By now every American not living underground or in the canopy of a forest knows about the Enron bankruptcy. Every American knows that some shady things took place with Enron and its auditing firm Arthur Andersen. What every American doesn’t know is the kind of effect the Enron debacle will have on the business world and what kind of legislation it will spawn.

Enron, a Houston based energy company, started out making its money from hard assets like pipelines. By the end of the 1990’s, they were generating 80% of their revenues from what they called “wholesale energy operations and services.” (Fortune, 12-24-2001) Between 1998 and 2000 Enron’s revenues went from $31 billion to more than $100 billion. Austin Ramzy, research director for Capital Income Investors, said “They were not an energy company that used trading as part of their strategy, but a company that traded for trading’s sake.”

No one could understand what Enron was dabbling in. Enron continually produced profits on paper, though, and that was all anyone seemed to care about. It was the way they were manufacturing these “profits” that would prove to be the downfall of what, in the year 2000, was the seventh largest company on the Fortune 500.

Enron set up LJM partnerships under the guise of slick names like JEDI and Chewco, which were inspired by Star Wars characters. These partnerships were backed by Enron stock, long thought to be invincible. In the midst of these partnerships, Enron executives such as Andrew Fastow and Michael J. Kopper were able to take investments of $5,800 and within months turn them into over $1 million each. Fastow even turned a $25,000 contribution from a family foundation into $4.5 million. (NY Times, 4-1-2002)
These partnerships were designed with evil intentions in mind. Increases in Enron stock prices were booked as income. This caused the stock price to go up again which caused more income to be booked. It was an endless cycle.

On top of the craziness with the stock prices, and probably the most important piece of the puzzle, hundreds of millions of dollars of Enron debt was being hidden in these partnerships. This allowed Enron to maintain its status as infallible. Without having to document its debt, Enron was able to continue fooling its employees, its stockholders, and the whole country.

Enron filed for bankruptcy on December 2, 2001, but it was obvious on November 8 that they were in over their heads. This was the day Enron announced it was restating its earnings for the past 4 ¾ years. This, they said was because “three unconsolidated entities should have been consolidated in the financial statements pursuant to generally accepted accounting principles.” This reduced earnings by $600 million and when, on November 28, Standard and Poor’s reduced Enron’s debt below investment grade, they were forced to pay back $4 billion, which they didn’t have. (Fortune, 12-24-2001)

Arthur Andersen’s role in this was very simple. When it should have been obvious to them that Enron was engaging in illegal activities, they did nothing. Actually they did something. They tried their best to destroy as many incriminating documents as possible. Enron management issued a memo on October 12, 2001, which directed workers to destroy all audit material, except for the most basic work papers. Prior to the first SEC subpoenas of November 8, Andersen supervisors reminded employees of the
memo. Andersen may have even continued to destroy documents after the first subpoenas were issued. (Time, 1-21-2002)

The Enron bankruptcy is the largest in the history of America. In many ways it resembles the Long Term Capital Management problems of the 1990’s. In the LTCM situation, upper management argued that the economic impact of their bankruptcy would be too devastating and lobbied government officials to bail them out. The officials did so and LTCM has since made a full recovery. Enron executives tried to lobby officials such as Treasury Secretary Paul O’Neill to bail them out but were unsuccessful.

Currently, legal battles are raging and only one conviction has been brought. That was against an Arthur Andersen executive for ordering documents to be destroyed. Convictions won’t be that easy to get against Enron’s dirty doers. The likely charges will be for fraud and fraud convictions require proof of “Knowing, willful, intentional misconduct,” says defense attorney Ira Sorkin. (Fortune, 12-24-2001)

Fraud charges that can be brought against Enron executives fall under the umbrella of three questions. The first is whether or not Enron’s partnerships were designed to hide its liabilities and mislead investors. The second is whether Enron executives knew the company was sinking as they sold over $1.1 billion in stock while encouraging employees and other investors to keep buying. The third is whether the overstatement of income for over four years was a result of negligence or an intent to defraud. One other question that is being raised is whether the political contributions of Enron’s executives, totaling over $700 million to George W. Bush’s campaign alone, resulted in any special favors. (Time, 1-21-2002)
Aside from the legality of the whole Enron scandal, some major questions beg to be answered. These include questions about how Wall Street will analyze stocks in the future. They also include questions about how the auditing and consulting industries will change. It will be interesting to see how 401(k) plans will be shaped in the future and most importantly the world is waiting to see what legislation will be passed regarding these and other issues.

Legislators are using the Enron scandal as a means to pass all their favorite bills through congress. Washington seems to have gone Enron crazy. In fact, health-care industry lobbyist Fred Graefe said “Congress would be more likely to pass my pet measure if it were called the Enron Medicare and Prescription Drug Benefit Act.” (Fortune 3-4-2002) The question is will any Enron legislation be passed and should it be passed.

As of now only one law has been passed with regard to the Enron scandal. That law makes it very difficult for angry citizens to run campaign ads complaining about politician’s ties to Enron. Other bills that are in the works, according to Ramesh Ponnuru of National Review magazine, are “1) presented as “reforms” that would “prevent future Enrons” 2) only tangentially related to Enron’s actual abuses and 3) on the merits, bad ideas.” (National Review, 5-6-2002)

The legislation being created in response to Enron falls across an array of issues. These mainly include campaign-finance reform, employee pension plans, and the objectivity of the auditing industry. The general consensus, though, is that congress will come to its senses before any of these bills are passed and realize that passing these bills will do nothing but complicate the business world.
Senators McCain and Feingold are using the Enron ordeal as a way to finally pass their pet campaign-finance “reform” bill. According to the senators, though, the bill is due to the alleged “lessons of Enron” and would have helped prevent the whole Enron ordeal from taking place. This makes very little sense, however, because the bill would have allowed Enron executives to donate more money because it raises the limits on individual contributions. (National Review, 5-6-2002)

Senators Boxer and Corzine want to pass a bill regarding pension plans. They feel that companies should only be allowed to include twenty-percent of company stock in employees’ 401(k) portfolios. This is utterly ridiculous. Ramesh Ponnuru said that if this had been a requirement when Microsoft hit it big, these same senators “would have been asking why Bill Gates hadn’t shared the wealth.” (National Review, 5-6-2002)

President Bush has a rebuttal plan to that of Senators Corzine and Boxer. In his plan employees will be permitted to sell company-matched shares after three years. (Fortune 3-4-2002) It also allows more access to personalized investment advice. On top of this, Bush wants to prohibit executives from selling their company’s stocks during periods when regular employees are not allowed to do so.

Another interesting issue is in regard to the objectivity of the consulting and auditing industries. For most companies, the same organization that does its auditing also does its consulting. Auditors are supposed to look for inconsistencies in accounting records and wave a red flag when evidence of fraud is found. The problem is that their clients are paying them huge amounts of money. During 2001 Enron paid $25 million for its audit and $27 million for “consulting and other services.” “How can any auditor be
independent,” asks industry analyst Arthur Bowman, “when his client is paying this kind of money?” (Time, 1-21-2002)

Enron isn’t the first major problem Arthur Andersen has had either. They previously paid a $7 million fine, without admitting fault, for allegations of fraud stemming from its audit of Houston-based Waste Management. They also paid $110 million to settle a class action suit brought by shareholders of a company called Sunbeam, which misstated its financial results during the 1990s. (Time, 1-21-2002)

The situation where an auditing firm also does consulting is an obvious conflict of interest. To overcome this many solutions have been proposed. Former chairman of the Securities and Exchange Commission Arthur Levitt wants firms that audit for a company to not be allowed to also consult for them. Many democrats want companies to be forced to rotate auditors every five years. Clive Crook, a National Journal columnist, proposes that audits be done by a governmental, or quasi-governmental agency. (National Review, 5-6-2002) These sound good in theory, but the fact is that the current auditor/consultant-client relationship that exists in America has worked well for many decades. The Enron-Arthur Andersen situation is simply an aberration of the system that is in place.

Something else that is called into question here is who is monitoring the bosses of companies. In today’s business climate, many upper managers are also members of the board of directors. It is not uncommon that the CEO is also the chairman of the board. This creates a situation where upper management, especially the CEO, is unchecked. Lord Acton once said, “Power corrupts, and absolute power corrupts absolutely.” (American Heritage, May 2002) Since the CEO/chairman can decide who sits on the
board, no one wants to test them and they essentially get away with whatever they want, no matter how unethical.

The fact is that the American economy is based on trust. The average person acts ethically and a small group of people acting unethically shouldn’t cause major changes in the system. What it should cause is an awareness that when something seems too good to be true it probably is. When a company can’t explain in simple terms how they are making money, a little skepticism is in order. Investors and Wall Street analysts should trust that the system works, but be aware that these types of things can happen.

In this situation, major reform seems very unlikely. The only bill that even seems remotely feasible is the one being offered by President Bush that would alter certain rules regarding pension plans. Within the system we have now, it would be impossible to prevent any company from ever fudging their records. As a society we should simply understand that records can be fudged and that we need to be more careful when investing our money.
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