Research conducted for Dr. Robert Hurley's Leadership Trust class at the Fordham Graduate School of Business Administration

"ENRON: WHERE WAS THE TRUST?"

Jessica Dudzinski

I. Introduction

When one hears the word “Enron” they immediately think of deceitful accounting fraud, corporate greed, a devastating bankruptcy and perhaps even a notion as simple as pure failure. However, rooted deep within the Enron bankruptcy is the fundamental issue of trust. Trust can be defined as confident reliance on another person or an organization (Hurley, 13). Enron Corporation violated shareholder and employee trust on a massive scale. This paper examines these trust issues, analyzing the specific trust violations at hand, and their underlying causes. The analysis will conclude with an examination of the government interventions that were put into place to prevent future trust scandals of similar nature.

II. Enron – The years of growth

In 1985, Kenneth Lay founded Enron through the merger of InterNorth and Houston Natural Gas, two natural gas pipeline companies. The newly formed Texas company owned 37,000 miles of interstate and intrastate pipelines for the transportation of natural gas between producers and utilities. Lay built the company from the ground up, enticing investors with his market changing “new energy” ideas. He was able to earn their trust through his benevolent appearance, philanthropic activities, business competence, impressive political contacts and humble upbringing as a Midwest preacher’s son (Currall & Epstein, 198).

In 1988, the energy business switched from a fully regulated industry to a deregulated one and Enron seized the opportunity to transform its business model from one of “energy delivery” to “energy broker” (Sims & Brinkmann, 244). Enron assumed its new role as energy matchmaker, and connected buyers and suppliers together, while

profiting handsomely from the exchanges. The company took full advantage of the newly deregulated industry by creating increasingly more creative and complex contracts. By 1992, Enron had grown to become the leading seller of natural gas in North America. Not willing to settle for dominance in one industry alone, Enron started to pursue a diversification strategy: first with the trading of natural gas, and then becoming a "financial trader and market maker in electrical power, coal, steel, paper and pulp, water and broadband fiber optic cable capacity" (Healy, 5). It also undertook large intercontinental projects involving the creation and management of energy facilities in Africa, Eastern Europe, India, China, the Middle East, and Central and South America. In many ways extreme and reckless growth was at the core of Enron's and other trust violations. (E.g. Lehman Brothers, Merrill Lynch, Countrywide)

Synonymous with the company's growth, Enron's stock rose accordingly, increasing steadily by 311% from 1990-1998, which was slightly higher than the average rate of growth in the S&P 500 (Healy, 3). Enron was viewed by the public as a pioneering market leader, and in 2000, was named Forbes Magazine's "*most innovative company in America*" for the fifth year in a row (Currall & Epstein, 198). "By 2001, Enron had become a conglomerate that owned and operated gas pipelines, electricity plants, pulp and paper plants, broadband assets and water plants internationally and traded extensively in financial markets for these same products" (Healy, 5). At its market peak, revenues reached $60 billion and the Texas based energy company seemed like an unstoppable force. However, the public was soon to learn that appearances can be deceiving and that Enron was simply a house of cards waiting to collapse.

III. Enron – What was really happening?

To the public, Enron seemed to be a powerful market leader that continued to have unparalleled success, however inside Enron there was a different story. The culture at Enron was behind the company's quick growth and even quicker downfall. Chief Operating Officer Jeffrey Skilling's favorite motto was, "Do it right, do it now and do it better" (Sims & Brinkmann, 244). However, the executives and employees quickly learned to disregard the "do it right" aspect as their moral compasses became more and more skewed over the years. The top management at Enron challenged their employees to be innovative, aggressive and independent, while primarily focusing on achieving short-term profit-driven results. The bottom line was the only thing that seemed to matter at Enron, and if one produced results, they were rewarded, regardless of the methods they used to achieve the results.

Enron's rising stock price, along with the positive buzz it was receiving from analysts and the business press, only added steam to the aggressive competitive culture at Enron. Top management and employees alike felt the need to sustain their reputation of explosive growth. A balance sheet showing negative earnings would have been a surefire indication to shareholders and financial analysts that Enron was not as efficacious as it appeared. Negative earnings would have caused a tremendously negative chain of effects for Enron: investor suspicion, a drop in stock price, a credit rating downgrade, trading partner abandonment, and lastly Enron would lose their ability to create earnings and

cash flows, causing their eventual demise and destruction. To prevent this, Enron used questionable accounting methods and deceitful partnerships known as SPE's to hide debt, disguise losses, and fabricate false profits.

Mark-to-market Accounting

Enron's senior management, Ken Lay (CEO), Jeff Skilling (COO), and Andrew Fastow (CFO) took every approach possible to create the illusion of a booming business with no signs of weakness. They bent accounting rules to their advantage by utilizing mark-to-market accounting. According to Investopedia.com, mark-to-market accounting is "the accounting act of recording the price or value of a security, portfolio or account to reflect its current market value rather than its book value." Since Enron had a complex business model with many products, trading operations, international projects, in addition to the many complicated long term trading contracts and deals, they were able to use their own models to forecast interest rates and energy prices for contracts well into the future – and record their revenue immediately. For instance, in July 2000, Enron and Blockbuster signed a 20-year contract entitled "*Project Braveheart*" to introduce entertainment on demand to homes via Enron's global broadband network. After a 1,000 home pilot test in multiple cities, the project failed, however Enron had already recognized an estimated $110.9 million in revenue, which was never realized (Healy, 10). It was the use of this accounting practice that enabled Enron to fool its investors into believing that it was growing exponentially, when in reality, a majority of their accounted revenue was never achieved.

Special Purpose Entities

In addition to loose accounting practices, Enron utilized Special Purpose Entities (SPE's), which are shell firms created by a sponsor but financed by independent equity investors and debt financing to fulfill temporary objectives of the company. Enron had over 100 SPE's, many of which were legitimate, however several which they used to "sell assets and create earnings that artificially enhanced its bottom line" (Sims & Brinkmann, 245). In order to ensure that the SEC did not consider these SPE's as subsidiaries, Enron's external accountant (Arthur Anderson) and law firm (Vinson & Elkins) leveraged the "arms length" rule in the Financial Accounting Standards Board which said that partnerships (SPE's) are not classified as subsidiaries as long as 3% equity comes from outside investors and they are independently managed from their sponsor (Benston & Hartgraves, 108). Though escaping the SEC on paper, Enron engaged in blatantly illegal SPE's in which its top executives were the managing partners of the entities, which directly violated their fiduciary duty to shareholders. CFO Andrew Fastow individually sponsored the SPE's known as LJM1 and LJM2, in which he profited immensely from, earning over $30 million personal profit. Enron's SPE's looked like partnerships from the outside, though they were indeed subsidiaries (Sims & Brinkmann, 246). It is because of these SPE's that Enron was able to hide its debt for so many years, as it disclosed minimal information of the SPE's on its financial statements. However, Enron was "using its own Enron stock and financial guarantees to carry out these hedges so that Enron was not actually protected from downside risk," which is what helped to fuel its eventual demise (Healy, 11).

The Collapse

The SPE's that had once allowed Enron to escape their losses, eventually came back to be a leading cause of their downfall. When these partnerships "began to fail with increasing regularity, Enron was liable for millions of dollars it had not anticipated losing. Promises began to come due and Enron did not have the ability to follow through on its financial obligations" (Sims & Brinkmann, 246). On October 16, 2001, Enron Corporation revealed that it was reducing its after-tax net income by $544 million and its shareholders equity by $1.2 billion (Benston & Hartgraves, 105). Additionally, on November 8 of the same year, it announced that due to "accounting errors" it was restating the past four years of net income. (Refer to *Appendix A* for the restatement amounts.) These four restatements reduced Enron's shareholder equity by an additional $508 million. To employee and investor shock, dismay, and outrage, Enron filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code on December 2, 2001– the largest US corporate bankruptcy at the time. Over 20,000 employees lost their jobs, as well as billions of dollars in stock and retirement savings. Therefore, the underlying question here is what went wrong? Where was the trust, and how could a corporation so large mislead so many people? The answers to these questions will be dissected in the next sections of the paper.

IV. The Nature of the Violation

Enron is an extreme example of corruption, unethical standards, and lack of internal organizational trust. Corporate accountability evaporated as Enron's overzealous leaders fostered a culture of "win at all costs." The bottom line was the only thing that

mattered to both Enron's executives and employees, which was the driving force behind their trust violation of accounting fraud. One former executive at Enron corroborated this by saying "…Skilling would say that all that matters is money. You buy loyalty with money" (Sims & Brinkmann, 247). It was this outlook that cultivated Enron's trust violations and caused the executive's lying, unethical behavior and accounting fraud to continue over the last five years of Enron's existence.

From an investor's perspective, Enron had provided steady stock growth from its inception until 2000, which created a sense of security and trust in the company and their financial integrity. (Refer to *Appendix B* for Enron's increasing stock price from 1986-2000.) "When they perform reliably over time, firms earn a reputation of trust with their customers, investors, and even those representing communities of future stakeholders (Hurley, 117). It is because of this false sense of confident reliance that employees and shareholders felt shocked and deceived by Enron's sudden collapse and blatant abuse of their trust. A trust violation is described as a "lack of transparency and concern for customer safety" (Hurley, 118). In this case, the Enron executives were clearly not concerned with their shareholders' financial security or well-being.

Enron's senior management took any and all approaches to ensure that their company succeeded, whether legal or not. "A trust violation occurs when the trusted party bears some responsibility for an act that significantly deviates from positive expectations (eg. fraud, deceit, gross incompetence, negligence, exploitation)" (Hurley, Gillespie, Ferrin & Dietz, 4). Therefore, Enron's specific trust violations are as follows: no alignment of interests, severe lack of integrity, no benevolent concern shown, overly

power hungry leaders, lack of transparency or communication, and a foolishly high risk tolerance that was fueled by greed.

V. The Root Causes

According to Dr. Robert Hurley's "Organizational Performance and Trust Model," there were four key root causes to the lack of organizational trust at Enron. These causes are as follows: Systems, Leadership, Values and Competencies and Structure (Hurley, 118). Together, these root causes are the reason for Enron's colossal failure and are examined thoroughly below.

Systems

"The challenge [for a company] lies in how to create trust and sustain it in an environment of change, risk and uncertainty" (Hurley, 113). It would appear that Enron simply could not figure out this balance. Enron's systems, which include their planning, reporting and budgeting, were one of the sole causes of their demise. Greed and power were at the forefront of the executives' minds, which was the main reason they committed accounting fraud. As mentioned previously, the senior management at Enron utilized two vehicles to carry out their lies: mark-to-market accounting and SPE's. Through these business practices, combined with their complex financing structures, they were able to hide their debt, disguise losses, and create false and fabricated profits. "Enron's decision makers saw the shuffling of debt rather as a timing issue and not as an ethical one. Clever people would eventually make everything right, because the deals

would all be successful in the long run" (Sims & Brinkmann, 245). It was this attitude, and Enron's unethical "systems" that enabled top executives to severely violate stakeholder trust.

Leadership

The leaders at Enron are entirely to blame for their dishonesty, greed, and power hungry attitudes, which caused the eventual implosion of the company. "When leaders act opportunistically, to the detriment of others in the organization, they sow distrust" (Hurley, 103). It is truly Enron's leadership that caused its failure. As seen in *Appendix C,* "A Model of Organizational Performance and Change," leadership is the central player which directly impacts a company's mission and strategy, structure, management practices, systems, organizational culture, and external environment. When the backbone of the organization, the leadership, "says it cares about employees, shareholders, and customers, but acts to enrich management at their expense, it invites distrust" (Hurley, 130).

In addition to top management's illicit accounting activities, the Enron executives were blatantly lying to employees and shareholders alike, advising them to invest heavily in Enron, while they were simultaneously dumping their own stock. Skilling told investors in 2001, "The company is in great shape…" and "We will hit those numbers. We will beat those numbers," while Lay was simultaneously pronouncing, "[The] company is in the strongest shape that it's ever been in." In September 2001, three months before Enron declared bankruptcy, Lay told shareholders that Enron stock is an "incredible bargain," and that, "third quarter is looking great" (Enron: The Smartest Guys in the Room). Clearly Enron's leaders acted without integrity and absolutely no

benevolent concern as they looked their shareholders in the eye and told them to keep investing in their sinking ship. "A trust betrayal occurs when the organization actively caters to a group (or groups) but fails to uphold responsibilities to others" (Hurley, Gillespie, Ferrin & Dietz, 6). In this case, it appeared that the Enron executives cared only about themselves: making their bank accounts flourish at the expense of their own employees and shareholders and failing to provide proper disclosure and transparent communication to investors.

Even after the Enron scandal came into the public light, "Jeffrey Skilling even went as far as telling an incredulous Congress that despite his Harvard Business School degree and business experience he neither knew of, nor would understand the intricacies of the accounting deals" (Sims & Brinkmann, 248). In addition, and worst of all, the ex-leaders of Enron still, to this day, do not show remorse for what happened in 2001. Skilling was quoted by CNN saying "…if he knew then what he knows now, he still would not do anything differently" (Ethics and Corporate Social Responsibility, 166). It is undoubtedly this despicable attitude and lack of responsibility that caused Enron's ultimate failure.

Values and Competencies

From the outside, Enron appeared to be "an excellent corporate citizen, with all the corporate social responsibility (CSR) and business ethics tools and status symbols in place" (Sims & Brinkmann, 243). Enron even went as far as having a vision and values mission statement which read, "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" (Kunen, 2002). How ironic, since the opposite seemed to

be true within the walls of Enron, which was instead a low-integrity organization with a loose moral compass. "In low-integrity organizations, behavior that runs counter to espoused organizational values is tolerated or overlooked. The culture in these companies is at odds with the espoused one… They begin to lose trust in senior management, who promote one set of values while allowing another to prevail" (Hurley, 133).

"Leadership is the critical component of the organization's culture because leaders can create, reinforce, or change the organization's culture" (Sims & Brinkmann, 247). As previously mentioned, Enron's leaders were dishonest themselves, which is why the culture at Enron was one of low trust. "Executives at Enron in practice created an organizational culture that put the bottom line ahead of ethical behavior and doing what's right" (Sims & Brinkmann, 243).

The article "A Causal Model of Organizational Performance and Change" states that "Culture can be described as 'the way we do things around here.'…It is the collection of overt and covert rules, values, and principles that are enduring and guide organizational behavior" (Burke, 532). Enron's culture was one of aggressive competitiveness, innovation, testing boundaries and winning at all costs. In regards to their work environment, ex-employees have said, "…you were expected to perform to a standard that was continually being raised", "the only thing that mattered was adding value", and "it was all about an atmosphere of deliberately breaking the rules…" (Sims & Brinkmann, 243). For example, from February 2000 until spring of 2001, Enron traders took advantage of California's wholesale electric market by trading aggressively to boost Enron's stock price. The traders unethically overbooked the power lines, which caused

sporadic days of rolling blackouts in Northern California. Enron then "used the fear created by the blackouts to push large California businesses into more than $1 billion in long-term energy contracts" (Leopold, 2002). One man even claims that because of Enron's blackouts, his son died from lack of power to his dialysis machine in March of 2001 (Kramer, 2007). The Enron executives rewarded this unethical behavior with financial bonuses and invitations to their exclusive "boys club" weekend trips.

"A company's reward system is a manifestation of its culture" (Burke, 529). At Enron, employees were annually ranked and publicly fired and humiliated for poor performance. How can one trust their company when they were afraid of public scrutiny? "The Decision To Trust" lists eight descriptions of low trust work environments, of which five are extremely relevant to Enron's atmosphere: stressful, threating, careful, divisive, tense and competitive (Hurley, 115). Trust appears to have been non-existent at Enron, which was the primary reason for its demise.

Structure

It would seem as though accounting fraud of Enron's magnitude would be impossible in the 21st century due to corporate compliance efforts and a corporation's internal and external system of checks and balances; however, Enron clearly proved this to be wrong. Enron's internal compliance officers, lawyers, executives, board of directors, as well as outside agencies such as Arthur Anderson, their law firm Vinson & Elkins, the SEC, and credit rating agencies all seemed to have either overlooked (or else ignored) Enron's deceitful accounting practices.

"Effective external governance plays an integral role in supporting organizational trustworthiness" (Hurley, Gillespie, Ferrin & Dietz, 8). The question at hand is why

Arthur Anderson, Enron's external auditor, and the key player who should have publicly revealed Enron's discretions, continued to validate Enron's questionable financial statements. As the external auditor, and a reputable "Big Five" accounting firm, it was their duty to ensure that Enron's books were accurate in order to protect stakeholders' interests. However, Arthur Anderson seemed to have a symbiotic relationship with Enron, and one that discouraged them to whisteblow on one of their largest clients: they were earning more money from consulting fees than from their auditing work at Enron. According to Enron's financial statements, in the year 2000 alone, Arthur Anderson made $25 million in auditing fees from Enron, and $27 million in non-auditing fees (Enron: After the Collapse). It was this co-mingling of interests, in addition to the personal relationships between Anderson and Enron employees, which created blurred lines that caused Arthur Anderson to overlook Enron's faulty books. To add fuel to the fire, and confirm Arthur Anderson's transgressions, in October of 2001, Arthur Anderson shredded all Enron-related auditing documents – only proving their guilt. It is apparent that the structure of Enron's internal and external checks and balances system failed miserably and did not uphold Enron's accountability to stakeholders.

VI. Implications

"Companies are often so concerned with appearance and damage control that they are unwilling to engage in the degree of examination required to root out the entrenched causes of trust violations" (Hurley, Gillespie, Ferrin & Dietz, 10). As thoroughly examined above, Enron executives were so concerned about cashing in their own stock, and ensuring that Enron "appeared" successful on paper, that they had no concern for

examining their own trust violations at hand and rectifying their wrongdoings. Instead, after Enron's bankruptcy, the government stepped in, tried and sentenced the guilty executives, and took appropriate action to ensure that the Enron scandal would not occur again.

Senator Paul Sarbanes and Representative Michael Oxley drew up the Sarbanes-Oxley Act (SOX), which was passed by Congress in 2002. The intent of SOX is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws" (Sarbanes-Oxley Basics). SOX was implemented to ensure corporate accountability and impose strict penalties for those who do not comply. The new act eliminates the possibility of a CEO or CFO claiming, "I was not aware of my company's financial problems" and holds the executives responsible by making them sign all financial statements and ensuring their complete accuracy. In addition, SOX mandates that all financial reports need to include an internal control report. "This is designed to show that not only are the company's financial data accurate, but the company has confidence in them because adequate controls are in place to safeguard financial data" (Sarbanes-Oxley Basics). Lastly, SOX created the Public Company Accounting Oversight Board (PCAOB) whose duties include registering and inspecting public accounting firms and for adopting and adjusting audit standards.

VII. Organizational Trust and the Future

Regardless of the government's newly enacted regulations, consumer trust in corporations was severely impeded by the Enron scandal. Investor confidence was shattered when thousands of employees and investors lost billions' in stock and savings

due to corporate greed. However, it is 2013, and corporate scandals are still frequently occurring at an alarming rate. What can be done to increase organizational trust and prevent these trust violations from occurring? Perhaps becoming educated about trust is the first step for the top management at these organizations. However, no one can force these companies to be trustworthy and ethical, the decision must come from within the organization itself. Whatever the solution may be, something needs to be done to prevent future ethical transgressions and trust violations.

Appendix

Appendix A:

Enron's misreported net income; 1997-2000

YEAR	ACTUAL NET INCOME	STATED NET INCOME
1997	$28M	$105M
1998	$133M	$703M
1999	$248M	$893M
2000	$99M	$979M

Source: (Benston & Hartgraves, 106)

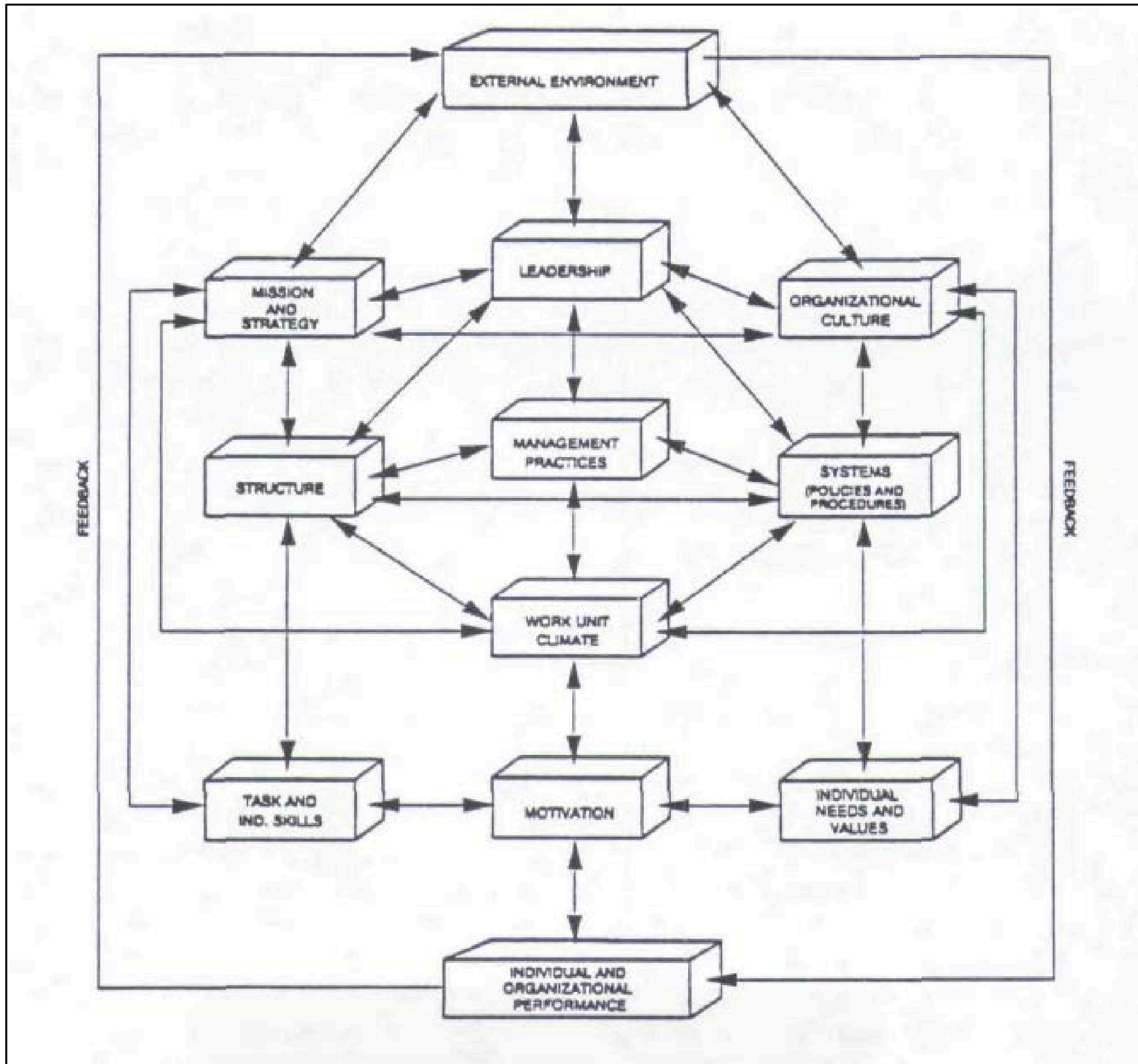
Appendix B

Enron's increasing stock price; 1986-2000

Source: Bank of America Merrill Lynch Chart

Appendix C

A Model of Organizational Performance and Change



Source: (Burke, 528)

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