Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-9 Chapter Review
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-9 Chapter Review

9-9a Questions for Discussion

1. How did the corporate culture of Enron contribute to its bankruptcy?
2. Did Enron's bankers, auditors, and attorneys contribute to Enron's demise? If so, how?
3. What role did the company's chief financial officer play in creating the problems that led to Enron's financial problems?

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-9 Chapter Review
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-1 Introduction
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-1 Introduction

Once upon a time, there was a gleaming office tower in Houston, Texas. In front of that gleaming tower was a giant "E," slowly revolving, flashing in the hot Texas sun. But in 2001, the Enron Corporation, which once ranked among the top Fortune 500 companies, would collapse under a mountain of debt that had been concealed through a complex scheme of off-balance-sheet partnerships. Forced to declare bankruptcy, the energy firm laid off 4,000 employees; thousands more lost their retirement savings, which had been invested in Enron stock. The company's shareholders lost tens of billions of dollars after the stock price plummeted. The scandal surrounding Enron's demise engendered a global loss of confidence in corporate integrity that continues to plague markets today, and eventually it triggered tough new scrutiny of financial reporting practices. In an attempt to understand what went wrong, this case will examine the history, culture, and major players in the Enron scandal.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-1 Introduction
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-2 Enron's History
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-2 Enron's History

The Enron Corporation was created out of the merger of two major gas pipeline companies in 1985. Through its subsidiaries and numerous affiliates, the company provided goods and services related to natural gas, electricity, and communications for its wholesale and retail customers. Enron transported natural gas through pipelines to customers all over the United States. It generated, transmitted, and distributed electricity to the northwestern United States, and marketed natural gas, electricity, and other commodities globally. It was also involved in the development, construction, and operation of power plants, pipelines, and other energy-related projects all over the world, including the delivery and management of energy to retail customers in both the industrial and commercial business sectors.

Throughout the 1990s, Chairman Ken Lay, CEO Jeffrey Skilling, and CFO Andrew Fastow transformed Enron from an old-style electricity and gas company into a $150 billion energy company and Wall Street favorite that traded power contracts in the investment markets. From 1998 to 2000 alone, Enron's revenues grew from about $31 billion to more than $100 billion, making it the seventh-largest company in the Fortune 500. Enron's wholesale energy income represented about 93 percent of 2000 revenues, with another 4 percent derived from natural gas and electricity. The remaining 3 percent came from broadband services and exploration. However, a bankruptcy examiner later reported that although Enron had claimed a net income of $979 million in that year, it had really earned just $42 million. Moreover, the examiner found that despite Enron's claim of $3 billion in cash flow in 2000, the company actually had a cash flow of negative $154 million.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-2 Enron's History
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-3 Enron's Corporate Culture
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-3 Enron's Corporate Culture

When describing the corporate culture of Enron, people like to use the word "arrogant," perhaps justifiably. A large banner in the lobby at corporate headquarters proclaimed Enron "The World's Leading Company," and Enron executives believed that competitors had no chance against it. Jeffrey Skilling even went so far as to tell utility executives at a conference that he was going to "eat their lunch." This overwhelming aura of pride was based on a deep-seated belief that Enron's employees could handle increased risk without danger. Enron's corporate culture reportedly encouraged flouting the rules in pursuit of profit. And Enron's executive compensation plans seemed less concerned with generating profits for shareholders than with enriching officer wealth.

Skilling appears to be the executive who created the system whereby Enron's employees were rated every six months, with those ranked in the bottom 20 percent forced out. This "rank and yank" system helped create a fierce environment in which employees competed against rivals not only outside the company but also at the next desk. The "rank and yank" system is still used at other companies. Delivering bad news could result in the "death" of the messenger, so problems in the trading operation, for example, were covered up rather than being communicated to management.

Ken Lay once said that he felt that one of the great successes at Enron was the creation of a corporate culture in which people could reach their full potential. He said that he wanted it to be a highly moral and ethical culture and that he tried to ensure that people honored the values of respect, integrity, and excellence. On his desk was an Enron paperweight with the slogan "Vision and Values." Despite such good intentions, however, ethical behavior was not put into practice. Instead, integrity was pushed aside at Enron, particularly by top managers. Some employees at the company believed that nearly anything could be turned into a financial product and, with the aid of complex statistical modeling, traded for profit. Short on assets and heavily reliant on intellectual capital, Enron's corporate culture rewarded innovation and punished employees deemed weak.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-3 Enron's Corporate Culture
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4 Enron's Accounting Problems
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4 Enron's Accounting Problems

Enron's bankruptcy in 2001 was the largest in U.S. corporate history at the time. The bankruptcy filing came after a series of revelations that the giant energy trader had been using partnerships, called "special-purpose entities" or SPEs, to conceal losses. In a meeting with Enron's lawyers in August 2001, the company's then-CFO Fastow stated that Enron had established the SPEs to move assets and debt off its balance sheet and to increase cash flow by showing that funds were flowing through its books when it sold assets. Although these practices produced a very favorable financial picture, outside observers believed they constituted fraudulent financial reporting because they did not accurately represent the company's true financial condition. Most of the SPEs were entities in name only, and Enron funded them with its own stock and maintained control over them. When one of these partnerships was unable to meet its obligations, Enron covered the debt with its own stock. This arrangement worked as long as Enron's stock price was high, but when the stock price fell, cash was needed to meet the shortfall.

After Enron restated its financial statements for fiscal year 2000 and the first nine months of 2001, its cash flow from operations went from a positive $127 million in 2000 to a negative $753 million in 2001. With its stock price falling, Enron faced a critical cash shortage. In October 2001, after it was forced to cover some large shortfalls for its partnerships, Enron's stockholder equity fell by $1.2 billion. Already shaken by questions about lack of disclosure in Enron's financial statements and by reports that executives had profited personally from the partnership deals, investor confidence collapsed, taking Enron's stock price with it.

For a time, it appeared that Dynegy might save the day by providing $1.5 billion in cash, secured by Enron's premier pipeline Northern Natural Gas, and then purchasing Enron for about $10 billion. However, when Standard & Poor's downgraded Enron's debt to below investment grade on November 28, 2001, some $4 billion in off-balance-sheet debt came due, and Enron did not have the resources to pay. Dynegy terminated the deal. On December 2, 2001, Enron filed for bankruptcy. Enron now faced 22,000 claims totaling about $400 billion.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4 Enron's Accounting Problems
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4a The Whistle-Blower
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4a The Whistle-Blower

Assigned to work directly with Andrew Fastow in June 2001, Enron vice president Sherron Watkins, an eight-year Enron veteran, was given the task of finding some assets to sell off. With the high-tech bubble bursting and Enron's stock price slipping, Watkins was troubled to find unclear, off-the-books arrangements backed only by Enron's deflating stock. No one seemed to be able to explain to her what was going on. Knowing she faced difficult consequences if she confronted then-CEO Jeffrey Skilling, she began looking for another job, planning to confront Skilling just as she left for a new position. Skilling, however, suddenly quit on August 14, saying he wanted to spend more time with his family. Chair Ken Lay stepped back in as CEO and began inviting employees to express their concerns and put them into a box for later collection. Watkins prepared an anonymous memo and placed it into the box. When Lay held a companywide meeting shortly thereafter and did not mention her memo, however, she arranged a personal meeting with him.

On August 22, 2001, Watkins handed Lay a seven-page letter she had prepared outlining her concerns. She told him that Enron would “implode in a wave of accounting scandals” if nothing was done. Lay arranged to have Enron's law firm, Vinson & Elkins, and accounting firm Arthur Andersen look into the questionable deals, although Watkins advised against having a third party investigate that might be compromised by its own involvement in Enron's conduct. Lay maintained that both the law firm and accounting firm did not find merit in Watkins's accusations. Near the end of September, Lay sold some $1.5 million of personal stock options, while telling Enron employees that the company had never been stronger. By the middle of October, Enron was reporting a third-quarter loss of $618 million and a $1.2 billion write-off tied to the partnerships about which Watkins had warned Lay.

For her trouble, Watkins had her computer hard drive confiscated and was moved from her plush executive office suite on the top floor of the Houston headquarters tower to a sparse office on a lower level. Her new metal desk was no longer filled with the high-level projects that had once taken her all over the world on Enron business. Instead, now a vice president in name only, she faced meaningless “make work” projects. It is important to note that Watkins stayed in the company after warning Lay about the risks and did not become a public whistle-blower during this time. In February 2002, she testified before Congress about Enron's partnerships and resigned from Enron in November of that year.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4a The Whistle-Blower
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4b The Chief Financial Officer
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4b The Chief Financial Officer

In 2002, the U.S. Justice Department indicted CFO Andrew Fastow—who had won the "CFO of the Year" award two years earlier from *CFO Magazine*—on 98 counts for his alleged efforts to inflate Enron's profits. The charges included fraud, money laundering, conspiracy, and one count of obstruction of justice. Fastow faced up to 140 years in jail and millions of dollars in fines if convicted on all counts. Federal officials attempted to recover all of the money Fastow had earned illegally, and seized some $37 million.

Federal prosecutors argued that Enron's case was not about exotic accounting practices but about fraud and theft. They contended that Fastow was the brain behind the partnerships used to conceal some $1 billion in Enron debt and that this debt led directly to Enron's bankruptcy. The federal complaints alleged that Fastow had defrauded Enron and its shareholders through off-balance-sheet partnerships that made Enron appear to be more profitable than it actually was. They also alleged that Fastow made about $30 million both by using these partnerships to get kickbacks that were disguised as gifts from family members, and by taking income himself that should have gone to other entities.

Fastow initially denied any wrongdoing and maintained that he was hired to arrange the off-balance-sheet financing and that Enron's board of directors, chair, and CEO had directed and praised his work. He also claimed that both lawyers and accountants had reviewed his work and approved what was being done, and that "at no time did he do anything he believed was a crime." Skilling, COO from 1997 to 2000 before becoming CEO, had reportedly championed Fastow's rise at Enron and supported his efforts to keep up Enron's stock prices.

Fastow eventually pleaded guilty to two counts of conspiracy, admitting to orchestrating myriad schemes to hide Enron debt and inflate profits while enriching himself with millions. He surrendered nearly $30 million in cash and property, and agreed to serve up to 10 years in prison once prosecutors no longer needed his cooperation. He was a key government witness against Lay and Skilling. His wife Lea Fastow, former assistant treasurer, quit Enron in 1997 and pleaded guilty to a felony tax crime, admitting to helping hide ill-gotten gains from her husband's schemes from the government. She later withdrew her plea, and then pleaded guilty to a newly filed misdemeanor tax crime. In 2005, she was released from a year-long prison sentence, and then had a year of supervised release.

In the end, Fastow received a lighter sentence than he otherwise might have because of his willingness to cooperate with investigators. In 2006, Fastow gave an eight-and-a-half-day deposition in his role as government witness. He helped to illuminate how Enron had managed to get away with what it did, including detailing how many major banks were complicit in helping Enron manipulate its financials to help it look better to investors. In

exchange for his deposition, Fastow's sentence was lowered to six years from ten. Fastow has also stated that Enron did not have to go out of business if there had been better financial decisions made at the end.

The case against Fastow had been largely based on information provided by Michael Kopper, the company's managing director and a key player in the establishment and operation of several of the off-balance-sheet partnerships and the first Enron executive to plead guilty to a crime. Kopper, a chief aide to Fastow, pleaded guilty to money laundering and wire fraud. He faced up to 15 years in prison and agreed to surrender $12 million earned from illegal dealings with the partnerships. However, Kopper only had to serve three years and one month of jail time because of the crucial role he played in providing prosecutors with information. After his high-powered days at Enron, Kopper's next job was as a salaried grant writer for Legacy, a Houston-based clinic that provides services to HIV-positive and other chronically ill patients.

Today Andy Fastow has been released from prison and works as a document-review clerk at a law firm. He also speaks about business ethics at many different forums, including Leeds Business School at the University of Colorado, the University of New Mexico, the University of Texas at Austin, and the Association of Certified Fraud Examiners global conference. During his speaking engagements, Fastow has emphasized that a major problem companies encounter in business ethics is not using principles and overly relying on rules. He claims that laws and regulations technically allowed the risky transactions he made at Enron. He also cited General Motors, IBM, and the nation of Greece as more recent examples of companies (or nations) that faced hardship and/or bankruptcy because they took actions that were highly risky but technically allowable by law.

The main idea that Fastow tries to communicate in his lectures is that it is not enough to simply obey rules and regulations. It is also easy to rationalize questionable behaviors. Fastow claims that ethical decisions are rarely black-and-white, and sometimes unethical decisions seem more or less unethical depending upon the situation. For instance, he used Apple's tax evasion as an example of an action that seemed less unethical because it was less pronounced than what often occurs in other cases. There are always murky areas where regulations can be exploited. Instead, businesspeople must be able to recognize when issues are going too far and stop them before they snowball into an Enron-esque crisis. Fastow recommends that the best way to deal with questionable situations is to construct and examine a worst-case scenario analysis and look at the risks of questionable deals with more scrutiny.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4b The Chief Financial Officer
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4c The Chief Executive Officer
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4c The Chief Executive Officer

Former CEO Jeffrey Skilling, generally perceived as Enron's mastermind, was the most difficult to prosecute. At the time of the trial, he was so confident that he waived his right to avoid self-incrimination and testified before Congress, saying, "I was not aware of any inappropriate financial arrangements." However, Jeffrey McMahon, who took over as Enron's president and COO in February 2002, told a congressional subcommittee that he had informed Skilling about the company's off-balance-sheet partnerships in 2000, when he was Enron's treasurer. McMahon said that Skilling had told him that "he would remedy the situation."

Calling the Enron collapse a "run on the bank" and a "liquidity crisis," Skilling said that he did not understand how Enron had gone bankrupt so quickly. He also said that the off-balance-sheet partnerships were Fastow's creation. However, the judge dealt a blow to Lay and Skilling when he instructed the jury that it could find the defendants guilty of consciously avoiding knowing about wrongdoing at the company.

Many former Enron employees refused to testify because they were not guaranteed that their testimony would not be used against them in future trials, and therefore questions about the company's accounting fraud remain. Skilling was found guilty of honest services fraud and sentenced to 24 years in prison, which he has been serving in Colorado. He maintains his innocence and has appealed his conviction. After his release from prison, Andy Fastow was quoted as saying that the bankruptcy of Enron was not Skilling's fault. In 2008, a panel of judges from the Fifth Circuit Court of Appeals in New Orleans rejected his request to overturn the convictions of fraud, conspiracy, misrepresentation, and insider trading. However, the judges did grant Skilling one concession. The three-judge panel determined that the original judge had applied flawed sentencing guidelines in determining Skilling's sentence. The Court ordered that Skilling be resentenced. The matter was taken to the Supreme Court.

In June 2010, the U.S. Supreme Court ruled that the honest services law could not be used to convict Skilling because the honest services law applies to bribes and kickbacks, not to conduct that is ambiguous or vague. The Supreme Court's decision did not suggest that there had been no misconduct, only that Skilling's conduct was not in violation of a criminal fraud law. The court's decision did not overturn the conviction and sent the case back to a lower court for evaluation.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4c The Chief Executive Officer
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4d The Chair
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4d The Chair

Ken Lay became chair and CEO of the company that was to become Enron in 1986. A decade later, Lay promoted Jeffrey Skilling to president and chief operating officer, and then, as expected, Lay stepped down as CEO in 2001 to make way for Skilling. Lay remained as chair of the board. When Skilling resigned later that year, Lay resumed the role of CEO.

Lay, who held a doctorate in economics from the University of Houston, contended that he knew little of what was going on, even though he had participated in the board meetings that allowed the off-balance-sheet partnerships to be created. Lay said he believed the transactions were legal because attorneys and accountants had approved them. Only months before the bankruptcy in 2001, he reassured employees and investors that all was well at Enron, based on strong wholesale sales and physical volume delivered through the marketing channel. He had already been informed that there were problems with some of the investments that could eventually cost Enron hundreds of millions of dollars. In 2002, on the advice of his attorney, Lay invoked his Fifth Amendment right not to answer questions that could be incriminating.

Lay was expected to be charged with insider trading, and prosecutors investigated why he had begun selling about $80 million of his own stock beginning in late 2000, even as he encouraged employees to buy more shares of the company. It appears that Lay drew down his $4 million Enron credit line repeatedly and then repaid the company with Enron shares. These transactions, unlike usual stock sales, do not have to be reported to investors. Lay says that he sold the stock because of margin calls on loans he had secured with Enron stock and that he had no other source of liquidity. According to Lay, he was largely unaware of the ethical situation within the firm. He had relied on lawyers, accountants, and senior executives to inform him of issues such as misconduct. He felt that he had been protected from certain knowledge that would have been beneficial and would have enabled him to engage in early correction of the misconduct. Lay claims that all decisions he made related to financial transactions were approved by the company's lawyers and the Enron board of directors. Lynn Brewer, a former Enron executive, states that Lay was not informed about alleged misconduct in her division. Additionally, Mike Ramsey, the lead attorney for Lay's defense, claimed that he was not aware of most of the items in the indictment. In the end Lay was convicted on 19 counts of fraud, conspiracy, and insider trading. However, the verdict was thrown out after he died of heart failure at his home in Colorado in 2006. The ruling protected some $43.5 million of Lay's estate that the prosecution had claimed Lay stole from Enron.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4d The Chair
Book Title: Business Ethics: Ethical Decision Making and Cases

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4e The Lawyers
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4e The Lawyers

Enron was Houston law firm Vinson & Elkins's top client, accounting for about 7 percent of its $450 million in revenue. Enron's general counsel and a number of members of Enron's legal department came from Vinson & Elkins. Vinson & Elkins seems to have dismissed Sherron Watkins's allegations of accounting fraud after making some inquiries, but this does not appear to leave the firm open to civil or criminal liability. Of greater concern are allegations that Vinson & Elkins helped structure some of Enron's special-purpose partnerships. In her letter to Lay, Watkins had indicated that the firm had written opinion letters supporting the legality of the deals. In fact, Enron could not have done many of the transactions without such opinion letters. The firm did not admit liability, but agreed to pay $30 million to Enron to settle claims that Vinson & Elkins had contributed to the firm's collapse.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4e The Lawyers
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4f Merrill Lynch
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-4f Merrill Lynch

The brokerage and investment-banking firm Merrill Lynch also faced scrutiny by federal prosecutors and the SEC for its role in Enron's 1999 sale of Nigerian barges. The sale allowed Enron to improperly record about $12 million in earnings and thereby meet its earnings' goals at the end of 1999. Merrill Lynch allegedly bought the barges for $28 million, of which Enron financed $21 million. Fastow gave his word that Enron would buy Merrill Lynch's investment out in six months with a 15 percent guaranteed rate of return. Merrill Lynch went ahead with the deal despite an internal document that suggested that the transaction might be construed as aiding and abetting Enron's fraudulent manipulation of its income statement. Merrill Lynch denies that the transaction was a sham and said that it never knowingly helped Enron to falsify its financial reports.

There are also allegations that Merrill Lynch replaced a research analyst after his coverage of Enron displeased Enron executives. Enron reportedly threatened to exclude Merrill Lynch from an upcoming $750 million stock offering in retaliation. The replacement analyst is reported to have then upgraded his report on Enron's stock rating. Merrill Lynch maintains that it did nothing improper in its dealings with Enron. However, the firm agreed to pay $80 million to settle SEC charges related to the questionable Nigerian barge deal.

Merrill Lynch continued to use risky investment practices, which contributed to severe financial losses for the company as the economy entered a recession in 2008. In 2008, Bank of America agreed to purchase the company for $50 billion, possibly after pressure from the federal government.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-4f Merrill Lynch
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-5 Arthur Andersen LLP
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-5 Arthur Andersen LLP

In its role as Enron's auditor, Arthur Andersen was responsible for ensuring the accuracy of Enron's financial statements and internal bookkeeping. Investors used Andersen's reports to judge Enron's financial soundness and future potential, and expected that Andersen's certifications of accuracy and application of proper accounting procedures would be independent and free of any conflict of interest.

However, Andersen's independence was called into question. The accounting firm was one of Enron's major business partners, with more than 100 employees dedicated to its account, and it sold about $50 million a year in consulting services to Enron. Some Andersen executives even accepted jobs with the energy trader. In March 2002, Andersen was found guilty of obstruction of justice for destroying relevant auditing documents during an SEC investigation of Enron. As a result, Andersen was barred from performing audits. The damage to the firm was such that the company no longer operates, although it has not been dissolved formally.

It is still not clear why Andersen auditors failed to ask Enron to better explain its complex partnerships before certifying Enron's financial statements. Some observers believe that the large consulting fees Enron paid Andersen unduly influenced the company's decisions. An Andersen spokesperson said that the firm looked hard at all available information from Enron at the time. However, shortly after speaking to Lay Vice President Sherron Watkins took her concerns to an Andersen audit partner who reportedly conveyed her questions to senior Andersen management responsible for the Enron account. It is not clear what action, if any, Andersen took.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-5 Arthur Andersen LLP
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-6 The Fallout
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-6 The Fallout

Although Enron executives obviously engaged in misconduct, some people have questioned the tactics that federal investigators used against Enron. Many former Enron employees feel that it was almost impossible to obtain a fair trial for Lay and Skilling. The defense was informed that 130 of Enron's top managers, who could have served as witnesses for the defense, were considered unindicted co-conspirators with Lay and Skilling. Therefore, the defense could not obtain witnesses from Enron's top management teams under fear that the prosecution would indict the witnesses.

Enron's demise caused tens of billions of dollars of investor losses, triggered a collapse of electricity-trading markets, and ushered in an era of accounting scandals that precipitated a global loss of confidence in corporate integrity. Today companies must defend legitimate but complicated financing arrangements. Legislation like Sarbanes–Oxley, passed in the wake of Enron, has placed more restrictions on companies. Four thousand former Enron employees struggled to find jobs, and many retirees lost their entire retirement portfolios. One senior Enron executive committed suicide.

In 2003, Enron announced its intention to restructure and pay off its creditors. It was estimated that most creditors would receive between 14.4 and 18.3 cents for each dollar they were owed—more than most had expected. Under the plan, creditors would receive about two-thirds of the amount in cash and the rest in equity in three new companies, none of which would carry the tainted Enron name. The three companies were CrossCountry Energy Corporation, Prisma Energy International, Inc., and Portland General Electric.

CrossCountry Energy Corporation would retain Enron's interests in three North American natural gas pipelines. In 2004, Enron announced an agreement to sell CrossCountry Energy to CCE Holdings LLC for $2.45 billion. The money was to be used for debt repayment, and represented a substantial increase over a previous offer. Similarly, Prisma Energy International, Inc., which took over Enron's 19 international power and pipeline holdings, was sold to Ashmore Energy International Ltd. The proceeds from the sale were given out to creditors through cash distributions. The third company, Portland General Electric (PGE), Oregon's largest utility, emerged from bankruptcy as an independent company through a private stock offering to Enron creditors.

All remaining assets not related to CrossCountry, Prisma, or Portland General were liquidated. Although Enron emerged from Chapter 11 bankruptcy protection in 2004, the company was wound down once the recovery plan had been carried out. That year, all of Enron's outstanding common stock and preferred stock were cancelled. Each record holder of Enron Corporation stock on the day it was cancelled was allocated an uncertified, nontransferable interest in one of two trusts that held new shares of the Enron Corporation.

The Enron Creditors Recovery Corporation was formed to help Enron creditors. It stated that its mission was "to reorganize and liquidate the remaining operations and assets of Enron following one of the largest and most complex bankruptcies in U.S. history." In the very unlikely event that the value of Enron's assets would exceed the amount of its allowed claims, distributions were to be made to the holders of these trust interests in the same order of priority of the stock they previously held.

In addition to trying to repay its shareholders, Enron also had to pay California for fraudulent activities it committed against the state's citizens. The company was investigated in California for allegedly colluding with at least two other power sellers in 2000 to obtain excess profits by submitting false information to the manager of California's electricity grid. In 2005, Enron agreed to pay California $47 million for taking advantage of California consumers during an energy shortage.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-6 The Fallout
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-7 Learning from Enron
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-7 Learning from Enron

Enron was the biggest business scandal of its time, and legislation like the Sarbanes–Oxley Act was passed to prevent future business fraud. But did the business world truly learn its lesson from Enron's collapse? Greed and corporate misconduct continued to be a problem throughout the first decade of the twenty-first century, culminating in the 2008–2009 global recession. Corporations praised high performance at any cost, even when employees cut ethical corners. In the mortgage market, companies like Countrywide rewarded their sales force for making risky subprime loans, even going so far as to turn their back on loans that they knew contained falsified information in order to make a quick profit. Other companies traded in risky financial instruments like credit default swaps (CDSs) when they knew that buyers did not have a clear understanding of the risks of such instruments. Although they promised to insure against default of these instruments, the companies did not have enough funds to cover the losses after the housing bubble burst. The resulting recession affected the entire world, bankrupting such established companies as Lehman Brothers and requiring government intervention in the amount of nearly $1 trillion in Troubled Asset Referendum Program (TARP) funds to salvage numerous financial firms. The economic meltdown inspired a new wave of legislation designed to prevent corporate misconduct, including the Dodd–Frank Wall Street Reform and Consumer Protection Act.

It is unfortunate that the Enron scandal did not hinder corporate misconduct. However, Enron still has lessons to teach us. Along with the business scandals of the financial crisis, Enron demonstrates that, first, regulatory agencies must be improved so as to better detect corporate misconduct. Second, companies and regulatory authorities should pay attention to the warnings of concerned employees and "whistle-blowers." Third, executives should understand the risks and rewards of the financial instruments their companies use and maintain a thorough knowledge of the inner workings of their companies (something that Ken Lay claimed he did not have). These conditions are crucial to preventing similar business frauds in the future.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-7 Learning from Enron
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-8 Conclusion
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

9-8 Conclusion

The example of Enron shows how an aggressive corporate culture that rewards high performance and gets rid of the "weak links" can backfire. Enron's culture encouraged intense competition, not only among employees from rival firms but also among Enron employees themselves. Such behavior creates a culture where loyalty and ethics are cast aside in favor of high performance. The arrogant tactics of Jeffrey Skilling and the apparent ignorance of Ken Lay further contributed to an unhealthy corporate culture that encouraged cutting corners and falsifying information to inflate earnings.

The allegations surrounding Merrill Lynch's and Arthur Andersen's involvement in the debacle demonstrate that rarely does any scandal of such magnitude involve only one company. Whether a company or regulatory body participates directly in a scandal or whether it refuses to act by looking the other way, the result can be further perpetuation of fraud. This fact was emphasized during the 2008–2009 financial crisis, in which the misconduct of several major companies and the failure of monitoring efforts by regulatory bodies contributed to the worst financial crisis since the Great Depression. With the country recovering from widespread corporate corruption, the story of Enron is once again at the forefront of people's minds. Andy Fastow has stated that businesspeople are falling into the same trap as he fell into at Enron and believes fraud is "ten times worse" today than it was during Enron's time.

The Enron scandal has become legendary. In 2005, four years after the scandal, a movie was made about the collapse of Enron called *Enron: The Smartest Guys in the Room*. To this day, Jeffrey Skilling continues to maintain his innocence and appeal his case. In April of 2012, the Supreme Court denied his appeal, claiming that any errors made in the trial were negligible. However, the following year a federal judge reduced Skilling's sentence to 14 years. Enron's auditor, Arthur Andersen, faced over 40 shareholder lawsuits claiming damages of more than $32 billion. In 2009, the defunct company agreed to pay $16 million to Enron creditors. Enron itself faced many civil actions, and a number of Enron executives faced federal investigations, criminal actions, and civil lawsuits. As for the giant tilted "E" logo so proudly displayed outside of corporate headquarters, it was auctioned off for $44,000.

Chapter 9: Enron: Questionable Accounting Leads to Collapse : 9-8 Conclusion
Book Title: Business Ethics: Ethical Decision Making and Cases
Printed By: Crystal Arzola (carzola1@liberty.edu)
© 2017 Cengage Learning, Cengage Learning

© 2020 Cengage Learning Inc. All rights reserved. No part of this work may by reproduced or used in any form or by any means - graphic, electronic, or mechanical, or in any other manner - without the written permission of the copyright holder.