ENRON

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Group 7

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Ethics

Ethics is the moral compass that shows us right from wrong. The problem is that not everyone's compass points to true north. Just as ethics are important for individuals to have, they are also extremely important for companies to have. When Jeff Skilling and Kenneth Lay allowed false financial information to be published for the company, they knew it was wrong. But if they knew it was morally wrong, then why would they take these actions? One obvious reason that corporations, or even people in general, make unethical decisions is because they stand to gain things they cannot have.

Ethics are very important on an individual and societal level. Without ethics, a stable, safe society would not be possible. People would owe no honesty to others. People would break promises and contracts without consequences.

There are many reasons why business ethics are important. One is to build trust between a company and its customers. Business ethics also help protect investors from making financially poor decisions. Many laws have been enacted to ensure that businesses follow the proper moral actions to allow investors, stockholders and the general public to see how a company is performing.

A large part of business ethics comes from corporate governance. Bruce Weber, Dean of the Lerner College of Business at the University of Delaware, defines corporate governance as "accountability to providers of capital" (Corporate Governance Defined). This means that each corporation needs to be honest and truthful with its shareholders and stockholders. They should not hold back financial information. An essential role in corporate governance is played by the board of directors. Having a group of people rather than an individual in charge generally leads to more ethical decisions. But this does not always happen, as we have seen with Enron. Being honest with shareholders and investor is important, because it builds trust between them and the corporation. An honest and trustworthy company will attract more investors than a company that is known to not be honest.

History of Enron

In the year of 1985, a gentlemen by the name of Kenneth Lay (former employee and chief executive of Houston Natural Gas) established a new pipeline company, Enron. It was a product of the merging of two very successful companies: Houston Natural Gas and Omaha-based Natural Gas. Soon after its establishment, Mr. Lay went on to run the company as CEO ("The Rise and…"). Later in 1999, Enron went from traditional buying and selling of its products to the creation of its company website and the emergence of negotiating future electricity and gas contracts and trading operations. Due to the fact that in the mid-1980s gas prices had been fluctuating, many individuals developed preconceived false perspectives of where the gas industry's future was heading. This brought about an opportunity for Enron to trade on electric powers. In 1990, Lay hired a consultant of McKinsey & Co., Jeffrey Skilling, to lead Enron's Finance Corp. and appointed him as president and chief operating officer of Enron in 1997 ("The History of Enron…").

With Jeffrey Skilling as a new member on board, Enron began to grow wealthy very quickly; due to his excellent marketing administration, the power of the company's advertising techniques, and the company's anticipated high stock price. "Enron was named 'America's Most Innovative Company' by the magazine Fortune for six consecutive years, from 1996 to 2001. It was on the Fortune's '100 Best Companies to Work for in America' list during 2000, and had offices that were stunning in their opulence" (Wikipedia).

However, in 2001 Enron declared bankruptcy, the biggest case in the U.S. at that time. According to CBC approximately 5600 employees lost their jobs. Additionally, the company's stocks and bonds fell drastically. Later, after a thorough internal investigation, Enron was accused and found guilty of committing deceitful bargaining and fraud. All of the company's books had been cooked, and Enron would go on to be remembered as the ideal corporate scandal and guide for policies against fraud (“The rise and...”).

What Went Wrong

Enron often overvalued its long term contracts; they would report their estimated profits as actual profits. For example, in 2000 Enron made a long term contract with Blockbuster to produce an online streaming network. They had only a few pilot projects in apartments in Portland and Salt Lake City. Based of the small pilot projects, they reported a profit of more than 110 million dollars even though it was questionable how well this project could scale in much larger markets (Palepu).

Another issue with Enron is that they used special purpose entities to hide their debt. These special purpose entities are essentially shell companies. By 2001, Enron had over one hundred special purpose entities most of which were used to purchase long term contracts with gasoline producers. One of the worse offending special purpose entities was Chewco which was created only to hide the debt from the purchase of a joint venture for over 380 million dollars. Enron revealed in 2001 Chewco and other special purpose entities that they owned violated accounting standards as they did not have the required three percent minimum of assets owned by independent investors (Palepu).

Under false pretenses, Enron kept their stock prices at a rapidly growing rate. This rate would entice banks, people, and companies to invest in their deceitful accounting practices. When Enron was making massive amounts of money in such a short timeframe, it seemed too good to be true, and it was too good to be true in all angles of the case. These mal-intent companies hid Enron's debts, and created the illusion of increasing their profit (Palepu).

Enron did not follow the checks and balances and GAAP, which led to external audits. External audits were done by bias auditors who were well compensated for their malpractices. Banks, accounting firms, and lawyers are all supposed to be the wall that protects investors, the people, and the government from scandals like these. But, the limitless money that Skilling and others offered made it easy to pay off these protective walls. Monster companies invested in the companies that held Enron's debt, with considerable knowledge that Enron was falsely increasing their profit and hiding their debts. These companies include Chase Capital, World Air Lease, GE Capital, J.P Morgan Capital, Merrill Lynch, C& I Partners, Dresdner, AON, Rho Management, CSFB, Fort wash Private Equity, Morgan Stanley, Ulysses Partners, and First Union Investors ("Enron Scandal").

For example, Arthur Andersen, one of Enron's auditors was paid 25 million dollars in auditing fees and 27 million dollars in consulting fees in the year 2000 alone (Palepu). This massive amount of money paid to this company could have very well led them to overlook accounting failures in order to keep their client happy and to continue paying them. In the year 2001 over 12 million stock options were offered to all officers and directors including 5 million shares to Kenneth Lay and 800,000 to Jeff Skilling (Palepu). These massive incentives to make the accounting information look good during a short term period encouraged the officers and directors to act unethically.

How it could have been prevented

In 2002, Congress passed the Sarbane Oxley Act which included severe penalties for reporting fraudulent accounting information. One of the penalties includes that the officers of the company must sign off on the accounting reports, and if the information is inaccurate, they can face jail time and a severe fine ("The Sarbanes-Oxley Act 2002"). If these penalties were in effect Mr. Skilling or Mr. Lay most likely would not have committed accounting fraud.

There were many ways that the Enron scandal could have been prevented. We could say that they made very unethical choices only thinking of the money that would be going into their own pockets, and not thinking of the millions of people that would be affected by their decisions. By making an ethical choice in the first place, the independent auditors Enron would not have been able to get away with so much for so long. The reason that the Sarbanes Oxley Act was created is for the same reason that Enron Scandal was successful for so long. The act is a set of rules for companies to input correct financial information that must be certified by top executives in the company. If there is fraudulent activity there will be a huge punishment ("Sarbanes-Oxley Basics").

Another way it could have been prevented was by putting a cap on stock options for the top executives in the company so they would not be tempted to make unethical choices. By putting a cap on it, the executives wouldn't be able to make moves like they did with their auditors. The main auditor of Enron, Arthur Andersen LLP accounting firm, was being paid 25 million in audit fees and 27 million in consulting fees (Palepu) clearly telling us that something wasn't right.

All in all, lack of ethics was the main reason Enron was able to do so much. Their business morals were to have money in their own pockets at the expense of investors without anticipating the consequences that would come after their choices. It would end in the fall of Enron and prison time for a couple of the executives. After the dust had settled, all of the unethical behavior finally caught up to Mr. Lay and Mr. Skilling. Mr. Lay was convicted of six counts of fraud and faced up to thirty five years in prison, but he died a few months before his sentencing. Mr. Skilling was convicted of nineteen charges including fraud, insider trading, and making false statements (“Enron’s Lay Found…”). He was sentenced to 24 years in prison which was reduced to 14 years in 2013 (Lattman).

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