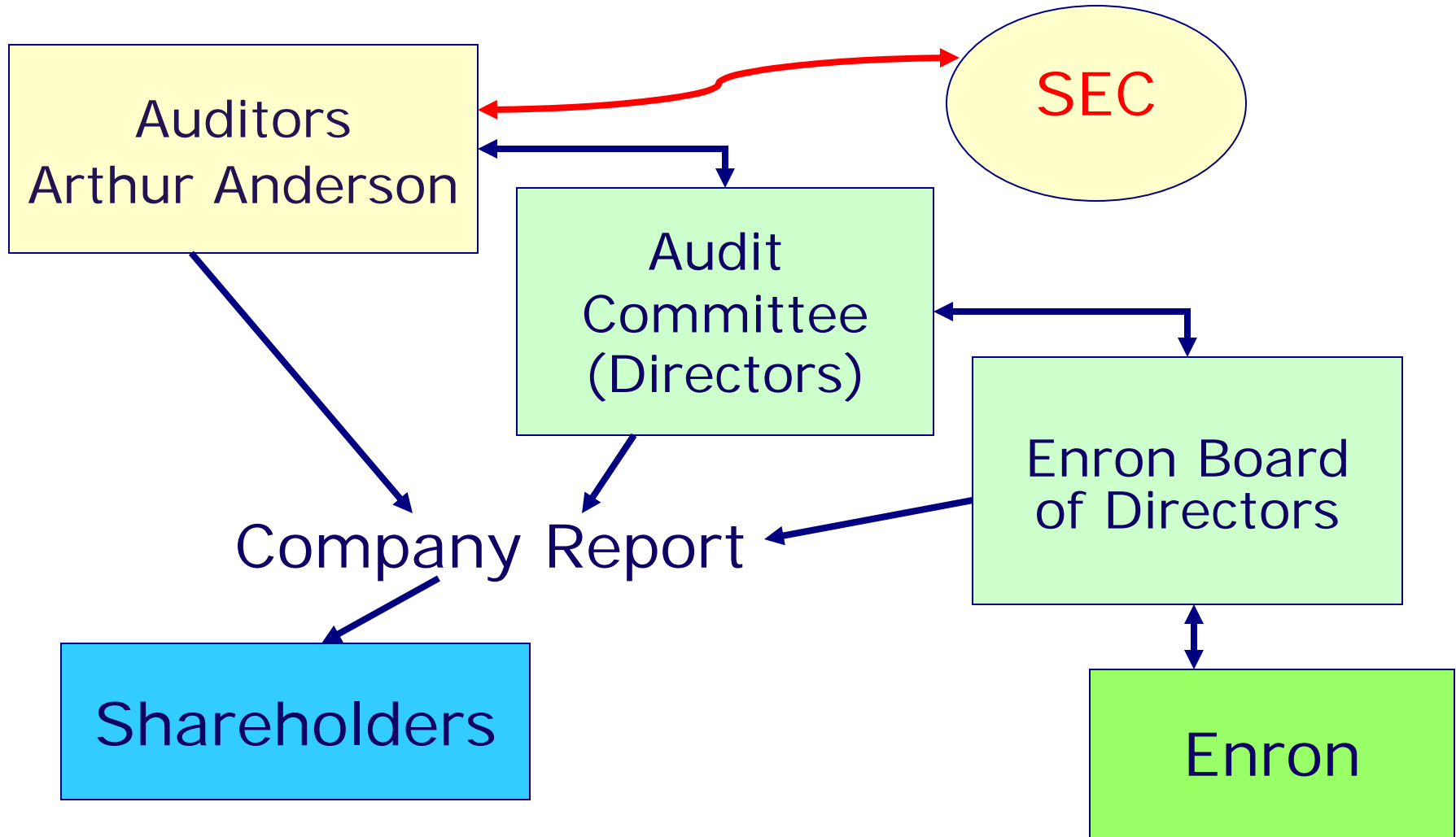
On the advice of Alliance Capital Management, one of its investment managers, the Florida state pension fund bought Enron stock even as the company's troubles became known. A former Alliance executive, Frank Savage, is also a member of Enron's board.



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

# Regulatory Oversight of Enron

(Basic Reference: Case Study by Prof. S. Ravenscroft)



# Investigative Findings

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1993-2001: Enron senior management used **complex and murky 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!**

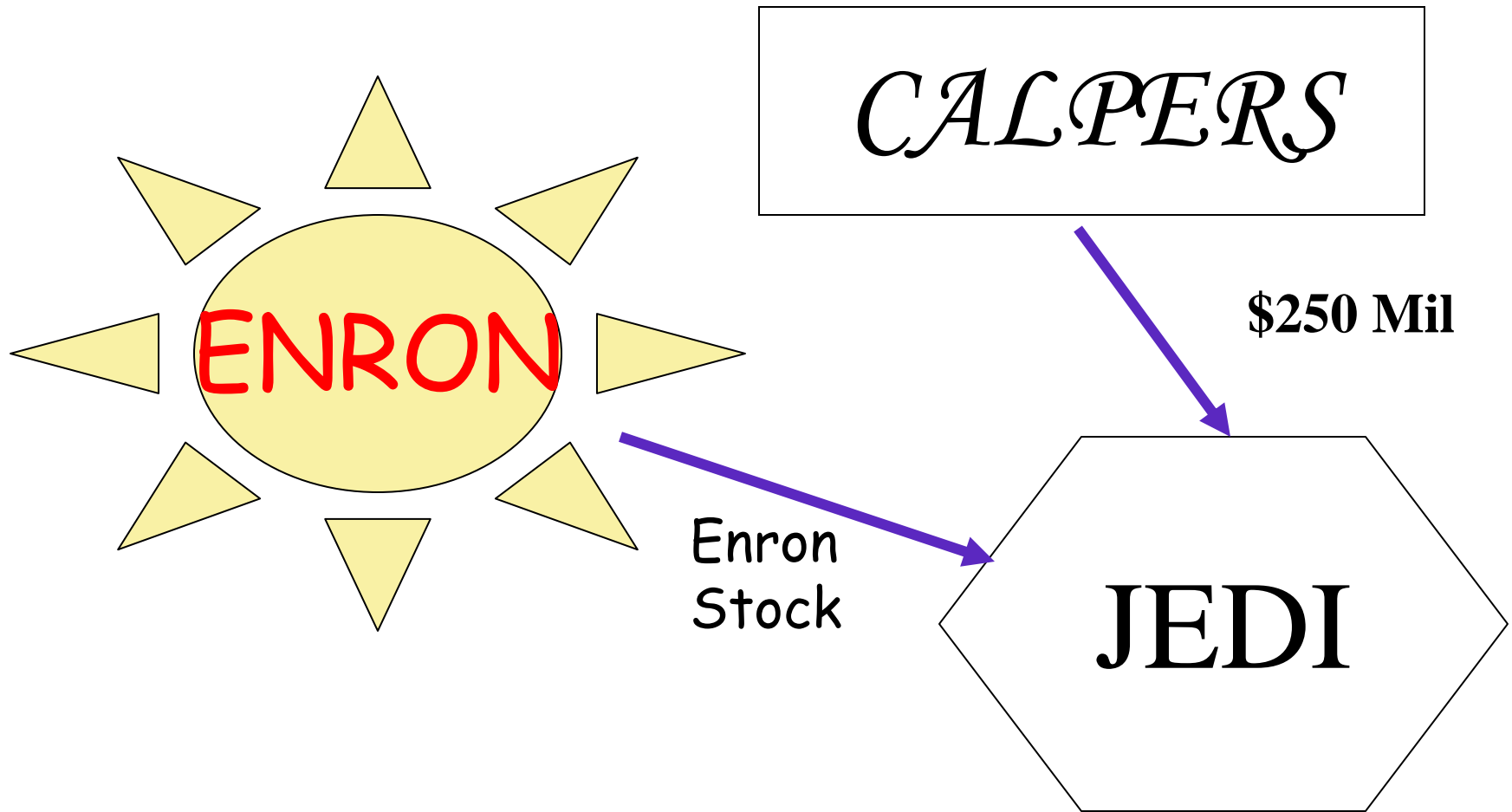
## Case Study of One Scheme

(Developed by Prof. Sue Ravenscroft, Accounting)

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- ***Enron's creation of over 3000 (!) partnerships*** started about 1993 when it teamed with ***Calpers*** (Calif. Public Retirement System) to create ***JEDI*** (Joint Energy Development Investments) fund.
- ***Why partnerships?*** As long as Enron could find another partner to take at least a 3% stake, Enron was not required to report the partnership's financial condition in its own financial statements.
- **Enron used partnerships to hide bad bets** it 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**)

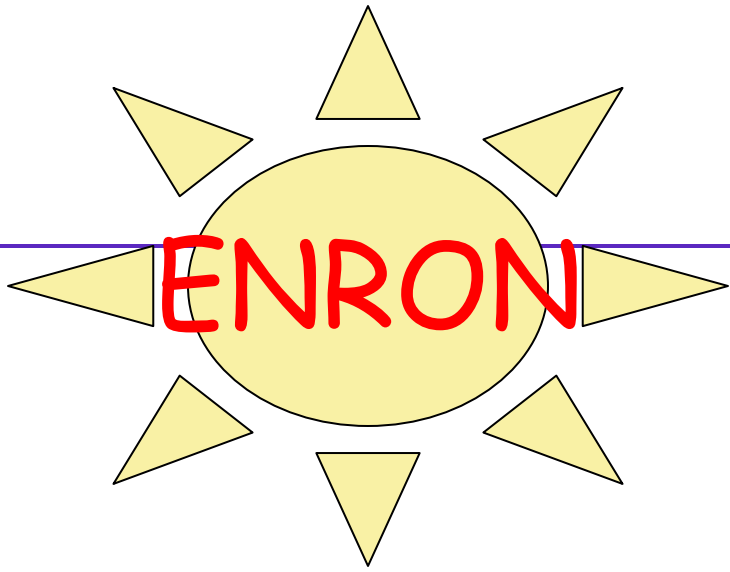
# 1993



# Case Study... Continued

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- In November 1997, Calpers wanted to cash out of JEDI.
- To keep JEDI afloat, Enron needed a new 3% partner.
- It created another partnership ***Chewco*** (named for the Star Wars character Chewbacca) to buy out Calpers' stake in JEDI.



*CALPERS*

\$383 Mil

**CHEWCO**



**JEDI**

This is the plan....

## Case Study...Continued

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- 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% from some outside source** to avoid inclusion in Enron's books (SEC filing, 1997).

## Case Study...Continued

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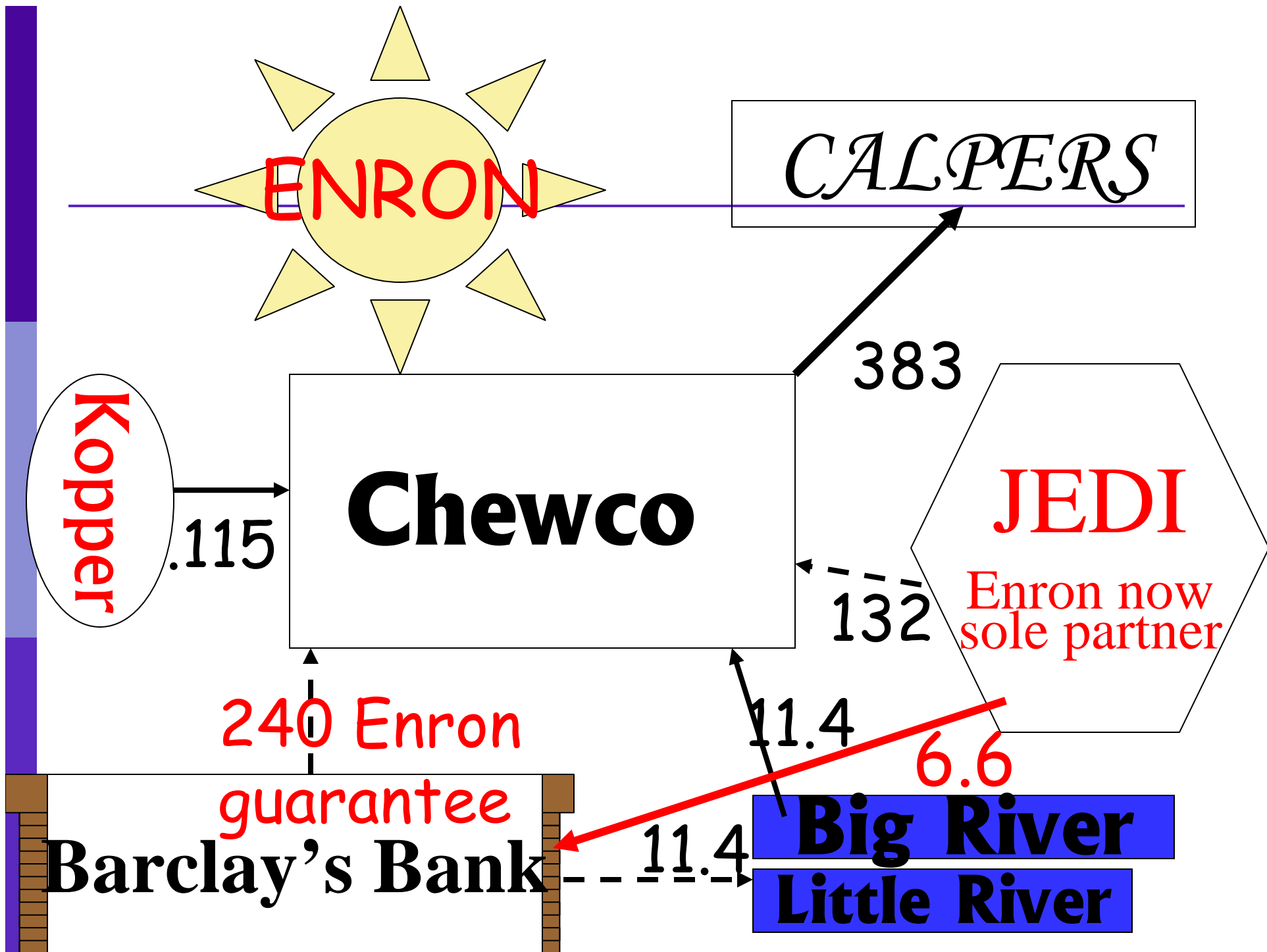
### Chewco Capital Structure: Outside 3%

- \$115,000 from **M. Kopper** (**worked at the time for Enron**)
- \$11.4 mil loans from **Big River and Little River** (two new companies formed expressly by Enron for this purpose **who get a loan from Barclay's Bank**)

# More Complications for Enron!

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- **Barclay's Bank** begins to **doubt** the strength of the new companies Big River and Little River.
- It **requires a cash reserve** 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.)



# Case Study... Continued

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

Walter Scott, Marimon, VI

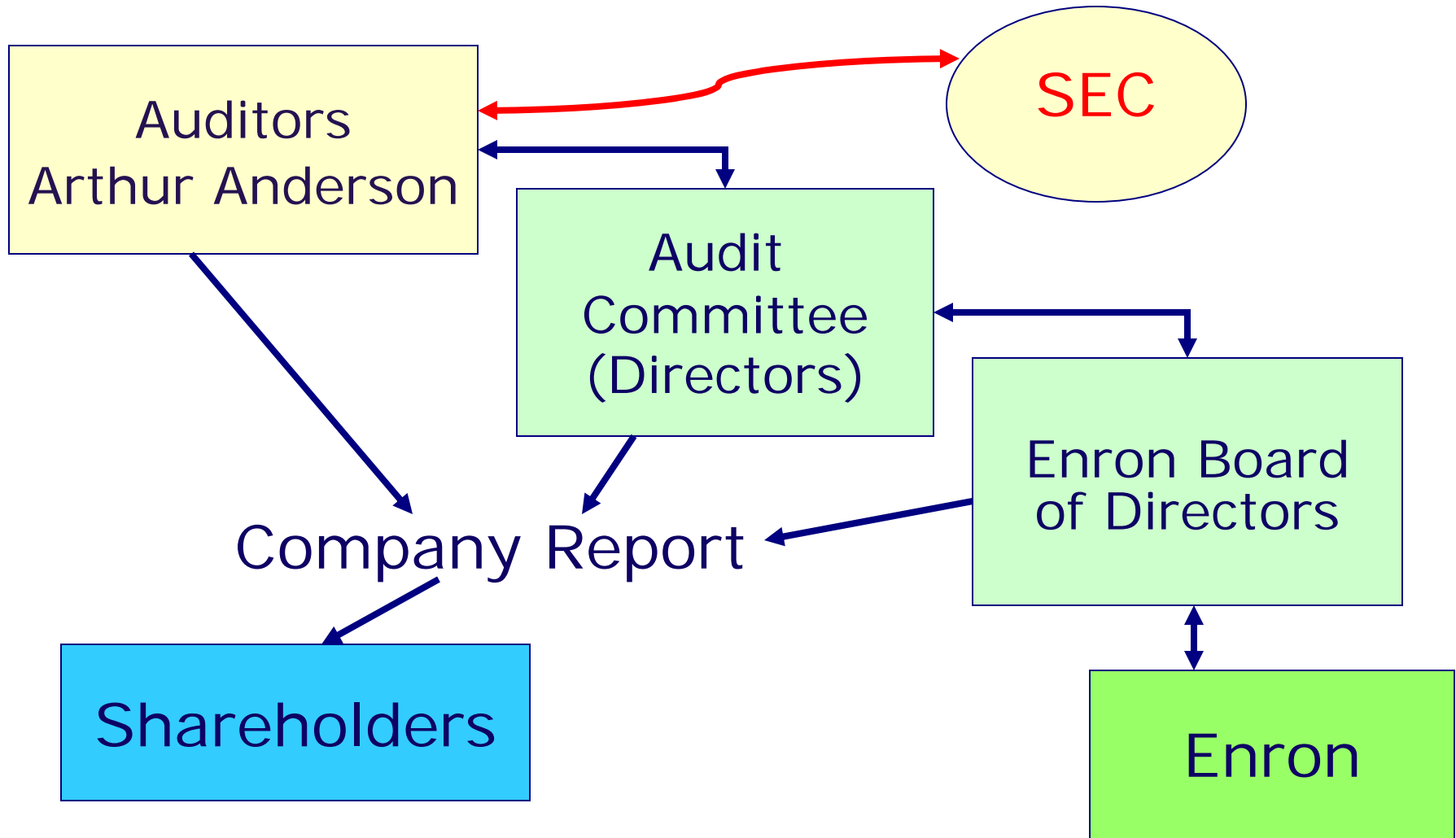
# Profit to Enron from all this?

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- \$10 mil in guarantee fee + fee based on loan balance to JEDI. A total of \$25.7 mil revenues from this source.
- Increase in price of Enron stock held by JEDI. Enron recognized \$126 million in the first quarter of 2000 from this.
- **But everything began to fall apart when Enron's share price started to drop in Fall 2000 (dot.com bubble ↓).**

# Who is to Blame for the Enron Scandal?

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# Who is to Blame for Enron?

- Lax accounting by Arthur Anderson (AA) Co?
- “Rogue” AA auditor **David Duncan** (fired 1/15/02)?
- **Enron’s management** for hiding losses in dubious off-balance-sheet partnerships?
- **CFO Andrew Fastow** for setting up these partnerships (10 year prison sentence 1/14/02)?
- **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?

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## 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?

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## 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?

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

# Lessons from Enron Scandal?

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- 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

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- **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

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- 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

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- 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.

# References

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