ENRON FIASCO: BUSINESS DIFFICULTY AND THE ROLE OF ENRON' DIRECTORS

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Abstract

Enron Corporation's high-profile collapses marked a new period for dramatic changes to corporate governance worldwide that mainly focuses on law reform to prevent, or al least mitigates, similar future corporate collapse. The paper investigates Enron's demise by addressing the two main aspects: Enron's business and the role of Enron's director in governing the Corporation, especially with the presence of dual role of the chairman and chief executive officer in its organisational structure.

Keywords: Enron, Corporate Governance, Corporate Culture, Board of Directors, Executives

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Introduction

Enron Corporation, known as one of the largest US-based companies, mainly provided wholesale services, retail energy services, broadband services and transportation(Enron Corp 2001). However, the company became well-known not because of its success but its failures. It is generally acknowledged that the time when Enron filed for bankruptcy (December 2, 2002) marked a new period for dramatic changes to corporate governance world-wide, mainly focusing on law reform to prevent, or at least mitigate, future corporate collapses. This paper examines the Enron fiasco by answering the three main questions: (1) Which segment of its operations got Enron into difficulty and how were profits were made in that segment? (2) What was the role of Enron's directors in controlling the firm? And, finally, (3) Was it good governance for Ken Lay to be acting in the dual role of chairman and chief executive officer (CEO) in Enron's organizational structure?

Discussion

Energy service creates difficulties for Enron

In terms of innovation, Enron's transition from an old-line energy company to a high-tech, globally trading energy enterprise is widely recognised. However, Enron was fraught with problems throughout the 1990s, resulting mainly from the creation of online energy, which aimed to carry out contracts to supply energy products. The first problem was that Enron was required to access substantial lines of credit as a means of guarantee that it had sufficient funds at the end of each day to settle its signed contracts traded on its online system. Additionally, Enron was also suffering due to considerable fluctuations in earnings from this business. Consequently, with the intention of maintaining investment-grade credit rating in order to access low-cost financing and stimulate investment, Enron employed numerous strategies aimed at increasing its financial and operating performances (United States Senate's Permanent Subcommittee on Investigations 2002). Of these, 'prepay' transactions, 'syndicating' assets, and hedging contacts with its special purpose entity (SPE) are worthy of attention.

As for prepay transactions, in accordance with the United States' generally accepted accounting principles, prepayment must be recorded as debt and cash flow from financing. However, in the case of Enron, with an attempt to improve its credit ratings and boost its share price, prepayment was booked as a trading liability and cash flow from operations (Roach 2002). Because the value of these transactions is tremendous in comparison with Enron's cash flow from operations[1], prepay transactions had an enormous influence on the picture of Enron's performance. Further, Enron's energy trading was considered as its crown jewel (Gordon 2002). In this sense, when such manipulated transactions were discovered and the financial statements were adjusted, Enron's share values declined dramatically as an inevitable consequence. Consequently, Enron could not carry out contracts to buy and sell energy, and accordingly no partners would continue to trade with the corporation (Gordon 2002).

[1] The value of prepay transaction at a pace of one or two per year from 1992 to 2001 was $8.5 billion, while cash flow from operations in 1999 was only $1.228 billion (Enron Corp 2001; Roach 2002).

In terms of the issue of being 'asset light' or 'syndicating' the assets, Enron transferred several billion worth of its assets to its 'unconsolidated affiliates'. As a result, such assets that slowly generate cash flow were syndicated throughout its numerous SPEs, and a vast amount of earnings were recorded (United States Senate's Permanent Subcommittee on Investigations 2002). Therefore, the corporation could not avoid encountering difficulties when the reality of these structured transactions unfolded.

Forming and making use of SPEs also got Enron into difficulty. Hundreds of SPEs were established in order to hedge Enron's investments (Millon 2003). Through Enron-SPEs transactions, Enron's revenue, earnings, and cash flow were generated, which helped Enron to improve its credit rating and maintain creditability in the energy trading business, while a burden of debt to debt investors was imposed on unconsolidated SPEs (Powers, Troubh & Winokur 2002; Schwarcz 2002). The reality, however, is that the treatment of Enron's SPEs as unconsolidated affiliates was unlawful[2]; its consequences are extremely serious. Ultimately, a massive deduction in its reported net income and a massive increase in its debt occurred when Enron retrospectively consolidated its SPEs (Powers, Troubh & Winokur 2002).

Briefly, instead of making profits by buying and selling energy services as usual, Enron manipulated its profits that ultimately led to its collapse by structuring numerous questionable entries through prepay and merchant investment hedge transactions. As a consequence of Enron's collapse, both the regulators and the accounting profession took evasive action as a response to the blame of insufficient requirements for corporate disclosure and lack of guidance on the treatment of SPEs transactions. In particular, the U.S. government passed the Sarbanes – Oxley Act 2002 that aimed to address the corporate disclosure of accurate financial information (Dnes 2005); and the American Institute of Certified Public Accountants had to publish a toolkit for accounting and auditing for related parties and related parties' transactions[3] (The American Institute of Certified Public Accountants 2001).

The role and responsibilities of Enron's directors for Enron's collapse

In the wake of the Enron fiasco, the attempt to allocate responsibility for the role of Enron's directors is re-examined. According to the testimony of Enron's board of directors, it seems that they were victims of a cruel hoax; and they were misled or uninformed about activities and plans that supported Enron's questionable strategies, and criticised policies and transactions (United States Senate's Permanent Subcommittee on Investigations 2002). However, it is argued that their sworn testimony was merely an excuse for their unfulfilled fiduciary responsibilities. By revealing the hierarchical corporate governance structure in the U.S, Clark and Demirag (2002) affirm that it is unbelievable that Enron's board did not know about such problematic economic issues which lead to its collapse and bankruptcy. Similarly, the U.S. Senate's Permanent Subcommittee (2002) strongly rejects the excuse of Enron's board members by affirming that the board not only knew of, but also explicitly approved and/or allowed, Enron's questionable plans, strategies, and policies that included high-risk accounting practices and off-the-books activities. In sharing this view, Powers, Troubh, and Winokur (2002) also assert that the board 'failed in its oversight duties'. From this point, it is logical to conclude that the board of directors serving at Enron knew of and permitted wrongdoing. Therefore, what lead to Enron's directors being uninstructed was that they inadequately oversaw the firm and totally relied on management reports without making any efforts to verify them.

Another criticism relates to the role of the board of directors is the permission for Fastow - Enron's chief financial officer - to establish and manage partnerships that ultimately brought him millions of dollars by engaging in self-dealt transactions with Enron (Emshwiller & Smith 2001; Kranhold & Schroeder 2002). In fact, Fastow's proposal for his role as a manager of Chewco – one of Enron's SPEs – was blocked because the Board realised that his participation required disclosure in proxy statements and needed to be approved under Enron's Code of Conduct. As an alternative, Kopper - an Enron employee who worked for Fastow - was appointed to this position in an attempt to prevent the conflict of interest (Powers, Troubh & Winokur 2002). However, it is argued that the conflict of interest still applied with this alternative. Firstly, Kopper's position in Chewco was not informed to the board of directors, although Kopper's participation in this partnership was required to be disclosed to and approved by Enron's board. This avoidance implied the conflict of interest still remained in the alternative. Secondly, Chewco's manager was the person who worked for

[2] Concerning this issue, the U.S. Senate's Permanent Subcommittee on Investigations (2002) reveals that the Enron collapse resulted from a billion's worth of off-the-books transactions that were conducted in Enron through its unconsolidated affiliates, ultimately leading to material off-the-books liabilities which are deliberately undisclosed.

[3] According to the American Institute of Certified Public Accountants (2001), the toolkit provides an outline of existing selected authoritative accounting and auditing literature, the Securities and Exchange Commission's requirements, and non-authoritative best practice guidance involving related parties and related party transaction. This implies that the treatment of Enron-SPEs transactions is unlawful.

Fastow; and, even worse, he was the sole person dealing with this partnership and had complete authority over this partnership's transactions. Accordingly, this relationship made him act in Fastow's interests rather than in Enron's. The evidence to support this contention is that Fastow directly interfered with negotiations between Enron's business negotiator and Kopper, which lead to increasing Chewco's benefit relating to Enron-Chewco transactions. Further, it is also worth considering the role of Fastow as the general partner in other SPEs, including LPJ1 and LPJ2, in which their day-to-day activities were managed by Kopper. Consequently, all these structured vehicles enabled Fastow to make millions of dollars in profit at Enron's expense (Powers, Troubh & Winokur 2002). By revealing this issue, it can be concluded that the conflict of interest issue was not solved, even though Enron's directors presumed they had dealt with the issue by setting up an alternative arrangement.

In short, the painful lesson drawn from the role of Enron's directors is the failure to avert the serious issue of conflict of interest. Remarkably, Enron's collapse resulted from manipulation by applying high-risk accounting practices, as discussed earlier. More importantly, these manipulations thrived owing to the conflict of interest existing in Enron - especially in that the chief financial officer gained a massive amount of compensation and returns by acting in favour of SPEs and in his own interests (Schwarcz 2002). Thus, enhancing conflict of interest regulations is one of the most effective measures to prevent corporate failure.

The dual role of the chairman and its effects on Enron's corporate governance

In the wake of the Enron collapse, there is some doubt about the lack of proper governance resulting from the combined roles of chairperson of the board and the CEO in the organisational structure of the firm (Brooks 2004). It is widely acknowledged that a chairperson is the person who acts in the shareholder's interest. Therefore, he or she has responsibilities for monitoring and advising executive officers' activities with an aim to best serve the shareholders. The Organisation for Economic Co-operation and Development (2004) suggests that the separation of the role of CEO and chairman enables the board to effectively exercise its responsibilities for monitoring managerial performance and preventing conflict of interest. In addition, in order to successfully fulfil its function of monitoring management and strategic guidance, the Organisation for Economic Co-operation and Development (2005) also recommends that it is necessary for the board to have the power to appoint and fire the CEO. Moreover, the prevalence of CEOs contributing to corporate collapse, such as with Health International Holdings Insurance, results in the necessity to separate the roles of CEO and chairman rather than to formulate a single structure (Johnson & Jianbo 2004) In addition, some research suggests that the duality on the board also increases the likelihood of fraud and earnings manipulation (Dechow, Sloan & Sweeney 1996; Sharma 2004). Further, the Australian Auditing and Assurance Standards Board (2006) also notes that ineffective monitoring of management is a consequence of domination of management by a single person without compensation controls.

It seems that, stemming from the limitations and the consequences of combination of the role of CEO and chairperson, shareholder activists have increasingly required a separation between the role of the chairperson of the board and CEO. However, there is, surprisingly, no evidence in the literature demonstrating the superiority of the separate structure (Dalton & Dalton 2005). In supporting unity of command in pursuit of a unified purpose, Dalton and Dalton (2005) encourage the dual roles of the chairman of the board rather than make efforts to advocate for the separate structure. Further, in terms of the U.S legislation, there is no requirement for the separation of the role of CEO and chairman in the company's organisational structure (Lipton 2006).

Briefly, there are some opponents of the suggestion that the role of the CEO should be separated from the role of chairperson. However, in terms of expected good corporate governance, it is believed that the dual role of CEO should not be permitted in the company's organisational structure. Therefore, in the case of Enron, it can be logically concluded that the dual role of Ken Lay significantly contributes to the lack of proper governance that ultimately leads the firm to go into bankruptcy.

Conclusion

It is widely accepted that the high profile collapse of Enron was caused by a number of factors. By outlining the roles and responsibilities of Enron's directors in connection with Enron's collapse, this essay identified reasons why corporate governance globally has significantly changed in recent years. These changes result in reforms introduced not only in accounting and auditing standards but also in law. Basically, these reforms aim to achieve good corporate governance in terms of best serving stakeholders by solving the conflicts of interest issue, mitigating the usage of creative accounting practices, and implementing the principles of corporate governance.

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