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Case Analysis: Enron; Ethics, Social Responsibility, and Ethical Accounting as Inferior Goods?

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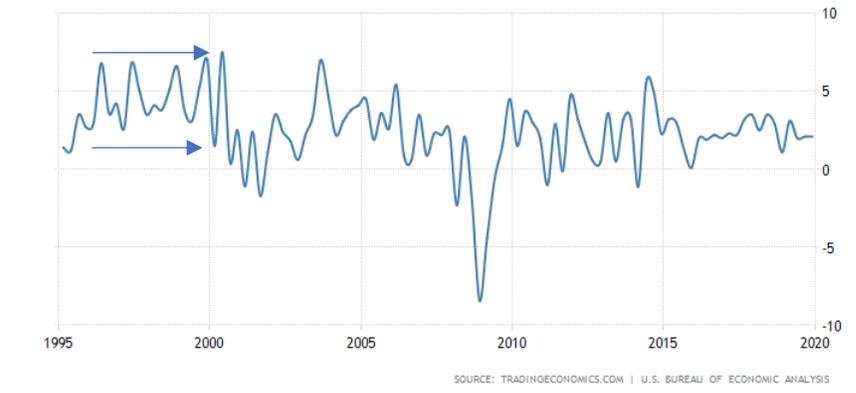
Abstract

In 2001 soon after the Asian Crises of 1997-1998, the Dotcom Bubble, 9/11, the Enron crises triggered a fraud crisis in Wall Street that impacted the market to the core. Since then scandals such as the Lehman Brothers and WorldCom in 2007-2008 and the Great Recession have surpassed it, Enron still remains one of the most important cases of fraudulent accounting. In 2000's even though the financial industry had become highly regulated, deregulation of the energy industry allowed companies to place bets on future prices. At the peak of the dotcom bubble Enron was named as a star innovator but when the dotcom bubble burst, Enron's plan to build high speed internet did not flourish and investors started to realize losses. Furthermore, the financial losses of the operations were hid using the market to market accounting technique instead of book value and using special purpose entities to hide debt. The root cause that was identified as a company with a toxic corporate culture focused on officer compensation rather than social responsibility and hence faulty leadership. Is it possible then that; ethical accounting practices, social responsibility and ethics all become inferior goods as income rises in an 'irrationally exuberant' era?

JEL Codes: N0, M1, M4, M12, M14, G32, K4, K32, H12

Keywords: Enron (ENE, ENRN), Dotcom Bubble, Accounting Fraud, Deregulation, Speculation, Corporate Culture, Social Responsibility, Government Intervention, Risk Management, Consumer Behavior, Energy Markets

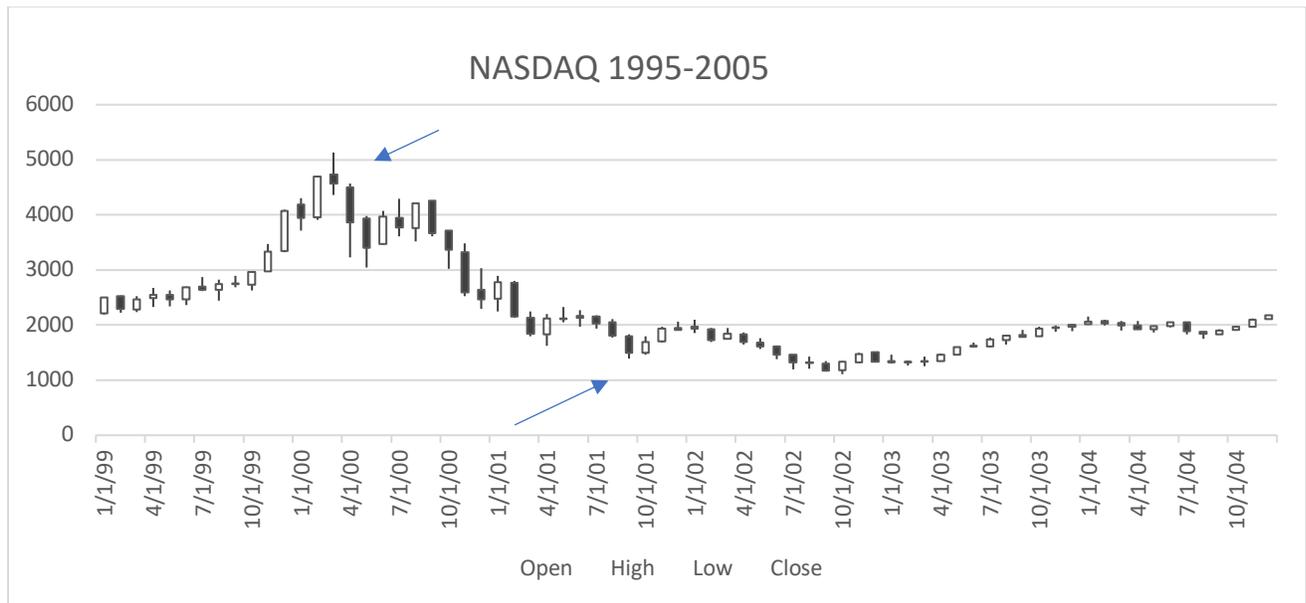
Introduction



Source: GDP Growth Rate 1995-2020; Trading Economics;
<https://tradingeconomics.com/united-states/gdp-growth>

It would be putting it mildly to say that the end of the 19th century was definitely not a stable utopian turn of the century. Not only were international relations strained to an extreme, the underlying moral culture of the economy, gleeful in its flurry of technological advancement, crumbled on itself. The Asian Crises, terrorists' acts, and an 'irrationally exuberant' stock market resulted into a chain of events that causes ripples to present day times. Enron the energy market favorite became embroiled in a fraudulent controversy that shattered the consumer and business confidence in the economy. The government bailouts have resulted into controversial debates on accountability that have lasted the past two decades with numerous complicated financial regulations holding the current financial markets accountable. (Rashid, 2019)

Literature Review



Source: NASDAQ 1995-2005; Index Data, Constructed from Yahoo! Historical Data Sets;
<https://finance.yahoo.com/quote/%5EIXIC/history?p=%5EIXIC>

The Wall Street Darling

Enron was born a merger between two gas pipeline companies in 1985, providing natural gas related goods and services throughout the US. By 2001 Enron was ranked a 7th largest 500 fortune company showing an exponential growth in revenue an increase from \$31 billion to \$100 billion between 1998-2000. In later years it was reported that the claimed \$979 million net income that year was really \$42 million. Furthermore, instead of the cash flow being positive a \$3 billion, in reality it was a negative \$154 million.

An audit of the corporate culture reveals an apathetic and exacting culture. The Enron culture is one that is aggressive and arrogant but prides in adhering to corporate values, but these values exist only on the surface, and increased risk taking on behalf of the shareholder to enrich

the corporate officers is a norm. A fierce “rank the yank”, “death of the messenger culture exists, impeding transparency and ethical work practice. A 2002 New York Times Article by details the overly competitive pay structure and lavish compensation being a standard at Enron, setting a bar and exceeding the standards of other Wall Street firms. Organizational culture is independent of effective leadership and occurs even if effective leadership is not present. In an organization where leaders show a tolerance and indifference for misconduct, will likely lead to a culture where employees cut corners and take excessive risks to derive profits.

The Major Players

Whistle Blower: Enron Vice President: Sherron Watkins was given the task to sell off assets, but she was worried with the high-tech bubble bursting and Enron’s stock prices slipping. Watkins was also responsible for finding unclear of-the-books arrangements backed only by Enron’s deflating stock. Watkin’s prepared a seven-page report that outlined her concerns about accounting scandals, but the report was found to be inconclusive by the CEO, the Chair and a third-party Arthur Anderson. In the October of 2001, Enron was reporting. Third quarter loss of \$618 million and \$1.2 billion write-off tied to the partnerships that Watkins’ had warned about. (Ferrel, Fraedrich, Linda, 2017)

CFO: Andrew Fastow a CFO of the year in 2000 was indicted on 98 counts for inflating the profits of Enron. The charges included, fraud, money laundering, and obstruction of justice.

- Fastow was the brain behind the operations to conceal a \$ 1 billion Enron debt, and this was directly responsible for the bankruptcy
- Fastow was responsible for making \$30 million by using kickback and partnerships.
- Fastow initially pleaded non—guilty but changed his plea to guilty and admitted to scheming and hiding Enron debts and inflating profits and became a key witness against Lay and Skilling. (Ferrel, Fraedrich, Linda, 2017)

CEO: Jeffery Skilling the CEO of Enron was considered to be the mastermind behind the Enron crises and was one of the hardest to prosecute. He attributed the failure of Enron to; “run on the bank” and a “liquidity crises”.

- The judge instructed the jury to that it could find the defendants guilty of consciously avoiding knowing about the wrong-doing of the company.
- Skilling was found guilty of honest service fraud and sentenced to 24 years in prison.
- In June 2010 the case was send to a lower court to be reevaluated. . (Ferrel, Fraedrich, Linda, 2017)

Chair: Ken Lay was the CEO and chair of Enron in 1986 and was responsible for promoting Skilling. Lay was expected to be charged for insider trading and as to why he had begun selling his stock worth \$80 million in late 2000’s.

- 19 counts of fraud, conspiracy and insider trading, but the verdict was thrown out in 2006 when Lay died in Colorado and the ruling protected \$43.5 millions of Lay’s estate that was claimed to have been stolen from Enron. . (Ferrel, Fraedrich, Linda, 2017)

Lawyers: Enron was a client of Vinson and Elkins and accounted to 7% of the firms \$450 million in revenue. The lawyers dismissed the whistleblower allegations and came under scrutiny regarding allegations of providing opinions regarding Enron’s special purpose partnerships. The firm did not admit to liability but paid Enron \$30 million to settle the claims of collapse. . (Ferrel, Fraedrich, Linda, 2017)

Merrill Lynch: Merrill and Lynch also came under scrutiny from prosecutors and the SEC for its role in Enron’s finances, starting with Enron’s 1999 sales of Nigerian barrages.

- Enron recorded \$12 million in earnings due to the Nigerian deal and hence meeting its earnings goal at the end of 1999.

- M&L allegedly bought the barges for \$28 million of which Enron financed \$21 million.
- M&L went ahead with the deal despite internal documents and sources advising that about aiding and abetting Enron's fraudulent transactions.
- Replacement of a research analyst due to Enron threatening to exclude M&L from a \$750 million stock offering.
- Paid \$80 million to the SEC to settle for the Nigerian deal.
- Risky practices by M&L continued till 2008 and it was bought out by Bank of America for \$50 billion. (Ferrel, Fraedrich, Linda, 2017)

Discussion

From our earlier analysis of the Enron situation and the major players, we can surmise that excluding the whistle-blower all of the major players had an important part to play in the downfall of the company. It has been argued that corporate culture and leadership play a big role in creating ethical and non-ethical practices in a company. Not only is the corporate culture and leadership of Enron being in questions but also of its major stakeholders who contributed to the crises.

Corporate Culture and Bankruptcy: Enron was considered a Wall-Street darling in the years prior to its bankruptcy and it posted exponential growth of revenue. But an audit of the corporate culture reveals that it had an apathetic and exacting culture. Furthermore, power was exercised in circumstances that would lead to a mis-use and abuse of power- Reward and Coercive power is apparent in Enron's culture, with reward power being a gateway to self-interest, and coercive power being a gateway to low transparency and fear in the organization. An article by Banerjee and Barboza (2002) in the New York Times, details the extravagance that was present in Enron. "For years Enron Corporation thrived on spending big and even as late as October – with warning ringing loudly about its rickety finances – no one at Enron saw any reason to change."

Banker's, Auditors and Lawyers: Enron was a very influential company and hence retained the best of talent both internally and externally. But the corporate culture of the firm and leadership was such that it had a negative impact on the external stakeholders as well. It can also be argued that the corporate culture and leadership of the external stakeholders was in itself faulty as they failed to prevent and disclose the wrong-doings at Enron that resulted in its demise. Vinson & Elkin's were responsible for dismissing the whistleblowers complaints, and their help in structuring special purpose entities.

Merrill and Lynch was responsible for engaging in business with Enron even though internal reports stated that it would lead to aiding and abetting. Furthermore, fear of a retaliation from Enron a \$750 million stock offering, was enough to offset any concerns Merrill had regarding ethics and going even as far as to replace research analysts who would not comply.

Arthur Anderson a prominent accounting firm was implicated during the scandal. Andersen was retained by Enron for about \$50 million a year but the was indicted on charged of obstruction of justice for destroying relevant documents and hence Arthur Andersen was barred from performing audits. . (Ferrel, Fraedrich, Linda, 2017)

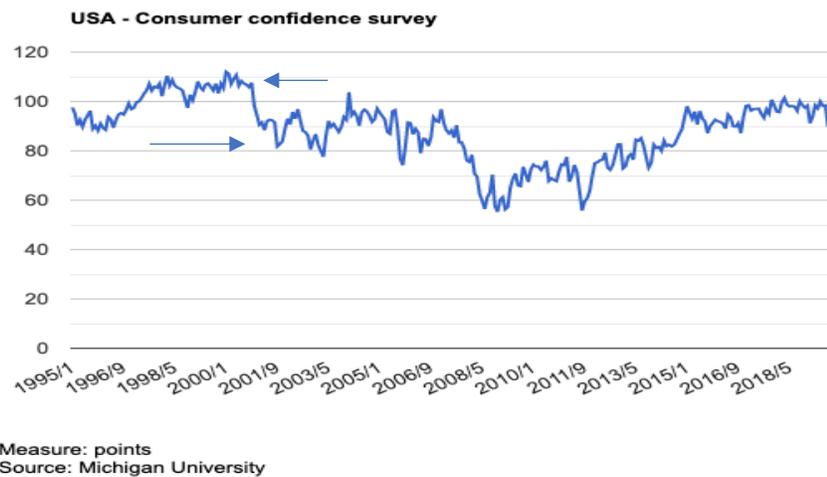
The Role of CFO in the Crises: Andrew Fastow named one of the best CFO's of the year was found responsible for embezzling both share-holders and other stakeholders. As a fiduciary has CFO position is a high-end responsibility that requires exemplary leadership skill. Being an award-winning CFO and then setting an example for people in the company is vital to the financial success of the company. As CFO, Fastow is privy to sensitive material that is important financial success. Using and building on referent power instead of aggressive coercive power can lead to healthier corporate culture. Enron was a competitor to one of most well-known Wall-Street brands.

Enron's 2000 Reported Revenue vs. Similarly Sized Companies: Too good to be true?

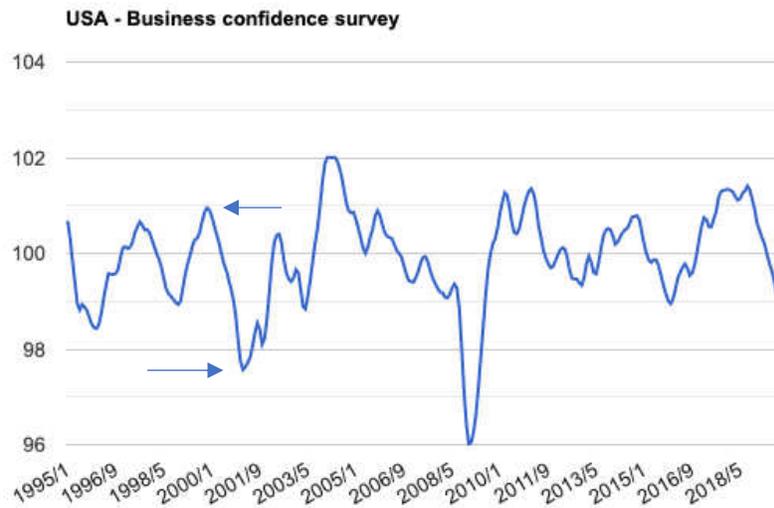


Source: Enron Revenue Comparison, Investopedia,
<https://www.investopedia.com/updates/enron-scandal-summary/>

Impact on Consumer and Business Sentiment: The turbulent point time represents a cascade of events that rattled consumer and business confidence in the economy. This series of event culminate in the Great Recession and government intervention is required to restore investor confidence. The Consumer and Business sentiment represent index that are important indicators of trustworthiness in the economy.



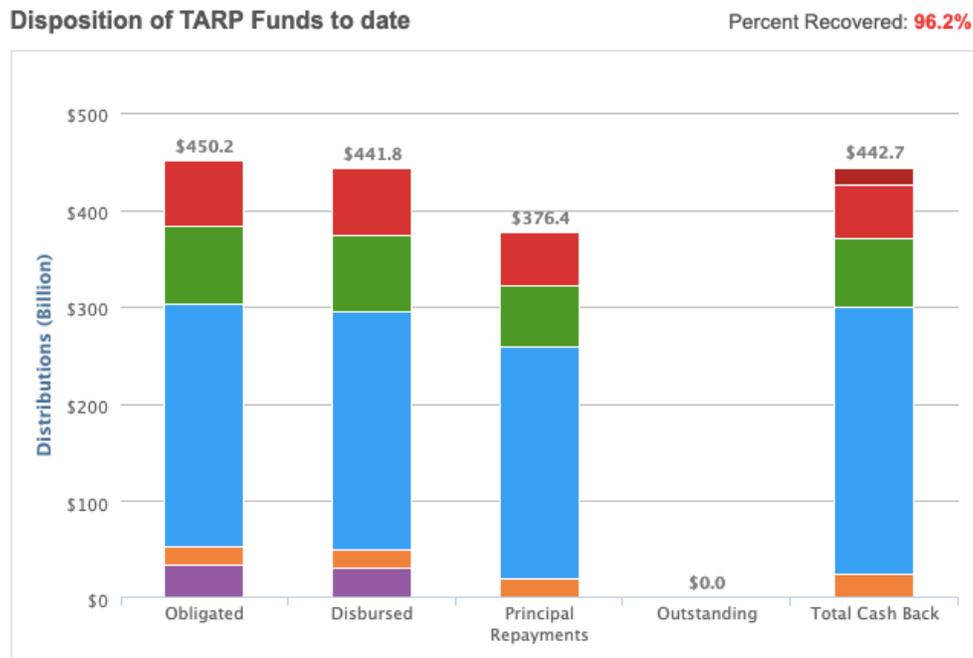
Source: Consumer Confidence, 1995-2018, The Global Economy,
https://www.theglobaleconomy.com/USA/consumer_confidence_survey/



Source: Business Confidence, OECD, The Global Economy,
https://www.theglobaleconomy.com/USA/business_confidence_survey/

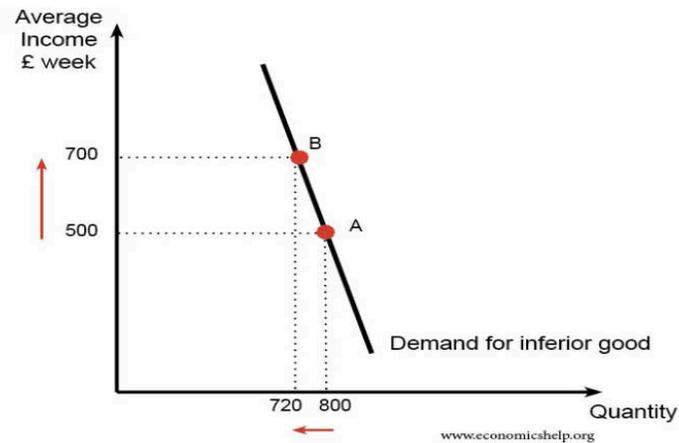
Both the Consumer and Business Confidence show a decline in the years of 2000-2001. The fall in NASDAQ, the Enron Scandal and the local and international reinforce our analysis about the gravity of our position. The Consumer and Business Confidence is developed by Michigan State and OECD respectively.

Great Recession and Government Intervention: The Sarbanes-Oxley act was a response to the Enron scandal allowing for more restriction on companies. But the negative impact of the scandal was large, and four thousand employees suffered unemployment issues and retirement and pension issues. The culminating impact was felt more acutely in 2008-2009 with the subprime and the credit default swap markets and the trillion-dollar TARP payments. According to an article by the U.S. Treasury, “Congress authorized \$700 billion for TARP in October 2008, and the authority was reduced to \$475 billion by the Dodd-Frank Wall Street reform and Consumer Protection Act (Dodd-Frank Act).” (treasury.gov)



Source: TARP Tracker 2008-2019, U.S. Treasury,
<https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx#All>

Ethics, Ethical Accounting and Social Responsibility as Inferior Goods: We have conducted analysis on several specific data points in a time-line that holds important financial positions in the financial, business and economic history of the U.S. Our earlier analysis of GDP growth rate shows a peak right before the Enron crises in 2001 and peak right before its dismal decline in 2007-2008. Is it then possible to hypothesize that once the income level of individuals increases the likelihood of scandals goes up as risk and reward increase? Are ethics, social responsibility and ethical accounting inferior goods whose demand goes down once income rises? This would hold to be true for all the executives who have been held responsible in the scandal. Hence, then the opposite would hold true as the damage to the society increase and income goes down, demand for ethics, social reasonability and ethical accounting increases leading to indictments and convictions.



Source: Inferior Goods, <https://www.economicshelp.org/concepts/inferior-good/>

Conclusion

In this paper we examine the years of 2000-2001 and the timeline of Enron, combined with the Asian Crises, Dotcom Bubble, International and local relations, and the Great Recession. It is not unlikely to believe that the financial crises and the dotcom bubble of 2001 were important factors in the fall of Enron. Furthermore, we audit Enron and its culture and ascertain a culture that is full of abuses of power, arrogance, and unneeded extravagance. Furthermore, the star-studded leadership does not lead by example but instead embezzles, the company and the stock holders. There is no focus on corporate social responsibility, or fiduciary responsibility. The culture of the firm and the extent of the corruption is a contagion that has spread to the lawyer, the auditors and the bankers. The Enron scandal and the collapse of the dotcom bubble is a major factor in the fall of NASDAQ and the fall in Consumer and Business Confidence and the consequent Government Intervention and Financial Crises. This paper also further hypothesizes about the possibility of ethics, social responsibility and ethical accounting being inferior goods and points towards peaks in business cycles and financial crises as evidence.

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