

# Free research paper about organizational analysis: enron

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## **Abstract**

This report analyzes the case of Enron and its failure. The practices adopted by the management have been analyzed and criticized in order to identify the main cause behind the whole issue. Along with this, the report also suggests different solutions and recommendations for the management in order to minimize or stop the risk of such issues in the future. The report has also highlighted the importance of Information System in this case.

Moreover, the report presents suggestions regarding how the implementation of Information System can help the management to avoid such issues.

## **Organizational analysis: Enron**

Enron scandal is one of the biggest financial scandals that have occurred in the history. The case of Enron has raised a number of questions for the management and practices adapted by the management of Enron (Wilson and Key, 2012). Different researchers have highlighted different reasons for the failure of Enron such as financial techniques and methods applied, compensation and bonuses paid to the executives, approving of credits

(Byrne, 2002), off-balance sheet financing, heeding transactions and Special Purpose Entities (SPEs) (Healy, & Palepu, 2003). This report, therefore, analyzes the case of Enron and its failure. Practices used by the management are analyzed in this report. After analyzing the practices, questions have been raised whether the practices under the circumstances were appropriate or not. Organizational analysis involves a number of steps and processes using which the management is able to analyze and interpret the situation of the organization, and then interpret whether the steps taken by the management were appropriate considering the organizational situation and organizational culture. This report not only analyzes the steps and strategies adopted by the management of Enron but the report also provides recommendations of how such failures can be minimized if not stopped.

Enron was an American based company operating in the energy sector mainly. The company had employed more than 20, 000 employees and Enron was considered as the one of the world's largest electricity, natural gas and communication companies. The company had enjoyed significant financial revenues as it reported annual revenue of \$101 billion in the year 2000. The company was also named as one of the America's Most Innovative Companies for six consecutive years by Fortune. In the year 2001, the company was revealed that Enron has been involved in some accounting fraud and this fraud has been systematically planned. After this fraud, the company got bankrupt in the year 2004 (Li, 2010). This case was considered as the largest accounting failure in the history (Felton, & Kim, 2002).

Moreover, this case was also the biggest auditing failure in the history (Li,

2010).

There are a number of reasons that have been the root cause of the failure and accounting scandal. According to Wilson and Key (2012), there are a number of practices and factors that reveal and expose their unethical and bad behavior. The management has been engaged in a number of practices and these practices are aimed at increasing the stock price and financial performances. These practices have resulted in enhancing the revenues of the company that would offset the economic losses of the company (Wilson and Key, 2012). Special Purpose Entities was one of the major strategies that resulted in the failure of Enron. This practice is to not show investment of large assets in the balance sheet. As these assets would not yield sufficient cash flows, therefore, these assets are not presented in the balance sheet and are considered as " Off-Balance sheet financing". The management used SPEs in a special way to remove long-term debt from its balance sheet.

Another significant issue was found in the accounting practices adopted. For instance, in 1999 Enron invested in 1 million stocks of Rhythms NetConnections at a price of \$10 per stock. When the company went public, the share price increased to \$30 although Enron could not sell these stocks at that time, but still the management decided to report this investment as \$300 million (Wilson and Key, 2012).

According to Byrne (2002), the role of the board members of Enron played a significant role in the bankruptcy of the company. The audit committee of the company was led by Richard Jaedicke. In the year 1999, Arthur Anderson told Mr. Jaedicke that the company is at maximum risk, and it was at the edge of the accounting prices. However, the board members did not

recommend the audit committee to be more cautious. Another important situation occurred when the company reported a net profit of \$975 million in the year 2000 and the board approved cash bonuses of \$750 million to the executives of the company. Moreover, according to the senate such practices could not have been possible without the involvement of Board members (Bryne, 2002).

Some of the decisions that the management made totally wrecked and destroyed the company. Their focus lately was on increasing and growing the earning per share of the company (Stewart, 2006). Moreover, some of the practices such as off-balance sheet financing and manipulation in the accounting practices were helpful in increasing the stock value and enhancing the profits of the company. The management used these practices more regularly in order to continuously keep the prices and profits high (Stewart, 2006).

The role of financial analyst is critical in any organization particularly in public organizations (Hutton, 2002). The objective of Enron was to significantly increase the share prices and profits of the company and for this purpose, the management used different unethical and bad practices. At times, the management manipulated totally the laws and accounting standards in order to increase the share price (Hutton, 2002). However such practice may be helpful in the short-term but may not be successful in the long run. Therefore, the roles of the management, board committee, the audit committee as well as the financial analyst were highly critical in this situation. If the board and the management were not involved in the Enron case, then the management would have agreed to show losses and allow

trading of their shares at low prices as they would have believed that the share prices would increase in the long run as the company would report profits. Enron was a growing company and the revenues of the company were rising over the years. Therefore, the board members would have been more strict and cautious at the time when the profits were reduced. The board should have dealt this situation more carefully and should have analyzed the situation with the analyst, financial analyst, management, executives and could have come up with different strategies to improve the current position of the company instead of being involved in such unethical and bad practices.

Fair and transparent reporting of the financial statements of the company is integral in gaining the trust of the shareholders, as well as other stakeholders. The failure of Enron destroyed the trust of the shareholders (Currall, & Epstein, 2003). However, the management did not believe in their company and its success and therefore wanted to maximize the short-term gains. The management should have used appropriate and internationally recognized accounting practices and standards to overcome such difficult situations. In addition to this, it should have reported profits only when they have been realized and should have reported all the losses according to the Generally Accepted Accounting Principles (GAAP) (Coffee, 2001). The audit committee should have been more strict and watchful regarding each and every expense and revenues presented in the financial statements in order to ensure that the information is transparent and fair. As these practices were not adopted; therefore, it resulted in such a big failure that led to bankruptcy.

A number of recommendations can be given to the management and leader of Enron. One of the most important recommendations should be to formulate fair and transparent strategies and practices and believe in these practices. These practices will yield benefits if not in the short-term then in the long-run. The other important recommendation that can be given to the management is to use fair and transparent accounting practices. The focus of the management should not be only on increasing the profits, but there should be a number of objectives of the management such as; ensuring transparent practices and fair presentation of information, improve customer satisfaction and services, reducing costs, increasing profits and others. If the management had focused on different organizational aspects then it would have ultimately resulted in increasing the profits of the organization in the long-run, and this would have resulted in increasing the share price and earnings per share.

According to Gwynne (2002), there is a need to take actions among different business aspects and these aspects include making improvements in the internal financial controls of the organization, improving the internal and external financial communications, applying a code of ethics at the workplace along with implementing and identifying procedures that would define the behavior of employees. Gwynne (2002) also highlighted that the relationships with the external auditors is also critical along with strengthening relationships with the board's members of the company. In addition to this, it is also recommended defining the scope of responsibility of internal audit or finance committees to make the overall organizational information transparent and fair.

Along with all these changes, it is highly important for the company to implement a proper Accounting Information System or ERP. A proper and well build Information System and IT infrastructure will allow the company to control any possible issue or mistake in the audit. The ERP and other Information System allow the organizations to access information and data on time, integrate the overall business processes, and transfer the internal information appropriately and correctly (Hall, 2010). This in turn will allow the organizations to avoid any accounting and auditing issue or fraud. It is important to acknowledge here that the issues like Enron scandal can be avoided with the help of effective and efficient internal control. For this reason, the organizations should implement a whole new and effective internal control monitoring technology by Information System and ERP in order to support the overall internal control processes (Simons, 2013).

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