Causes of enron collapse

ASSIGN BUSTER

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INTRODUCTION

Enron Corporation, an energy company based in Houston, Texas, was involved in one of the most devious economic scandals of the 20 th century. The company was also a commodities and services organization that served much of the country. Multitudes of the financial reports that the company submitted were found to be grounded in a systematic structure that can be boiled down to simply accounting fraud (Wikipedia). Throughout the 1990's, Enron had been challenged many times on its relationship with the accounting firm Arthur Anderson. Questionable accounting techniques were brought to light, and many suspected that the stench of fraud was lingering around the business. During the profitable years Enron's stock price was above $90 per share. However, the scandal that eventually was revealed toppled the business in an instant (Bottiglieri, Reville, and Grunewald 1). The stock closed on November 30, 2001 at an ultimate low of 26 cents a share. Furthermore, December 2, 2001 hosted Enron's inevitable declaration for bankruptcy (Thomas 4).

Kenneth Lay, the founder of Enron, promoted the importance of high stock prices above all else. He pushed employees to focus on rising rates of return by trading assets and borrowing more money. An asset free balance sheet meant that new resources could come in and trick the public into thinking that the company was hugely successful (Tonge, Greer, and Lawton 6). Lay essentially began the craze for high earnings, an obsession that cost his company its life. Ultimately, it was Lay's role that set in motion the collapse of Enron.

Jeffrey Skilling, President, COO, and CEO (from February-August 2001), was the driving force behind Enron Finance Corp., an organization that became the middle man in gas line contracts. The firm would buy large amounts of gas from distributors and then sell it for a profit with a hefty aggregate of fees on both ends for the accompanying risks. The genius behind this idea was that it not only created a new product, but also a completely new standard for the trade (Thomas 1). Skilling led his company with aggressive moves that often traded assets that they didn't actually own at that time.

Andy Fastow, Enron's CFO, was a master at manipulating liabilities. He used a technique common among energy corporations that used special purpose entities to relocate liability away from Enron. He made it so that the stock price per share would continually increase, which allowed it to continually hold a high investment rating (Wikipedia). Fastow was the reason that Enron got away with the scandal for so long. He enabled the company to hide behind false information and comfortably take advantage of the system.

EXPLANATION

Four management truisms explain the Enron collapse. The firm ignored solid business practices and the result was a disaster that could have easily been avoided.

The first truism is simple: people do what they know will reward them, and refrain from actions that invite punishment (Crews 5). Skilling only wanted the smartest, most accomplished individuals working for him. He sought after them in the best MBA schools and challenged the top competing companies for them. While the work was difficult and the hours long, Enron

committed to providing the luxurious amenities that kept their employees working hard. There weren’t caps on these rewards, which pushed Enron employees even further (Thomas 1). Skilling set up an environment that was cut-throat and only cared about profit, which fostered an unhealthy workplace that was tolerant of executive wrongdoing. Non-standard accounting techniques and deal inflation became common practice, which caused Enron to collapse when they were caught. Enron employees knew what was expected of them based on what actions rewarded them.

Even the executives of Enron were pressured to keep up with the growth from the late 90’s. They knew that this type of growth was not sustainable, but continued the same practices never the less. These executives were rewarded for the consistent growth and knew that if it did not continue, they would be punished by credit agencies and trading partners (Sims and Brinkmann 245). This line of thinking ultimately led to major corner cutting during the exercise of very suspicious and misleading practices. This corner cutting then proceeded to plunge the company into massive debt without a reliable back up option. Unfortunately, everyone is shaped by incentives, even executives members. In fact, once they tasted success they were even more influenced by the rewards and punishments.

The Performance Review committee fueled a dog-eat-dog environment that rose up the top employees and axed the lower ranking ones. People were harshly discouraged to ask questions about the business dealings with the company. Very few people were willing to raise objections in this environment (Tonge, Greer, and Lawton 12). The forced group-think led to a broken system of checks and balances. If employees raised concerns they

were punished by demotion or firing, which was a nonstop cause for the company's broken moral compass. Left unchecked, illegal deals were made and accounting fraud became rampant. The entire system was fueled by rewards, punishments, and fear. Everyone in the company was subject to it. Even the ethical people in the company were misled, pressured, or scared into doing the things that the company wanted them to do.

The second truism states that all organizations don't have the same moral standard (Crews 8). Enron's risk manual supported the idea that reported earnings were merely what the accountant wrote down instead of a solid and reliable strategy for continual growth. The company fostered the philosophy that corporate and personal wealth could be captured by cutting corners and creating false accounting records (Stewart 119). There was a culture about risk management and wealth growth techniques that looked to the accounting records as an easy scapegoat to ventures that were not actually profitable. This line of thinking quickly led to the use of non-traditional and illegal accounting practices and then the collapse when the records were realized to be fraudulent. It created a system where the firm relied on money that was never actually theirs. Employees were taught by the risk tolerance practices that it wasn't necessary to share the ethical standards of other organizations. What was important to them was a positive number on the balance sheet and nothing else, a stark contrast to other companies.

Some companies approach the issue of underperformance with restructuring positions or relocating employees. Another approach is to fire workers without any second chances or support from the organization. Enron believed in punishing the lowest fifteen to twenty percent with dismissal, an

act that was managed by peer reviews. Therefore, the culture of Enron was one of distrust and paranoia (Sims and Brinkmann 251). Peer reviews caused mistrust and management was able to get away with many unethical practices with little to no fear of being challenged. Management's arrogance then led to unregulated practices that fostered debt creating strategies instead of profit creating ones like they reported. This also led to poor decision making and unsavory business practices that eventually imploded Enron. Ethical companies handled employee issues with respect and valued an employee's opinion. Enron handled its problem by creating fear in its organization and removing those that stood against them. The blatant disparity between these types of companies depicted a clear image of the differences in moral code.

When officials, both external and internal, decide to ignore essential ethical practices due to personal greed, it will most likely lead to investor loss whether or not regulations are enforced. This greed does not benefit the corporation, but instead simply destroys those interested parties that invest in the organization (Cunningham and Harris 29). The greed of high placed executives never was intended to actually help the company at all. Greed caused the downfall of both the corporation by developing a system where no one was actually looking out for the good of the company. The hunger fueled executives to make decisions in their own personal interest, at the sacrifice of the company, which led to the Enron collapse. The continual chase for more money set Enron apart from other more ethical companies and it became apparent where their priorities were. This company clearly was not like many others.

The third truism states that people and the organizations are not the same (Crews 1). Both Jim Alexander and Sherron Watkins, employees of Enron, informed Lay that they were going to get into trouble for the ethics break. Lay ignored these messages and continued business as usual and even denied that there were issues with accounting, trading, or reserves (McLean, Birnbaum, and Kahn). Both Alexander and Watkins tried to talk to the top executives and let them know that things were being noticed, but the culture at Enron was to look the other way and keep working. By ignoring the warning signs, Lay doomed the business to eventually fail due to disregarded malpractice and unchallenged illegal activity that soon became realized by the public. In this example the organization clearly had a different mindset than the two people that had concerns. They wanted to do the right thing, but the organization's mentality was completely different.

Partnerships easily and efficiently raised money for Enron, but came at the cost of setting up promises that could later not be kept. For example, Project Braveheart was an idea created with Blockbuster to deliver movies over phone line. Enron documented $110. 9 million in earnings shortly after the partnership was made. The project fell apart not long after its creation, but the profits were never seized (Prindle). The investments that Enron made were largely fictional and rarely actually profitable. They would promise partners money that had also already been guaranteed to a different partner. This eventually came crashing down as investors called in what was owed to them, leading to the Enron collapse. The partners had become part of the organization, but in no way did they want the same things that Enron truly wanted. The partners wanted a profitable relationship for both

companies, but the organization just cared about itself. Hence, Enron and its associates were very different.

Skilling obsessed over the business and had no problem doing whatever it took to be the best in the industry and continuously lied about financial numbers (McLean and Elkind “ The Guiltiest”). His strong personality, which often was described as arrogance, led to terrible ethical choices and if he thought that he had to change fiscal numbers he would. These compromises, driven by his reckless personality, crashed the firm into the ground. This example works in reverse compared to the other third truism illustrations. In this case it was actually the individual that negatively affected the organization. Skilling shaped the company how he wanted it to be, despite what it cost.

The fourth truism focuses on how ethical scandals are often not stopped due to useless in-house and external oversights (Crews 10). Deregulation laws in December 2008 gave energy traders too much power over prices. Consequently, Enron encouraged power blackouts in California in order to increase the price of reliable energy by up to 20x its normal value (Wikipedia). The deregulation of energy traders led to overconfidence in investments that Enron made because they thought they were in control. Arrogance caused them to risk more than they could afford, and when the market didn’t end up how they thought, it caused the collapse. The problem with the deregulation was that Enron was trusted to behave ethically. This oversight by officials gave Enron the perfect opportunity to take advantage of the situation and its customers.

Internal and external auditing must be done be separate corporations in order to be ethical. Arthur Anderson acted as both roles for Enron and in turn allowed them to partake in many practices that would normally not be acceptable. Anderson ignored the unethical business practices and instead supported a corporation paid for their massive consulting fees (Cunningham and Harris 43). Anderson wanted the streamline of money that came in with Enron’s partnership and it got to the point that they were fine breaking rules if it meant they could continue to make money. The accounting shortcuts they used to satisfy Enron were illegal and once discovered, caused the Enron collapse. Anderson was clearly in a conflict of interest and should not have been allowed to do the financial statements of Enron. If there were better restrictions in place the ethics scandal would not have been able to happen.

Enron strategically stacked its house with political representatives, well-connected up-and-comers, and well-known public figures. They placed people of similar mindset in the board of directors and audit committee in order to have someone in their corner when they needed them (Chandra 107). By hand picking the people of importance in their environment, Enron was able to break the rules when they needed to. Having their people on the board of directors and audit committee allowed them to essentially do what they needed to provide results, which directly led to many illegal activities, and consequently the breakdown of Enron. Regulations should have stopped Enron from placing their own people in external positions of power. The conflict of interest begged for abuse of the rules.

CONSEQUENCES

Enron, as a company, completely fell apart after the collapse. It was forced to renounce earnings with multiple partnerships such as Chewco Investments and JEDI. Then the company was forced to recall earnings all the way back to 1997, which only summed to $586 million and was only 20% of what had been reported. The stock prices fell to mere pennies and all consumer and financial buoyancy was lost. Shortly after, Enron declared bankruptcy (Prindle).

Enron’s shareholders did not benefit from the greed of the executives. Those that had their pension funds financed in the company lost almost everything. Consequently, the SEC and Congress worked swiftly to begin immediate restructuring to reduce losses like those experienced, in the future (Cunningham and Harris 29). A $40 billion lawsuit followed the collapse, demanding compensation for the shareholders’ worthless stock. The collapse destroyed more than $2 billion in pension plans (The New York Times).

The employees of Enron also greatly suffered and in most cases lost everything that they had invested in the company (McLean and Elkind “ The Guiltiest”). One employee, Charles Prestwood, lost $1. 3 million in the Enron collapse. Money entrusted in the company in retirement savings or investments disbanded overnight. After the collapse, the SEC stated that they would try and recover as much of the lost money as they could in their judicial system (The New York Times).

Enron executives also felt the consequences of the collapse. Paula Rieker was charged with insider trading when she sold just under $1 million worth of shares just a week before the collapse. Skilling was charged with 24 years in

prison due to mostly charges of securities fraud. Lay was charged with 45 years in prison, but died before the sentence was scheduled. Fastow was sentenced to 10 years in prison with no parole (Wikipedia).

Creditors involved with Enron struggled to receive all of the money that was owed to them. Enron sold CrossCountry Energy for $2. 45 billion in order to address some of the credit outstanding. When its last business was sold, it left Enron without any assets. In 2007, the company’s name was changed and set a goal to completely repay all creditors and end all its activities (Wikipedia).

LESSONS LEARNED

The first lesson that I learned was that there needed to be significant reforms in the accounting practices that corporations utilize. It is not enough to assume that they are doing the right thing and it is important to always be skeptical (Crews 1). Conflicts of interest are an extremely detrimental crutch in accounting and it made the Enron collapse essentially imminent. By restricting which accounting firms can provide services to an organization and also controlling how those firms are getting paid is a good step in eliminating conflicts of interest.

The second lesson is that the ethical choices of corporations need to be more closely monitored. If an organization is left unchecked, it has the ability to abuse the system and do whatever it wants. I believe that due to the Enron collapse people will pay more attention to how corporations operate even if they cannot directly control the ethics of the company (Silverstein). At least in this case there will be significant pressure to do what’s right.

The final lesson that I learned was organizations can be as ethical or unethical as they want. They will treat their employees, shareholders, partners, and creditors however they want. Sometimes corporations will act in their best short term interest, but there’s also the option to behave properly and look at the long term goals. Risk tolerance can be a good thing, but it is up to the corporation to decide how much risk they are going to take and at what cost are they going to take risks (Crews 8). We can do our best to regulate and criticize, but in the end it’s their call. We can only hope they do the right things.