Revisiting Enron Tragedy from the Perspective of Top Management Moral Responsibility

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ABSTRACT

In October 2001, Enron scandal unfolded, where the top management mishandled their privileges, manipulated with the data, gave priority to their own interest over others and failed to execute proper leadership actions which gradually led to the downfall of Enron. Arthur Anderson, the coveted public accounting firm also went belly up. Enron was undoubtedly the biggest audit failure and was also the largest case of bankruptcy in the history of an American organizations. In this case, we will revisit the incidents and view it in the light of issues that continues to plague the organizations, even today. We will also analyze the moral responsibility from individual's point of view as well as from the corporation's point of view.

Keywords: Enron, Financial scam, Bankruptcy, moral responsibility

Introduction

Series of corporate scandals surfaced with the filing of Enron bankruptcy in November 2001. Soon after, there was a wave of accounting scandals including World Com, Global Crossing, Tyco, Adelphia, Quest etc. Enron's problem was quickly pushed to the background by successive disclosure of misconduct of corporate which had been center stage at one time. Due to the unethical practices of its visionaries, Enron failed in large part. Observing the misplacement of the ethical compass of the top management at Enron, coupled with other factors that led to their misconduct is a very important information as how to deal with such ethical dilemmas and transgressions in the contemporary scenario.

Historical back ground of Enron Corporation

Enron can be considered as one of the most spectacular fraud scandals of all times. ENRON was forced in December 2001 to file for bankruptcy after the fraud investigations result was made public. The company was “provider of products and services in natural gas and transmission and distribution of electricity and communications for retail costumers” (Chary, 2004: Curall and Epstein 2003). To create a new energy company, Houston Natural Gas was acquired by Inter North in 1985. By combining several pipeline systems, Enron created natural gas pipeline system for the first time throughout the nation. Ken Lay was named as the new chief executive and chairman of the new energy company in

1986.

Almost a year later, Enron started its first overseas branch at England. Here, Enron followed a new strategy of uncontrolled pipeline market by controlled pipeline business. In 1989, Jeffrey Skilling joined Enron, where he launched a system called Gas Bank under which the supply of natural gas could be locked for long term at fixed rate by its buyer and at the same time, the firm started offering financial help to its oil and gas producers. Enron after acquiring Transport i.e. adora de Gas del Sur started expanding to South America and to the rest of the continent in 1992 (Hosseini & Mahesh, 2016). The corporation traded electricity for the first time in 1994 and it turned out to be one of the biggest profit centers for Enron the very next year.

In 1995 Enron as “Enron Europe” entered the European wholesalers market. In 1996, the construction of Dabhol power plant started in India but due to political issues and feasibility report the project was unsuccessful and was put on sale in 2001. Then Portland General Electric Corporation, the utility serving the Portland, Oregon (USA), was bought by Enron about a year later and then sold to Northwest Natural Gas Co. for about 1.9 billion dollars. In the very same year, Enron started its own Energy Services to provide energy services to commercial and industrial customers (Hosseini & Mahesh, 2016). Thereafter, Enron acquired Wessex Water in 1998 which formed the main basis of its water subsidiary “Azurix” and when one-third of Azurix share was sold to public, the price of the shares fell down sharply after early rise in it. This was amongst the first signs of deep-rooted trouble at Enron. In the same year, Enron Online, the company's commodity trading internet site started to operate (Hosseini and Mahesh, 2016).

In 2000, reflecting the importance of trading among the companies, Enron's annual revenue was 100 billion dollars but the problem with “Azurix” carried on and one senior employee, Rebecca Mark, resigned from her position. In the same year, Enron was ranked the sixth-largest energy company in the world, based on its market capitalization (Hosseini & Mahesh, 2016). While the top management was aware of the debt and illegal practices, until October 2001, the fraud was not revealed but surfaced when Enron announced its actual net worth of 1.2 billion dollars which was significantly lower than the previous year. This gave rise to an investigation by the Securities and Exchange Commission, which disclosed many illegal practices conducted by Enron official, investment banking partners, and the Enron's accounting firm- Arthur Anderson (Lucian & Cristina 2007). The most important dates in this fraud saga are October 16, 2001 and November 8, 2001.

On October 16, Enron announced that it had made losses in last three months, and in further dates announced that it had been overstating its revenue since last four years i.e. From the year 1997,which was approximately around 586 million dollars. The magnitude of the indebtedness of Enron was not depicted clearly in Enron's account at that point of time.

Fraud Analysis: Financial and Timeline Highlights

Until December 2001, Enron continued to be 'creative' in presenting its accounts to the world. Around 1990s, Enron expanded itself into many areas such as developing pipelines across the continent, water services, online trading services and a power plant, but in order to make these expansions possible it needed large initial capital to invest and very long period to develop. In order to achieve this, Enron raised huge amount of debt funds from the market which means more fund raising from the market would affect its credit rating. Enron was not making enough profits and at the same time for continuing doing business, it had to maintain its credit score. Hence, to achieve its purpose of attaining good credit score, it started making partnerships or acquiring other firms and at the same time started making other special “arrangements” like Special Purpose Entity (SPE) (Hosseini & Mahesh, 2016). The objective of these SPE or firm was simple: to remove all debts and losses away from its balance sheet to make its financial book looks good to the market, to the investors and maintain the good credit rating in the market (Adela, 2016). The strategy that Enron pursued was to find investors who would be willing to invest into financial arrangements with them and hence start various 'managed' entities in name of SPEs. Enron provided guaranty which would help SPE to draw credit from the market. Enron followed this policy so that it would enable several rating agencies and Wall Street analysts to appraise its financing book record attractively in their favour (Loss, 1983). Enron utilized various dependent sectors in raising equity by purposely not fulfilling various legal conditions by taking the advantage of existing lacunae in the law to reform its financial arrangements.

ENRON'S Management

Kenneth Lay (Chief Executive, Chairman and Board Member)
Enron was created in 1986 after the merger of two pipeline firms from Texas and Nebraska, and Lay took the responsibility as CEO of the newly formed organization. Lay was given full credit for the success of Enron before its collapse. After Jeff Skilling resigned in August 2001, Lay took complete control but had to resign in January 2002 as he was held responsible for loss of billions of dollars of its employees, stockholders and pension fund holders and was under the radar for the disaster (Leung, 2005, Hosseini & Mahesh, 2016).

Jeffrey Skilling (President, Chief Executive and Chief Operating Officer)
Earlier Jeffrey use to work for the consultancy firm McKinsey and joined Enron in 1990. Skilling was Chief Operating Officer at Enron before becoming Chief Executive. Skilling was one of the main architects of Enron's complex structure and strategy. Skilling resigned from his post in August 2001 without any pay-off (Hosseini & Mahesh, 2016).

Andrew Fastow (Chief Financial Officer)
Fastow was made accountable for creating the balance sheet that allowed the firm Enron to hide and

cover up its losses which was amounting to 600 million dollars and as a result he was fired from the company in October 2001. Fastow was also found guilty of secretly making 30 million dollars from these accounting frauds by an internal Enron investigation team (Hosseini & Mahesh, 2016).

Clifford Baxter (Vice Chairman and Chief Strategy Officer)

One of the Enron's most important executive members retired from Enron in 2001, May and committed suicide in 2002, January of guilt of wrong practices at the firm. He had opposed the company's creative accounting practices (Hosseini & Mahesh, 2016).

Enron's Auditor (Arthur Andersen) and its evaluation

One of the world's leading accounting firms, Arthur Andersen was Enron's auditing firm which means, Andersen's job was to keep a check on company's accounts and its fair functioning.

All the documents connected with the collapse of Enron were destroyed by Arthur Andersen. Early in 2002, it was revealed that documents were destroyed in October 2001 after the world woke up to the fact that Enron's accounting was faulty and would be investigated. This bought bad publicity to Enron as well as Arthur Anderson.

Arthur's did not keep Enron's Board aware of its concerns until 2001(Hosseini & Mahesh, 2016). Enron was at important risks that were not considered for public but were known to Duncan and others at Arthur Andersen in early 2001. There is also the issue of the 1.2 billion dollars' entry (debit) to notes receivable and entry to stock equity (credit). It is not allowed for anyone to record an increase in stock equity balanced and promises to pay the amount in the future according to accounting principles. It is not acceptable in accounting to record the increase in stock equity, but it is not considered as a big crime. Why was Arthur Andersen fooled? The true nature of the transaction was hidden due to complexity of SPE until 17 October 2001. We cannot rule out the possibility that Arthur Andersen were glove in hand with Enron and knowingly allowed the faulty entries. It is debatable It is more likely that the complex manner of structuring the transaction hid the transaction's basic nature, even to Arthur Anderson.

At what stage Arthur Andersen should have urged to demand to draw the curtain on the Raptors or the predators? There was no significant accounting issue concerned with the Raptors before the decrease in value of assets held by Enron. Raptors could no longer put their honors to the liabilities of Enron were known to all. We do not know when this happened, but it was somewhat before October 2001. The stocks equity held by Enron were not effective now should have been informed to high official at Enron.

There are many important issues related to the recording of debt, the timing of revenues, the timing of expenses, where the possibility of the assets not being actually sold is more.

Arthur Andersen had to face the trial in the court of public opinion where they were found guilty even before the legal trial took place. After Arthur Andersen was found guilty even before the actual legal trial by court of public opinion, then after many public corporations restrained themselves from hiring Arthur Andersen as its auditor. Even CFOs did not defend Arthur Andersen as the firm's auditor after its name was already defamed in public especially after it was found guilty by public opinion court. Hence Arthur Andersen was dissolved and shut down and later on the actual fact came out and it was found that Arthur Andersen was considered not guilty but still it did not help the already dissolved firm. (Alexander et al, 2002).

It is possible that the accounting errors made by Enron were not Arthur Andersen's responsibility and that, aside from shredding, no crimes were committed by Arthur Andersen before 2001.

Employees and Pension Fund Holders as a Victim

Thousands of people were left jobless due to collapse of Enron and many lost their personal investments and pensions and it had even left thousands of employees out of their work such as many employees who had personal pension funds made out of Enron shares, a very common scenario in America, where occupational schemes based on final salary payments are increasingly rare then the money purchase schemes, which are the norms. The company prohibited its employees from selling the stocks, and when the share price decreased and company's destiny became clear then in contrast, many Enron's senior officials themselves sold their share in return of cash.

The main causes for Enron's bankruptcy

Truthfulness

According to Kirk Hanson, the executive director of Mark Kula Center for Applied Ethics, the truth about the condition of the company was ignored by the management. Kirk was of the opinion that Enron had to save their face value and reputation by being the best in everything it does (Hosseini & Mahesh, 2016). About the probable rise in stock price and selling of the share, there is no confirmation that the CEO of Enron told his employees about the shares value. Shareholders came to know about the sale of shares by the CEO only after investigation regarding the bankruptcy of Enron was carried out otherwise as per the normal norms the employees as well as the shareholders would have never known regarding the sale of stocks by CEO for several weeks (Li, 2010).

Accounting system scandal (using "mark to market" and SPE as tools)

Mark to Market as a tool

Enron, being a public firm was subjected to many external sources of governance that includes regulators of government, and many private entities such as auditors, equity analysts etc. (Hosseini & Mahesh, 2016). Here we will focus and discuss only the main mechanisms. According to this method once a deal or contract was signed, the present value of the anticipated future value of the asset would be recorded in the current financial book. The traders at the firm were forced to predict the low discount rate and high future cash flows on the deals signed with firm in order to satisfy the investors to show consistent profit for the company. The net present value recorded by Enron in its financial book may not have taken place in future but still the calculated difference between the net present value and the originally paid value had to be considered as the firm's profit in its financial book. (Li, 2010).

SPE (Special Purpose Entity) tool

Use of SPEs allows the firm to eliminate SPE from its financial book statements if it has the full dominance over an independent party or at least 3 percent of the SPE is owned by them. Enron was very desperate to hide its debt as high debt would have alerted the investors and the sources of loans, that is banks. So due to this reason, Fastow, who controlled and headed the SPE borrowed large amount of money using stocks of Enron as collateral. Hence, the SPE allowed Enron to convert its debt and loans into income by overvaluing the books of account of Enron's financial report. The shareholders were in dark and were taken for a ride. (Li, 2010).

The Extent of Corruption

Was Enron corrupt? How evil was the Enron management to look away from such ghastly human tragedy?

When Arthur Andersen and Enron knew that investigations against them were pending, they shredded their documents. And huge amount of money was taken by Fastow and other senior officials of the company from the several related entities. While upsetting, these actions were not the core elements of Enron's bankruptcy. The SPEs were established and were utilized for hedging the accounting and the financial purposes for these entities. The accounting, economic and several other problems came into being when the losses became large. It is interesting that the accounting for Chewco would have been technically acceptable (if not admirable) if an additional 7 million dollars of independent equity had been raised. These were not consistent with the traditional objectives of financial accounting, but they did not indicate any thing about the existence of corruption. No one guessed that Lay and Skilling were not paying much attention to the accounting and financial entries in details which at that point of time was most important and desirable thing to do. Although clever, Fastow failed to consider the consequences of a severe fall in the value of the merchant assets and the value of the SPE's assets. Fastow had established a house of cards which could not even withstand a little breeze. The auditors and the CFO of Enron did not keep the Board adequately informed. The investment banks and commercial banks and several other related banks helped Enron to raise the capital for Fastow to play his games.

After the investment banks had some idea that there was some problem with the accounting and financial details then the Analysts advocated about the Enron stocks. This could be an illustration of the analysts saving out the investment banks or it could have been that the wall between the investment banking and security analyses actually worked.

Damaged and Misplaced Loyalties

Top level management at Enron were loyal to themselves and to the top leadership. Very little thought was put into the interests of stakeholders like shareholders, foreign governments, local communities etc. Employees seemingly trusted Lay's hopeful approach for the company (Johnson, 2003). The sense of betrayal felt by Enron's employees increased their pain of losing jobs and retirement savings as they were regularly betrayed by their own top management officials.

Irresponsible Behavior

Enron top management officials reacted very negligently by failing to take required course of action, to conduct genuine oversight, and to shoulder liability for ethical blooper of the firm by failing to take required course of measures to maintain the ethical status of the firm (Johnson, 2003). Some board members at Enron did not recognize the proceedings or working operation of the firm as the then CEO Lay down played them with financial corruption warnings. Many a times it happened that the top officials use to leave their employees on their own to take required decisions and encouraged them to earn profit and increase the number for the company by any possible means by which they can. But then after the collapse of the company none of the top officials came forward to accept blame for what had happened.

Sharing the Blame:

Finding out the entities who can share the blame for the collapse of Enron have resulted in the formation of long list that includes:

1. The transactions that were not understood were still carried out and not stopped by the top level Enron's high official management and board (maybe they did not know about it).
2. Investment, commercial banks and other banks for not identifying the pitfalls for Enron associated with complexity and large amounts of leverage.
3. Of all dispute of interest in situations, the law firm did not inform the Enron's high official management about it.
4. Rating agencies and security analysts that did not insist on better updated information.
5. The auditors seemed to be too permissive.
6. Many of the transactions that can be condemned were initiated by the CFO.
7. Investors who paid too much for the stock (hindsight helps us with this one).
8. The hiding of the debt at Enron was initiated by the designers of the accounting rules.

Moral Responsibility and ENRON'S collapse

How Top Managers Were Responsible

The individuals who must be seen as the main bearer of moral responsibilities are: Lay and Skilling who allowed Fastow, to secretly build a private institution for illegal transfer of property. In turn

Fastow, performed the crime of wrongdoing by breaching the professional ethics. Thereafter, Lay and Skilling, ordered the less famous or displayed employees to perform the unlawful act, then these employees are also morally responsible for their unlawful deed (Pasha & Seid, 2006). But it's quite clear from all the facts that came up that Enron senior management's moral compass was definitely misplaced. The harm to the company face value and reputation has already been done through a negative recognition of corporate ethics. Arthur Andersen violated its industry specification by being part of this corrupt deed.

How Corporation Was Responsible

The corporation acts for managers are assigned to the firm as long as the managers continue to perform conscientiously within their boundaries. The entire corporation cannot be held responsible for the fraud as the shareholders and other investors of Enron were misled by the false hike in stock price and had no idea about the unethical undercurrent. But one must say that if the board and shareholders of the firm had looked into the decisions made by the chief executives and those important employees more closely and clearly, then ENRON could have avoided this debacle.

Conclusion

The top most management at Enron misused the benefits as well as the power. It exploited the correct data and at the same time were appealing at odd therapy of external and internal constituencies (Johnson, 2003). These selfish leaders gave priority to their own interest over others and miserably failed to put forth their responsibility that ultimately led to Enron's bankruptcy.

Therefore, there is a need for the directors and other key member of different corporates to follow particular examples in following matters:

Firstly, in any company there should be a well-designed and well-organized corporate culture. But in this case, the firm's working environment and its culture played the lead role in the collapse. Enron's top management was very high in achievement orientation. They had an unfailing belief in their ability to be industry disruptors and trend setters. However, somewhere along the line they turned their focus more on the ends and less on the means that they adopted. Perhaps, they also had a misplaced belief that they will be able to turn things around and make money for all the stakeholders (Sims & Brinkmann, 2003). When the company failed to perform and losses became evident, to protect their reputation and image in the market they started focusing on to cover the losses they faced instead of focusing on how to make everything right. They succumbed to the pressure of keeping up the pretense of running a good show. Therefore, the directors and board members of any company should pay more attention to adopt transparent and conscientious practices, especially when things start looking bleak. There have been innumerable examples of such ethical lapses since Enron. In the Indian context, the most spectacular example was the Satyam case, where Raju admitted that that *"it was like riding a tiger, not knowing how to get off it without getting eaten by it"*.

Secondly, to have the full information about the working operation of the company, one has to get a more secure system to advice and supervise its management and executives. The board of directors and even the top management authorities should keep an eye on not just the behavior and actions of its employees but also on how money is being earned and reported. In response to the Enron debacle, Sarbanes Oxley Act, 2002 was legislated, revamping the role of regulators as well as introducing a heightened sense of responsibility to be assumed by the management.

Third, Skilling and Fastow used **"Mark to market"** accounting method to hide the losses and to push the Enron's stock price was not just immoral but also illegal to gain in a long-term period. Later, US Exchange Commission gave permission to Enron to use "mark to market" method of accounting which lead to the final scandal. Hence, an accounting regulatory body should be careful in allowing creative methods of accounting. People doing business should be focused and give more importance to business ethics. Had the whistle blower come forward sooner in the Enron case, many repercussions of this debacle could have been averted.

It is worth mentioning that after Enron scandal corporate executives are more careful about tampering with accounts that might be inaccurate (Hosseini & Mahesh, 2016), which would lead them to face criminal liability as a direct result of introduction of the Sarbanes Oxley Act, 2002.

Unfortunately, the issues that plagued stakeholders continued to two decades after the Enron scandal. It is sad to note that the corporate world has learnt very little from this experience. The important question is that are we ready and trained enough to share this tragedy of this corporate scam to our young managers and expose them to these malpractices so that in future they will always be aware to avoid these fraudulent practices.

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