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A CASE OF CORPORATE DECEIT: THE ENRON WAY

EL CASO ENRON.

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Abstract
This case documents the evolution of 'fraud culture' at Enron Corporation and vividly explicates the downfall of this giant organization that has become a synonym for corporate deceit. The objectives of this case are to illustrate the impact of culture on established, rational management control procedures and emphasize the importance of resolute moral leadership as a crucial qualification for board membership in corporations that shape the society and affect the lives of millions of people. The data collection for this case has included various sources such as key electronic databases as well as secondary data available in the public domain. The case is prepared as an academic or teaching purpose case study that can be utilized to demonstrate the manner in which corruption creeps into an ambitious organization and paralyses the proven management control systems. Since the topic of corporate practices and fraud management is inherently interdisciplinary, the case would benefit candidates of many courses including Operations Management, Strategic Management, Accounting, Business Ethics and Corporate Law. In order to enhance the academic value, the in-class discussions could be initiated by elucidating the effects of mass unethical behaviour and conceptualisation of the management morality principles, delving into the implications for managers.

Keywords: Enron, Management Control System, Fraud, Sarbanes-Oxley Act, Corporate Leadership

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Abstract
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INTRODUCTION

In late 2001, when Enron, the world's leading energy, commodities and services company revealed that its financial condition was sustained by an institutionalized accounting fraud, many people actually became deranged. A man sitting by the roadside of a jazzy American city, with his head buried in his hands was shouting cynically, "How can Enron collapse? How can a company with 20,000 employees and operations in 40 countries fail? Unbelievable! All lost, public pension funds evaporated, stocks worth minuscule."

Inside the court, 'Kenny Boy' the so popularly nicknamed Enron icon Kenneth Lay was testifying before a senate committee that started the proceedings with some rather nasty comments and sternly demanded answers from bosses who had grown to be almost worshipped in American homes, till this scandalous moment. The harsh reality bluntly revealed, 'Enron is fraud and fraud is Enron'. The post mortem analysis wonders the modus operandi of this huge corporate deceit that left thousands jobless and aghast. How was this permitted? How did such a company rise? This article attempts to provide valuable insights to managers through vivid description of the Enron case.

LITERATURE IN CORPORATE FRAUD

Fraud is considered as a pervasive business risk and in fact an inherent risk of engaging in business. Many organizations have responded by developing fraud detection strategies and today there is a deluge of literature in corporate fraud although much of the literature is based on the early research and works of Edwin Suntherland (1949), and others who were inspired by Suntherland's research, for example Cressey (1972). It was Suntherland who coined the term 'white-collar crime' and elaborated it to mean criminal acts of corporations and individuals acting in their corporate capacity. The term has now become more generalized and may mean almost any financial or economic crime, from mailroom to the boardroom. The original association theory of Suntherland related to occupational offenders, has been taken forward to suggest that in organizations, dishonest employees eventually will infect a portion of honest ones (Wells, 2007). Furthermore, Cressey's hypothesis - 'trusted persons become trust violators when they conceive of themselves as having a financial problem which is nonsharable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property' - has firmed into frameworks or analytical discourses (See for e.g. Coburn, 2006; Sitorus and Scott, 2009; Brody, 2010). The term 'fraud' in the broadest sense has come to mean an intentional deception made for personal gain or to damage another individual, while the term 'corporate fraud' is described as a fraud occurring within an organization and involving deliberate dishonesty to deceive public, investors or lending companies, usually resulting in financial gain to the criminals or organization. Fraud differs from unintentional errors because fraud has elements of intent and purpose of gaining an advantage over another through false pretence (Albrecht et al., 2008). Often corporate fraud is difficult to detect due to several reasons:

- Perpetrators may be familiar with accounting procedures and hence they have the ability to cover up the fraud.
- Auditors may lack adequate training in the nature of fraud and investigative methodologies (Bayou and Reinstein, 2001; Meservy et al., 2006). The association of certified fraud examiners (ACFE) the world's largest anti-fraud organization believes in disseminating the anti-fraud literature and providing training and education, but it has still a long way to go in practice.
- The time and budgetary constraints associated with external audit results in external auditors increasing their reliance on management's representations of financial statements (Hogan et al., 2008).
- External auditors can experience an agency problem of an inherent conflict of interest because they are investigating the party that paid for their services, thus creating built-in conflict for auditors (Bazerman et al., 2002; Gavious, 2007).

The management of company can address fraud risk by two corporate control mechanisms viz. internal audit function and external audit function. However, fraud detection remains an unstructured task and often requires the auditor to think out of box and derive information from disparate sources. Also, corporate culture has a significant impact and fairness, justice and moral approach to organizational issues are not automatically guaranteed (Small, 2006). According to Hollinger and Clark (1983), management must pay attention to four aspects of policy development:

1. A clear understanding regarding theft behaviour
2. Continuous dissemination of positive information reflective of the company's policies
3. Enforcement of sanctions
4. Publicizing the sanctions

Evidence shows that workplace deviance and theft are in large part a reflection of how management at all levels of the organization is perceived by the employee (Coenen, 2008). Specifically, if the employee is permitted to conclude that his or her contribution to the workplace is not appreciated or that the organization does not seem to care about the theft to its property, there is a greater possibility of involvement. In other words, lowered prevalence of fraud or employee theft may be one consequence of a management team that is responsive to the current perceptions and attitudes of its workforce.

METHODOLOGY

This paper utilizes the case study approach implying a detailed examination of a single example of a class of phenomena. A case study allows an investigation to retain the holistic and meaningful characteristics of real-life events, such as organizational and managerial processes (Yin, 2008). In concurrence, according to Gummesson (2000), an important advantage of case study research is the opportunity to obtain a holistic view of a specific phenomenon or series of events. In this paper, the Enron Corporation was considered since it was representative, illustrative and access to data from various sources was feasible. Moreover, the company aligned well with the case study aim of description. As stated by Yin (2008), descriptive case studies provide rich description of phenomenon being studied and enable several insights. Together with the aim of description, three specific questions were examined:

1. How did Enron’s culture foster fraudulent practices?
2. How management control models can change with the leadership at the top?
3. How the Enron fraud shattered the ‘myths’ in the regulatory environment?

The qualitative data has been built through systematic documentation and collection of secondary data available in the public domain. The focus was not on the discovery of a generalizable truth or cause-effect relationship instead the emphasis was on description and presentation of a descriptive case that demonstrates a particular phenomenon.

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BACKGROUND OF THE CASE COMPANY - BIRTH OF ENRON

The Houston Gas Company merged with InterNorth Inc. in 1985 to create the Enron Corporation. The new company founded by Kenneth Lay inauspiciously started with heavy operating losses to the tune of $15 million and several hostile takeover attempts in the early years. At one point it seemed almost certain that Enron would dissolve when the Jacobs and Leucadia National Corporation accumulated more than 15% shares in a short period. But Enron survived, lashing back to repurchase the major blocks of shares at premium price as the New York Times reported conspicuously on 21 October 1986, “Enron buys backs its stock.” Incidentally, another catastrophe struck when the Peruvian government enforced nationalization of Enron’s pipelines and the situation aggravated further as Enron suffered losses from its oil trading activities, again leading to speculations that Enron was doomed. The Enron Corp. Vice President for Corporate Communications, Mark Palmer commented, “In 1988 the company had a ‘near death’ experience following the very difficult 1986-87 period.”

Enron, being a typical natural gas firm, relied on traditional techniques of exploration, customary financial structure and ‘old economy’ business model. Natural gas as such is ancient considering that 1000 BC flames of this type were utilized at Mount Parnassus in Greece, and Britain commercialised natural gas two hundred years ago. Moreover, natural gas is a fossil fuel that is usually found underneath the surface of the earth and rises through loose, shale rocks and other material. The established production methods involve drilling a hole into the impermeable rock in order to recover the natural gas trapped under the earth. Naturally, the Enron Company was unattractive for stock market enthusiasts who favoured high technology industries and advanced financial instruments. However, the constant lobbying on the part of Enron and others kept the system in place and Enron soon became an important player with some 37,000 miles of pipeline. In the mid-1980s, Enron president Richard Kinder encouraged the idea of decentralization since he believed that decentralization would enable the company to be more responsive to customer needs.

Nonetheless, decentralized decision-making often induces the top management to rely more on management control reports than on personal knowledge of operations, entailing some loss of control. Also, the creation of profit centres may increase friction because of arguments over the appropriate transfer price, assignment of common costs and credit for revenues generated earlier jointly by business units working together. However, under the leadership of Richard Kinder, Enron operated with a highly effective management control system. There were frequent boardroom meetings in which each business unit head presented innovative proposals for business development together with the key performance indicators (Fox, 2003). As one executive asserted, “Kinder promoted realistic proposals rather than overly ambitious ones and preferred to freely discuss several details of the strategic, tactical and operational plans. Although he focused on the expense statements or divisional cash flows, he was equally people-oriented and created an Enron-family feeling in the organization.”

RISE OF ENRON

In early 1987, Enron unveiled its new logo and its first global advertising campaign. Later, Enron acquired Zond Corporation, a leading wind-power company, to form Enron Renewable Energy Corp. At the time, renewable energy enjoyed rising popularity and the Clinton administration further promoted renewable energy thereby enabling Enron Renewable to quickly win contracts to build two huge wind generation projects using its Z-750 Kilowatt wind turbines – MidAmerican Energy’s 112.5 Megawatt project in Iowa, and Northern State Power’s 100 Megawatt project in Minnesota. The company followed a growth strategy with renewable energy as it acquired the assets of Tacke Windtechnik GmbH, a German company manufacturing 1.5 Megawatt wind turbines in Europe. The customers were ready to pay price premium for renewable energy making it a lucrative business.

Kenneth Lay was keenly interested in expanding the company and creating value for shareholders. He approached McKinsey & Company and met the head of energy consulting business, Jeffrey Skilling. Enron was interested in taking advantage of the liberalization policies in other countries and developing international networks. The liberalization of markets in emerging countries such as India indeed provided immense opportunities for growth. Even the UK government favoured liberalization of the energy market. Further, Enron wanted to stimulate the shareholders with whiz trading abilities and Kenneth Lay saw this in Jeffrey Skilling who impressed him with the ‘Gas Bank’ proposal, an idea that proved instant success. Gas Bank allowed gas producers and wholesale buyers to purchase gas supplies and hedge the price risk at the same time.

The scheme intended to take advantage of the fact that the short-term demand and supply for gas was chronically out of balance. Skilling also suggested a strategic shift to pursue unregulated markets and charted plans for tapping the global potential. Eventually, Kenneth Lay moved to hire Skilling to lead the trading and finance operations. Kenneth Lay was convinced that Skilling was the man who would transform the organization into a postmodern, networked enterprise thriving on ‘informational capitalism.’ He used to openly say, “In ten years, we expect Jeff to deliver majority of our profits from innovative businesses that we aren’t even in today.”

Skilling certainly was no novice to leadership, having worked as chief production director at the age of 16 and then thriving at the Harvard Business School as a top scholar. Even in the high school days, Jeff had a reputation of excelling in his work that mixed somewhat dangerously with his penchant for risks and materialism. When Skilling joined the Enron Corporation, the company manoeuvred with established strategies of Richard Kinder specifying three core pillars of management control system viz. risk assessment and control, performance review system and code of ethics. Apart from the independent risk review by the risk assessment and control group (RAC), business deals of individual units were formalized in a deal approval sheet (DASH), scrutinized by analysts and approved by senior managers. Enron’s performance review incorporated the peer review committee (PRC) report that ensured fairness, consistency and alignment with strategic objectives of the company. The code of ethics stressed integrity, behavioural controls and respect. The affirmation of code was mandatory for all employees and the practices were so much recognized by Americans that the political history division of the Smithsonian National Museum of American History acquired a copy of the code for permanent display. Enron also maintained the usual corporate governance mechanisms, board of directors with high credentials (see Table 1), audit committee, reputed external auditor Arthur Andersen and office for financial disclosure under the normal observation of the U.S. Securities and Exchange Commission (SEC). This adherence to standard procedures signalled a stable environment for most stakeholders.

In 1993, Enron's international strategy reaped fruits when Enron's Teesside power plant in the U.K. commenced operations. Enron became the first company to construct a new power plant in U.K. after the liberalization of the energy market. Same year, Enron reached an agreement with the Maharashtra State in India to build a massive power plant at Dabhol in the Konkan region. However, still the stock market disposition with regard to Enron was rather lacklustre largely because the Enron's trading deals were pretty much basic, driven by information advantage or counting on whether gas prices would rise or fall in the following months. In 1996, Jeff Skilling took over as COO of Enron and that was no surprise whatsoever considering his exemplary track record, enviable array of resources, political connections, expert knowledge and motivation. "He was an obvious choice," said a senior officer.

Table 1: Enron Board of Directors (1995-2001)

Director	Age	Particulars
Kenneth Lay	58	Chairman of the board of Enron since 1986. Also held directorships of Eli Lilly & Co., Compaq Computer Corp. and i2 Technologies.
Jerome Meyer	63	Served as Chairman and CEO of Tektronix Inc. for more than eight years.
John Wakeham	68	Retired former UK Secretary of State for Energy and Leader of the Houses of Commons and Lords.
Jeffrey Skilling	47	Served as President and CEO of Enron. Also served as director of Azurix Corp.
Robert Belfer	65	Served as Chairman and CEO of Belco Oil & Gas
John Duncan	73	Also served as director of EOTT Energy Corp.
Wendy Gramm	56	PhD Economist and director of the regulatory studies program at George Mason University.

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Norman Blake	59	Former CEO and Secretary General of the US Olympic Committee. Had also served as director of Owens-Corning Corp.
Herbert Winokur	57	Served as Chairman and CEO of Capricorn Holdings.
Rebecca Mark-Jusbasche	45	Served on advisory board of Chase Manhattan Corp and Chairman of Azurix Corp.
Ronnie Chan	51	Served as director of Standard Chartered Bank plc and Motorola Inc.
Frank Savage	62	Served as director of Lockheed Martin Corporation and Alliance Capital Management.
Ken Harrison	58	Served as Chairman and CEO of Portland General Electric Company.
John Urquhart	72	Served as director of the Weir Group plc and TECO Energy.
Robert Jaedicke	72	Professor Emeritus of Accounting at the Stanford Business School.
Charles Lemaistre	77	Served for eighteen years as the President of the University of Texas.
J. H. Foy	71	Former President of Houston Natural Gas Corp.
Bruce Willison	49	Served as CEO of Ahmanson Company.

The business environment was changing fast at this time and with the rise of news networks, investment chat rooms, and so on, business was becoming more of a gladiator show. Analysts' expectations soared as they published estimates of quarterly earnings of companies, often on per-share basis. Exceeding the analysts' expectation was viewed as confirmation of company growth and affirmation of corporate policies. Hence, it became a goal for many companies to beat the analysts' expectations. Furthermore, the shareholders became more demanding and CEOs were pressured to put shareholder interests above everything else, leading to the proposal that management should have stakes in the company at par with the shareholders.

Consequently, companies increasingly granted their executives with employee stock options that turned large portion of their compensation riding on their companies' stocks. Executives also started demanding growth along with the investors, even if it was unrealistic or unsustainable. "The stock-based compensation actually

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initiated hypercapitalism but then any incentive compensation plan has its dark side. The fixed pay philosophy teem complacency and hence performance-based schemes rate better in motivating managers to put forth maximum effort," remarked one official.

Business Segments				
Transportation and Distribution	Whole sale Services	Retail Energy Services	Broadband Services	Corporate and Other

Figure 1: Business Segments of Enron and Comparative

Transportation and Distribution included Enron's interstate natural gas pipelines, primarily Northern Natural Gas Company, Transwestern Pipeline Company and other gas company interests.

Wholesale Services included Enron's wholesale businesses around the world including North America, Europe, Japan, India and South America.

Retail Energy Services was about extending the energy expertise to end-use retail customers in the industrial and commercial business sectors.
Broadband Services intended to provide customers with a single source for broadband services, including bandwidth intermediation and delivery of premium content.

Corporate and Other includes Enron's investment in Azurix Corp., EREC and overall corporate activities.
In late 1999, web-based system, EnronOnline was launched in order to broaden the market reach and accelerate the business activity. By the end of 2000, EnronOnline had executed 548000 transactions with a notional value of $336 billion, thereby becoming the world's largest web-based eCommerce system.

Enron released its third quarter earnings in October 1997 reporting earnings of 42 cents a share, surpassing the analysts' estimates of 34 cents thereby enabling Enron's stocks to rise by more than one percent. Encouraged by the bullish market support, Skilling set goal of 15 percent earnings growth every year and within a short span of time shifted the Enron's business model towards a Wall Street type financial engineering platform operating in energy futures, expanding rapidly into all kinds of financial commodities. Moreover, the pace of acquisitions and independent partnership deals accelerated with Enron taking over the electric utility Portland General Corp. for $2.1 billion stock swaps.

In March 1998, Andrew Fastow was promoted as the Chief Financial Officer. Fastow, a seasoned finance professional with MBA from Northwestern University proved to be an asset for the company because of his market knowledge and capability to play in Enron's favour by designing a complex web of companies that solely did business with Enron. In 1999, Fastow organized two limited partnerships, LJM Cayman (LJM1) and LJM2 Co-investment L.P. (LJM2). The entities were formed to participate as the outside equity investor in special purpose entities set up by Enron. Fastow had to

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convince the Enron board to permit him run the companies, effectively waiving the Enron's code of ethics. By then, so much business came from trading that Enron had essentially stopped being an energy company and functioned as a kind of bank (see Figure 1).
The Fortune Magazine named Enron as ‘America's Most Innovative Company’, while the President and CEO of Enron, Jeffrey Skilling mesmerized the audiences of businessmen, academics and scientists across the United States. By 2000, Enron morphed into a full-scale Wall Street trading corporation specializing in the financial engineering of derivatives with trading operations accounting for a large portion of the income. The transformation spurred massive expansion so that from revenue of USD 4.6 billion in 1990, Enron grew to over USD 100 billion in revenue by 2000 making it the seventh largest company in the United States, indeed even bigger than IBM. The Figure 2 indicates the Enron’s financial highlights. The balance sheet (2000) and the income statement are shown in Table 2 and Table 3 respectively.

Figure 2: Enron’s Financial Highlights (1996-2000)

Table 2: Enron Balance Sheet

Enron Corp. and Subsidiaries Consolidated Balance Sheet: December 31,		
(In USD millions, except shares)	**2000**	**1999**
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,374	$ 288
Trade receivables (net of allowance for doubtful accounts of $ 133 and $ 40, respectively)	10,396	3,030
Other receivables	1,874	518
Assets from price risk management activities	12,018	2,205
Inventories	953	598
Deposits	2,433	81
Other	1,333	535
Total current assets	30,381	7,255
Investments and Other Assets		
Investment in and advance to unconsolidated equity affiliates	5,294	5,036
Assets from price risk management activities	8,988	2,929
Goodwill	3,638	2,799
Other	5,459	4,681
Total Investments and other assets	23,379	15,445
Balance Sheet Contd. **Property, Plant and Equipment, at cost**		
Natural gas transmission	6,916	6,948
Electric generation and distribution	4,766	3,552
Fibre-optic network and equipment	839	379
Construction in progress	682	1,120
Other	2,256	1,913
	15,459	13,912
Less accumulated depreciation, depletion and amortization	3,716	3,231
Property, plant and equipment, net	11,743	10,681
Total Asset	**$65,503**	**$33,381**

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	December 31	
	2000	**1999**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 9,777	$ 2,154
Liabilities from price risk management activities	10,495	1,836
Short-term debt	1,679	1,001
Customers' deposits	4,277	44
Other	2,178	1,724
Total current liabilities	28,406	6,759
Long-Term Debt	**8,550**	**7,151**
Deferred Credits and Other Liabilities		
Deferred income taxes	1,644	1,894
Liabilities from price risk management activities	9,423	2,990
Other	2,692	1,587
Total deferred credits and other liabilities	13,759	6,417
Commitments and Contingencies		
Minority Interests	2,414	2,430
Company-Obligated Preferred Securities of Subsidiaries	904	1,000
Balance Sheet Contd. **Shareholders' Equity**		
Second preferred stock, cumulative, no par value, 1,370,000 shares authorized,		
1,240,933 shares and 1,296,184 shares issued, respectively	124	130
Mandatory Convertible Junior Preferred Stock, Series B,		
No par value, 250,000 shares issued	1,000	1,000
Common stock, no par value, 1,2000,000,000 shares authorized, 752,205,112 shares and 716,865,081 shares issued, respectively	8,348	6,637
Retained earnings	3,226	2,698
Accumulated other comprehensive income	(1,048)	(741)
Common stock held in treasury, 577,066 shares	(32)	(49)

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and 1,337,714 shares, respectively		
Restricted stock and other	(148)	(105)
Total shareholders' equity	11,470	9,570
Total Liabilities and Shareholders' Equity	**$65,503**	**$33,381**

(Source: Enron Annual Report, 2000)

Table 3: Enron Income Statement

Enron Corp. and Subsidiaries Consolidated Income Statement	Year ended December 31		
(In USD millions, except per share amounts)	2000	1999	1998
Revenues			
Natural gas and other products	$ 50,500	$ 19,536	$ 13, 276
Electricity	33,823	15,238	13,939
Metals	9,234	-	-
Other	7,232	5,338	4,045
Total revenues	100,789	40,112	31,260
Cost and Expenses			
Cost of gas, electricity, metals and other products	94,517	34,761	26,381
Operating expenses	3,184	3,045	2,473
Depreciation, depletion and amortization	855	870	827
Taxes, other than income taxes	280	193	201
Impairment of long-lived assets	-	441	-
Total costs and expenses	98,836	39,310	29,882
Operating Income	1,953	802	1378
Other Income and Deductions			
Equity in earnings of unconsolidated equity affiliates	87	309	97
Gains on sales of non-merchant assets	146	541	56
Gains on the issuance of stock by TNPC Inc.	121	-	-
Interest Income	212	162	88
Other income, net	(37)	181	(37)
Income Before Interest, Minority Interests and Income Taxes	2,482	1,995	1,582

(Source: Enron Annual Report, 2000) Consolidated Income Statement Contd. Interest and related charges, net	838	656	550
Dividends on company-obligated preferred securities of subsidiaries	77	76	77
Minority interests	154	135	77
Income tax expense	434	104	175
Net income before cumulative effect of accounting charges	979	1,024	703
Net Income	979	893	703
Earnings on Common Stock	$ 896	$ 827	$ 686
Earnings Per Share of Common Stock			
Basic			
Before cumulative effect of accounting changes	$ 1.22	$ 1.36	$ 1.07
Cumulative effect of accounting changes	-	(0.19)	-
Basic earnings per share	$ 1.22	$ 1.17	$ 1.07
Diluted			
Before cumulative effect of accounting changes	$ 1.12	$ 1.27	$ 1.01
Cumulative effect of accounting changes	-	(0.17)	-
Diluted earnings per share	$ 1.12	$ 1.10	$ 1.01

Downward Spiral

Jeff Skilling radically transformed the Enron's culture to align with the 'new economy' as exemplary intellectual capital company that thrilled the stock market and stakeholders. Skilling exercised control over almost all facets of the organization and his leadership style and vision apparently shaped Enron's culture. Enron expanded by re-branding its corporate image, enhancements in technological capabilities and feeding an increasingly expectant investor forums, building on a culture of creative risk taking, innovation, entrepreneurship and mercenary practices (Free et al., 2007).

Skilling declared, “Our culture is a tough culture. It is a very aggressive, very urgent organization.” Accordingly, Skilling recruited graduates and MBAs of prestigious universities who could perform as aggressive, extrovert, and ruthless traders or as brightest financial engineers, IT experts and investment bankers (Rippin and Fleming, 2007). Those who did not produce deals were quickly terminated putting enormous pressure for short-term output. Those who succeeded in the 'cowboy capitalism' structure were rewarded with large pay cheques, bonuses and stock options. Skilling thus contributed to a culture of arrogance, extreme decentralization, fierce internal competition and an attitude that the company could do anything. He was a forceful advocate of postmodern, nay hypermodern organization- hyperflexible, impermanent, endlessly reinventing itself at speed, and relying on intensification of acceleration in the development of new profit sources (Roberts and Armitage, 2006). As one Enron employee reflected, “The ‘Company’ was forever reorganizing, perpetually changing, so much so that no one ever really knew for whom they were working or what would happen to them in an ever altering business concept.”

Enron's corporate environment promoted creative, hardworking people but the drive and independence also fostered financial deception since the company encouraged experimentation but discouraged anything other than success. In its innovative aspirations there were some inevitable misses such as energy outsourcing business and trading telecommunication networks business that lost hundreds of millions of dollars but there was reluctance to acknowledge the stumbles because of the corporate culture that preferred to rely on accounting trickery to paper over the losses (Fox, 2003). Former Vice President for Corporate Development at Enron, Sherron Watkins articulated, “Enron executives did not demonstrate that they valued integrity, it was way down the list. The only way an organization can sustain a value system is to let people go when they violate it and to reward those who live by it. This did not happen at Enron.” Enron executives began to tamper the books in order to support the huge growth engine.

Several special partnerships were created that were not reported on Enron's books, which were able to make its earnings and debt levels look better than actual situation. The shift to 'new economy', financial firm image meant for Enron an increasingly fraudulent accounting practice to keep its credit rating high so as to appear a solid and reliable partner (Henderson et al., 2009). Arthur Andersen, the big accounting firm mutely authorized the company's questionable accounting practices and downplayed the violations that were often too complex to be comprehended or bordered on vagueness. “After all they earned $25 million in audit fees and $27 million in consulting fees,” said one representative. Wall Street washed its hands happily, ignoring the financial opacity of Enron, as the stocks continued to rise in the jubilant market of the late 1990s (Healy and Palepu, 2003). The New York Times, 25 July 2000 brightly flashed, “Enron profit up on trades in natural gas and power; most widely traded natural gas contract on the New York Mercantile Exchange.”

The trades at Enron were often recorded at full value as revenue rather than aligning in accordance to the actual profit achieved; inflated revenues followed naturally in the schema. Entire emphasis was on stock values almost to the exclusion of everything else and money was the only yardstick, code of ethics was only a window dressing. As one officer described, “The risk assessment and control (RAC) group was manned by knowledgeable risk management professionals but over time they became increasingly reluctant to turn back projects, since the corporate ethos held that the driving force of its business model was its continual flow of deals. Moreover, rejecting proposals implied ‘political death’ for RAC members, with further repercussions from Skilling.” The employees were scared to express their opinions or question potentially illegal business practices as the managers used the system to reward blind loyalty and quash brewing dissent (Shermer, 2008).

The theory of planned behaviour (TPB) best reasons the situation as a vicious circle of corruption, emphasizing that behaviour is often preceded by intent and values are important in the development of intent. The prima facie evidence suggests that most employees favoured unethical, extreme competitive actions derived from observing the behaviour of those favoured in the organization. The pervasive unethical behaviour is thus the simultaneous emergence of congruent, systematic unethical behaviour among leaders and followers to the extent that the ethical norms are demoted to a contradictory status in the organization’s social network (Kulik at al, 2008). Writings in the New York Times suggest that: “Enron culture shaped a vulgar capitalist cult that developed around the intersections of digital technology, deregulation and globalisation.

Advisors recommended unloading baggage of hard assets like factories and concentrate on buzz and brand. Accountants who imposed conservative balance sheet disciplines were eroded as the Wall Street harped on geniuses that flickered the stocks."

Unexpectedly in August 2001, Jeff Skilling tendered his resignation to the company and soon sold blocks of shares valued more than $33 million. Kenneth Lay who held the position of Chairman immediately re-assumed the job of CEO and assured the stunned market watchers that there would be no change in the performance or outlook of the company. But, the stock prices started declining. After the September 11, 2001 attacks, media attention moved away from the company and during the period the company initiated the process of preserving the core businesses by selling marginal assets. Subsequently, Portland Electric was sold to an Oregon utility for $1.9 billion in cash and stock. As these transactions became rampant, the Wall Street Journal, New York (26 October, 2001) declared, "Deals and Deal Makers: Enron officials sell shares amid stock-price slump." In the same month, Enron announced, "We do have some problems and there could be restatements to the financial disclosures, but we attribute the losses to some investment errors and restructuring." (See Table 4)

Later, Fastow revealed that he earned $30 million from compensation arrangements through LJM limited partnerships. By this time, SEC was formally investigating the Enron deals and financial instruments thus causing the share prices plunge to $20.65 from the peak high of $90 per share in mid-2000 (see Figure 3). Kenneth Lay then removed Fastow from the CFO position sparking fears about Enron's liquidity. Probably the market had already got a whiff that Andersen had been shredding documents since the company was being probed. The credit rating agencies downgraded Enron's status issuing warnings of reducing the rating to 'junk level'.

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Figure 3: Enron Stock Prices (1999-2002)

Table 4: Restated Financial Information

Income Statement (USD millions)	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
	2001	2000	2001	2000
		Restated	Restated	Restated
Revenues	$46,877	$29,834	$138,718	$59,887

Costs and Expenses				
Cost of gas, electricity and other products	45,742	28,036	133,762	55,494
Operating expenses	929	943	2,942	2,340
Depreciation, depletion and amortization	293	257	746	617
Investment losses	768	-	768	-
Taxes, other than income taxes	62	65	228	190
	47,794	29,301	138,446	58,641
Operating Income (Loss)	(917)	533	272	1,246
Other Income and Deductions				
Equity in earnings (losses) of unconsolidated				
Affiliates	194	72	440	246
Gains (losses) on sales of non-merchant assets	(1)	45	49	135
Internet Income	91	50	237	121
Other income (loss), net	(33)	(21)	(17)	60
Income (Loss) Before Interest, Minority				
Interest and Income Taxes	(666)	679	981	1,808
Interest and Related Charges, net	201	259	630	643
Dividends on Company-obligated Preferred				
Securities of	20	20	56	59

Subsidiaries				
Minority Interests	33	24	90	115
Income Tax Expense (Benefit)	(276)	73	(1)	194
Net Income (Loss) Before cumulative Effect				
Net Income	(644)	303	225	797
Preferred Stock Dividend	20	21	61	62
Earning (Loss) on Common Stock	$ (664)	$ (282)	$ 164	$ 735

(Source: SEC Filings 1-13159)

In November 2001, Enron formed a committee headed by William Powers, Dean of the University of Texas to independently investigate the financial irregularities. On November 9, 2001, Enron announced that it had found a buyer, Dynegy, an energy trader based in Houston. Dynegy agreed to buy Enron in a $9 billion stock deal with Chevron Texaco, which owned about quarter of Dynegy, pledging to inject almost $2.5 billion in cash to complete the acquisition process. However, the market lacked confidence in the deal considering the major differences in the corporate cultures of the two companies, particularly with the 'straight-talking' CEO Charles Watson at the helm of Dynegy, and with Enron embroiled in earnings reduction to the tune of $600 million linked to two special partnerships in Jedi and Chewco. A few days later, the US Securities and Exchange Commission (SEC) filed civil fraud complaints against Andersen that led to Wall Street expressing serious doubts about whether Dynegy should proceed with the Enron acquisition deal. On November 28, 2001, CEO of Dynegy held an emergency press conference and announced, “Dynegy has decided to unilaterally disengage from the proposed acquisition of Enron.” The news reverberated with Enron's stocks trading at a low of $0.61, anxiety creeping into the markets, Wall Street Journal releasing the supplement (29 November, 2001),

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"Dynegy's move to disconnect Enron merger powers volatility spike as investors seek cover." As a last resort on 2 December 2001, Enron filed for chapter 11 bankruptcy protection in a New York bankruptcy court. Then, the proceedings started under the regular judiciary procedures. Kenneth lay was forced to resign as Chairman and CEO of Enron. The trials of Kenneth Lay, Skilling and Fastow began in 2006 with a 65-page indictment covering range of financial crimes including bank fraud, perjury, securities fraud, money laundering, insider trading and conspiracy. It became apparent that the accounting practices were designed to massage the reported earnings in order to meet the analysts' expectations. Figure 4 presents the indictment document of Arthur Andersen, Enron's auditor. Arthur Andersen firm was closed after the scandal. Skilling was sentenced to 24 years in prison while Kenneth Lay died in July 2006 before the sentencing was due.

CHANGES IN THE REGULATORY ENVIRONMENT

Enron's failure stemmed from many factors such as extreme corporate culture, unreasonable expectations from the CEO, unprecedented market conditions, and so on although accounting malpractices are largely considered to be the cause. The deviations from generally accepted accounting principles (GAAP), off-balance-sheet schemes and faulty independent auditor performance all contributed to the collapse of this giant organization.
Pursuant to the Enron scandal, social activist Ralph Nader called for a roll back of many deregulatory reforms enacted in the United States and world over, referring to 'the Enron supermarket of corporate crime, fraud and abuse' as damaging for the world far more than crimes in the street.

Many steps were taken in the regulatory environment as follows:

- The US Securities and Exchange Commission (SEC) decided to constitute a disciplinary board to accelerate the investigation of alleged fraudulent companies or non-compliant organizations.

- The SEC announced plans to create new organizations outside the structure of AICPA-American Institute of Certified Public Accountants to oversee auditors of publicly held companies.

AICPA already existed in United States with more than 330,000 members.

- AICPA agreed in principle to limit the non-audit services provided to public company audit clients.

- AICPA agreed to develop improved financial reporting models applicable in the e-era (see Figure 5) and also accepted the responsibility to set new measures for deterring fraud such as expanded internal control procedures for management and audit committees.

- The most important change was the enactment of Sarbanes-Oxley Act, a United States Federal Law for Public Company Accounting Reform that was passed on 30 July 2002 as a reaction to the growing corporate and accounting scandals. President George Bush signed the law stating that it included “the most far-reaching reforms of the American business practices since the time of Franklin Roosevelt.”

Figure 4: Arthur Andersen Indictment

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CLERK, U.S. DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
FILED
3/7/02
MICHAEL N. MILBY, CLERK

LRC:AW:SB

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS

- - - - - - - - - - - - - - - - - - -X

CR H-02-121

UNITED STATES OF AMERICA,

-against-

ARTHUR ANDERSEN, LLP,

Defendant.

- - - - - - - - - - - - - - - - - - -X

I N D I C T M E N T

Cr. No. ________
(T. 18, U.S.C., §§ 1512(b)(2) and 3551 *et seq.*)

THE GRAND JURY CHARGES:

I. ANDERSEN AND ENRON

1. ARTHUR ANDERSEN, LLP ("ANDERSEN"), is a partnership that performs, among other things, accounting and consulting services for clients that operate businesses throughout the United States and the world. ANDERSEN is one of the so-called "Big Five" accounting firms in the United States. ANDERSEN has its headquarters in Chicago, Illinois, and maintains offices throughout the world, including in Houston, Texas.

2. Enron Corp. ("Enron") was an Oregon corporation with its principal place of business in Houston, Texas. For most of 2001, Enron was considered the seventh largest corporation in the United States based on its reported revenues. In the previous ten years, Enron had evolved from a regional natural gas provider to, among

(Source: www.findlaw.com)

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other things, a trader of natural gas, electricity and other commodities, with retail operations in energy and other products.

3. For the past 16 years, up until it filed for bankruptcy in December 2001, Enron retained ANDERSEN to be its auditor. Enron was one of ANDERSEN's largest clients worldwide, and became ANDERSEN's largest client in ANDERSEN's Gulf Coast region. ANDERSEN earned tens of millions of dollars from Enron in annual auditing and other fees.

4. ANDERSEN performed both internal and external auditing work for Enron mainly in Houston, Texas. ANDERSEN established within Enron's offices in Houston a work space for the ANDERSEN team that had primary responsibility for performing audit work for Enron. In addition to Houston, ANDERSEN personnel performed work for Enron in, among other locations, Chicago, Illinois, Portland, Oregon, and London, England.

THE CHARGE: OBSTRUCTION OF JUSTICE

13. On or about and between October 10, 2001, and November 9, 2001, within the Southern District of Texas and elsewhere, including Chicago, Illinois, Portland, Oregon, and London, England, ANDERSEN, through its partners and others, did knowingly, intentionally and corruptly persuade and attempt to persuade other persons, to wit: ANDERSEN employees, with intent to cause and induce such persons to (a) withhold records, documents and other objects from official proceedings, namely: regulatory and criminal proceedings and investigations, and (b) alter, destroy, mutilate

(Source: www.findlaw.com)

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Historical Financial Statements Reporting — Enhanced Business

Past — Present — Future

One size fits all (GAAP)	Tied to company-specific mission, vision and values
Ignores non-financial measures	Focuses on factors critical to success
Historical	Real-time
Cost-basis	Fair value basis
Financial only	Comprehensive
Statements	Custom reports and analysis
Periodic	On-demand
Reports results of past decisions	Moves decision criteria to forefront
Backward-looking	Forward-looking

(Source: AICPA resource centre)

Figure 5: Improving the Business Reporting Model

Some highlights of the Sarbanes-Oxley Act (2002) that is of particular relevance to the case study are as follows:

Section 101: The board's members will serve on a full-time basis. No member may, concurrent with service on the board, share in any of the profits of, or receives payments from, a public accounting firm.

Section 103: The board must adopt an audit standard to implement the internal control review required by section 404 (b). This standard must require the auditor evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transactions of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.

Section 102 (a): Mandatory Registration Clause
Section 104: The SEC may order a special inspection of any firm at any time.
Section 107 (d): The board must notify the SEC of pending investigations involving potential violations of the securities laws, and coordinate its investigation with the SEC division of enforcement as necessary to protect an ongoing SEC investigation.
Section 206: The CEO, Controller, CFO, Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the one-year period preceding the audit.
Section 302: Corporate Responsibility for Financial Reports-The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the appropriateness of the financial statements and disclosures contained in the periodic report and that those financial statements and disclosures fairly present in all material aspects, the operations and financial condition of the issuer.
Section 401 (a): Each annual and quarterly financial report...…..shall disclose all material off-balance sheet transactions and other relationships with unconsolidated entities that may have a material current or future effect on the financial condition of the issuer.
Title VIII: Corporate and Criminal Fraud Accountability
It is a felony to knowingly destroy or create documents to impede, obstruct or influence any existing or contemplated federal investigation. Auditors are required to maintain all audits or review work papers for five years.
Section 1105: The SEC may prohibit a person from serving as an officer or director of a public company if the person has committed securities fraud.

Discussion of Specific Questions

1. How did Enron's culture foster fraudulent practices?

Enron's culture was apparently influenced by the leadership style of Jeff Skilling who pressed for a 'cowboy capitalism' structure (Gini, 2004). There was tremendous pressure to achieve through unending, aggressive, risky deals and the organization steered towards a hypermodern form in which short-term outputs and fast rewards became a norm. Those who were unable to produce fast results were actually terminated. The corporate environment refused to accept anything but success although ostentatiously favouring risk-taking, creativity and experimentation that are inherently packaged with disappointments. Thus, the people were provided an incentive to commit fraud at the peril of survival in the organization or redundancy in an ever-altering concept. The company did not respect integrity and actions of the top management signalled winding up of ethical values (Tomasic, 2009). The fraud culture was perpetuated through selection of new employees and systematic indoctrination of people during daily conversations, legends or official ceremonies. It was rationalised by employees who consistently observed the organization favouring leaders with unethical conduct. The proven management control system crumbled as the risk assessment and control (RAC) members themselves became reluctant to decline projects fearing repercussions from colleagues and the top management. A culture of arrogance buoyed with intense internal competition and stock option compensation schemes, soon led the Enron employees to tamper the account books and create special entities to opaque the earnings and debt levels.

2. How management control models can change with the leadership at the top?

The change of top leadership at Enron from Kinder to Jeffrey Skilling virtually devastated the management control model promoted by Kinder. Skilling's aggressive style and unconcerned approach to business ethics led people to change the track in accordance to his demands and 'show' performance or face the axe. His strong background and extreme capitalism ideologies pressurized the employees and dented the prevalent RAC group.

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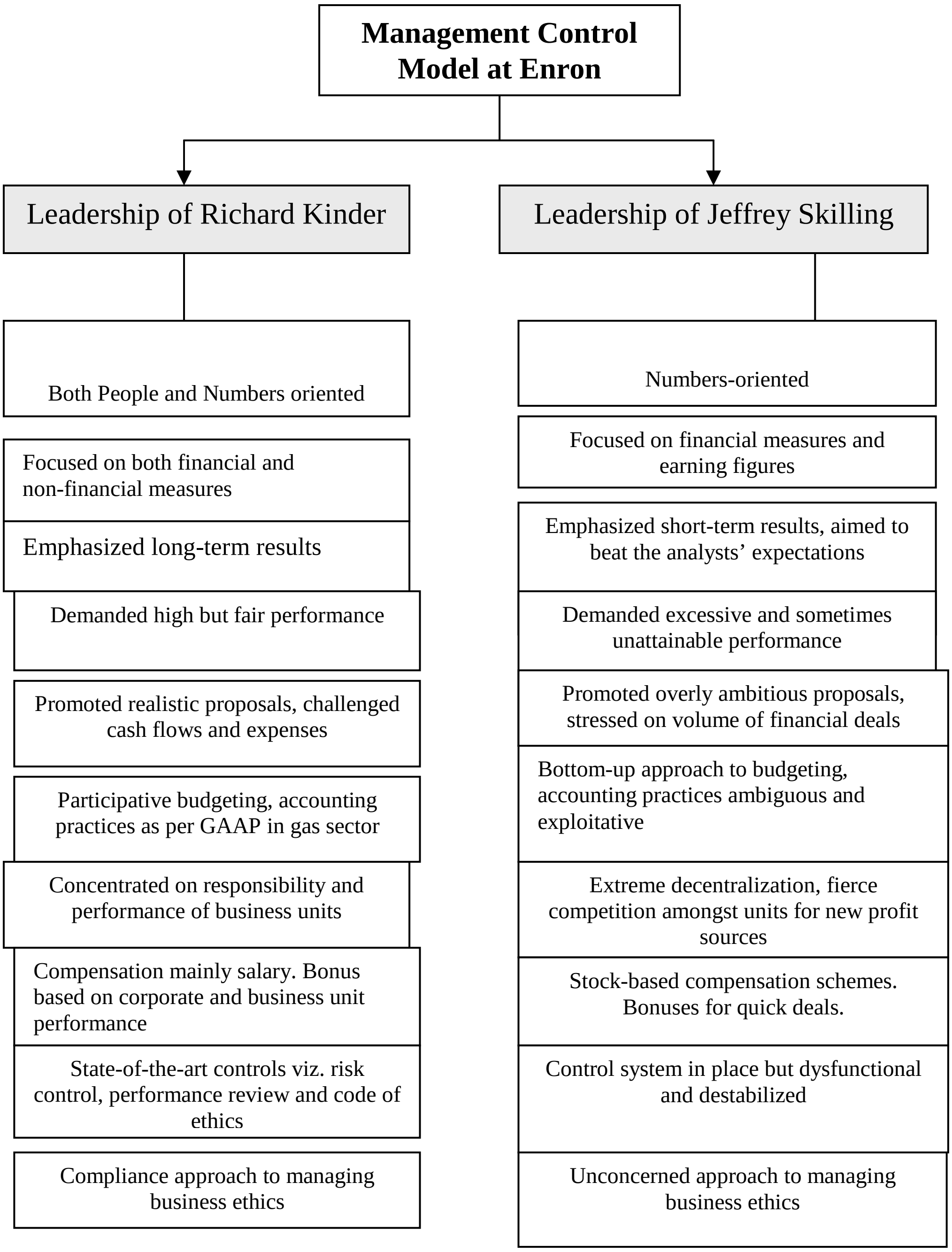

3. How the Enron fraud shattered the 'myths' in the regulatory environment?

Several myths in the regulatory environment were shattered as the Enron scandal erupted blatantly. The regulatory system was considered full poof from all violations whatsoever, entirely representative and all encompassing. The penalties for economic crimes were set to deter people from even thinking about committing frauds, leave perpetuating corruption farther away. But the historical Enron case blew holes in the established system. The American Institute of Certified Public Accountants (AICPA) financial reporting model lost its sanctity and the general public utterly lost confidence in the auditors and audited account statements. Evidence suggests that the accounting profession itself has come under scanner and has suffered extensively (Carnegie and Napier, 2010). The US Securities and Exchange Commission (SEC) procedures that were supposedly exhaustive needed reviews and reformulations. There were calls to roll back deregulatory reforms and develop new fraud management systems for scrutinizing internal controls in public companies. Sarbanes-Oxley Act actually revisited the business practices in parallel with the happenings at Enron in order to extend the mandatory clauses and curb corporate deceit in the future. The so-called white-collar crimes were regarded as much as, if not more than the grave crimes, and penalty was enhanced in its domain.

Concluding Remarks

The occurrence of fraud within an organization can be comprehended by examining the elements that comprise such actions. According to the Auditing Standards Board, the occupational fraud triangle consists of three main conditions namely an incentive or pressure that provides a reason to commit fraud, an opportunity for fraud to be perpetrated, and an attitude that enables the individual to rationalize the fraud. Enron case is a classic example of how changes in leadership and culture can undermine a state-of-the-art management control system. Under Skilling, an extreme performance-oriented culture that both institutionalised and tolerated deviant behaviour emerged. The lauding of radical, revolutionary, risk-taking subjects not just stretched but broke through the legal and ethical limits. The stock options regime exacerbated the competitiveness to the extent of manipulating the entire system. The corruption culture prevailed at Enron resulting in an overvalued financial reporting rather than economic value expressions, probably undesirable pressures from the analysts and investor community added fuel to the already degenerative structure. The blatant approach seeks to view corporate crime as a reflection of culture that tolerates or allows it to prevail. However, the legal views indicate that such phenomenon of corporate criminality have to be uncompromisingly handled as opposed to a benign dismissal, occurrence of a mere 'market failure' or poor corporate governance practices, since large corporations are the major business mechanisms of advancing the economies thereby capable of regulating the unacceptable deeds. The issue at Enron's corporate board was a moral one pressing for boardroom leadership that recognizes its role in the company and the society responsibly. The Enron demise leaves many threads bare that are probably far beyond just reforming of the laws, being linked to the intrinsic values and principles.

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