

# Enron filed for bankruptcy case study

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It led an aggressive and apparently effective expansion model from its creation in 1985, as an interstate pipeline operator based in Houston, until secret cracks split wide open and the corporation was engulfed in a dramatic implosion. The climb to greatness took all of fourteen years, its fall was brief and brutal. On 02 December 2001, Enron filed for bankruptcy. – The Killing way: A- ‘Light asset’ trading: a risky business model Enron sells off heavy assets and sets its sights on light asset’ trading.

Assets were kept based on the reasoning that they generated key information for the business. It expanded focus from trading energy to all highly inefficient markets with the following characteristics: single commodity, fragmented/undergoing significant change (deregulation); complex distribution channels, capital intensive, lengthy sales cycles, loose contracts for supply/service quality and standards; opaque pricing, no public disclosure; buyers with limited flexibility to manage key business risks.

In every new market, it acquired the assets necessary to guarantee delivery then offered customers contracts which allowed them to manage the business risks. Enron would offset market price volatility and hedge risk using a variety of future and forward contracts. B- Innovation, ‘benefit of doubt’ talent management and immediate gain ratification Enron pushed for innovation and creativity.

Its staff were among the best and brightest business and science graduates. They were encouraged to move to business units where they felt they could add value.

Achievement was compensated by generous bonus systems (potentially doubling the annual salary) while traders received bonuses on the current value of assets traded (even though they were trading for future payment on contracts). In short, Enron was staffed with hungry competitive achievers who were driven by the company's bonus system, eventually adding them to overlook sustainable business processes due to the gratification system compensating rapid gain. Decentralized decision-making processes encouraged action but reduced oversight by senior management.

Shilling's Performance Review Committee classed staff according a grading system where the 'superior' staff would receive the 'benefit of doubt' when attempting something new. A 1 OFF late Internal AAA memo notes ten personnel's aggressive accounting strategies to comply with firm reporting (something they did not bring up with their client). C- Corporate Controls to Minimize Risk ARC – Risk Assessment and Control was created by Killing to offset the high risks of trading in these hazardous markets, notably after the North Sea project \$675 million write-off.

It was charged with analyzing the financial and non-financial risks of Enron businesses, projects and transactions for which it implemented an array of reporting programmed to monitor trading risks, providing up to day-to-day reporting on different portfolios. ARC also evaluated new business ideas based on proximity to corporate core competencies.

Staff were required to sign off on a 64 page Code of Ethics. Investments by senior management with potential conflicts of interest needed to be signed off by Chairman of the Board and CEO (Ken Lay).

The ARC became a ‘speedup’ many would have preferred to avoid and manifestly found a way around according the AAA internal memo but also when considering the management of Enron SEEP. II – Accounting, Finances and Hedging A- Precarious accounting Enron’s books were at best, complex. They had to account for transnational exchanges, numerous products, physical assets and trading operations.

The company specialized in long-term contracts (swaps, forwards and future contracts) to assure rice stability in volatile markets.

The company effectively lobbied for and obtained the right to mark-to-market accounting allowing present value of future contracts recognized as revenue on the books. Present value of expected costs also expensed on books. This discounted the potential gains and losses inherent to the nature of future contracts. Forward contracts meanwhile were non-standardized and privately negotiated, holding both parties to each other’s credit risks and complicated by non- deregulated markets in states which led to subjective estimates of cost of contract fulfillment.

B- Special Purpose Entities SEEP (often funded by private equity investors/lenders) were subject to special rules.

However, this rule and the controls put in place by ARC were also overlooked by the most senior members of staff. Chew and ELM SEEP were not consolidated on ENRON’s books. The Alms were proposed and managed by Enron’s COOP, Andrew Fast, and yet the potential conflict of interest was overlooked by the Board and CEO who hurriedly signed off on LIMIT and 2, without performing their due diligence.

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By his 3rd SEEP proposal, at least one Director was uneasy. He requested information from the Board's Compensation and Management Committee concerning Factors accounts, but let it drop after two failed requests. It later transpired that the Factors interests in ELM SEEP were far larger than perceived (earning him \$mm).

Only after Raptor projects (aimed to hedge company gains) were fully operating did a study show that if Enron stock were to fall significantly, the Raptor SEEP would force them to produce tens of millions of Enron shares to back their commitments.

In short, Enron's creative accounting strategies led the company to overstate its profits and understate TTS liabilities by discounting these SEEP from its books. III – Conflicts of interest: Enron was failed by its Board and Senior Management A- CEO and the Board of Directors Ken Lay was both CEO and Chairman, a position which creates natural conflict of interests between the CEO in charge of the company and the Board, charged with oversight into the activities of the company as well as the evaluation and compensation of the Chief Executive.

By 2000, Lay was among the highest paid CEOs of the year. The Board was in all appearances competent and composed of a mixture of seasoned professionals from the sector, academic and government backgrounds.

Its role was the CEO appointment, overseeing firm strategy and new major initiatives. It met an acceptable 5 times a year, but it never without management presence which is a risk when you have a CEO with nearly 15

years of running the company (only a strong, resilient character not afraid of a challenge could have built the Enron empire).

The generous compensation schemes were also once again debatable: Directors received grants of stock and stock options bringing total compensation over six times higher than annual directors' set fees at peak time. In the meantime, the ARC controls failed to cancel out personal gain even at a Director level. Many respected outside members on the Board had financial ties to Enron (consulting fees, donations).

B- Audit Committee and External Auditor The Audit Committee had a mixed composition, they were figureheads of academic, business and government backgrounds supported by AAA, an external audit firm.

Meetings were extremely brief. It is debatable how the audit committee of a corporation dealing in volatile markets with risky contracts could come to satisfactory conclusion on the management of affairs in less than 90 minutes. The Committee was technically in charge of appointing the external auditor, but this was done based on management recommendation. The external audit firm, AAA, shirked its duties to disclose its full and honest opinion of the goings-on.

Their client Enron filled 25% of their annual revenue for that branch.

In early days, Enron also shifted 40 of its staff to the Arthur Anderson payroll. Over the years, more than 80 AAA employees were taken on by ENRON including its CACAO, COOP and Treasurer. AAA had a long and close relationship with the Enron officials and a large financial stake. This probably

explains why it chose to highlight, without condemning, the risks of Enron's edgy accounting while underlining that other auditors would probably take a ' different view regarding their creativity.

Internal documents show Enron was classified as ' maximum risk category and in 2000, the AAA internal memo outlining staffs aggressive accounting strategies brought some AAA partners to question whether Enron be retained as a client.

This memo was not brought up with the client. C- Compensation and Management Committee The Compensation Committee was chaired by the CEO. This is wrought with entitling Interests won can nonsense evaluate Nils own performance Ana propose compensation if he is, De facto, the Committee Chief.

Ken Lay had one of the highest CEO salaries of 2000. The Committee fails to notice when Lay starts to abuse his \$mm credit line he is repaying with company stock (he withdraws \$million cash in 1 year) in 2000. He was replaced by Killing who received similar treatment.

Massive cash bonuses, stock options of all sorts were common currency in Enron, responding to results over sustainable (commendable? ) business practices. The Committee failed o respond when asked to provide Factors outside sources of revenue.

Had they complied, we can only wonder if Enron would still be here today. Conclusion of the Enron case Nearly all Enron senior managers Jumped ship in 2000, including Killing who engineered the company's light asset strategy.

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The Board, when eventually convened, following the head of Corporate Development's alert to potential 'implosion' was not given the full information, received an edited version of the Watkins letter content, excluding SEEP concerns and was made aware of the external investigation into attention 'accounting scandals' only after it has happened.