Governance Failure at Enron

Did Enron fail because of illegal activities, falsified accounting, governance failure, or something else?

Governance Failure at Enron: Case Questions

1. Which parts of the corporate governance system, internal and external, do you believe failed Enron the most?

2. Describe how you think each of the individual stakeholders and components of the corporate governance system should have either prevented the problems at Enron or acted to resolve the problems before they reached crisis proportions.

3. If all publicly-traded firms in the United States are operating within the same basic corporate governance system as Enron, why would some people believe this was an isolated incident, and not an example of many failures to come?

Exhibit 1 Enron’s Actual Operating Income

The Structure of Corporate Governance

<table>
<thead>
<tr>
<th>Equity Markets</th>
<th>Debt Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis and other market agents examine the performance of the firm on a daily basis.</td>
<td>Ratings agencies and other analysts review the ability of the firm to service its debt.</td>
</tr>
</tbody>
</table>

The Corporation (internal)

- Board of Directors: Chairman of the Board and members are accountable for the corporation.
- Management: Chief Executive Officer (CEO) and his team run the company.
- Auditors: External auditors examine the fairness of the financial statements and audit them.
- Legal Counsel: Provides legal opinions and recommendations on legality of corporate actions.

The Marketplace (external)

- The Corporation
- Regulators: SEC, the NYSE, or other regulatory bodies by country.

Enron’s original business model consumed capital

- The asset-heavy side of the business, power plants and pipelines, required massive amounts of capital up-front for their construction, yet would not generate cash inflows for many years to cover (if ever).
- As the asset-heavy businesses aged, they did not really produce the net operating cash inflows which had been promised; as a result, Enron needed more and more capital to “fuel the beast”.
- The asset-light side of the business, primarily power trading, required substantially less capital; trading is a service-oriented activity which does not require substantial capital infrastructure.
- Enron needed more and more capital to grow the business.
- But it had existed for most of its short corporate life as BBB-, on the edge of being considered “speculative grade” by the rating agencies given the industries it was operating in and its relatively high levels of debt.
- It therefore saw the Special Purpose Entities (SPE) as a way for the company to acquire more and more debt and yet not have those debts show up on its balance sheet—raising debt and hiding it in-short.
- The following exhibit illustrates the growing financing needs of the firm by simply illustrating how its statement of cash flows evolved over time.
Growing Discrepancy Between Earnings & CF (millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Earnings</th>
<th>Operating CF - Investing CF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$500</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>$1,500</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>$2,500</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>$3,500</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>$4,500</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>$5,000</td>
<td></td>
</tr>
</tbody>
</table>

The difference between operating cash flow and investing cash flow is a basic measure of the added financing the firm needs from year to year assuming no changes in cash balances.

Governance Failure at Enron: Case Questions

2. Describe how you think each of the individual stakeholders and components of the corporate governance system should have either prevented the problems at Enron or acted to resolve the problems before they reached crisis proportions.

- As it turns out, much of what Enron reported as earnings were not. Much of the debt raised by the company via a number of partnerships which was not disclosed in corporate financial statements should have been.
- massive compensation packages and bonuses earned by corporate officers were inappropriate.
- It appears that the executive officers of the firm were successful in managing the Board of Directors towards their own goals. Management had moved the company into a number of new markets in which the firm suffered substantial losses, resulting in redoubled attempts on their part to somehow generate the earnings needed to meet Wall Street’s unquenchable thirst for profitable growth.
- The Board failed in its duties to protect shareholder interests due to lack of due diligence and most likely a faith in the officers which proved unfounded. It is also notable that Enron’s legal advisors, some of whom report to the Board, also failed to provide leadership on a number of instances of malfeasance.

Governance Failure at Enron: Case Questions

1. Which parts of the corporate governance system, internal and external, do you believe failed Enron the most?

   - The failures at Enron were so wide and deep, it is difficult to say which failed most. Clearly Enron’s leadership – its Board and senior executives, failed to protect all stakeholders in the company.
   - Internally, although there were a few cases proven of malfeasance and illegal activities and fraudulent reporting, much of the internal failure appears to have been a combination of corporate culture failure and what many authors have characterized as “massive incompetence.”
   - Externally, it appears that nearly every institution which is part of the U.S. governance system failed as a result of self-interest and greed.
   - If pushed, it might be argued that the massive failures and internal culture of accounting enrichment and profits at all costs led to a contagion of the external governance.
   - Because many of Enron’s businesses such as power trading fell between the cracks of many regulatory systems, some failures were inevitable. In other cases, however, such as with its auditors and the debt and equity markets, the failures were in many cases related to the self-enrichment and profits at all costs culture which permeated many of these businesses inside and out.

What Happened at Enron?

“‘What I can tell you straight up-front is that life hasn’t been the same ever since the collapse. Working at Enron was like dope. You couldn’t get enough of it. You’re surrounded by talent, money is good, lavish expense accounts, and you’re all on a race against a snowball called MTM – aka, the accounting magic called market-to-market! Pretty exciting, huh? Well, not if you were one of the thousands who ‘doubled or nothing’ their 401k’s on accounts, and you’re all on a race against a snowball called MTM – aka, the accounting magic called market-to-market! Pretty exciting, huh? Well, not if you were one of the thousands who ‘doubled or nothing’ their 401k’s on Enron... how’s that for starters? I see the corporate world and life under a whole different light now. Unfortunately, I see Enrons everywhere. They are just not as good, and are probably still around because they are not as greedy as Skilling, Fastow and Lay.”

--- A former Enron employee