Greed essay – enron and northern rock corporate collapse

Business, Company

Abstract

The spectacular collapse of both Enron and Northern Rock illustrate two very distinct methods of errant policy that deserve continual study. This essay examines and compares the roles of both companies during their respective period offailurein order to determine the fundamental causes that led each of these companies to ruin. The evidence presented outlines a pattern of greed, ambition and poor policy that combined to drive the entities to failure. This research will be of value to any person looking into corporate collapse.

1 Introduction

Failure in business comes in many forms making continual evaluation beneficial. The cases of the spectacular collapse of both Enron and Northern Rock illustrate two very distinct methods of errant policy. This essay examines and compares the roles of both companies during this period of failure in order to determine the fundamental causes that led each of these companies to ruin. With a focus on the role of fraud, market value accounting, fraud and creative accounting this study will identify and evaluate the underlying causes that have been credited with defining business risk in the modern age.

In the end, this essay examines and evaluates the fundamental factors associated with the collapse of Enron and Northern Rock with the stated goal of determining the best methods of avoiding such a scenario in the future.

2 Corporate Collapse

2. 1 Overview

Enron was once considered a blue chip investment with the inherent capacity to bolster any portfolio during the 1990’s until the collapse of 2001 (Khan, 2011). Once regarded as a premier investment, Enron became associated with a wide range of questionable accounting practice, fraud and insider trading during their term of operations. Over the course of 1990’s, Enron was cited and held up as a pillar of innovation and performance with many institutions attempting to emulate their professed success (Arnold and Lange, 2004). This early idolization of the rising company seems to have increased overall investor interest and expectation. With a platform based on gas and electricity and a long list of associated enterprises including online and investment services utilized by nearly every other energy entity of the period, Enron was the acknowledged leader in the international energy industry (Solomon and Solomon, 2004). With a broad based system of investors, there was substantial fallout when the final collapse of the company was announced in 2001, with many in the industry decrying the lack of oversight amid the opportunity for fraud (Khan, 2011). The rise and fall of Enron, even on basic level is a reflection of a company’s ability to build and play upon investors’ expectations, which indicates a willingness on the part of the investors to risk theirmoneyin a questionable investment.

Northern Rock was once considered a leading voice in the UK banking industry (Marshall et al, 2012). Created as a result of a merger between the North East Building Society and the Northern counties Permanent Building Society and the Rock Building Society, the Northern Rock Building Society was in an ideal position to create and further their own business interests. A key area of concern for investors was the fact that Northern Rock derived its capital from depositors until the deregulation efforts of the 1980’s (Marshall et al, 2012). With the relaxation of oversight, it became possible for entities such as Northern Rock to consider and implement alternate solutions for revenue increase that included heavy investment in the stock market and mortgage industry. Complementing the perception ofleadershipand dedication to the market were statistics that cited Northern Rock as one of the leading mortgage lenders during the period of the early 2000’s (Mclean and Elkind, 2003). With a wish to capitalize as much as possible on the conditions of the growing market, which included the American mortgage market prior to 2008, Northern Rock leadership opted to invest heavily in the subprime market that generated so much profit during this period (Dawley et al, 2012). This argument suggests that the old industry region that was home to the company’s operations had a direct impact on the initial success and eventual failure of the Ban.

This initial overview demonstrates that there was a real drive to produce revenue on the part of both of these companies, which in turn fuelled their need to succeed at any cost. In both cases, Enron and Northern Rock began with a legitimate business foundation, yet desired a continual increase in power and revenue which led to poor decisions and policy implementation. In a very real way, this brief illustration suggests that the success factor prompted these companies to act in the selfish and rash manner that brought about their downfall.

2. 2 Companies

2. 2. 1 Enron

The manner in which leadership creates, endorses and implements a company policy is a critical component to any entities day to day operations (O'Connell, 2004). In this case Enron leadership including Ken Lay, Jeffrey Skilling and Andy Fastow were primarily credited with first leading the company to incredible heights, and then engineering the massive failure due to their own incredible greed. Perhaps a leading indicator of the manner of leadership Ken Lay found appealing lay in his continual support of the oil trading company headed by Borget that was deemed acceptable as long as there was a profit, regardless of method (Swartz and Watkins, 2003). Organizationalculturebuilt on greed and corruption will continue to breed these same elements throughout any organization (Solomon et al, 2004). In this case Enron leadership's goal of creating a nature gas stock exchange was driven by the desire to increase market share and revenue. In the beginning this form of innovation and aggressive marketing were deemed acceptable, but with subsequent discoveries of accounts including M. Yass, or My ass, created by Borget there was an acknowledgement of corruption (Fox, 2003). Despite Enron initially endorsing Borget and his practices as the scope of the losses mounted, Ken Lay actively denied any wrong doing, taking advantage of the lack of information that he cultivated.

The lack of any serious form of financial oversight allowed Enron to create questionable forms of accounting and bookkeeping that extended their perception of propriety (Solomon, 2004). During deregulation effort of the late twentieth century, there was serious contention on the part of the business community that there was a need to reduce regulation in order to benefit the consumer. Leadership at Enron eagerly campaigned on the notion that deregulation would actively increase the capacity for the worker (Swartz et al, 2003). Blaming regulation for higher electricity the lobbyists were largely successful in their drive to remove any meaningful oversight in the industry. This push included a state by state approach that allowed Enron to utilize their regional positions to great advantage, thereby ensuring a smoother experience (Boje et al, 2004).

Skilling created concept of an asset lite strategy, or not actually owning the assets, simply bundling and selling the energy, which in turn provided Enron with a potential method to drastically increase revenue with little to no paper trail (Solomon et al, 2014). The summer of 1998 witnessed a bonanza for Enron as there was a perception of volatility that enabled them to drastically capitalize on the market, leading to the perception that Skilling was a genius (Swartz et al, 2003). During this period following deregulation many of the Enron’s greatest profits were made by employees finding loopholes and exploiting these accounting or business practices to the utmost in order to increase revenue (Arnold and Lange, 2005). Again, this policy of attempting to end run regulation only promotes the false ideal that the company or its employees was smarter than the system.

Enron has been credited with employing many questionable accounting techniques during their period of operation in order to bolster expectations (Gordon, 2002). This drive to provide a continuous profit for the company led the leadership to adopt accounting practices that did more to obstruct the revelation of negative data in order to maintain profits. A combination of being at the right place in the form of evolving deregulation and belonging to a culture of greed and corruption created the atmosphere that prompted these increasingly poor accounting practices (Macey, 2003).

At the heart of Enron's trouble rests a lack of strong corporate governance and an increasing disregard for public regulation and investor welfare (Vinten, 2002). Beginning with methods that merely bent the rules, the accounting practices at Enron had to become larger in order to account for the burgeoning debt that was being created (Parker, 2005). This form of creative bookkeeping suggests that there was a strong knowledge that operations at the company were not only limited in scope, but there was a need to make as much money as possible at any cost. This form of accounting was illustrated in the Mark to Market accounting expansion that served to misinform investors on accurate valuations, thereby increasing Enron's value (Shelly, 2011). While essentially legal, the stretching and reinterpretation of the rules allowed Enron to create a wide margin of profit on paper. Further, the use of limited partnership and outside parties increased the level of secrecy and uncertainty that surrounded every Enron valuation process including the Credit Default Swaps and Collateralised Debt Obligations (Swartz et al, 2010). These measures became necessary in order to provide the company with the means to maintain expectations, bonuses and pensions.

From the outset, Enron was out to make money (Jennings, 2002). Each innovation was aimed at delivering the most revenue to the leadership, not the investors. Each decision and example of culture illustrates the greed and ambition of those behind the Enron debacle. In the accounting profession a fair presentation is regarded as an accurate representation of a working operation, creative accounting is identified as flexible practice that best serves the interests of the clients, with fraudulent accounting made up of those that blatantly step outside the law (Buckley, 2011). Enron has displayed an initial fair value accounting method that degenerated into a fraudulent accounting method with evidence that paints a portrait of unrestrained greed, propped up by poor regulation and aided by tacit indulgence of success. There is a clear need to conduct ethical business in order to sustain opportunities (Gill, 2009). This was does not seem to have happened in the case of Enron. This evidence suggests that no matter how Enron had attempted to compensate for poor practice, there could have been no other plausible outcome than failure.

2. 2. 2 Northern Rock

Initially specialising in residential and commercial mortgages Northern Rock quickly became an industry frontrunner under the leadership of Adam Applegarth in 2001(Marshall et al, 2012). This form of leadership actively profited from the prior methods of operation, utilizing the past profit to invest in the present stock market, primarily the growing sector mortgage securities. Linsley and Slack (2013) argue that prior to 2001 Northern Rock projected a ethic of care, which in turn was cited for the intense feelings of betrayal following the collapse of the Bank. There was a sense that leadership of the Bank was overly ambitious in their efforts to capitalize on their existing assets by putting all of the previous savings at risk (Marshall et al, 2012). This suggests that the clientele of Northern Rock expected their leadership to take greater care and substantially less risk. Three primary points including Northern Rocks previous existence as a building society, the local or regional nature of the bank and the appearance of the Northern Rock Foundation bolstered the perception of a caring institution that was out to serve the populace (Linsley, 2013). With the change in policy brought about by a new leader, there was a palpable sense of anger and disillusionment with both Northern Rock and the direction of their investments. It very much seems as if was this effort from the previous eras, the caring and attentive attitude that served to amplify the negativity as the bank began to crumble under the weight of poor leadership and management. With the onset of the subprime collapse in the United States and the massive international recession that followed, it became impossible for Northern Rock to meet its financial obligations, which in turn prompted the failure of the bank (Linsley et al, 2013).

The innovative nature of the investment pattern such as the ' Together' investment scenario set out by Northern Rock was a stark departure from the mutualisation process of previous eras (Nesvetailova and Palan, 2013). With the ambitious investmentgoalsset out by Applegarth, it became necessary for the bank to move from the 75% per cent income from depositors to a much more modest 25% with the remaining balance being accounted for by investment and loans (Nesvetailova, 2013). As reflected by consumer discontent with the policy decision, the entire process became disliked and heavily blamed for the eventual run on the bank. The new pattern of investment required Northern Rock to pursue securitization in a fashion that created special purpose vehicles in order to allow these securities to become liquid and thereby tradable (Deegan and Unerman, 2011). This process allowed Northern Rock to obscure their accurate worth by essentially hiding these accounts offshore (Scott, 2008). With an accounting practice that was creative and innovative at the time, Northern Rock utilized this method in order to expand their projected revenues, thereby further enhancing their operations. In order to continue lending at the bank level, mortgages could be sold, or further funds borrowed on the mortgage securities, which in turn kept Northern Rock liquid initially (Gaffikin, 2008). This culture of greed no matter the cost fuelled the leadership drive to not only continue this practice, but expand it to incorporate up to 50 per cent of the Northern Rock operational platform (Deegan et al, 2011).

Depending too heavily on any volatile market has the potential to put any operation at risk at any time (Domhoff, 2013). This evidence suggests that Northern Rock was substantially impacted by the subprime mortgage collapse and the inability to borrow money from the lenders. With a business model that was directly dependant on the interbank lending process, this sudden halt of funding was a severe and crippling blow, only enhanced by the need for the bank to have these funds on hand in order to shore up fading public support. The perception of dismay and lack of trust only increased as Northern Rock found itself undercut by rivals with better loan rates (Deegan et al, 2011). With no ready pool of funding available and no one to purchase the securities, some of which were frozen due to questionable value, the internal situation deteriorated to the point of collapse nearly overnight.

Regulation and lack of effective constraints in the financial process has been cited as an element of the Northern Rock collapse (Nesvetailova, 2013). There was a sustained feeling that the explosive pattern of growth quickly overwhelmed any regulation effort, which in turn led to unsatisfactory testing and performance assessments. The caring culture that once benefited operations at Northern Rock was transformed to increased discontent with the announcement of the government bailout, which in turn fuelled the run on the bank (Deegan, et al, 2011). This evidence suggests that it was the very elements of safe investment that had given Northern Rock the opportunity for investment initially and that the prudent course of action would have been to maintain a pattern of considerate investment rather than an all-out bid for industry leadership. With the nationalization of the Northern Rock entity, the government became the only remaining investor, shouldering the substantial loss that had once been a thriving multi-generational company (Deegan et al, 2011).

3 Conclusion

Both Enron and Northern Rock exhibited similar and distinctly different traits as this study as illustrated. Each of the companies possessed leadership that was very focused on success and revenue. This culture of greed and ambition served to initially propel both companies into positions of leadership which was demonstrated by their drastic increase in value and recognition during the early phases. While both companies began with fair trade accounting methods, there were driving forces behind each entities operation after that period. Enron began to employ outright fraud in their accounting practices, in some cases going so far as to completely create fictional assets in order to maintain viability. In contrast Northern Rock employed creative accounting methods to legally utilize their existing assets to invest in the subprime mortgage market. While Northern Rocks leadership made poor choices, there was no element of blatant fraud as perpetrated by Enron.

There was a distinct organisational culture gap between Enron and Northern Rock. The ethic of careenvironmentenacted a perception of interest in the consumers of Northern Rock aided the long term business efforts and sustained operations over generations. Enron was focused on profit and the means to increase profit from the point of inception, creating management techniques that encouraged a liberal interpretation of any regulation, placing revenue generation above the need to present a high level of honesty during operation. A similarity that binds both companies together was the leadership intention to use the open market to increase their net assets. Further, there was a directed action by both management institutions to hide the debt from the consumer and investors in order to prop up their image and brand. Once considered pioneering, creative and innovative the combination of deregulation, massive growth and complex rules provided a wide range of opportunities that these companies chose to exploit for their own gain. Each of these entities found itself in the position that required them to borrow money in order to meet expectations. Lacking the means to borrow money was the death knell for both of these enterprises. Northern Rock found itself caught in the subprime mortgage collapse and Enron found itself the focus of scrutiny concerning their assets and true valuation.

In the end both Enron and Northern Rock exhibited poor policy decision as well as experiencing bad luck. While there is no guarantee in the business world, large scale deception and fraud will eventually come back to roost. It was the utilization of questionable practice, greed and ambition that served to derail these companies, teaching us all that honesty is indeed the best policy.

4 References

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