

Enron: The Fall from Grace/ The World's Biggest Fraud



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A. Enron's History

Enron, a Houston-based energy firm founded by Kenneth Lay, transformed itself over its sixteen years lifespan from an obscure gas pipeline concern to the world's largest energy-trading company (both off and online). Enron has become an interstate and intrastate natural gas pipeline company with approximately 37,000 miles of pipe. Enron was largely credited by creating market trading in energy, allowing energy to be traded in the same way as other commodities such as oil.

Enron was long viewed as the star of the stock market. It experienced a meteoric rise and ranked 22nd in the Fortune's 100 best companies list in America in 2000. The company had offices around the world including Australia, Japan, South America and Europe. Furthermore, Enron established itself in the UK, as the first foreign company, to begin construction of a power plant, after the electric industry in the UK was privatized.

B. Overview of Enron's Operations

Enron had three main business units - Wholesale Services, Energy Services and Global Services combining broadband and transportation services. It offered its services to thousands of customers around the world.

The **Wholesale Services** unit was responsible for marketing a number of wholesale commodity products, allowing industrial companies to manage commodity delivery and price risk. Customers could arrange selling or buying commodities on terms that suited their needs (i.e. long term, short term, fixed price, indexed price or other innovative variations).

Enron's **Energy Services** unit, the retail arm of Enron, offered companies a better way to develop and execute their energy strategies. Enron was the largest provider of energy services to commercial and industrial companies, with a total contract value amounting to \$2.1 billion in 2000.

Enron's **Global Services** unit included North American pipeline businesses of Enron Transportation Services including Northern Natural Gas, Transwestern Pipeline, Florida Gas Transmission, Northern Border Partners, Portland General Electric and Enron Global Services. On an international level it encompassed engineering businesses; Enron Wind; EOTT Energy Corp; Azurix and Wessex Water. EnronOnline was the world's largest e-commerce site for global commodity transactions, which provided real-time transaction tools and information for commodity transactions.

Enron in Numbers:	Enron in 1985	Enron in 2000
Employees	15,076	18,000+ (worldwide)
Countries in which Enron Operates	4	30+
Assets	\$12.1 billion	\$33 billion
Miles of Pipeline Owned	37,000	32,000
Power Projects under Construction	1	14 in 11 Countries
Power Projects in Operation	1	51 in 15 Countries
Fortune 500 Ranking	Not Ranked	18

C. Enron's Timeline

With the deregulation of the energy sector in the **early 1980s**, **Enron's rose to stardom** as energy corporations lobbied Washington to deregulate the business. Companies including Enron argued that extra competition would benefit both companies and consumers. As a result, the US government began to lift controls on who could produce energy and how it was sold. New suppliers came to the market and competition increased. However, the price of energy became more volatile in the free market.

Enron saw its chance to make money out of these fluctuations. It decided to act as middleman and guarantee stable prices. Encouraged by deregulation, Enron turned to electricity to supplement its natural-gas business. Furthermore, Enron tried to buy into the water business and to hedge London weather.

ENERGY DEREGULATION IN THE US			
	Before	After	Impact
Generating power	Utilities owned stations and sold directly to customers	Plants sold; New owners compete to sell to utilities	Mixed. Critics attack removal of strategic planning
Distributing power	Monopolies tightly controlled to protect consumers	Utilities compete to win consumers and contracts on basis of price	Enron and others created new markets focusing on energy trading
Regulating the industry	Special commissions monitor prices charged to consumers	Market competition theoretically to set prices, but some controls remain	Mixed political reaction; some legislators opposed unhindered markets

1989: Enron Trading Futures

Futures markets are used by buyers and sellers to get what they hope will be a better deal on commodity prices than they would do on the open market. Enron profited from trading futures in gas contracts between suppliers and consumers, effectively betting against future movements in the price of gas-generated energy. Below is a graph that displays how Enron traded energy futures.

HOW FUTURES WORK

XYZ Gas Corp wants to protect its' future production against price falls. It takes the gas to Enron's futures market and signs a deal to sell six month's worth of gas at \$5 per unit.

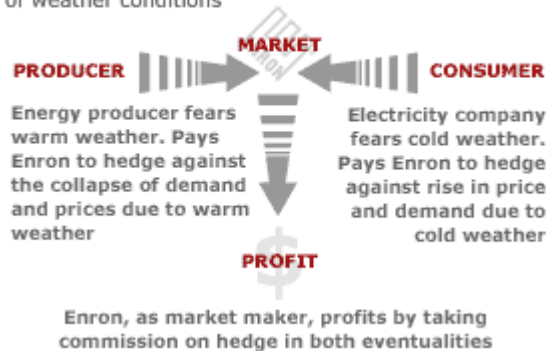


1990s: Enron Creating An Energy Commodities Business

Enron became a massive player in the US energy market, controlling a quarter of all gas business. Buoyed by the success, the company went on to create markets in myriad energy-related products. Enron began by offering companies the chance to hedge against the risk of adverse price movements in a range of commodities including steel and coal. By the end of the decade, Enron expanded its trading arm to include hedging against external factors such as weather risk. Enron was not the only company in the game, but through its online trading arm, Enron was becoming the biggest on what was dubbed Energy Alley (90% of its income came from trades). The company started expanding internationally, moving into water in the UK and power generation in India.

MARKET MAKING: WEATHER RISKS

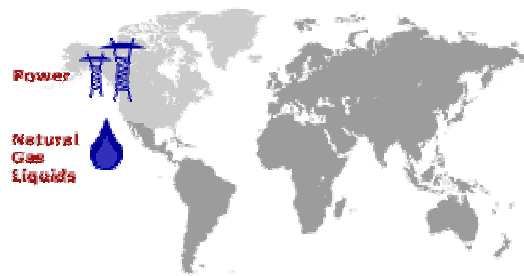
How Enron tried to profit in energy deals irrespective of weather conditions



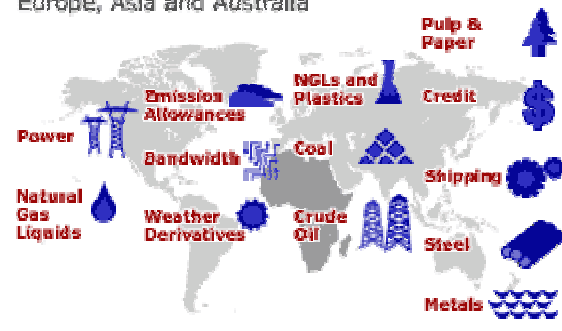
Early 2000: dot.com Boom

Enron began 2000 with a plan to move into broadband internet networks and trade bandwidth capacity as the dot.com economy prospered. Enron's dynamic ideas, coupled with its stable old-economy energy background, appealed to investors and its share price soared. The following chart highlights Enron's International Growth from the time it started its operations in the 1980s till 2001 when it became an energy giant.

Mid 1980s: Enron business entirely in the USA, focused on gas pipelines and power



2001: Enron trading in hundreds of commodities
Interests In: USA, South America,
Europe, Asia and Australia



Enron's 2000 annual report reported global revenues of \$100bn. Income had risen by 40% in three years and by the summer of 2000, Enron's shares had hit an all time high of more than \$90.

The **dilemma for Enron** started with the energy crisis in California, which was blamed by many on the poor handling of deregulation. Some consider it the real smoking gun for Enron. As the Enron mess continued to heat up, the energy crisis in California was one of the company's biggest political embarrassment.

D. What Was Enron's Role in The Energy Crisis in California?

After a turbulent political battle, with Enron being one of the loudest voices, California State in 1996 came up with an energy market design like no other in the world. The new design created the **Independent System Operator**, which is charged with running the power grid so that the lights stay on as well as operating a spot market for last-minute power purchases. Another agency, the **California Power Exchange**, ran the financial auction in which power companies bought and sold megawatts. Energy experts are of the opinion that keeping these two functions separate created an inefficient system in which a company like Enron, which dealt in huge volumes of energy and ran sophisticated computer models, could predict shortages in markets and accordingly was able to manipulate them. Examples include:

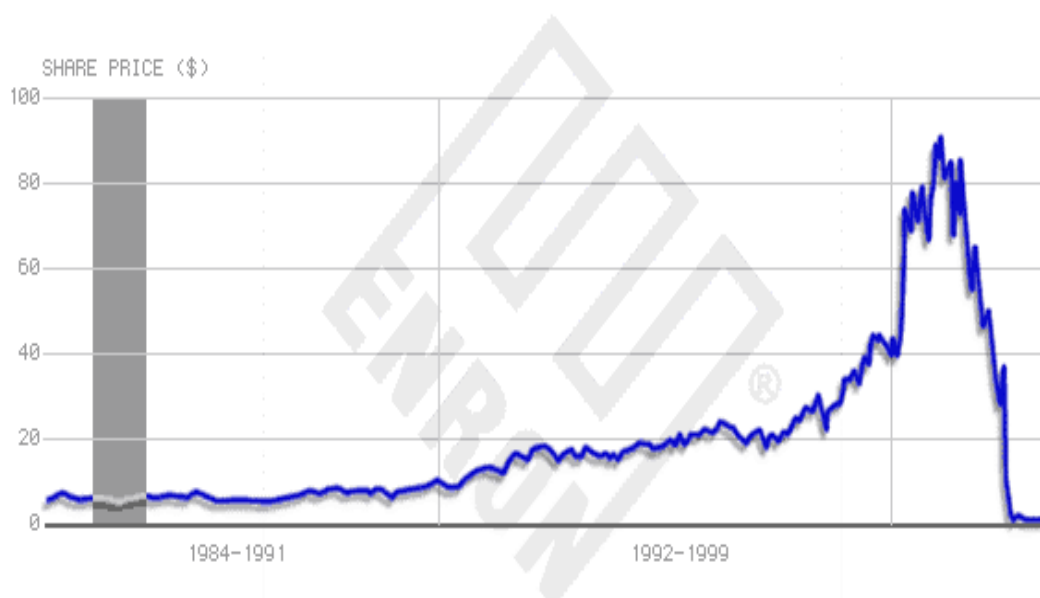
Power managers running the auction would stack energy bids from the least expensive to the costliest, then select enough bids to cover the state's energy needs. But the managers were forced to pay everyone the same price, the highest cost selected. Companies aware of shortages knew they could bid in at high prices and make big profits.

Companies were not penalized for failing to deliver the power they offered in the auction. If prices were higher on the spot market, marketers could withdraw energy from the auction and sell it on the spot market. Companies could play on the transmission limits of the state. Companies could purposely over-schedule power deliveries and end up getting paid to not deliver.

In the mid-1990s, California was faced with crippling energy bills and changes in federal regulations that encouraged deregulation. Big businesses and energy officials thought they could lower electricity prices by forcing utilities to compete with other companies. In meetings sponsored by the State **Public Utilities Commission**, Enron officials passionately argued their case for deregulation. Deregulation talks focused on a centralized energy market that would handle both the physical process of delivering electricity and the financial market, a model used by most deregulated energy markets. This plan was eventually implemented and created separate entities and fewer regulations.

Because most market data are confidential, it is unclear which companies may have benefited the most from the California's crisis, and whether there was any illegal activities. **What is clear is that Enron recorded earnings of about \$404 million in the second quarter of 2001, up 40 percent from the year before.** And while Enron's stock was beginning to fall even during the latter months of the energy crisis, it crashed hardest in June 2001 after federal regulators implemented electricity price caps in California which eased the crisis. Enron dismissed allegation, that it artificially manipulated the price of energy to profit off California's poorly constructed energy deregulation plan.

E. The Fall of Enron



In **May 2001**, Enron's executive Clifford Baxter left the company, apparently in uncontroversial circumstances. It was rumored that Baxter, who later committed suicide, had clashed with Jeff Skilling (Enron's CEO), over the righteousness of Enron's partnership transactions.

On **14th August 2001**, Jeff Skilling resigned as Chief Executive, citing personal reasons and Kenneth Lay became Chief Executive Officer. Skilling's departure was prompted by concerns over Enron's bungled accounting and bad management.

In **mid August 2001**, Sherron Watkins, Enron's Corporate Development Executive, who was later referred to as the "whistleblower" in the Enron scandal, wrote a letter to Kenneth Lay warning him of accounting irregularities that could pose a threat to the company.

This development shocked investors who suddenly panicked. The lack of transparency sent a selling wave in the market. Investors sold millions of shares, knocking almost \$ 4 off the price to less than \$40 over the course of the third week of August 2001. In spite of the drop in price, management still insisted all was well.

Despite the air of impending doom, Kenneth Lay found two banks willing to extend credit. But the worst of revelations were to come yet.

On **8th November 2001**, the company took the highly unusual move of restating its profits for the past four years. Enron effectively admitted that it had inflated its profits by concealing debts in its complicated partnership arrangements (Special Purpose Entities).

On **9th November 2001**, the humiliation of Enron appeared complete as it entered negotiations to be taken over by its much smaller rival, Dynegy. The following graph shows how Enron's restated accounts.

ENRON'S ACCOUNTS: THE TRUE PICTURE				
	Reported income	Revised income	True debt	True equity
1997	\$105m	\$77m	Up \$771m	down \$258m
1998	\$733m	\$600m	Up \$561m	down \$391m
1999	\$893m	\$645m	Up \$685m	down \$710m
2000	\$979m	\$880m	Up \$628m	down \$754m

Reported and revised income, debt and shareholder equity 1997 - 2000 following special partnership revelations;
Source: Enron/Powers Special Report

Enron filed for bankruptcy **in December 2001** and filed a suit against Dynegy for pulling out of the proposed merger. Enron's share price collapsed from around \$ 95 to below \$ 1. Enron's employees lost their savings as well as their jobs.

Mr. Kenneth Lay, the once renowned visionary chairman of the firm, resigned in **January 2002**.

It appears now that the **phenomenal success of Enron** was a daydream and it seems to have sunk into a financial predicament that is largely of its own creation. In just sixteen years, Enron grew into one of America's largest companies, however, its success was based on **artificially inflated profits, questionable accounting practices and fraud**. Several of the company's businesses were losing operations; a fact that was concealed from investors using **off balance sheet vehicles or structured finance** vehicles.

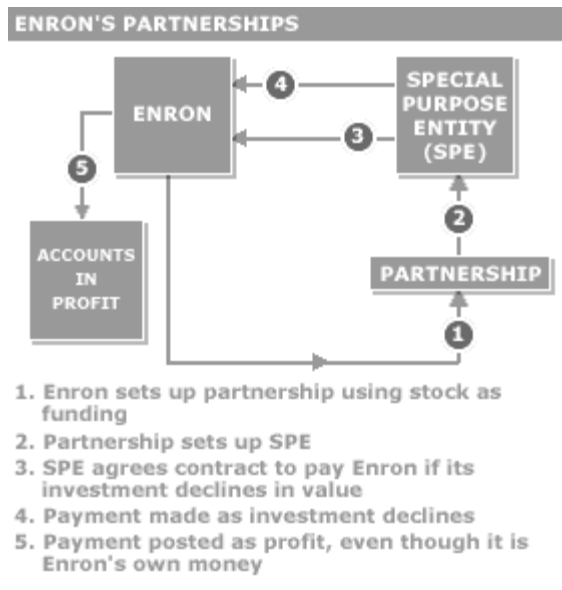
F. Why Enron Fell from Grace

Enron was one of the first amongst energy companies to begin trading through the internet, offering a free service that attracted a vast amount of customers. But while Enron boasted about the value of products that it bought and sold online around \$880 billion in just two years, the company remained silent about whether these trading operations were actually making any money.

It is believed that Enron began to use **sophisticated accounting techniques** to keep its share price high, raise investment against its own assets and stock and maintain the impression of a highly successful company. These techniques are referred to as **aggressive earnings management** techniques.

Enron also set up independent **partnerships** whereby it could also legally remove losses from its books if it passed these "assets" to these partnerships. Equally, **investment money flowing into Enron from new partnerships ended up on the books as profits**, even though it was linked to specific ventures that were not yet up and running. It now appears that Enron used many manipulative accounting practices especially in transactions with Special Purpose Entities (SPE) to decrease losses, enlarge profits, and keep debt away from its financial statements in order to enhance its credit rating and protect its credibility in the market.

The main reason behind these practices was to accomplish favorable financial statement results, not to achieve economic objectives or transfer risk. These partnerships would have been considered legal if reported according to present accounting rules or what is known as "applicable accounting rules". One of these partnership deals was to distribute Blockbuster videos by broadband connections. The plan fell through, but Enron had posted \$110 million venture capital cash as profit.



Although these practices were generally disclosed to Enron's investors, the disclosure was inadequate. This inadequacy may have stemmed from conflict of interest to avoid revealing, the extent to which some top Enron executives were enriching themselves, which simply represents fraud. Another explanation may relate to Enron's governance whereby Enron's structured finance transactions were so complex that disclosure becomes necessarily imperfect. Therefore Enron's investors had to rely on their business judgment of Enron's management, but such reliance failed due to a tangled web of conflicts of interests. This becomes crystal clear when it was known that most of the senior Enron executives, especially Andrew Fastow, served as the SPE's principals, receiving massive amounts of compensation and returns, in order to skew their loyalty in favor of the SPEs.

G. The Crash of Enron:

The shockwaves of the corporate crash resonated worldwide as investors around the world demanded answers. Congressional hearings began in **December 2001**. Four of Enron's most senior executives (Andrew Fastow, Richard Buy, Michael Kopper and Kenneth Lay) pleaded Fifth Amendment protection against self-incrimination and refused to testify.

In **January 2002**, the US department of justice announced a criminal investigation.

For the average **layman**, the collapse of Enron is a scandal of a major energy provider that used to be the seventh largest corporation in America and became the biggest bankruptcy in the US corporate history. As revelations of the Enron affair continue to tumble out, employees and investors are furious at the way senior executives behaved and at how auditors, analysts, banks, rating agencies and regulators turned a blind eye to what was going on.

The Enron fiasco is an unprecedented situation. This was a company with an extraordinary complex and risky business model that entered into highly questionable transactions. The market capitalization of Enron had reached exceptional valuations

relative to the realism of the company's ability to produce recurring excess cash flow. What finally brought the company down is finalized? Internal policies, investment advisors, investment banks, undetermined criminal activity, poor auditing, poor rating probably all played a role in its rapid demise.

1. Key Management at Enron:

Kenneth Lay:

Former Enron Chief Executive, Chairman and Board Member.

Lay took up the reins at Enron in 1986 after it was formed from the merger of two pipeline firms in Texas and Nebraska. Prior to Enron's collapse, he was credited with building Enron's success. Lay resigned as CEO in December 2000, and was replaced by Jeffrey Skilling. In August 2001, he resumed leadership after Skilling resigned. Lay resigned again in January 2002 after becoming the focus of the anger of employees, stockholders and pension fund holders who lost billions of dollars in this disaster.

Jeffrey Skilling:

Former Chief Executive, President and Chief Operating Officer.

Skilling joined Enron in 1990 from the consultancy firm McKinsey, where he had developed financial instruments to trade gas contracts. Prior to becoming Chief Executive in February 2001, Skilling was President and Chief Operating Officer of the firm. Skilling was also seen as a key architect of the company's gas-trading strategy. Skilling resigned his post as Enron's chief executive in August 2001 without a pay-off.

Andrew Fastow:

Former Chief Financial Officer.

Fastow was fired in October 2001, when Enron made losses amounting to \$ 600 million. Fastow was allegedly responsible for engineering the off-balance sheet partnerships that allowed Enron to cover its losses. Fastow was also found by an internal Enron investigation to have secretly made \$30 million from managing one of these partnerships.

Clifford Baxter:

Former Chief Strategy Officer and Vice Chairman.

Baxter was known to have been one of the Enron executives, who had opposed its creative accounting practices. Baxter retired from Enron in May 2001. Baxter committed suicide in January 2002.

2. Enron's Auditor (Arthur Andersen):

Arthur Andersen, one of the world's five leading accounting firms, was Enron's auditing firm. This means that Andersen's job was to check that the company's accounts were a fair reflection of what was really going on. As such, Andersen should have been the first line of defense in the case of any fraud or deception.

Arguments about conflict of interest had been thrown at Andersen since they acted as both auditors and consultants to Enron. The company earned large fees from its audit work for Enron and from related work as consultants to the same company. When the scandal broke, the US government began to investigate the company's affairs, Andersen's Chief Auditor for Enron, David Duncan, ordered the shredding of thousands of documents that might prove compromising. That was after the Securities and Exchange Commission (SEC) had ordered an investigation into the speculative actions of Enron. Duncan said he was acting on an e-mail from Nancy Temple, a lawyer at Andersen, but Temple denied giving such advice.

While Andersen fired Duncan, its Chief Executive Officer, Joseph Berardino, insisted that the firm did not act improperly and could not have detected the fraud. Berardino conceded that an error of judgment was made in shredding documents, but he still protested Andersen's innocence.

3. Credit Rating Agencies:

Credit rating agencies like **Moody's, Standard & Poor's and Fitch IBCA**, whose main duty is to provide guidance to investors on a borrowers' creditworthiness i.e. inform investors how risky buying a company's bonds might be, failed to spot any problems with Enron until the company was nearly bankrupt, only downgrading its bonds on 28 November 2001. The agencies claimed they could only act on public available financial information.

An interesting comment regarding Enron's operations was made in March 2001, when credit analysts at S&P and Fitch told a Fortune reporter they had no idea how Enron made its money. Commentators attribute the lack of action on part of the credit agencies to Enron's ordeal is their fear that downgrading a company's bond rating could drive it into bankruptcy by sharply raising the costs of its loans. This is because the analysis that rating agencies provide is influential in determining the interest rates that borrowers pay on their debt.

Enron had been facing dreadful financial troubles throughout October and November 2001, but rating agencies only downgraded their bonds to "junk" status on November 28th. This has caused critics to wonder if they were doing their jobs correctly.

Rating agencies have responded by saying that Enron "had evolved from a an energy company to a broker and as a result in the context of a financial institution or a broker that loses confidence, these things can happen relatively quickly," as quoted by Fitch's chief credit officer Bob Grossman. However, the three big agencies confirmed that they will be looking at modifying the way they do business.

4. Investment Banks:

Several investment banks were involved in Enron's collapse:

Credit Suisse First Boston (CSFB) played a central role in creating the controversial partnerships that Enron used to hold billions of dollars of unprofitable assets and that eventually contributed to its bankruptcy. Enron depended heavily on a team within CSFB, known as the "**Structured Products Group**", to engineer the partnerships. The team worked closely with Andrew Fastow, Enron's ex-Chief Financial Officer, and his deputies to develop partnerships that shielded unprofitable Enron assets. CSFB devised three partnerships, known as Osprey, Marlin and Firefly, which held a

total of \$ 4 billion in assets. The team was part of US firm Donaldson Lufkin & Jenrette (DLJ), which merged with CSFB in 2000. CSFB has defended its role in advising Enron and handed over documents relating to its work with Enron to Congressional investigators. A CSFB spokesman insisted that Enron officials understood the partnership structures they worked on with CSFB.

Another US investment bank, **JP Morgan Chase**, was involved in the Enron tragedy. The investment bank was a major lender to Enron and the bankrupt telecom group Global Crossing. Loan losses related to Enron contributed to the bank's 2001 fourth-quarter loss around \$ 332 million and JP Morgan was forced to put aside another \$ 510 million in case of future loan defaults.

JP Morgan is also under probe by federal prosecutors as to whether the bank could have helped Enron disguise loans as part of its normal trading. JP Morgan is known to be one of the investment banks that helped Enron set up the "**Special Purpose Entities**", which were at the heart of the company's collapse. Questions have also been raised regarding trades between Enron and an offshore company set up by Chase Manhattan Bank, which is now part of JP Morgan Chase. The offshore entity, Mahonia, traded with Enron, paying it in advance for future delivery of oil and gas. The resources it used came from JP Morgan itself.

In short, on **2 December 2001**, Enron's **total global investment exposure** to major financial institutions amounted to at least **\$4 billion**.

INTERNATIONAL SHOCKWAVES: Companies with substantial exposure to Enron	
J P Morgan: \$900m	Sumitomo Mitsui Corp: \$210m
Citigroup: \$800m	Nikko Cordial: \$207m
Credit Lyonnais: \$250m	Principal Financial Group: \$171m
Bank of Tokyo-Mitsubishi: \$248m	Abbey National: \$164m
Chubb Corp: \$220m	National Australia Bank: \$104m
Canadian Imperial Bank: \$215m	Duke Energy Corp: \$100m

Some 25 further companies have declared Enron exposure totaling an estimated \$1bn
Total global investment exposure at least \$4bn

5. Links with The Government (Bush Administration):

In spite of the fact that there are no suggestions currently that there were any illegal connections between the current US administration and Enron officials, there are close links that exist between Enron and the current administration at all levels

whether personal, social, financial, professional or political. According to reports, thirty five administration officials have held Enron stock, some had six figure investments. Several, less senior officials, have served as paid consultants for Enron.

According to the US Center for Public Integrity, Lay (CEO of Enron) and Enron donated more than \$ 500,000 to the Bush campaign, thus making Enron the President's largest single patron. Bush has championed some issues Enron considered important, such as deregulating utilities and limiting compensation awards. Bush has also favored more oil exploration and drilling in spite of opposition from environmentalists.

As for the US Vice President, Dick Cheney, he is alleged to have met Enron executives four times in 2001 to discuss energy policy. Cheney's critics say that no company in the US stood to gain more from the energy policies than Enron. Later the General Accounting Office, the investigative arm of the US Congress, demanded that the Vice President releases documents relating to the formulation of government energy policy but he resisted. It is also known that Cheney was the former Chief Executive of an oil services company named Halliburton, which built the Enron Field stadium in Houston, when Mr. Cheney was its Chief Executive.

Paul O'Neil, the current US Treasury Secretary, had been contacted by Lay who asked O'Neil to encourage US banks to extend their credit to Enron, a request refused by O'Neil.

SEC Chairman Harvey Pitts was hand-picked by Lay for the position, due to his notorious aversion to governmental regulation of any kind.

6. The Link of Enron with The British Front:

Shock waves of the Enron scandal have been felt in Britain too, where Enron acted as a sponsor of the two main political parties, Labor and Conservatives.

The Labor party was accused of taking Enron's money in return for access to government ministers. The party had apparently changed its policy on gas-fired power stations after being lobbied by companies, including Enron. This was seen by some as possible evidence of Enron's influence on government policy. However, the UK Government insists its links with Enron have neither changed policy nor bought access to ministers. The row has renewed campaigners' calls for political parties to be funded by the state rather than relying on business donations.

A second front of allegations emerged over Labor's close ties with Andersen, Enron's accountants, a company barred from government work for failing to prevent the DeLorean car company collapse. This ban was later lifted, which has caused the rise of awkward questions faced by the Labor party now.

Furthermore, Lord Wakeham, a former Conservative Cabinet Minister and a non-executive director in Enron. Lord Wakeham served on the audit committee that was meant to oversee Enron's auditing procedures, which is at the heart of the scandal, and supposed to protect shareholders' interests. In response to these allegations, Lord Wakeham stepped down as Chairman of the Media Watchdog, the Press Complaints Commission (PCC).

7. The Victim: Employees and Pension Fund Holders:

The collapse of Enron has left thousands of people out of work. Thousands lost their personal investments and pensions after the scandal broke out and Enron's stock plunged.

Many employees had personal pension funds made up of Enron shares - a common situation in America, where occupational schemes based on final salary payments are increasingly rare and money purchase schemes, known as 401(K) plans, are the norm. Employees at Enron were encouraged to do so by the company, which also forbade them from selling their stocks, when the company share price came down.

In contrast, many Enron executives were able to cash in their share options when the company's fate became clear.

H. Investigators and Regulators Involved

1. Capital Market Regulatory Authorities:

In theory, such a scandal should never have taken place. The US financial markets are supposed to be the best regulated in the world, with the **Securities and Exchange Commission (SEC)** enforcing strict rules on disclosure to protect investors, besides the presence of private agencies that monitor companies. The SEC's main role is to ensure that investors have accurate information about companies and that companies do not deceive investors or manipulate the market price of their shares. The SEC has strong investigation powers and can fine companies for violations or failing to cooperate.

Although, the **SEC's investigation into Enron** started in **October 2001** based on allegations regarding the mismanagement, mistreatment of shareholders and potential fraud, the SEC was accused of failing to notice earlier irregularities in Enron's accounts and failed to scrutinize the company's reports in detail since 1997. The SEC has defended its actions by stating that Enron's accounts were impenetrable to regulators, since its core business, energy trading, was only lightly regulated by another set of government agencies, which exempted it from many reporting requirements.

Moreover, the **Commodity Futures Trading Commission (CFTC)**, the regulator of futures and derivatives markets was supposed to regulate Enron. Originally most futures trading were related to physical commodities like the price of wheat or pigs, but in recent years, much of the trading has been in financial commodities like exchange rates.

Enron pioneered the trading of energy contracts for the supply of gas and electricity, which became the centerpiece of its business. The main problem is that CFTC believed in "**light-touch**" regulation. In 1993, the CFTC exempted such energy trades from its regulatory overview, a ruling that was confirmed in the 2000 Commodity Futures Modernization Act. The chair of the CFTC at the time was Wendy Gramm, the wife of prominent Texas Republican Senator Phil Gramm. She later joined the board of Enron!

Another regulatory body that oversees the energy market is the **Federal Energy Regulatory Commission (FERC)**, which was established to oversee the US domestic energy markets in 1977 and is part of the US Department of Energy. The FERC's main duty is to ensure that fair prices are paid for the transmission of gas, oil and electricity across state boundaries, a job that gained importance as the deregulation of energy markets gathered pace. However, the FERC exempted trading in electricity contracts from its reporting requirements after lobbying from Enron in the 1990s. It also failed to closely examine reports filed by Enron. Its current chairman is Pat Wood, a close associate of President Bush. Wood was the chief energy regulator for the state of Texas before taking up his current post. Press reports suggest that Enron boss Lay suggested his appointment to the Bush administration.

The **Financial Accounting Standards Board (FASB)** is currently reviewing industry standards to check their applicability and whether changes or amendments are required to avoid future corporate collapses like Enron's.

2. Judicial and Legislative Entities:

The **US Department of Justice** investigates allegations of fraud and stock manipulation on recommendation of the Securities and Exchange Commission (SEC). Enron executives could be prosecuted for concealing evidence. Other charges that are investigated include defrauding Enron's pension fund.

The **Federal Bureau of Investigation (FBI)** is charged with investigating federal crimes. FBI agents in Houston have already been involved in sealing off Enron's offices after allegations that crucial documents were shredded.

The **US Congress** began investigating the Enron scandal. The congress has the power to call witnesses and compel them to testify over the scandal, but it cannot bring criminal charges itself. Because a criminal investigation is under way at the same time, witnesses have the right to remain silent in order to avoid incriminating themselves. This right has already been exercised by Enron's Chairman Lay and former Chief Financial Officer Andrew Fastow.

There are currently **11 investigations by Congressional Committees** from both the House of Representatives (controlled by the Republicans) and the Senate (controlled by the Democrats) into why the Enron scandal happened.

There are **four key areas** that Congress is expected to investigate which include:

- The regulation of energy markets.
- Enron's accounting practices.
- Legislation on pension plans.
- The political influence Enron enjoyed in the Bush administration.

The **General Accounting Office (GAO)**, the investigative arm of the Congress, is also involved trying to obtain from the White House records of the energy task force headed by Vice President Cheney. Vice President Cheney refused to release information on discussions between Enron and his special energy taskforce to the General Accounting Office (GAO). The GAO is demanding details of the talks in order to gauge the influence Enron exercised on US energy policy.

The refusal to release these documents has led congressional investigators to take an unprecedented step of suing the White House. In an effort to calm down the anger of the public, the **White House** has commissioned two task forces teams to report to Bush on pensions and corporate disclosure standards. Bush has been quick to underplay his links, both personal and political, with Enron.

I. Lessons Learned from Enron:

1. Concern over conflict of interest between auditing and consulting raises the need for accounting firms to separate their consulting activities from their auditing businesses.
2. Securitization and other legitimate structured finance deals have to be disclosed with sufficient depth and detail to adequately inform sophisticated investors.
3. Management has to be free of material conflicts of interest because private investors rely on their business judgment.
4. There should be a method or basis that distinguishes between structured finance transactions that should be allowed from those that should be restricted. This requires regulatory re-examining of structured financing transactions. However, a long-term perspective must be taken that excessive safeguards can stifle business innovation
5. The importance of taking corporate codes of conduct seriously and carefully thinking through their implementation.
6. There is a move considering forcing firms to routinely change auditors and for accounting firms to separate their consulting from their auditing businesses in an attempt to prevent Enron-style collapses. However, accountants are opposing the move because they fear they could lose contracts with clients dating back decades, which established cozy and dependant relationships. For example last year FTSE 100 companies paid their auditors £216 million in audit bills and £675 million in advisory fees. They also argue that the change would increase the audit costs.

J. Proposed Reforms to Avoid Future Enronitis

After the collapse of Enron, several issues were earmarked for the attention of reformers including:

- The role of business funds in political campaigning.
- The extent of energy companies' influence on national energy policy.
- The need to reform pension laws to stop over-exposure to one stock and prevent a company from investing its pension funds in its own stock.
- The need for higher standards of transparency and disclosure in the audit profession.
- Potential conflicts of interest between consultancy and auditing work undertaken by financial houses.
- The need for tighter regulation on financial derivatives trading.

One of the first reforms that took place after the scandal was the appointment of **Stephen Cooper** as Enron's Chief Executive in January 2002.

The most publicized repercussion of the scandal was the debacle of Enron's auditor, **Andersen**. Andersen has lost several prestigious clients (including Delta Air Lines, Merck, Freddie Mac, SunTrust Banks and FedEx) that provided it with combined annual fees of about \$100 million . As a result in February 2002, **former Federal Reserve Chief Volcker was hired by Andersen** to help restore its credibility and review policies and procedures within the accounting firm. In spite of Andersen CEO's denial that it helped set up a series of complex external financial partnerships to squirrel away millions of dollars of undisclosed debt, Volcker accused regulators of being lax in front of the Senate Banking Committee saying that "regulators had not kept auditors in check after they became greedy during the financial boom".

In **March 2002**, Andersen announced that it was in talks to sell itself to one of its major rivals; Ernst & Young or Deloitte, Touche & Tohmatsu or KPMG. Talks about a possible merger or takeover started after it became clear to Andersen that the Department of Justice and Federal prosecutors were seeking a criminal indictment against it for shredding documents relating to the investigation.

The final blows came when Andersen was banned from US government work after being indicted by a federal grand jury on the charge of obstruction of justice. This was coupled with the case brought by the US Department of Justice against the Andersen UK office for joining in the shredding of Enron documents. This caused Andersen UK practice to reopen merger talks with other accounting firms in response to these claims made against the office. Both KPMG and Deloitte had been interested in Andersen's UK business, but KPMG's interest trailed off as more information became available about Andersen's financial situation and the potential risk of litigation. Andersen UK agreed to join with Deloitte, Touche & Tohmatsu. In addition, Deloitte reached agreements with Andersen partners in Spain, Portugal, the US and Mexico.

On June 15, 2000, a federal jury convicted Arthur Andersen of obstruction of justice for impeding an investigation by securities regulators into the financial debacle at Enron. The decision was based on a single altered internal memo that showed the accounting firm interfering with the government's investigation into Enron's collapse. The memo written by David Duncan, the lead partner on the Enron account, was about a news release Enron was planning to issue regarding its third-quarter earnings. That release characterized certain losses Enron was reporting as "nonrecurring;" at the time, several Andersen experts, including Mr. Duncan, had concluded that such a representation was misleading. Andersen did not approve that earnings release and Enron went along anyway and issued it, then Andersen set about to change things to alter documents to keep that away from the SEC.

Thus, the guilty verdict against Arthur Andersen — on a charge brought because of the shredding of thousands of records and deletion of tens of thousands of e-mail messages — was ultimately reached because of the removal of a few words from a single memorandum.

Although Andersen has already lost much of its business, and two-thirds of its once 28,000 US workforce, the most important result of the verdict was that it closed the books on the firm's hopes of surviving even in a reduced state. Also following the conviction, multimillion dollar lawsuits brought by Enron investors and shareholders

demanding compensation are likely to follow, and could bankrupt the firm. In addition Andersen faces the possibility of fines up to \$500,000.

The company called the verdict “wrong” and is contemplating an appeal, but at the same time informed the government that it would cease auditing public companies as soon as the end of August, effectively ending, the life of the 89-year-old firm.

Investment banks are facing problems too. The first offensive was made by the New York State Attorney General, Eliot Spitzer, against Merrill Lynch, the renowned Wall Street banking firm. Merrill Lynch was accused of misleading small investors by issuing buy recommendations on Enron while its analysts simultaneously warned its investment-banking clients to steer clear of them. This has renewed criticisms for investment bankers for failing to separate their research and banking departments.

- **The Reinstatement of Chinese Walls**

As a result, talks about the reinstatement of the **Glass-Steagall Act** introduced in 1933, which placed barriers between commercial banking, investment banking and insurance were again risen. The Act was introduced in the early thirties in response to investors protests about conflicts of interest on Wall Street following the 1929 stock market collapse.

The reinstatement of the act was brought up in response to allegations that the two investment banks: JP Morgan and Citigroup have overlooked some lending standards to win investment business from Enron. This allowed the energy giant to become over-leveraged. It also fostered conflict of interest as the investment banks acted as both creditors and advisors for Enron. This might have caused them attempt to preserve whatever value was left for Enron and encourage it to pursue riskier strategies to maximize their chance of being repaid and keep the company alive. That could have been a reason why analysts refrained from warning the market about the foreseen crash of the firm.

- **The Securities and Exchange Commission (SEC)** is deeply troubled by the underlying events that resulted in Andersen's conviction, especially as the verdict reflects the jury's conclusion that Andersen engaged in conduct designed to obstruct the SEC process. Accordingly, the SEC is currently considering implementing changes to its corporate disclosure rules, including speedier and fuller explanation of significant events. Under pressure from Harvey Pitt, the SEC's Chairman, the New York Stock Exchange and Nasdaq are also reviewing their governance rules and listing standards. In addition, the Financial Accounting Standards Board (FASB), is planning changes to its rules on accounting for off-balance-sheet vehicles.

K. What Could be Done to Avoid Such Enron-like Crises in Emerging Markets Such as Egypt?

Investors were scared away from the stock market following Enron's bankruptcy, and an array of different companies have been infected by “**Enronitis**”, i.e. a lack of trust in the accounting practices of those firm. Buying shares in a company, just like most other transactions, has a lot to do with trust. Because investors do not necessarily know the people who run the firm, shares come packaged with a form of guarantee - with much legal back-covering. In other words, company reports are rigorously

audited, capped with the soothing statement that they “represent fairly, in all material aspects, the financial position of X Corp and subsidiaries”. The dramatic collapse of Enron has called into question the validity of such assurances and has besmirched the good name of the accountancy industry.

Enron’s scandal highlights several issues that emerging markets, including Egypt, should be aware of.

❖ In Relation to The Exchange (CASE):

- Great care and due diligence should be undertaken in the listing of foreign companies on CASE to avoid having Enrons. CASE should not suffice if a foreign company is listed on an developed and well regulated stock exchange, rather it must conduct due diligence analysis of prospective issuers prior to their listing.
- Importance of educating investors about the importance of disclosure of listed companies and how to be able to read financial statements of listed companies.
- Regulations should be enforced to ensure timely and full disclosure of information from issuers.
- Imposing penalties on listed companies that are engaged in fraud or misguide its investors.

❖ In Relation to The Regulator (CMA):

- Although Egypt does not currently have a derivatives market, capital market regulators should undertake educational courses about futures and options markets prior to their introduction in Egypt.
- Market regulators should be aware of sophisticated accounting practices that firms can use to hide losses from investors and report unrealized profits. Regulations should be passed to ban such practices.
- Capital market regulators should have publish a list of auditing firms that are licensed to carry out auditing for listed companies on CASE.
- Capital market regulators should exert effort in the regulation on credit rating agencies, their competency and the credibility of the ratings they publish to the market.
- Pension funds regulations should be revised to ensure that investments are properly placed. Pension funds investments are long term ones and consequently influence is best exercised by ensuring that companies are well managed. This should call into question corporate governance practices of the organizations that attract these investments.
- Barriers should be reinforced between commercial banking, investment banking and insurance arms of the same financial institution to avoid potential conflict of interest. Regulators (Central Bank as well as CMA) should be aware that conflicts of interest within the same organization leads to the demise of corporations such as Enron.
- Fines should be levied on financial institutions where corporate clients or investors were exploited. One of the suggestions that were recently introduced after Enron scandal is to separate investment analysts from the underwriters of initial public offerings.

❖ **In Relation to Auditing & Accounting Practices:**

- Expected changes in the international accounting standards. It is anticipated that the US GAAP have become too rule based-so there will be a move towards more principle based accounting or International Accounting Standards (IAS). This will strengthen the global stature of IAS.
- The presence of Chinese walls between the auditing and consultancy divisions in the big five auditing firms. Auditing is a quasi public statutory function that merits maximum protection and consequently should not be infringed upon by the consultancy division. For example, PricewaterhouseCoopers started separating its auditing and consulting activities into two separate firms.
- Expected dramatic changes in the way information is presented in financial statements or corporate report modeling. More emphasis will be placed on the value of reporting where it is expected that capital markets will punish companies whose financial statements are regarded opaque or uncommunicative.

❖ **In Relation to Investors:**

- Investors must be aware not to follow market rallies blindly. Investors should study companies based on fundamental and technical researches and not resort to market rumors and rallies. Investors should review the board of the company, its strategy, its industry, its competitive position, analyze long term projections, cash flows, financial terms and changes in the share price.
- Investors should understand the underlying reasons for the rise and fall in stock prices. They should monitor the reasons of the change in price and not merely dismiss it without thought. While a high share price can give the investor some comfort, the stock market can be brutal and send the share price to depressing levels within a day. A low share price can be very indicative of bad news.
- Investors should be wary of poor recommendations and approvals by market participants, credit rating companies and auditors.

❖ **In Relation to Board of Directors & Management:**

- There is a critical need for truly independent directors and knowledgeable audit committee members, that are willing to be involved, ask tough questions to management and accountable. Independent directors are directors, who own stock and therefore, in theory, have interests aligned with those of shareholders.
- The Board must sufficiently understand the nature of and strategy behind major transactions, including complex business structures and is willing to challenge whether such transactions are beneficial to the company and make good business sense.
- The Board must be fully aware of major risks inherent in the business, specially in complex financial instruments and structured financial transactions and be comfortable that there is an effective system of internal control in place covering operations, financial reporting and compliance objectives.
- The Board must be proactive to ensure compliance programs and to question management if “**red flags**” arise. The board should institute control processes to ensure the effective performance of its role to oversee the general performance of the company and its strategy in the market.

- The Board should monitor the integrity of the financials and ensure transparency and disclosure of the firm's financial position.
- The Board must make effective use of committees such as audit, compensation, nomination and corporate governance.
- External auditing is a necessity since it supports proper corporate governance by subjecting the results of the company's operations to an expert external review. However, it is important to understand that auditors do not interfere with the decisions of management. Therefore if anything goes wrong, it is the sole responsibility of management.