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The Enron Scandal a Decade Later: Lessons Learned?

Alexandre Di Miceli da Silveira

School of Economics, Management and Accounting of the University of São Paulo
(eMail: alexfea@usp.br)

Abstract: The year 2011 has marked a decade since the Enron collapse, considered the most emblematic corporate scandal worldwide. Despite its importance, few studies provide an integrated analysis of the underlying failures that allowed Enron's debacle, going beyond the traditional view that reduces the case to a mere "accounting fraud". Few studies also evaluate the main lessons from the Enron scandal in perspective, by comparing its common causes with corporate scandals that emerged during the global financial crisis in 2007-2008. These are the gaps I aim to fill. I conclude that Enron's accounting manipulations, rather than being the cause of the problems, were the consequence of managerial failures and wishful blindness by its stakeholders. I also show that some lessons from Enron have not been fully internalized by companies worldwide, since most of its underlying causes are similar to those of several corporate scandals that emerged a couple of years later.

Keywords: Corporate governance, case study, Enron, corporate scandals, global financial crisis.

JEL codes: G32, G34, G30, M19.

1. Introduction

A decade ago, the Enron debacle, the most emblematic corporate scandal associated with corporate governance problems in history, took place. The company has become the seventh largest U.S. company by revenues in 2001, the same year it went bankrupt after the disclosure of a series of frauds (Wearing 2005: 67).

The impact of the collapse was disastrous to its shareholders and stakeholders, including the firing of the approximately 30,000 employees. The case drew even more attention because of the image of success that

the company had built in previous years. By the year 2000, for example, Enron had received for six consecutive years the award as the most innovative company from Fortune magazine's annual ranking of the most admired companies. Its Chief Finance Officer (CFO) Andrew Fastow has received in 1999 the award as most creative CFO of the year from CFO Magazine.¹ In September 2001, a month before the eruption of the scandal, Enron was on the list of the 50 U.S. companies fastest growing, being by far the largest company in the list.²

The company had also a lot of power and political influence. It is estimated that three-quarters of U.S. lawmakers have received campaign donations from Enron.³ In 1999, its lobbyists in Washington included people like Henry Kissinger and James Baker, both former U.S. Secretaries of State. In the years immediately preceding the collapse, Nelson Mandela and Alan Greenspan went at the company's headquarters in Houston to receive the then prestigious "Enron Prize". Enron's Chairman and founder, Kenneth Lay, was affectionately called "Kenny Boy" by his then friend George Bush (Wearing 2005: 67, and McLean and Elkind 2004: 87).

Enron was, therefore, a high-profile company, cited as a role model by market's leading experts, including stock analysts, investment analysts, journalists, consultants and even by business schools professors – its "success story" was required reading at Harvard's MBA.⁴ Appendix A provides a detailed timeline of the events that took place at Enron.

The Enron scandal generated huge repercussions, being the start of a wave of other corporate governance problems at major American and European companies (e.g. WorldCom, Tyco, Parmalat, Royal Ahold). It was a key factor for the enactment of the Sarbanes-Oxley Act in 2002, whose impacts were felt by companies worldwide.

¹ Micklethwait and Hamilton (2006: 36). The award received by the Fastow was CFO Magazine in 1999 entitled "Excellence Award for Capital Structure Management."

² Enron's revenues increased from \$ 40 billion in 1999 to \$ 100 billion in 2000. If the year 1996 is taken as the starting point (revenues of \$ 13.3 billion, revenues increased 750% in four years).

³ The Economist, November 30th, 2002 (p.12). Investor self-protection.

⁴ A report from HarvardWatch, a nonprofit organization formed by Harvard's alumni, details the various conflicts of interest between Enron and Harvard University. According to it, Enron promoted a process of institutional capture of the university through financial incentives and personal connections, strongly influencing its research agenda, particularly by promoting the benefits of further deregulation. "Trading Truth: A Report on Harvard's Enron Entanglements." The HarvardWatch Report, January 31, 2002.

Several studies have been conducted to examine the case under multiple facets. O'Connor (2002) and Barrett (2005) discuss Enron's relationship with its auditors. Bratton (2002) analyzes the excessive focus of its managers on share price maximization and its consequences. Partnoy (2002) investigates Enron's wide use of derivatives, while Rosen (2003) concentrates his attention on the company's risk management flaws. Bratton (2003) and Catanhach and Rhoades (2003) analyze Enron's failure from the point of view of the lack of transparency of its public information and accounting decisions. Gillan and Martin (2002) and Schwarcz (2006) focus on the financial engineering operations architected by its CFO Andrew Fastow. Brickey (2003) and Kroger (2004) investigate the case under the legal standpoint by discussing the penalties applied, while the failure of Enron's gatekeepers such as investment banks, rating agencies, auditing, etc. was the focus of Coffe Jr. (2003) and Healy and Palepu (2003).

Despite its relevance, few studies so far have tried to assess in an integrated way the underlying managerial faults associated with corporate governance that caused Enron's collapse. Moreover, as the vast majority of works about the Enron case has been conducted shortly after the eruption of the scandals, few studies have evaluated the main lessons from this scandal in perspective, discussing their degree of internalization among market players and regulators a decade later as well as providing a comparison with several corporate scandals that emerged as a result of the global financial crisis of 2007-2008. These are the gaps that this study intends to fill and thus contribute to the literature.

This paper is structured as follows. I begin by providing a chronological summary with the main events that took place at Enron. I then explain the financial engineering operations between the company and its special purpose entities that allowed Enron to hide its debt. The real causes of the Enron failure are then discussed, focusing on the management problems and ethical decisions that led to wrong business decisions and accounting fraud. The following section details the role of the gatekeepers of Enron investors in the case – investment banks, stock analysts, independent auditors, credit *rating* agencies, law firms, consultancies and regulators. The consequences for the main involved are presented subsequently. I then compare the causes for the Enron collapse with the common causes associated with ten corporate scandals that emerged together with the global financial crisis in 2007-2008 and I conclude by presenting the “red flags” that could have been observed by investors as well as the main lessons to be drawn from Enron's case.

2. Key governance issues: the central problems at Enron

Enron created an ingenious series of financial operations in order to inflate its results and, as a result, allow the exercise of stock options worth millions by its executives.⁵ These operations were carried out through Special Purpose Entities (SPEs)⁶ created by its CFO Andrew Fastow, who simultaneously acted as manager of these companies.⁷ The SPEs, although under almost full control of Enron in most of the cases, took advantage of an accounting loophole that allowed it not to be consolidated in the company's balance sheet of the company if they had at least 3% of outside investors in their capital.⁸ Among the "financial engineering" products structured at Enron, two stand out: the "prepaid" operations⁹ and the "sale and repurchase" of bad projects. Both aimed at disguising loans from

⁵ In addition to allowing the exercise of stock options by its executives, the financial engineering operations at Enron aimed to reduce the company's debt in order to allow new borrowings. The company sought to avoid capital increases, since the issuance of new shares would decrease its earnings per share, the primary focus of both its executives and the several analysts covering the company.

⁶ A Special Purpose Company or Special Purpose Entity is a legal vehicle created to achieve a specific business purpose, which should be clearly defined in their corporate documents. In practice, it is usually created by companies or other legal entities in order to segregate risks, develop specific projects, or make use of tax advantages.

⁷ Among the best known SPEs, there are the LJM series (initials of the names of Fastow's children and wife), JEDI (named due to Fastow's devotion of Star Wars movie), Condor and Raptor. Tonge et al. (2003: 6) describe four examples of complex SPEs created by Fastow. The authors show how some SPEs were also managed by Fastow subordinates, as was the case of Michael Kopper in SPE Chewco. Altogether, it is estimated that Enron has created about 3,000 subsidiaries and it has paid about \$ 300 million to advisers (investment banks, law firms, auditors, etc.) over the years to create this network of off-balance sheet entities. For comparison purposes, the Financial Accounting Foundation, an organization that generates and maintains accounting standards in the U.S., has spent about \$ 20 million in its programs in 2001. In the words of University of Chicago professor Richard Leftwich: "It takes two years the FASB to issue a ruling and two weeks for investment bankers to figure out a way around it". For more information, see <http://www.nysscpa.org/cpapjournal/2003/0403/features/f042403.htm>

⁸ As an example, LJM2 and Raptors (two SPEs) could in fact be considered part of Enron, since in both cases there was not an independent entity with risks and rewards associated with their ownership. Both, therefore, should have been consolidated into Enron's financial statements and the shareholdings of Fastow and other partners should be accounted for as minority interests. For more details on this issue, see Deakin and Konzelmann (2004: 136).

⁹ Also known as prepaid forward sale contract.

investment banks in the form of alleged activities involving operational cash flow.

Typically, a prepaid transaction involves a full upfront payment of a commodity by the buyer at the time of the deal, leaving the seller responsible for supplying the product in the coming months or years. It is, therefore, a transaction in which the seller speculates that the market price of the commodity at the time of the delivery will be lower than the price agreed in the contract, while the buyer speculates the opposite. In a typical prepaid operation, therefore, each party assumes a risk of commodity price.

In the case of Enron's prepaid operations, however, there was a fundamental difference: a series of simultaneous transactions meant that the price of commodity risk was fully assumed by Enron, making the operation essentially a loan transaction. The transactions were structured as follows¹⁰: Initially, Enron sold a certain amount of gas to one of its SPEs, receiving an upfront payment in exchange of a promise of future delivery of the commodity. The SPE simultaneously resold the same gas for an investment bank in identical conditions, receiving the correspondent upfront payment and committing to future deliveries. The investment bank then resold the same gas to Enron, this time with the promise of future periodic payments to be made by Enron instead of an upfront payment. Since the promised future payments to the investment bank were usually based on the future price of the commodity, the bank became exposed to commodity price risk. To eliminate the price risk of the investment bank, Enron then performed a swap transaction with the institution, promising to pay a fixed amount in the following months. At the end, the bank kept only with Enron's credit risk, clearly characterizing a loan operation.

A simplified version of Enron's prepaid transactions is illustrated in the Figure 1. As noted in Figure 1, there was no gas supply. Enron received cash in advance, allocating this disguised loan as "operating revenue". These operations helped Enron to meet its quarterly earnings goals at the expense of increasing indebtedness. It was a very profitable operation for the investment banks involved, since they received their money back later with a substantial profit for their "energy sales". For Fastow, the prepaid operations were also advantageous, since he received fees for "managing" the SPEs in addition to his compensation as CFO. It is estimated that Enron has made about \$8.6 billion in prepaid transactions, especially with the Chase Manhattan bank (via Mahonia entity) and Citigroup (via Delta entity).

¹⁰ Enron's prepaid operations are detailed at:
<http://www.sec.gov/litigation/complaints/comp18252.htm>

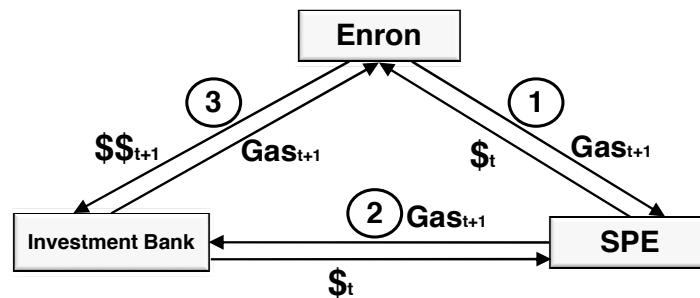


Figure 1 - Illustration of Enron's prepaid transactions.

The sale and repurchase of bad projects to increase quarterly earnings was a simpler operation.¹¹ Enron had several poorly performing assets, acquired at high prices with low cash flow generation. In a given quarter, these assets were sold to one of its SPEs. To pay for the purchase of the assets, the SPE in turn obtained a loan from an investment bank, giving Enron stock as collateral. The SPE then returned the cash received from the investment bank to Enron, which registered the sale of assets as profits. In the next quarter or after a certain agreed period, Enron repurchased the same asset at a substantially higher price than it sold previously. Part of the “profit” of reselling the asset remained with the SPE. The other part paid the loan from the investment bank. A power generation project in Brazil has been sold and repurchased to LJM1¹², whose members were Credit Suisse and NatWest (later acquired by RBS).¹³ On certain occasions, Enron sold the bad assets directly to its investment banks with promising

¹¹ For more details on the sale and repurchase transaction, see McLean and Elkind (2004: 189).

¹² In 1999, Enron, through an integral subsidiary, owned approximately 65% of a power plant in Cuiabá, Brazil. The goal of the project was the generation and sale of electricity. However, the project has proved problematic from the start, leading Enron to incur into substantial costs. As Enron did not want to consolidate the Cuiaba project on its balance sheet, it tried to sell its stake. However, the project was so problematic that no independent entity expressed interest in acquiring it. Enron then decided to “sell” a 13% stake of the enterprise to Fastow’s SPE called LJM1 in September 1999 for \$ 11.3 million. The sale allowed Enron to characterize the Cuiaba project as an independent entity to be kept off-balance sheet. In March 2001, Enron repurchased LJM1’s stake at a substantially higher price, despite the deterioration of the unit’s performance. More details at <http://www.sec.gov/litigation/complaints/comp17762.htm>

¹³ See <http://www.sec.gov/litigation/litreleases/lr17692.htm>

to repurchase it afterwards. One example was the sale of assets in Nigeria to Merrill Lynch to repurchase later¹⁴. A simplified version of Enron's sale and repurchase of poorly performing assets is illustrated in the Figure 2.

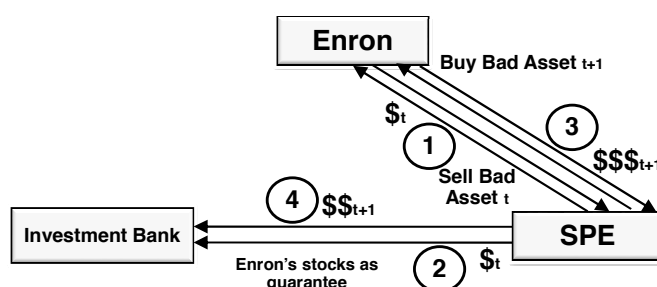


Figure 2 - Illustration of the sales of Enron bad ventures.

In short, Enron's SPEs were similar to a Ponzi scheme, since they depended on the appreciation of Enron's stocks in order to maintain their viability. As a result, people tend to say that Enron was a house of cards powered by accounting manipulations.

The reduction of this emblematic case to a mere event of "creative accounting" constitutes, however, a simplistic analysis. In fact, the relevant question is whether the company's accounting practices were the core of the problem or just the consequence of several problems with Enron's corporate governance model and managerial philosophy.

The probably answer is that the accounting manipulations were just the outcome of a company with several governance deficiencies, especially:

1. A huge gap between internal practices and the rhetoric disseminated to external audiences: while top executives proclaimed to the public that ethics and social initiatives were the central tenets of the company, internally everyone knew that the bottom line was the only thing that mattered. For instance, when employees from the oil trading division were caught embezzling funds after an internal audit in 1987, they evaded punishment on the condition, in a memo written by CEO Kenneth Lay, that they "keep making us millions".¹⁵ Other examples of the distance between rhetoric and practice at Enron can be seen in the following sentences:

¹⁴ See <http://www.sec.gov/litigation/complaints/comp17762.htm>

¹⁵ In January 1987, Enron's internal audit discovered that Louis Borget and Tom Mastroeni, two oil traders from his office in Valhalla (NY), had diverted company

*"I spend much of time on philanthropy and on charitable works. I love to speak about corporate values ... Everyone knows that I personally have a very strict personal code of conduct that I live by. This code is based on Christian values."*¹⁶ – Kenneth Lay, Chairman and CEO.

*"We are doing something special. Magical. Money was not what really matter to me. It is not a job, it's a mission. We are changing the world. We are doing God's work."*¹⁷ – Jeffrey Skilling, COO.

*"We're going to do the right thing and make money without having to do anything but the right thing."*¹⁸ – Andrew Fastow, CFO.

*Enron Values:*¹⁹ 1) Respect – We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness and arrogance don't belong here; 2) Communication – We have an obligation to communicate. Here, we take the time to talk with one another... and to listen. We believe that information is meant to move and that information moves people; 3) Integrity – We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.; 4) Excellence – are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

2. Wrong selection of internal leaders: Enron became notorious for putting the wrong people in the wrong positions for the wrong reasons. The CEO should be the one to lead by example, requiring high ethical standards from all executives. As evidenced by the case of the oil trading division in 1987, Kenneth Lay, however, was a leader who put financial results above ethical issues. In addition, he used to prioritize his public image through charitable activities and social events instead of the daily operations of the

funds to their personal accounts. In April of the same year, the council - chaired by Kenneth Lay - was informed that they had operated well above their limits and destroyed reports trading in order to maintain the appearance that they were getting steady profits. As the Department of traders had been responsible for much of Enron's profits in the previous year, Lay made it clear that they were generating profits too much to be dismissed. The case is described in detail by McLean and Elkind (2004: 20). According to the authors, Lay ended his letter to the accused with the following request": "please and keep making us millions ...".

¹⁶ McLean and Elkind (2004: 3).

¹⁷ <http://money.cnn.com/news/specials/enron/intro1.pdf>

¹⁸ Mills (2002: 47).

¹⁹ Enron's 1998 Annual Report:

<http://picker.uchicago.edu/Enron/EnronAnnualReport1998.pdf>

company. Chief operating officer Jeff Skilling was a known abstract thinker, averse to operational details and idea implementation.²⁰ As a result, many of Enron's creative business initiatives had problems in their implementation. The chief finance officer Andrew Fastow had been a weak performer at other positions he had previously occupied within the organization²¹ as well as was probably inexperienced to qualify for a CFO role in a large company,²² having been lifted to the post on account of his excellent personal relationship with Skilling, who saw him as someone he could trust. (The relationship between Fastow and Skilling was so good that Fastow named one of his sons Jeffrey, in honor of his boss.)

3. An inadequate incentive system: compensation at Enron was too aggressive and pegged to closing deals. As a result, executives focused much more on sales rather than on the long term cash flow generated during the projects' implementation. They quickly pocketed million-dollar bonuses for investments and contracts that ultimately would make the company lose money.

4. Fierce internal rivalry among executives: the internal work environment was extremely aggressive, diminishing the possibility of cooperative efforts required for all companies to succeed. Enron enforced the Performance Review Committee, a rigorous, 360-degree performance evaluation system where, in theory, employees were required to rate their peers on a 1-5 scale based on four values: communication, respect, integrity and excellence. Those who received the worst ratings should be dismissed within six months, in an attempt to promote "natural selection" at the company. (Skilling's department was known to fire about 15% of its people every year.) In practice, the process was a sham. The only real measure of performance was the profit generated by executives. In the pursuit of good evaluations, many executives also began producing fictitious profits and working out agreements with their peers based on

²⁰ Regarding Skilling's profile, McLean and Elkind (2004: 28) argue that "Skilling had a tendency to oversimplify... and he had an active distaste for the messy details involved in plan execution."

²¹ According to McLean and Elkind (2004: 137), "Fastow did not stand out in his first few years at Enron. Certainly, people would not have guessed that he would one day ascend to become CFO of a Fortune 500 company".

²² According to Micklethwait and Hamilton (2006: 52), Fastow had experience in asset securitization and structured financial transactions, but lacked experience in accounting and controlling, crucial areas for a CFO of a large company. A former boss at Continental argued that "Andy did not have the knowledge base required to be CFO of a major company" (McLean and Elkind: 2004: 140).

personal relationships in order to secure good evaluations. The overall result was the creation of a work environment verging on paranoia in some cases (McLean and Elkind 2004: 63, and Tonge et al. 2003: 12).

5. Bad business decisions, with even worse implementation by its executives: Enron became known for a large number of strategic mistakes, overpriced acquisitions and disastrous overseas investments. Thus, the decision process in its top management has a much larger share of the blame for his downfall than accounting manipulations, something necessary to keep Enron afloat since the company was always in need of resources due to unprofitable operations. For example, among famous wrong business decisions at Enron, stand out the frustrated entry in the segment of broadband Internet,²³ the attempt to sell electricity directly to the retail market, and the construction of true “white elephants” abroad as his enormous Dabhol energy plant in India.²⁴

6. An atmosphere of corporate arrogance: the constant media portrayal as a success story and its highly valued stocks enhanced the internal atmosphere of hubris and intellectual superiority shown by Enron executives regarding its competitors and market in general, leading the company to reinforce its deficient practices without relevant internal challenge.

7. Having an “ornamental” board of directors: though adequate on paper, the Enron board clearly failed, appointing the wrong people for top executive positions and approving decisions based on conflicts of interests, obscure off-balance activities, and excessive executive pay. One board decision was particularly crucial for the company’s troubles. According to

²³ One of the most notorious business failures at Enron occurred through its partnership with Blockbuster, a provider of movie rental services. In July 2000, they signed a 20-year agreement to launch the concept of movies on demand (via a broadband network to be implemented by Enron). Although conceptually interesting, operational difficulties undermined its financial viability. This case also illustrates the problems associated with mark-to-market accounting at Enron. Initially, it estimated earnings of \$110 million for the project, booking it as operational income. After several problems and the termination of the partnership with Blockbuster, Enron continued to recognize the “future profits” of this project.

²⁴ In addition to the huge and failed Dabhol energy plant in India, Enron suffered severe losses in energy investments in Brazil and Bolivia, as well as with sanitation projects in Argentina. Altogether, these investments have been major consumers of the company’s cash.

Enron's Code of Ethics,²⁵ no employee could be compensated for other activities than those as a company executive. Hence, the CFO Fastow could not be appointed executive of the SPEs created to carry out business transactions with Enron. In June 1999, in an unbelievable decision, the board approved him a special exemption from the Code,²⁶ authorizing Fastow to act as manager of the SPEs and to negotiate with Enron's financial department (of which he was also at the head) the fees he would charge for "managing" those entities. Wearing (2005: 70) estimates that Fastow has earned at least \$30 million as manager of Enron's SPEs.

3. The role of Enron's gatekeepers²⁷

In addition to internal management flaws, the Enron scandal was brought about by external flaws related to misconduct by entities that should have safeguarded the interests of its investors — in other words, audit firms, investment banks, stock analysts, law firms, and credit rating agencies. There is a so-called "A, B, C, D, and E theory" to explain the failures of Enron's gatekeepers.

3.1 Auditors

Arthur Andersen was the audit firm retained by Enron uninterruptedly since the company's founding in 1985 until its collapse in 2001. The

²⁵ Extract from Enron's Code of Ethics: "*Employees of Enron are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the Company*".

Available at <http://www.thesmokinggun.com/enron/enronethics1.html>

²⁶ Tonge et al. (2003: 10). According to McLean and Elkind (2004: 193), the board meeting that granted the exemption to Fastow — in which the majority of directors participated by telephone and including other topics on the agenda — lasted less than 1 hour.

²⁷ The corporate governance literature often uses the term "gatekeepers", which are professionals that provide services of verification, certification and analysis, using their reputational capital to protect investors. The expression was initially formulated in the corporate governance context by Professors Ronald Gilson and Reinier Kraakman in 1984. Among the main gatekeepers, stand out auditors, investment banks, law firms, credit rating agencies and market analysts. Some authors also point out advisors and consultants as gatekeepers, since the market expects these agents to properly guide companies regarding best governance practices.

company was founded in 1913 by a very conservative university professor in Chicago and was considered highly respected throughout its history. From the 70s, however, changes in its management and the entry into the consultancy business have created internal tensions that contributed to the failures in its audit service. In addition to the external audit services, Andersen rendered consulting and internal audit services for Enron. By late 2000, Enron was Andersen's second largest client worldwide. During this year, Andersen received \$52 million from Enron (about \$1 million per week), the most part coming resulting from consulting services. The involvement with the client was enormous. Andersen occupied an entire floor with about 100 auditors at Enron's headquarter throughout the year (McLean and Elkind, 2004: 146). Over the years, it has become common practice for Enron to employ people from Andersen. The Chief Accountant Officer (CAO) and Enron controllers were all former Andersen executives.

It is estimated that Enron hired at least 86 former Andersen executives. Despite objections from Andersen technical area on different occasions, David Duncan, Andersen's lead auditor in charge of the Enron account, accepted Enron accounting practices without any qualifications until 2001.²⁸ According to critics, his pay system – tied to the profitability of the Enron's account – have been a crucial factor to avoid tougher questions and to the postponement of qualifications in the auditors opinion. Andersen was criminally prosecuted for destroying documents and obstructing justice. In the same period, the firm was involved in other governance scandals (e.g. Worldcom, Global Crossing, Qwest) that resulted in losses of approximately \$300 billion for investors. At the end, its staff was reduced from 85,000 to 3,000 employees in 2002 and the 90-year-old company went bankrupt due to the loss of its most precious asset: the reputation.

3.2 Investment banks and their stock analysts

Enron paid hundreds of millions annually in fees to investment banks for advisory services in its operations, approximately \$238 million just in

²⁸ Tonge et al. (2003: 7) argue that Andersen was aware of some significant losses in Enron's off-balance sheet SPEs in early 2001, but decide not to take them to the Enron's Audit Committee. Hamilton and Micklethwait (2006: 54) point out that Andersen internally used to consider Enron as a "high risk" client and that the political weight of David Duncan at Andersen – an executive who had risen quickly through the ranks due to the growth of Enron's account and whose compensation was tied to the maintenance of the client – always prevailed over the opinions of Andersen's technical area. They also note that Duncan used to suffer internal pressures at Anderson to generate more revenues from the clients.

1999 (McLean and Elkind, 2004: 163). A good relationship with Enron senior management was essential for investment banks to secure access to highly profitable businesses. As a result, investment banks participated actively in Enron's financial engineering operations, some even going so far as to become investors in many of its SPEs. Tonge et al. (2003: 7) show how Citigroup and a Morgan Stanley affiliated entity became partners of some SPEs of the LJM series. Hamilton and Micklethwait (2006: 45) claim that the LJM2 SPE had renowned banks like Citigroup, Deutsche Bank, GE Capital and JP Morgan as their partners.

At the same time, their stock analysts continued to recommend investors to buy the Enron's shares. On October 9th, when Enron shares were trading at about one-third of their peak value one year before due to the eruption of its dismal accounting, a Goldman Sachs report called Enron "still the best of the best", indicating a target price for its shares about 45% superior than its market price, praising the company with sentences such as "We expect Enron shares to recover dramatically in the coming months... our confidence level is high... Misconceptions abound and perceptions are far below reality, in our view... We believe Enron's fundamentals are still strong".²⁹ At that time, 16 out of the 17 analysts that covered the company continued to post "buy" or "strong buy" recommendations (McLean and Elkind, 2004: 230).³⁰

No bank clearly warned their investors about the problems at Enron. According to McLean and Elkind (2004), in fact acted as true partners of Enron's shady dealings:

"One of the most sordid aspects of the Enron scandal is the complicity of so many highly regarded Wall Street firms – a complicity that is stunningly documented in internal presentations and e-mails.... They show banks helping Enron mask debt as cash flow from operations and create phony profits at the end of a quarter. They also show how almost all of them put money into Fastow's partnerships because of – not in spite of – their potential for abuse. Most of all, the documents show that the banks weren't merely enablers; they were truly Enron's partners in crime."

²⁹ Goldman Sachs Report. October 9th, 2001. Enron Corp. (ENE): Gas & Power Convergence. Available at: <http://www.dauphinefinance.com/MFE/ALire/Enron%20The%20best%20of%20the%20best.pdf>

³⁰ According Tonge et al. (2003: 15) analysts that did not support Enron by recommending its shares were likely to face problems with their employers.

3.3 Consultants: Strategic and legal advisors

Enron was advised by highly renowned consultancies and law firms. Its main strategic advisor was McKinsey, considered “the most renowned global management consulting firm”. McKinsey has provided continuous business advisory service for Enron throughout 18 years, by which it is estimated to have received about \$10 million per year in fees.³¹ Some of Enron’s managerial practices were cited as role models in the McKinsey’s publications, including several “innovations” created by the company as the “asset light strategy”, the culture of “loose and tight controls” and the securitization of most of its debt (McLean and Elkind 2004: 240). In the same period, McKinsey advised other companies with governance problems, such as Swissair and Global Crossing. McKinsey worked so closely to Enron that its CEO decided to send the head of the legal department to Houston after the Enron collapse in order to assess possible legal consequences to the consulting firm.³²

Prestigious law firms also received huge sums (often above the market fees) for their services. Some, like the renowned office Vinson and Elkins, Enron helped to prepare the legal documentation for its SPEs. For instance, two of its partners have been designated by Kenneth Lay in August 2001 to investigate rumors of problems taking place in the company. At the end, their report did not find anything “fundamentally wrong” at Enron. Later, the firm they were accused of failing to disclose to the public problems concerning the SPEs, agreeing to pay \$30 million to avoid prosecution.

3.4 Credit rating agencies

Enron was also rated by the three major credit risk agencies – Moody’s, Standard & Poor’s and Fitch. Despite having frequent access to Enron’s management in order to obtain additional information, none warned investors of the impending danger. A few weeks before Enron’s bankruptcy (when the company’s shares were already trading at about \$3), they still assigned an “investment grade” rating for Enron debt.³³

³¹ Business Week Magazine, July 8th, 2002. Inside McKinsey. Cover Story. Available at

http://www.businessweek.com/magazine/content/02_27/b3790001.htm

³² Business Week Magazine, July 8th, 2002. Inside McKinsey. Cover Story.

³³ The “investment grade” rating was a fundamental condition for the viability of the SPEs and for the very business model of Enron in the broader sense. As explained by Konzelmann and Deakin (2004: 138), “As Enron’s credit status declined (eventually falling below investment grade level), debts automatically fell

3.5 Board of directors

In early 2001, Enron Board of Directors had 17 members, 15 of which were outside directors. Kenneth Lay was both the Chairman of the Board and CEO. The board was subdivided into five committees,³⁴ all chaired by directors deemed as independent. The Audit Committee was coordinated by the same person since 1985 and its two other members received Enron funds in the form of consulting or through the sponsoring of entities with which they were connected (Wearing (2005: 70)). The Audit Committee used to meet four to five times a year, with meetings lasting only about two hours, very little taking into account its heavy agenda full of complex issues (Micklethwait and Hamilton (2006: 53)).

Despite having several prestigious members – including CEOs, Chairmen of other boards, professors emeriti and former Secretaries of State – Enron's board clearly failed by not making crucial questions and decisions. According to a report from the U.S. Senate Investigation Committee from July 2002, Enron's failed to fulfill its fiduciary duty, allowing the company to engage in high risk accounting, inappropriate conflict of interest transactions, extensive, undisclosed off-the-books activity, and excessive executive compensation. The board also had its independence impaired due to several financial ties between the company and its directors deemed as "independent".³⁵ One of the major failures of Enron board was to allow excessive executive pay with a short-term focus. As an example, the compensation committee of the board approved bonuses totaling \$750 million to Enron's 65 top executives for the year 2000 (\$253 million for the top five executives), the year in which the company reported a net profit of \$975 million.³⁶ Besides allowing exorbitant salaries to its executives, the compensation of the members of

due and liabilities accumulated under the terms of its loan covenants... Enron's entire strategy depended upon being able to maintain the confidence of the credit and capital markets."

³⁴ Audit, Compensation, Nominating, Executive and Finance Committees.

³⁵ Tonge (2003: 17) argues that at least six Enron independent directors received significant funding from the company in the form of sponsorships, donations or services.

³⁶ Source: Business Week, July 29th, 2002. According to Micklethwait and Hamilton (2006: 37), the 200 top executives of Enron received about \$ 1.4 billion in total compensation (including salary, bonuses, stock, options, etc.) in the year 2000. Between January 2000 and October 2001, the top three Enron executives pocketed nearly \$290 million by selling company stocks (Lay, \$184 million; Skilling, \$70 million; Fastow, \$33 million).

the board was also substantially above the market. Appendix B details the consequences for the key people involved with Enron's case.

4. Red flags for investors and regulators

The Enron case is rich in red flags for investors and regulators. Among the warnings signals that could have drawn investors' attention, the following stand out:

4.1 An excessive concentration of power in the hands of the business leader: Kenneth Lay – the man responsible for the merger that gave rise to Enron who acted as CEO and Chairman for 15 years – exercised a near complete control over the company's major decisions, with no relevant counterbalance at the board level to his views;

4.2 A Chairman/CEO more interested in self-promotion than in managing daily operational activities: although Lay wielded immense power over the board, he clearly showed less interest in daily matters. Over the years, he started spending less time managing Enron than did organizing charity events and other external activities meant to feed his ego and increase his social status;³⁷

4.3 The lack of transparency about the company activities and earnings sources: few people understood Enron's business and its hypothetical sources of profit. But that didn't keep investors from putting money into the company. In an interview in early 2001, COO Jeffrey Skilling acknowledged this lack of transparency: "Yes, (the company) is a black box. But it is a black box that is growing revenues and profits 50 percent. It's a good black box";

4.4 An inadequate compensation system: in addition to clearly excessive bonuses, the compensation policy was flawed, allowing managers to quickly pocket profits from projects that would only theoretically happen in the long term; and,

4.5 The extraordinary growth in the previous years before the collapse: between 1996 and 2000, Enron revenue jumped almost eight times from \$13.3 billion to \$100 billion. This phenomenon was made possible mainly by acquisitions, most of them costly and underperforming. Over time, the

³⁷ The focus on social events and reduced interest on Enron businesses, especially in the last years running the company, was even used by Lay in his defense.

acquisitions became a mechanism to divert attention from the company's shortcomings.

5. Key lessons

Analyzed in integrated fashion, the Enron case teaches us many lessons. Seven key lessons stand out:

5.1 The enormous gap between “checklist” governance and effective governance: although many of Enron's corporate governance mechanisms were “on paper” in line with best practices, things worked very different internally. The board of directors and the risk management department are two examples. Though apparently independent, many directors had other, subtle bonds to Enron and its leaders, such as indirect financial ties and personal friendships that undermined their ability to call things into question. Lack of dedication was another adverse factor: the board and its committees seldom met, a reflection of the directors' lack of available time for the company. The risk management department – consisting of around 150 experts in finance, banking and statistics educated in top-tier MBA programs – was also celebrated by consultancies and credit rating firms as a major competitive edge for Enron. However, internally, its leaders had little power to obstruct projects or operations considered excessively risky.

5.2 The risks of perceived success: the high visibility of Enron's “success” in the media, stock market and academia enhanced the ambience of euphoria and arrogance within the company, lulling its executives into a feeling of certain invincibility. This diminished critical sense drove people to stop questioning whether they were really doing the right things for the company's long-term success.

5.3 The focus on quarterly profits instead of long-term value creation: instead of stimulating the sustainable creation of value over the years, Enron's executives focused their efforts on systematically raising the company's quarterly earnings per share (EPS), the main indicator taken into consideration by Wall Street stock analysts.³⁸ The company's engagement in this type of market game based on an insufficient, maneuverable and short-sighted parameter became an unstoppable snowball.

³⁸ In its 2000 Annual Report, Enron was clear about its exclusive focus on quarterly earnings per share: “Enron is laser-focused on earnings per share and we expect earnings to remain strong performance.”

5.4 The attachment to highly reputable names as a way of conveying a false sense of security to investors: Enron very skillfully dropped A-list names as a way of “certifying” its activities. What investors might think of a company strategically guided by McKinsey, legally advised by offices such as Vinson and Elkins, financially steered by investment banks including J.P. Morgan and Citibank, audited by Arthur Andersen, and systematically praised by such institutions as Harvard? Probably, that everything was very well managed internally. However, investors failed to question the ties and interests of these gatekeepers, relying solely on their reputation.

5.6 Blind trust and investors’ greed: although Enron slogan was “Ask Why”, the truth is that investors, including employees who invested their retirement money in Enron, failed to do this, not asking themselves simple questions such as: how could a large company in the commodities industry grow 50% yearly? How a company trading derivatives could provide a constant increase of about 15% in its earnings per share quarterly? Is a 500% return on investment within four years a reasonable performance? In other words, investors were dazzled by Enron's extravagant advantages and profits and beguiled by prospects of easy short-term gain.

5.7 The potential problems of marking-to-market accounting: though correct from a conceptual point of view, the accounting rules of marking-to-market or fair value (a more interpretive concept) were shown to be susceptible to fraud, particularly when the market price of assets could not be determined objectively. As a result, many of Enron’s assets started being “marked-to-model” through estimates derived from financial models manipulated to yield the desired results.

5.8 The dangers of poor regulation: many problems were caused by regulatory loopholes systematically exploited by Enron. Its SPEs provide the clearest example, most of which were not consolidated in the company’s balance sheets. Furthermore, Enron controlled several derivative markets (including the securities known as weather derivatives, which help to diminish the risks associated with weather conditions), and was usually able to set their “market” prices.

6. A comparison with recent corporate governance scandals from the 2007-2008 global financial crisis

In this section, I compare Enron with ten corporate scandals that emerged in the 2007-2009 period. If we observe similar causes, then we would have

an evidence in favor of the argument that the lessons from the Enron's collapse have not been fully learned.

There is a previous literature that seeks to identify the causes of governance scandals. Hamilton and Micklethwait (2006), concluded that seven scandals from the early 2000s – including Enron –were caused by six main common causes: 1) poor strategic decisions; 2) over-expansion and ill-judged acquisitions; 3) dominant CEOs; 4) greed, hubris and a desire for power; 5) failure of internal controls; and, 6) ineffective boards. Coffee Jr. (2005, 2006) listed the “gatekeeper failure” as another reason for the emergence of corporate scandals. More recently, a OECD report (2009) concluded that four main problems have caused the governance failures at financial institutions that collapsed in the 2007-2009 period: 1) inadequate incentive systems; 2) deficient risk management practices; 3) poor board practices; and, 4) the tendency for shareholders – especially institutional investors – to act reactively rather than proactively.

Building upon these works, I propose an expanded framework with fourteen possible interrelated common causes associated with corporate governance scandals:

1. Excessive concentration of power: corporate decisions coming from the single views of specific individuals without the appropriate counterbalances.
2. Ineffective Board of Directors: boards do not satisfactorily performing their role of monitoring managers and providing the right strategic direction.
3. Passivity of investors: investors do not correctly exercising their role as active shareholders and end up wrongly rewarding firms with unsustainable practices by inflating their stock prices.
4. Failure of gatekeepers: reputational intermediaries – such as auditors, stock analysts, credit rating agencies, attorneys, investment banks, and consultants – who pledge their reputational capital to vouch for information that investors cannot verify failing in their duties.
5. Poor Regulation: deficient or nonexistent regulation allowing the occurrence of governance problems.
6. Illusion of success of the business: people inside and outside the organization believing that the company is an absolute success, ignoring contrary evidence and generating a feeling of invincibility.
7. Internal atmosphere of greed and arrogance: an internal atmosphere of euphoria and hubris creating an inner sense of superiority to people outside the company.
8. Lack of ethical tone at the top: leaders clearly failing to promote high ethical standards within their organizations, not treating the issue as something essential and priority.

9. Corporate governance seen as a marketing tool: the company clearly seeks to meet the check-list of recommended governance practices without actually embracing the theme at its core prior to the emergence of the scandals.

10. Overexpansion of the business: excessive growth of the company in the years immediately preceding the governance problems, especially via acquisitions, contribute to the scandal.

11. Biased strategic decisions: unintentionally bad top level strategic decisions made due to cognitive biases such as overconfidence, groupthink, information cascades, etc.

12. Inflated Financial Statements: intentionally publishing of doctored financial statements, often inflating its profits or hiding its debts.

13. Weak internal controls: the main components of a sound internal control system are missing, such as an adequate control environment, effective risk management and control activities.

14. Inadequate compensation system: a compensation system too aggressive and too connected to short-term goals substantially contributing to governance problems.

In Table 1, I provide a qualitative analysis of Enron and the other ten selected scandals from the 2007-2009, aiming at understanding the specific relevance of each factor for the selected cases. In spite of the severe limitations of this qualitative assessment, such as its admittedly subjectivity, Table 1 suggests that the lessons from the Enron's case have not been fully learned worldwide since most of its main underlying causes seem to have been repeated by the corporate scandals of the 2007-2009 period. Specifically, nine similar causes can be pointed out when we compare the Enron case with the cases of U.S. investment banks Lehman Brothers and Bear Stearns and the insurer AIG – all of them crucial for the eruption of the global financial crisis in 2007-2008: 1) Excessive Concentration of Power, 2) Ineffective Board of Directors, 3) Passivity of Investors, 4) Failure of Gatekeepers, 5) Poor Regulation, 6) Illusion of Success of the Business, 7) Atmosphere of Greed and Arrogance, 8) Lack of Ethical Tone at the Top, and 9) Inadequate Compensation System.

Although scandals from the 2007-2009 period appear to have occurred due to the same causes identified at the Enron case, it is nevertheless important to recognize that Enron and the other scandals from the early 2000s have brought about to some positive impacts.³⁹

³⁹ The author thanks the anonymous referee for highlighting the need to reflect on the positive aspects resulting from the Enron's case.

Table 1: Enron case vs. selected corporate scandals from the 2007-2009 period.**Panel A.** Common causes associated with corporate governance scandals from the first decade of the 21st Century on a 0-3 scale⁴⁰

	#		1	2	3	4	5
	Company	Enron	Siemens	Société Générale	Lehman Brothers	Bear Sterns	AIG
	Year	2001	2007	2008	2008	2008	2008
1	Excessive Concentration of Power	2		2	3	3	3
2	Ineffective Board of Directors	3	3	2	3	3	3
3	Passivity of Investors	3	1		2	2	2
4	Failure of Gatekeepers	3	2	1	3	3	3
5	Poor Regulation	3	3	1	2	2	2
6	Illusion of Success of the Business	3	1	2	3	3	3
7	Atmosphere of Greed & Arrogance	3		3	3	3	3
8	Lack of Ethical Tone at the Top	3	3	3	3	3	3
9	CG seen as a Marketing Tool	3	3	2	3	3	3
10	Overexpansion of the Business	3			3	2	2
11	Biased Strategic Decisions	3			3	3	3
12	Inflated Financial Statements	3	1		1	1	1

⁴⁰ The qualitative scale aims to analyze the different relevance of each common cause associated with corporate scandals. “1” indicates that the factor was relevant for the emergence of the scandal. “2” indicates that the factor was highly relevant and “3” indicates that it was critical for the eruption of the scandal. Void cells indicate that the respective factor was not relevant to the case at hand.

13	Weak Internal Controls	2	2	3	2	2	2
14	Inadequate Compensation System	3	1	2	3	3	3

Panel B. Common causes associated with corporate governance scandals from the first decade of the 21st Century on a 0-3 scale⁴¹

	#		6	7	8	9	10
	Company	Enron	Sadia	Aracruz	Madoff	Sat-yam	Pana-meri-cano
	Year	2001	2008	2008	2008	2009	2009
1	Excessive Concentration of Power	2	1	1	3	3	3
2	Ineffective Board of Directors	3	3	3	3	3	3
3	Passivity of Investors	3	2	2	3	2	3
4	Failure of Gatekeepers	3	3	2	2	3	3
5	Poor Regulation	3	3	3	2	1	2
6	Illusion of Success of the Business	3	3	3	3	2	2
7	Atmosphere of Greed & Arrogance	3	1	2	3	1	3
8	Lack of Ethical Tone at the Top	3	3	3	3	2	3
9	CG seen as a Marketing Tool	3	3	3	2	3	3

⁴¹ The qualitative scale aims to analyze the different relevance of each common cause associated with corporate scandals. "1" indicates that the factor was relevant for the emergence of the scandal. "2" indicates that the factor was highly relevant and "3" indicates that it was critical for the eruption of the scandal. Void cells indicate that the respective factor was not relevant to the case at hand.

10	Overexpansion of the Business	3			1		2
11	Biased Strategic Decisions	3	2	3	2	1	2
12	Inflated Financial Statements	3			3	3	3
13	Weak Internal Controls	2	3	3	3	3	3
14	Inadequate Compensation System	3	2	X	3		3

From the academic point of view, the scandals led to an increasing questioning of agency theory and its tenets so strongly embraced by companies such as Enron as the dominant intellectual framework to devise solutions for the governance of corporations. According to agency theory, corporate governance should be seen as a set of incentive and control mechanisms to be implemented in corporations in order to ensure the maximization of stock prices. This view – grounded on the work of orthodox economists (Jensen and Meckling 1976; Fama and Jensen 1983) – is basically concerned with creating ways to motivate one party (the “agent”), to act on behalf of another (the “principal”). As a result, the good governance of a business, a very complex subject, is reduced to a mere set of incentive and control mechanisms in order to induce agents (managers) to make decisions in the best interests of their principals (shareholders).

Enron adopted most of the incentive and control mechanisms advocated by agency theory. From the incentive point of view, for instance, the company heavily relied on stock option plans in order to align the interests of executives and shareholders. Enron also relied on several control mechanisms such as independent board members, audit committee, risk management area, and internal and external audits, among others.

The limitation of the corporate governance debate to the theoretical framework prescribed by agency theory is problematic because it has left business leaders free to treat this complex and intrinsically human subject as a mere check-list of recommended practices based on rewards and punishment mechanisms in order to be well perceived by the outside stakeholders. This problem was quite clear at Enron, where there was a sharp discrepancy between the essence of good governance – companies where decisions are made in their best long-term interest and in which people comply with the rules – and the internal focus on the compliance with the best governance practices just to satisfy external audiences through a good corporate image.

Among the papers that emerged after the Enron case calling for new approaches toward corporate governance by questioning and widening the agency theory concept, there are Charreaux, (2005), Van Ees et al. (2009), Cuevas-Rodríguez et al. (2012), Martin et al. (2012), Wiseman et al. (2012) and da Silveira (2012).

Enron scandal also induced the enactment of the Sarbanes-Oxley (SOX) Act in July 2002, impacting companies worldwide. The main goal of the Law was to improve the accuracy of the financial statements. Although there has been much debate about SOX's overall cost-benefit for the companies and the U.S. market as a whole, the analysis of the ten selected corporate scandals presented in Table 1 indicates that inflated financial statements have not been a key component for the majority of the governance scandals that emerged from 2007 to 2009.

Specifically, fraudulent statements with elements of a Ponzi scheme were at the core of only three scandals of this period: Madoff⁴² (a U.S. investment fund), Panamericano Bank⁴³ (a Brazilian bank), and Satyam⁴⁴ (an Indian IT company). Since Madoff was not subject to the stricter accounting standards of Sarbanes Oxley (because it was an investment advisor and not a U.S. listed company) and the two other companies were from emerging markets and also not subject to this Law, it is possible to infer that the enactment of Sarbanes-Oxley as a result of Enron have had a positive impact on the market by avoiding the emergence of new scandals based on inflated financial statements. Therefore, although it is not possible to estimate the number of companies that have been saved by Enron's fate due to the improved regulatory and market vigilance after its collapse,⁴⁵ the analysis of ten selected scandals from the 2007-2009 indicates that financial inflated statements have not been as relevant as a

⁴² In 2008, founder and CEO Bernard Madoff confessed that a Ponzi scheme had been running for decades at his asset management company, resulting in losses of around US\$ 65 billion for his approximately 4,800 investors.

⁴³ In 2009, the Panamericano bank, which had successfully made its IPO just two years earlier, announced a hole of about \$ 2.0 billion on its balance sheet, about 2.5 its equity and half of its total assets.

⁴⁴ In 2008, Ramalingam Raju, Chairman and founder of Satyam (India's fourth largest IT company), sent a letter to both the board of directors and to the country's regulator confessing that the company had inflated its revenues by 76% and its profits by 97% in the previous year.

⁴⁵ The conjecture about the number of companies that could have ended up with fraudulent statements if Enron collapse had not happened if obviously something not possible to be done.

key factor as it has been with Enron and other scandals from the early 2000s.⁴⁶

7. Conclusion

The Enron scandal is extremely rich in lessons. Aiming at providing a deeper analysis of this emblematic case, this paper investigates the internal and external causes of the problems at Enron as well as the red flags that investors could have observed and the lessons that were learned. The most important lesson is the understanding that the fraudulent accounting was not the cause of the scandal, but the consequence of how Enron was governed. In other words, the root of the problem was not the accounting manipulation, which has just been a consequence of collective failures by a wide range of internal and external agents.

However, despite its significance, the lessons from the Enron case seemed to have been systematically overlooked. I provide evidence of this by presenting a comparison of the Enron case with ten corporate scandals that emerged in the 2007-2009 period in order to assess if the causes have resulted from similar causes. This qualitative analysis suggests that relevant lessons from the Enron's case have not been fully learned worldwide, since most of its underlying causes – such as excessive concentration of power, ineffective board of directors, passivity of investors, failure of gatekeepers, poor regulation, and inadequate compensation system – seem to have persisted in the corporate scandals that emerged along with the global financial crisis.

On the other hand, we identify two positive outcomes from Enron and other scandals from the early 2000s. From the academic perspective, the scandals have increased the debate about the validity of agency theory and its tenets so strongly embraced by Enron – such as the exclusive focus on stock price maximization and the adoption of stock option plans as the main mechanism for alignment of interests – as the dominant intellectual framework to devise solutions for the problems of corporate governance. From the market perspective, the Enron scandal has induced the enactment of the Sarbanes-Oxley (SOX) Act in July 2002, which possibly has avoided the emergence of some new scandals mainly caused by inflated financial statements.

The Enron case should be viewed as an opportunity to prevent other ill-governed companies from causing similar losses to investors and society.

⁴⁶ The author thanks an anonymous referee for pointing out that perhaps many companies have been saved from Enron's fate due to increased vigilance after Enron's debacle.

As those who don't know history are sometimes doomed to repeat it, the lack of knowledge and reflection on an episode that left so many lessons like this can make investors and society at the mercy of the occurrence of similar scandals in the coming years.

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Appendix A – Timeline of events

- July 1985: Enron is born from the merger of two natural gas companies: Houston Natural Gas (based in Houston) and Internorth (based in Nebraska).
- 1986: Kenneth Lay, PhD in economics from the University of Houston with humble origins is appointed Enron's Chief Executive Officer (CEO) and Chairman of the Board. As one of his first initiatives, he hires McKinsey, a consultancy firm, to help him develop a new business strategy. McKinsey allocates a consultant named Jeffrey Skilling, a Harvard MBA with background in banking and finance, to lead the work. His recommendation was simple: to transform Enron into an "energy bank" by bringing together buyers and sellers of energy products and taking advantage of the beginning of the energy market deregulation.⁴⁷
- 1989: Enron starts trading natural gas, becoming the largest marketer of gas distribution in the U.S. and in the U.K.
- 1990: Lay creates a new division entitled Enron Finance Corp. Skilling is hired as its managing director. His acceptance is conditioned on the adoption by Enron of mark-to-market as accounting method.⁴⁸

⁴⁷ Skilling was responsible for Enron's "asset light strategy", which prompted the company to shift its focus from holding physical assets towards the trading of energy contracts (Wearing: 2005: 68).

⁴⁸ The mark-to-market or fair value accounting aims at accounting for the fair value of an asset or liability based on: i) its current market price, ii) similar assets and liabilities, or iii) on another objectively assessed "fair" value. In contrast to traditional accounting system based on historical prices, the value of assets and liabilities subject to mark-to-market tends to change more frequently. It is, therefore, a tradeoff between a stable and generally outdated accounting method by a more volatile and updated one. However, the mark-to-market accounting can become very inaccurate when prices deviate from their "fundamental" value due to incorrect inputs in valuation models.

- June 11th, 1991: Enron lobbies in Washington for the Securities and Exchange Commission (SEC) to authorize it to adopt mark-to-market accounting.
- January 30th, 1992: SEC grants permission for Enron's adoption of the mark-to-market accounting, only present in financial institutions at that time.⁴⁹
- 1990s: Enron is transformed from a natural-gas pipeline company into an energy-trading powerhouse. As a result, it hires the "best and brightest" traders, with extremely aggressive and potentially astronomic compensation packages. Skilling is promoted to Chief Operating Officer (COO) in December 10th, 1996.⁵⁰ Andy Fastow, a Kellogg MBA hired in 1990, becomes CFO in 1998. Inspired by working practices of its former consultancy, Skilling installs the Performance Review Committee (PRC), a harsh evaluation system aimed at to fire at least 10% of the staff annually, fomenting strong internal rivalry in the company.
- June 28th, 1999: The Board of Directors exempts the CFO Fastow from Enron's Code of Ethics, allowing him being the fund manager of special purpose companies created to carry out business with Enron.
- November 1999: Enron begins to trade exotic products such as weather derivatives.⁵¹ The company launch Enron Online, an Internet based

⁴⁹ The mark-to-market accounting naturally does not bring with itself a corporate governance problem. However, it depends on minimally reasonable criteria for determining the fair value of an asset, something that according to McLean and Elkind (2004: 42) had often not happened at Enron. In practice, the company seems to have discovered that mark-to-market was an easy way to generate fraud, especially when market prices of assets could not be objectively determined. As a result, many assets seem to have been marked-to-models by value estimates derived from financial models frequently manipulated to achieve certain values. In the natural gas market, traditional accounting for long-term contracts was very simple: in each period, the company booked the supply costs and revenues from gas sales. With mark-to-market, the accounting became more complex: whenever the contract was signed, its profit throughout the period were estimated and booked by applying the net present value technique. In many cases, the viability of these contracts and their future costs were difficult to judge.

⁵⁰ Authors such as Hamilton and Micklethwait (2006: 36) argue that irregularities at Enron started after the departure of its former COO Richard Kinder, an executive dedicated to more traditional businesses and to the operational matters of the company's projects. Kinder left the company in November 1996 after being passed over for the CEO job.

⁵¹ Weather derivatives are financial instruments that can be used as part of a risk management strategy to reduce risks associated with adverse weather conditions. In comparison with other derivatives, the underlying asset (e.g., rain, temperature)

platform for wholesale energy trading considered a new paradigm in the industry.

- August 23rd, 2000: Enron reaches or exceeds the goals of its quarterly earnings per share for 16 consecutive quarters. Its shares hit a historic peak of \$ 90.56, reaching a price-to-earnings (PE) multiple of 70. The company annual revenues reach \$ 101 billion, reporting a net profit of \$ 979 million. Its market capitalization exceeds \$ 70 billion.
- February 2001: Lay retires as CEO, remaining the Chairman of the Board. Skilling assumes the post
- February 6th, 2001: Arthur Andersen senior executives hold an “Enron retention meeting”. They call the company use of mark-to-market accounting an “intelligent gambling”.⁵²
- February 21st, 2001: in an all-employees meeting, Skilling says: “Yes, it (the Company) is a black box. But it is a black box that’s growing the wholesale business by about 50 per cent in volume and profitability. That’s a good black box”.⁵³ He takes the opportunity to announce Enron’s next strategic goal: “to become the leading company in the world”.
- March 2001: a Fortune magazine article by journalist Bethany McLean raises doubts about the quality of Enron’s results.⁵⁴
- August 14th, 2001: After months of decline in the stock price in which it reaches \$42.93, Skilling resigns unexpectedly just six months after taking over as CEO citing personal reasons. Lay resumes the CEO post. In his final conference for analysts, Skilling says that “the company is in great shape...”. Lay corroborates his view by saying that “the company in the best shape it’s ever been in”.
- August 15th, 2001: Sherron Watkins, an executive from Enron’s accounting department, emails Kenneth Lay warning that the company may “implode in a wave of accounting scandals”.⁵⁵
- August 20th, 2001: Lay sells stock options for \$2 millions. He sells shares worth about \$20 millions in the three weeks after Watkins’s

of weather derivatives has no direct value to price.

⁵² http://www.washingtonpost.com/wp-srv/business/daily/transcripts/andersenmemo_020601.pdf

⁵³ First Consolidated and Amended Complaint. Civil Action No. H 01-3913 and Consolidated Cases. Available at: <http://picker.uchicago.edu/Enron/courtdoc-enron-consol-complaint.pdf>

⁵⁴ “Is Enron Overpriced?”, Fortune, March 5th, 2001. Bethany McLean. Available in http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/index.htm

⁵⁵ Available at: <http://www.ragm.com/enron/elib/watkins.pdf>

email. It is estimated that he sold about \$ 100 million in Enron stock in 2001.⁵⁶

- September 26, 2001: In an online chat with employees, Lay says that the company's shares are "an incredible bargain" and that the third quarter "is looking great."⁵⁷
- September 2001: Skilling concludes his sell of \$63 million in Enron stocks initiated in early 2000.
- October 9th, 2001: Merrill Lynch, an investment bank, upgrades Enron stock from "Neutral" to "Buy."⁵⁸
- October 12th, 2001: David Duncan, the lead partner on the Enron account for Arthur Andersen, begins a two-week document destruction effort of Enron related paperwork. Almost two tons of papers are shredded.⁵⁹
- October 16th, 2001: Enron reports a loss of \$ 618 million, its first quarterly loss in more than four years.
- October 17th, 2001: the Wall Street Journal publishes an article detailing the conflict-of-interest questions raised by a pair of limited partnerships run by Enron's CFO Fastow and the precarious nature of Enron's business.⁶⁰ The SEC begins an informal inquiry into the company.
- October 23rd, 2001: In a presentation to employees, Lay reaffirms his confidence in Fastow as CFO, arguing that "I and the board are also sure that Andy has operated in the most ethical and appropriate manner possible."⁶¹
- October 24th, 2001: Andy Fastow is fired.
- November 8th, 2001: Enron restates its financial statements for the prior four years for the last four years to consolidate partnership

⁵⁶ The New York Times, February 16th 2002. Enron's many strands; ex-chairman's finances; Lay sold shares for \$100 million.

⁵⁷ Senate Hearing 107-773: Hearing before the Committee on Commerce, Science, and Transportation of the United States Senate. February 12th, 2002. Available at: <http://www.gpo.gov/fdsys/pkg/CHRG-107shrg82951/html/CHRG-107shrg82951.htm>

⁵⁸ Tonge et al. (2003, appendix 1).

⁵⁹ Sources: The New York Times, June 6th 2002. Summations In Andersen's Criminal Trial. <http://openjurist.org/374/f3d/281/united-states-v-arthur-andersen-llp>

⁶⁰ The Wall Street Journal, October 17th 2001. Enron jolt: Investments, assets generate big loss LJM.

⁶¹ http://www.cbsnews.com/8301-100_162-502198.html

arrangements retroactively, with a write-down of \$1.2 billion of shareholders' equity.⁶²

- November 28th, 2001: when stocks are already priced at less than \$ 1, all three rating agencies downgrade Enron below investment grade to speculative grade.⁶³
- December 2nd, 2001: Enron goes bankrupt, then the largest ever in the U.S. market.⁶⁴ The shares, which peaked \$90 in the previous year, dive to \$30 cents.

• **Appendix B – Consequences for the people involved**

- After its bankruptcy in late 2001, the players involved with Enron suffered the following consequences:
- Executives: Andrew Fastow made a deal with the U.S. justice pleading guilty of fraud and agreeing to incriminate his superiors. He was sentenced to ten years in prison and pay \$ 24 million. In 2006, his sentence was revised and reduced to six years. The Abbreviation for Chief Accounting Officer (CAO) Richard Causey also pleaded guilty, receiving a sentence of seven years in prison in 2005. Jeffrey Skilling and Kenneth Lay continued to plead innocence and went into trial. In May 2006, they were found guilty on almost all allegations. Skilling was sentenced to 24 years in prison and a fine of \$ 45million in October 2006. Lay did not receive his final sentence, dying from a heart attack at his country residence in July 2006.
- Independent directors: Enron's former independent directors faced very different consequences than of its executives. Although seven have been prosecuted for insider trading and ten directors have agreed to pay \$13 million from their pockets in a deal with prosecutors, none have been criminally prosecuted for fraud. Many of them continue to serve on boards of large companies, with some simply omitting from their resumes any mention about their term on Enron's board.
- Audit: Arthur Andersen was charged with obstruction of justice, initially being convicted in June 2002. Two months later, the company

⁶² Healy and Palepu (2003: 4) and

<http://www.sec.gov/Archives/edgar/data/1024401/000095012901504218/h92492e10-q.txt>

⁶³ <http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT80604/html/CPRT-107SPRT80604.htm>

⁶⁴ Technically, the company filed for "Chapter 11" bankruptcy protection, a famous chapter of the U.S. bankruptcy code that allows the company's reorganization. Since Enron has not resumed operations, this is considered the *de facto* date of its bankruptcy.

(an empty entity at the time due to the exit of customers and employees), paid \$60 million to settle the case, then going bankrupt. In May 2005, the U.S. Supreme Court reversed the initial decision of the justice after understand that the destruction of Enron documents was made in accordance with Andersen's document retention policy. In 2007, the bankrupt estate of the company agreed to pay \$72 million to investors who had sued it in 2001.

- Investment banks: many investment banks with active participation in the structuring of SPEs agreed to reach billionaires deals to finish the various lawsuits filed by investors and prosecutors. By the end of 2009, Enron investors were able to recover about \$7.2 billion from several investment banks such as JP Morgan, Citigroup, Merrill Lynch, Chase and CSFB. The biggest disbursements were made by Canadian Imperial Bank of Commerce (\$2.4 billion), JP Morgan Chase (\$2.2 billion) and Citigroup (\$2 billion). The investment banks also agreed with internal reforms in their areas of research and investment analysis. In earlier 2012, some cases were still pending.

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