

# Enron and the white collar crime research paper

[Business](#), [Company](#)



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## **Abstract**

This paper does an analysis of Enron's debacle and why it was termed as the biggest and the most complex financial fraud in U. S. history. The paper highlights the desperate attempts by the bankers, auditors and top leadership at Enron Corporation to hide the actual liabilities. They successfully did this by balance sheet management and skewed accounting treatments permissible for using the restructured assets under financial reengineering. The attempts to show profits led the top leadership at Enron and the entire financial system to abet in the svelte white collar crime of fooling the investors by dressing up the financial reports and ignoring the social implications completely.

## **Introduction**

Enron, once named as the ' America's Most Innovative Company' by Fortune for six consecutive years, turned out to be known for one of the largest and most complex bankruptcies in U. S history.

Enron Corporation was energy and natural gas manufacturer and supplier, based in Houston, Texas. Its history dates back to 1985, when Kenneth Lay merged his company Houston Natural Gas with Internorth of Omaha, Nebraska and formed Enron. Kenneth Lay was Enron's CEO and played heavily in the futures market (Reeher, n. d., " The history of Enron"). In 1980s, under Ronald Reagan's presidency, the energy markets were deregulated and under Lay's leadership Enron forayed into other markets trying to beat the competition by mergers and acquisitions of other energy players (Wynne, 2004, " Structured finance: The Enron debacle"). Before its bankruptcy in December 2001, Enron reported to have approximately 22, 000 staff and claimed revenues of nearly \$101 billion in 2000 (" Enron", 5 June 2011).

### **The research and analysis**

As a company Enron was said to be swimming in debt even as early as 1986, when Kenneth Lay shifted its headquarters from Omaha to Houston. As soon as Lay shifted the headquarters to Houston, he began selling the key assets. Back then, analysts did not think that selling of the key assets would solve Enron's debt issues (" Enron", 5 June 2011).

To meet the needs of high debt, Enron had diversified into a company dealing with selling of many products other than transport of oil and LNG (liquefied natural gas). These products were petrochemicals, plastics, pulp and paper, steel, water and waste water, shipping and freight just to name some.

But the problems seemed far from over. The rising competition, market consolidation, mergers and takeovers took toll on their balance sheets. There were rising debts as the revenue inflow from selling utilities did not match the rate of sudden increase in costs due to expansion and mergers and acquisitions. The top leadership under Kenneth Lay neglected the main business. The fierce competition which ensued due to privatisation of this industry, led to squeezing profit margins (Wynne, 2004, "Structured finance: The Enron debacle").

Kenneth Lay brought Jeffery Skilling on board in 1990 as the Chief Operating officer (COO). Skilling was a former consultant and wanted to introduce new ways of increasing business through information based model. Skilling resorted to not just selling energy through building power plants and generating energy, but he also focussed heavily on selling contracts for delivery of energy. He further 'structured' the pieces of these contracts into 'derivatives' and sold them both in the primary and secondary financial market. The deregulation of energy markets under President Ronald Reagan allowed Enron and other players to buy and sell energy futures - contracts to deliver energy at future dates (Reeher, n. d., "The history of Enron").

Skilling also lobbied with Securities and Exchange Commission and requested with their accounting firm Arthur Anderson to allow Enron to use 'mark-to-market' accounting policy, which would allow Enron to account for profits in advance in the first year of selling futures (long-term contracts). Enron was thus the first non-financial company to get to practice 'mark-to-market' accounting policy.

Apart from the sinew of the corporate governance and using it to their advantage, the top leadership also did not disclose many small companies that Enron had formed to diversify its business. They cajoled their accounting firm Arthur Anderson to partake into unethical practices and not disclose the existence of separate business entities to the investors (Reeher, n. d., " The history of Enron").

Such malfeasance did not do much good. The revenues could not meet the soaring debts and Enron filed for bankruptcy by 2001 end.

The biggest contributor in helping Enron push up its share prices even when it was reeling under debts was the structured financial tools - the derivatives. Structured finances were seen as the ultimate tools which the company executives could use to maximise value for shareholders within the limits of the law (Wynne, 2004, " Structured finance: The Enron debacle"). Structured finance has been around as the legal recourse to maximise profits since 1970s. But structured finance emerged to provide more flexibility and lower the borrowing rates for the corporates. Instead of borrowing money against their credit rating, the companies could move their assets to a separate business entity, also known as special purpose vehicle, and then borrow funds against that asset's value. This method would provide extra security to the banks against their loans because the assets against which the funds were borrowed could be seized by the banks even if the parent company filed for bankruptcy. Due to the extra security that this provided, banks could lend at lower rates.

Enron leadership caught the lacuna in this system and used its separate business entities to sell its assets and book income. Enron created 'fake' sales where they would sell their assets without there being any real buyer. Banks were equally culpable participants in taking advantages of the loopholes in the financial system. Banks would finance deals for smaller separate business entities which a company wanted to form, and these partnership deals were financed not by the sale of bonds but by securing company stocks. To secure their interests, banks would set a trigger level for the price. If the market price fell below this trigger, then the banks would recover their money as the trigger price would get activated. Such deals were vetted by the lawyers as well. Though these deals were legal they had social implications which the entire system ignored.

Enron's fraudulent practices started surfacing when it filed for bankruptcy. The fraudulent practices were either overlooked or ignored by one and all who help in running the corporate governance as a system. These people were the lawyers, accounting and audit firm and the top leadership at the Enron.

Enron's debacle was more of an orchestrated white-collar crime. White collar crime is defined in simple terms as lying, cheating and stealing, as per the FBI ("White-collar crime", n. d., FBI. gov). White collar crime term was coined in 1939 by Edwin H. Sutherland and is more appropriately defined as "approximately as a crime committed by a person of respectability and high social status in the course of his occupation" ("White collar crime", Kari Sable Burns, 1994-2011). When an educated person, of high stature learns

technical knowledge, and uses it to conceal some information on the pretext of managing someone else's assets but safeguards his interests, it is a clear case of a white collar crime. It is a crime done by taking advantage of the lacuna in the system, calibrated and orchestrated by many groups in order to steal away the public money with the use of exclusive technical knowledge of the subject matters. Enron did precisely the same thing. Banks such as Citibank and J. P. Morgan, the audit company (which is supposed to be most unbiased in values and principles) Arthur Anderson and the CEO Kenneth Lay all perpetrated the white collar crime which swept away billions of dollars of valuable investors wealth. White collar crimes such as that done by Enron, undermines investor confidence, puts tens of thousands people out of job and severely hit the savings of the common man.

Enron has not been the first case of white collar crime and neither will it be the last. There have been many behemoth organizations such as WorldCom as well as individuals with superior knowledge of the matter such as Madoff, who have also deprived ordinary people of their lifelong savings only because they had ulterior motives of creating more wealth for themselves. It is important here to understand what goes in a corporate organization which drives a concerted act of frauds and malpractices which ultimately wipes away millions of dollars from the market. Why do all the leaders, who do not have any prior criminal record, succumb to partake in a white collar crime?

Many a times the white collar crimes are committed because of factors such as individual characteristic, coupled with organization culture and an opportunity (Stevens, n. d., " The process of white collar crime"). The

individual characteristics are significant if the psychopathic behaviour, such as mix of offensive personality traits with antisocial behaviour, occurs due to some organizational pressures so much so that the individual succumbs to the illegal activities without taking cognizance of the long-term impacts. Similar behaviour was seen in Enron's collapse too.

Kenneth Lay and Jeff Skilling yielded to the pressure of showing wealth to the shareholders and investors and in the process lobbied for some of the biggest policy reforms such as getting permission to use 'mark-to-market' accounting policy for showing income in the first year of selling derivatives and utilizing special purpose vehicles to realise 'fake' sales to book incomes. The financiers, bankers and advisers all together helped Enron Corporation to transform financial reports in order to hide debts and mask volatility in earnings.

Many reluctant participants, as one can assume, turned out to be the whistle blowers. They intimidated Jeff Skilling who was the CEO till he resigned suddenly in August 2001. But most of the attempts to warn the senior management and the concerns raised by the whistle blowers were either side-tracked or ignored by the senior management and the lawyers too vetted that everything was legal and hence fine. It is reported that when Mr. Mintz joined the finance division at Enron, he saw trouble with the finances and transactions of the partnerships of Enron. Mr. Mintz did inform Jeff Skilling diplomatically, to which Skilling never responded. In fact, in a turn of events, Skilling announced to the market on August 14, 2001, that he was resigning from Enron due to personal reasons just after six months as the



CEO of Enron Corporation. It is believed that Jeff Skilling saw the trouble coming in the form of huge financial upheavals as soon as within one year.

Later, auditors from Anderson discovered that they had earlier added \$1 billion dollars' worth of shares which were used to finance Raptor partnership, as assets in Enron's balance sheet. Correcting that would mean reducing \$1 billion straight from Enron's assets. The reality set in and Enron announced deducting \$1 billion from its third quarter earnings, reflecting first quarterly loss in four years. The Enron's share prices started to fall steeply and the trigger levels got activated, which were agreed upon earlier with the banks during financing the deals and partnerships. As was intended by the bankers, the falling prices threw back the losses in the balance sheet of Enron. Enron's stocks fell by over 80% in the coming weeks and this forced Enron to declare that they had overstated its earnings by almost \$600 million since 1997 (Wynne, 2004, " Structured finance: The Enron debacle"). Enron finally filed for bankruptcy in December 2001. The complexity of the financial fraud and the number of parties that were involved, made it really long before the fraud was finally unravelled.

## **Conclusion**

Structured finance invites deception while still being all legitimate. Financial engineering allows corporates to break the loans into different marketable assets which have their own names, credit ratings, tax breaks, repayment schedules and accounting treatments. When these marketable assets born out of financial re-engineering, are traded, supported and backed by other key parties of the system such as the banks, it leads to a bubble of artificial

wealth. Fragile as these bubbles are founded on weak fundamentals, when they burst they erode millions of dollars from the markets apart from weakening the investor confidence and leaving a gaping hole in their savings.

It is clear from the above analysis that both the banks and the Enron Corporation knew that the partnership that they were developing in form of separate business entities were to hide the debts from the shareholders. The revenues from Enron's business, which got neglected due to focus on acquisitions and market consolidations, could not suffice to bring down the heavy debt of Enron which was running in millions of dollars. In the shield of law and legal courses, banks had entered into transactions with Enron which were in reality loans but were structured in intricate ways so that they could be reported as other types of liabilities. It will be absolutely incorrect to assume that such experts from the financial world with superior technical knowledge of financial management could not have known the social repercussions of those structured marketable assets. It was quite naïve of those financial bellwethers like Citibank and J. P. Morgan (who helped Enron with fraudulent deals) not to sense that there will be few whistle blowers close to the matter inside the companies, who can lead to disclosure of the entire financial and accounting fraud that has been going on in Enron. All of these suave managers were carried away by the short-term objective of profit making opportunity but failed to realise the long-term consequences.

Business wise Enron was already reeling under debts. It would have been wiser to file for bankruptcy and save the grace earlier without abetting into

the white collar criminal act of financial fraud. Enron anyway collapsed but when it did file for bankruptcy, it brought shame and disgrace to the corporate governance and business ethics. The bankers, auditors and Enron hid behind the convenient jargons of 'balance-sheet management', 'structured finance' and 'special purpose entities'. The fact that their methods would defraud and swindle wealth from others was of least concern. It is quite evident that they had turned a blind eye to the business ethics. The brief research and analysis in this paper clearly show that the Enron collapse was inevitable - sooner or later it was meant to default. It also shows that Enron debacle was a crafted case of white collar crime of the highest order using the lacunae in the financial system in the U. S.

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