Enron and How It Changed the World of Business

Background

Enron was a multibillion-dollar energy company who, through dishonest accounting practices, was able to hide their losses till the point where their next major merger fell through. They did this with shell companies that they would off load their losses to, to make their own financials look pristine. At the point of the failed merger, they filed for bankruptcy as their liabilities were too much for them to stay afloat. This resulted in tens of thousands of people to lose millions, both in pensions and shares of the company they could not sell.

Questions Before the Case

1) Is it alright to exaggerate anything when submitting official documents? Be it a resume, timesheet, or something else.

2) Back when all of this happened, the incentivization for people who came forward with information (whistleblowers) was almost non-existent. Should there be incentives beyond the social recognition of "doing the right thing" for whistleblowers?

3) If you are a manager, is it ever right to bend the truth so that you and those under you can keep your jobs or tell the truth and possibly lose them?

Enron Case

Revenue Recognition: Why Doing Something Different Isn't Always Better.

In the case of Enron, they, like most of their competition, had a system of "historical cost" principles they had to follow when they booked their revenue. Basically, they bought the natural gas they sold at a given price, and when they sold it at whatever price they could get for it, they took the costs off and reported that as profit. This was how it worked in any given year to account for fluctuations in the selling price; they had to wait until they sold the gas before they could record revenues.

However, their executives lobbied for, and got, the permission from the SEC to change the way they reported their revenues. Instead of following the "historical cost" model, they switched to a "mark-to-market" model, which allowed them to record the profits on their contracts before the contracts were fulfilled. This led to several concerning outcomes. They were booking hypothetical profits as actual profits before they had sold their natural gas, based on forecasts of what the market would do. But they were booking this profit on contracts that had 20 years to fulfil, in some cases. The first concern is what they would do if they couldn't continue signing these contracts, and revenues dropped off. The second is what would happen if they wound up having to sell the gas at lower prices than forecasted.

In short, they switched from a system of recognizing revenue *after* the transaction happened to a system where they recognized revenue at some value which they *thought* they would get for it at *some time* in the future. By using this "fair-value" system, it became a system that was almost entirely

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dependent on manager forecasting, which is almost impossible for managers to accurately calculate and even closer to impossible for anyone else to check (Benston, 2003).

Insider Trading: Making Sure the Boss Gets His...Money, That Is

Alongside the issues Enron was beginning to face from their CEO's resignation for "personal reasons," both internal and external sources began to realize that there were issues with the accounting processes at Enron (Healy, 2003). An Enron VP began to raise concerns about the issues with some of the reporting happening, and as such, got both internal and external auditors involved. The external auditors, Arthur Andersen LLP, had their lawyer contact Enron to "remind" them that the official action to take with old documentation was to shred it. All of this eventually led to October 2001.

On October 16, 2001, Enron filed their quarterly earnings statements. When they did this, it came to light that they had incurred their first (recognized) loss in four years. Also included in this figure is the write-down, or loss of income, of more than $1 billion. Finally, one of their subsidiaries which they were using to hide debt was terminated before Enron would be called on to exercise 58 million share options, which caused Enron to have to clear another $1.2 billion dollars from their balance sheet (Thomas, 2002). At this point, the Securities and Exchange Commission began to get involved. However, this isn't where the insider trading began.

At this point, many of the Enron employees had been compelled to use their company pensions to buy Enron stock. More importantly, many of them had wanted to: the company was doing phenomenally well up to this point, and they saw opportunities for massive returns. However, on October 17, the day after the damning earnings statements, the company announced that their pension plan administrators had changed. This meant, by law, that no trading could happen with Enron's pension plan assets for 30 days (Healy). So, in the wake of the most terrible earnings statement Enron had released, the employees had their pensions frozen and were unable to do anything about it. The worst aspect of this, however, was that the executives were still free to exercise their stock options and sell the stocks in the open market: this ban on trading only meaningfully affected the rank-and-file employees.

So, not only did Enron's employees wind up by losing their jobs when Enron filed for bankruptcy in December 2001, they also wound up by losing their entire pension as well (Healy).

Conclusion

There were no good outcomes to the Enron saga; millions of investors lost billions of dollars, the employees wound up unemployed with their life savings wiped out, many of the executives spent years in jail, and two major corporate entities wound up bankrupted. But the conclusions to be learned are quite simple: in the absence of truthful, good faith communication, it doesn't matter how good you engineer yourself to look. If you lie, cheat, falsify, you will wind up losing everything in the end.

With this information discuss with your group how Enron's exaggeration of their financials and other unethical dealings led to their bankruptcy. Also discuss the questions posed at the beginning of the case, and if any of your perspectives have changed after reading this case.

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