Enron Scandal: Role Played By Financial Instruments And Recommendation Of Risk Mitigation Techniques

The role played by Financial Instruments

To analyze the role of financial instruments in the downfall of Enron, a suitable starting point would be to clearly define a financial instrument. 'A financial instrument is a representation of an ownership interest claim or the contractual or contingent claim to receive or deliver cash, another financial instrument, or asset, and can either be a cash instrument like cash, securities, loans, bonds, notes, and equity, or a derivative instrument such as forwards, futures, options, and swaps' (NC State University, 2014).

Equity (specifically the Enron stock) was one of the most important financial instruments in the whole ordeal because the Enron scandal largely revolved around the management trying to keep it's the price from falling. Keeping investor confidence and maintaining the 'buy' rating of analysts was the main motivation behind several actions of Enron, such as mark-to-market accounting. This method requires that once a long-term contract was signed, the amount of which the asset theoretically will sell on the future market is reported on the current financial statement (Li, 2010: 38). Another tactic used by Enron was the use of SPEs (Special Purpose Entities) to hide losses so that Enron could show profits on their quarterly results and boost the share price.

Another important financial instrument in the Enron scandal were commodity contracts. Here Enron had pioneered as a market maker, creating the long-term natural gas market, and later expanding to other commodities such as electricity, chemicals, coal and many more. But as a market-maker, Enron was a middle man in every transaction between the buyer and seller. Thus every trader had credit exposure to Enron, and the value placed on a contract depended on Enron’s creditworthiness. But as Enron came under scrutiny, buyers began to bid lower and sellers began to ask for more, because of the risk that the contract would not be fully consummated. As a consequence Enron’s profit margins shrunk or disappeared, disabling the market, and leading to Enron’s collapse (McAfee, 2004: 3).

Broader Market Effects of the Collapse

One of the most direct broader-market-effect of Enron's collapse was the Sarbanes–Oxley Act (SOX), which can be considered a mirror image of Enron: the company’s perceived corporate governance failings are matched almost point for point in the main provisions of the Act. SOX consists of guidelines for facilitating the independence of directors and auditors, so as to align managerial behaviour with the interests of shareholders (Deakin and Konzelmann, 2003: 1). Often SOX is criticized for discouraging businesses from listing in the US, notably by Michael Bloomberg (Office Of The Mayor Of The City Of New York, 2007: ii), and this could also be considered an indirect consequence of Enron's collapse.

The second major broader market result would be the transformation of the 'Big Five' accounting firms into the 'Big Four', i.e., the fall of Arthur Anderson. The corrupt manner in

which the auditing of Enron had been performed and the subsequent obstruction of justice by shredding over one tonne of Enron documents (Enron: The Smartest Guys in the Room, 2005) resulted in Arthur Anderson's reputation being damaged beyond repair. In spite of their conviction getting reversed, the firm could not survive the crisis.

The collapse also created fear in the market, with investors wondering which company may succumb next, resulting in indices such as the Dow and Nasdaq falling steeply.

Recommendation of Risk Mitigation techniques

The largest risks in case of Enron's demise were systemic risks. One of the largest risks which was repeatedly exploited and abused by Enron was going aftermarkets, industries and geographic places with a very low degree of regulation, with examples like Natural Gas (market) and California (place) (Enron: The Smartest Guys in the Room, 2005). Therefore, having proper regulation would be an appropriate step to mitigate risks in such a scenario.

Another systemic risk in Enron's case was the lack of independence of third parties such as auditors and financial analysts. Enron would go so far as to get financial analysts fired from other companies if they wouldn't give Enron a 'buy' rating (Enron: The Smartest Guys in the Room, 2005). Also, this was despite federal law requiring a publicly-traded company to hire an independent accounting firm to perform an annual audit (Kendall, 2002: 460). So, stricter enforcement would greatly reduce risk in this scenario (eventually SOX would aim to do this).

When SPEs were set up by Enron, one of the purposes was to do hedging to provide some risk mitigation. However, their implementation of this hedging strategy was inherently flawed. The hedging SPEs, known as the Raptors, were supposed to be protecting Enron from losses. However, the majority of the stock that capitalized the Raptors was Enron's own stock. So, when Enron well, so did the Raptors (Genova 2010: 41). However, had the hedging been properly set up and used a more appropriate stock rather than Enron's own, it would have provided much better risk mitigation and would be recommended.