Enron Case Analysis

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Executive Summary

This case analysis will talk about the local, state, national, and global effects of Enron's corporate decisions that led to the company's bankruptcy in 2001. The case will give an in depth discussion about Enron and their business practices. It will also explain the social environment the company faced and what caused the decisions that led to Enron's demise.

The case will first give a background of Enron and the electricity industry, then go on to explain how they got into the situation they faced. The case will then describe the corporate culture of the company as well as the major cohorts involved in decision making. Some of these cohorts include the top executives, shareholders, and board members.

The case will then discuss Enron's accounting practices and their financial statements. It will explain why Enron made certain decisions and who benefited from making these decisions. Then the paper will discuss the underlying issues involved in the Enron scandal.

Finally, the paper is wrapped up by personal reflections and recommendations for the company and others involved. Suggestions are given of what Enron should have done in order to never get into the trouble they did, and also what the company can do now to regain face.

2.0 Company History

Enron was founded in 1985, when two small natural gas companies, Houston Natural Gas and InterNorth, merged and become Enron. InterNorth was a natural gas company based in Omaha, Nebraska. [1] This gave the company a large customer base and over 37,000 miles of pipe. Later in 1985, Enron merged with Florida Gas Transmission's, another natural gas company with operations mostly in the Southeast United States; this nearly doubled Enron's amount of customers. [1]

Enron has been led by company CEO Kenneth Lay from 1985 till 2001 when he abruptly resigned for personal reasons. [7] Lay made Enron into the caliber business they were in 2001. He was the advocate of going overseas and was truly a leader and a visionary. After Lay resigned in 2001, Jeffrey Skilling took over as CEO. Skilling had worked for Enron since 1991, working his way up to CFO and President of the company. [6] Skilling's tenure as CEO did not last long, resigning in only six months. [2]

On December 2, 2001, Enron filed for chapter 11 bankruptcy. They were the largest corporate bankruptcy in the world (until WorldCom one year later). [3] There were many factors that led up to this huge collapse of one of the largest electric companies in the world. From their company's corporate culture to their corrupt accounting practices, the company as a whole was not operating on sound business principles.

3.0 Organizational Mission

In 2001, Enron was the largest supplier of electricity in the United States. [3] Enron also served over thirty countries and employed over 18,000 people. Enron had been rapidly expanding since the early 1990's. Enron's mission was to be the leading supplier of electricity in the world. Because of this, Enron's executives put huge pressure on employees to be the best. Every year since the early 1990's Enron has expanded its presence into more countries to pursue their mission and become the largest energy supplier in the world. [4] This strong drive for expansion also relates directly to why the company ended up in disaster.

Enron had encountered large scandals as early as 1987, when the company itself was only created in 1985. [6] These scandals never disappeared because top executives (mainly Kenneth Lay) did not act appropriately when these reports were discovered. In 1987, it was discovered that one of their New York offices was involved in a Billion dollar scandal. Lay chose not to fire the any of the people involved, but instead to cover up the situation. [6] This action paved the way for others to get away with these unethical practices. If Lay had fired all those involved in the scandal in 1987 Enron would not have been in the same problems in 2001.

4.0 Market Conditions

The electric industry in the United States was privatized in 1987, thus taking all governmental control away from the industry. [2] With the industry deregulated it allowed electric companies of all types to compete with each other on any level. Companies that had previously been controlled by the government and had a monopoly now had to fight to survive. This allowed Enron to expand rapidly in the United States as well as overseas. Later that year Enron began building operations in the UK. In 1993, Enron built the Teesside power plant in the UK. This was the world's largest gas-fired heat and power facility producing 1,875 megawatts of power. [1]

5.0 Accounting Practices

Enron's top executives and their board members measured performance strictly by the numbers. Actually, it was just one number that they truly focused on, the share price. For those at these top levels, the share price determined how much money would end up in their own pockets. Enron was seeking short term success while damaging their future. "It was Skilling's relentless push for creativity and competitiveness that fostered a growth-at-any-cost culture, drowning out voices of caution and overriding all checks and balances." [6] This describes the feelings of several of the accountants that were aware of what was happening.

5.1 Bonus Program

Another key reason for these incorrect accounting statements was the company's bonus program. The program gave managers bonuses when they created deals with new customers. [6] The problem with this was that they were paid when the contract was made, not when the contract was actually carried out. So when a deal would go sour the managers would still get their bonuses. Also, the amount of the bonuses was a percentage of the estimated revenues earned from the deals, not the actual amounts made. [5] This led to managers claiming a project will make more than it actually would produce. Enron was rewarding their managers for stretching the truth. According to Tom Folwer of the Houston Chronicle, "Enron's obsessions with bonuses, the stock price and exotic accounting" were also growing out of control since the early 1990's." [6]

5.2 Mark to Market System

Upper management also led the way for corruption with the creation of the "mark to market" accounting system. When Skilling became chief operating officer he implemented this system to make the company more attractive to investors. [6] This system allowed managers to use the estimated figures of the future in financial statements. Instead of using actual numbers, most of their numbers they used were estimates of future cash flows. Since they also rewarded bonuses according to these numbers, the numbers tended to be inflated. This is the reason Enron reported gains from 1997 to 2000 when it was later reported that they actually lost 600 million during this period. [7] The culture of the company for the most part supported these accounting practices, but when there was a conflict or someone spoke up, that person was removed from their position. [6] This left little opposition to their faulty business practices.

6.0 Culture

Enron over the years created a very distinct culture that actually rewarded unethical behavior. Instead of hiring managers for their management skills, they hired aggressive young candidates right out of college, so they could instill their values upon them. [6] Most of these people knew little about management, but were smart, bold, and aggressive. These were the type of managers Enron wanted to create deals and expand the company at all costs.

6.1 Financial

Much of the company's finances were done by Arthur Anderson accounting firm. [2] This meant that the corruption ran deep within the company. For every new deal being made was supposed to be reviewed by the legal department of the manager, the corporate legal department, the chief risk officer and chief accounting officer (Arthur Anderson). [6] But in practice many of these people were often skipped. When Carl Bass of Arthur Anderson spoke out about an unethical business deal being made in 1997, he was quickly demoted and taken off that project. [6] This type of leadership, promoted the unethical practices that were occurring and did not care about the consequences.

6.2 Supervision

Skilling, who was the chief financial officer (CFO) before becoming CEO, was a major part of the disaster created by Enron in the 1990's. Skilling was not interested in day-to-day operations, and only wanted to know how much the company was earning. Skilling delegated most of his authority to the Chief Accounting Officer Rick Causey. [6] Causey reported to Skilling and simply told him how the different businesses were doing. Since Skilling did not check over most of the spending, only the company's earnings, it allowed managers to do whatever they wanted. This attitude of not caring led to unorthodox spending and ridiculous expansion projects.

7.0 Affects on the Local Community

With the collapse of Enron came the immediate loss of jobs for 4,000 workers in 2001. Thousands of others have since lost their jobs due to liquidation of investments and reorganization efforts. Many of these employees have lost their savings, their retirement funds, their health insurance, and their income. This has not only bankrupted the company, but it has also bankrupted many of the former employees who can no longer pay their bills. With all of Enron's bankruptcy proceedings employees no longer know where to go to obtain severance packages or health benefits. Many employees made deals with the company before they went under, while others received nothing. Two years later and some laid-off employees are still not receiving any severance packages, nor do they have any health benefits. These lost jobs have significantly affected the economy in Houston, Texas where most of these jobs were lost. The city is suffering from thousands of lost high income jobs and is also seeing many of these people relocate to other areas of the country.

7.1 Worldwide Effects

The collapse of Enron on December 2, 2001 caught the attention of companies worldwide. Many corporate executives were actually thankful that Enron got caught before they did. [5] One critic, Marianne Jennings, a professor of legal and ethical studies at Arizona State University, says "The collapse of Enron will be better for the economy as a whole in that it will force companies to change their business models." [5] Such detrimental events as this have huge ripple effects. This incident has made other companies aware of the importance of ethical behaviors and proper financial recording. Because of this companies are now requiring more of their employees to be sent to ethics seminars. Also, many colleges are now requiring students to take courses in business ethics. [4]

7.2 Effects in the Industry

Enron's failure not only affected people involved in the company, but also other related businesses and industry competitors. This event has caused thousands of people to change electricity providers in order to deal with a more stable company or source of electricity. This one event it has caused the general public to loose faith in accountants and corporate businessmen. A Gallup poll showed that in 2000, 41% thought accountants were ethical, in 2001 that number shrank to 32%. [4] It is especially harmful that Enron had Arthur Anderson employees working for them. For Arthur Anderson was once considered the Marine Corps of accounting, because of their strength and honesty. [4] This incident has ruined Arthur Anderson's reputation, even though they fired the people responsible, they are still associated with Enron and all that is wrong with corporate America.

8.0 Underlying Issues

Enron was a company built by greed; their managers were rewarded for creating extraordinary business deals, even if these deals were not successful. These managers were most often rewarded with shares of the company stock. This gave them even more incentive to stretch the numbers. Months before the actual bankruptcy, Chairman Kenneth Lay sold 1.8 million shares for $101 million and former CEO Jeffrey Skilling sold 1.1 million shares for $67 million. They were so rich in company stock that they would do whatever it took to make themselves look good.

Enron spread itself too thin with too many investments. Enron invested in anything that would make them money. They created their own internet stock trading called Enron Online, bought a water distributor called Azurix, purchased transportation companies, and they also invested heavily in high speed internet and fiber optics. This worked great for them while all internet companies were booming, but once fiber optics were no longer in demand these investments had very little value. Enron hastily invested in anything that would make them a quick buck without weighing the long term effects. When these investments began to loose money Enron shifted capital from other projects to them, and sold more shares to make them appear profitable. This only temporarily fixed the problems.

9.0 What Enron did Wrong

Enron shot themselves in the foot from the very beginning. There culture allowed for these huge financial scandals to take place as early as 1987. When the company executives did not punish the individuals accountable for these actions they basically said that these actions were acceptable. Also, through the misguided accounting practices of recording future numbers instead of actual numbers their balance sheet was inflated greatly. The CFO, Jeffrey Skilling, should have never instituted the “mark to market” accounting system. Instead, they should have used real numbers like every honest company. All of these problems contributed to the collapse of Enron. Through their negligent financial recordings to there extremely strict culture, Enron destroyed themselves by pushing too hard too fast.

9.1 Recommendations

Even though Enron went bankrupt the company is still around. They have been forced to sell off many of their assets, including their corporate office in Houston, but they company itself is not completely erased. [7] Enron should continue to liquidate all assets that do not pertain to their core business, the natural gas industry. They have to in essence start over again as a small gas company. This will allow them to slowly regain their customer base and eventually build back their once proud name. By expanding so quickly in so many areas Enron lost focus on their core business of supplying customers with natural gas. They must regain this focus by producing and distributing low cost natural gas.

Also, Enron must make sure that all corrupt company officials are terminated and basically start with a new top management team. This team must be built with not only strong ideas, but also strong ethical beliefs. For Enron to continue on they must do absolutely everything by the numbers, because their books are going to be continuously reviewed for the next five to ten years and they will not be able to withstand any further mistakes.

Enron will never regain the prominence it had in the late 1990's, however with hard work and a lot of luck, Enron may land back on their feet within a few years. Enron must make ethical decisions and make socially responsible actions, for all eyes are on Enron to see if they can survive. If they can gratify their creditors and regain their business they can eventually begin to grow again.

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