Enron: Flaws In Organizational Architecture And Its Failure

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Abstract: A series of corporate scandals at the beginning of last decade has given rise to the doubt on the efficiency of corporate governance practice in the United States. Of these scandals, the collapse of Enron has exceptionally captured the public concern. It was the once seventh-largest company in the United States [1]. It was rated the most innovative large company in America in Fortune's Most Admired Companies survey [2]. In August 2000, its stock reached a peak of nearly $70 billion [3]. However, within a year, its stock had become almost useless papers [2]. It just was unbelievable for many people. What went wrong? Was it due to the failure of corporate governance in general? Actually, the central factor leading to the collapse of Enron was the failure in its organizational architecture. This paper starts by providing an overview of corporate governance system with an emphasis on the corporate organizational architecture as its important facet. Then, it discusses flaws in the organizational architecture of Enron and argues that these eventually led to the breakdown of the whole corporate governance system at Enron. Finally, some implications and lessons for the practice of corporate governance are presented.

Keywords: Enron, corporate governance, organizational architecture.

1. The organizational architecture as an important facet of corporate governance

Separation of ownership and control

The separation of ownership and control in a public company gives rise to the situation that managers may make decisions to improve their own welfare, but not in the shareholders' best interest. Academics refer to such a situation as the principal-agent problem or agency problem, which arises due to the presence of moral hazard and adverse selection [4]. Charter or labour contracts normally leave the executives a large space of discretion due to the fact that they have the knowledge and the ability to run the company [4]. Therefore, they may only pursue enough profit to make stockholders satisfied while they sought self-serving rewards in terms of perks, power, and/or fame [5]. Eventually, this would lead to the inefficient allocation of the company's resources and the loss to the shareholders. What should be done to overcome this problem?

Necessity of an integrated system of governance

There are a number of mechanisms that have been set up in practice to mitigate the agency problem. They together form an integrated system of corporate governance and are classified into two categories, incentive and monitoring. The incentive mechanism refers to compensation plans, under which executives are given bonuses, stock and stock options for their contribution. Stock and stock options are believed to reduce the conflict between shareholders and executives [5]. The idea is that, owning a stock option, executives have the incentive to behave in such a way as to increase the firm's stock price over the long term [6]. This then brings benefits to both, the shareholders and the executives. However, these compensation plans give rise to the potential that executives may be tempted to manipulate or even falsify earnings [5]. Thus, the incentive mechanism is not efficient as expected. It should be reinforced by mechanisms of monitoring.

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Mechanisms of monitoring refer to actions of closely watching the corporate performance by the interested parties in order to ensure the good behavior of executives and protect shareholders. They are called monitors, which can be internal or external. The internal monitor of a public company is the board of directors [5] that is elected by the shareholders to be in charge with managing the company in the best interests of shareholders. In practice, boards have for many years delegated authority to managers to make the most of investment and operating decisions while regularly monitored the performance of managers [7]. Such delegation of decision-making authority requires the boards to be active, knowledgeable about the company, and independent from management, in order to fulfill its monitoring mission.

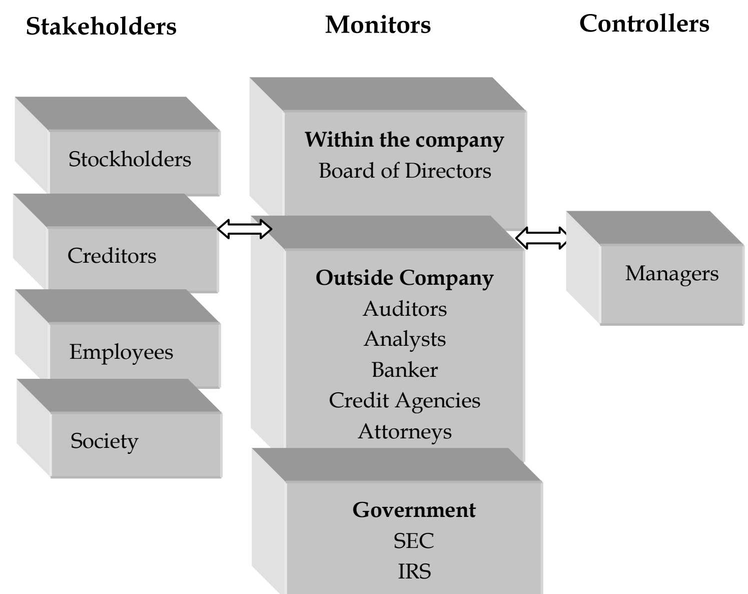

Figure 1.1: *Separation of Ownership, Monitoring and Control*

As can be seen in the Figure 1.1, parties such as auditors, analysts, investment banks, credit rating agencies, and regulators, are external monitors, all interacting with the company and monitoring the company's performance [5]. First of all, external auditors are contracted to express their independent comment whether financial statements fairly

reflects the financial position of the company. Then investment analysts are in place to produce unbiased evaluation reports on the company's stock for the interest of the investment community. Similarly, credit rating agencies assign credit ratings for the company's debt obligations. For their part, investment banks assist companies in interacting with the capital market and raising fund there by issuing securities. Finally, to protect public investors in general, governmental regulators such as the Securities and Exchange Commission (SEC) in the United States enforce the statutory requirement that public companies submit their periodic financial reports for disclosing to the public. Clearly, the corporate governance system consists of interconnected and reinforcing mechanisms of incentives and monitoring. At first glance, such an imperative system seems to efficiently align the interests of the two groups, executives and shareholders. Unfortunately, each mechanism of the system has its problem [5]. Since there is an existence of interrelated incentives in the system that together contributes to create a setting where people might behave unethically [5], a failure of one part would negatively impact the operation of the whole system.

Weakness in the corporate organizational architecture and the ultimate failure of corporate governance

Of the mentioned mechanisms of the corporate governance system, the executive compensation and the monitoring role of the board represent the core internal mechanisms that play the decisive role in forming a sound corporate governance system. The principles of these mechanisms together with the objectives of the company's business strategy are factored into the process of designing the company's organizational architecture in which framework the stakeholders within the company interact with each other. The company's organizational architecture has three fundamentally interdependent elements: the assignment of decision-making authority, performance evaluation and compensation structure [3]. In a well-designed corporate organizational architecture, the three mentioned elements are mutually reinforcing to support the company's business strategy and drive shareholder value creation. In other words, the company's strategy and organizational architecture should be influenced by and consistent with each other. For example, companies normally reappraise and modify their strategies when there are significant changes in an industry's operating environment. In this case, they should also have to consider if the existing organizational architecture remain effective [3]. Thus, an effective corporate organizational architecture is the foundation for successfully achieving strategic objectives and maintaining sound corporate governance. A weakness in one element of the organizational architecture can lead to the failure of the corporate governance system and the recent wave of corporate failures actually stem from flaws in the organizational architecture [3]. The next section will discuss how flaws in the organizational architecture have pulled down the once famous Enron.

2. Enron's failure stemming from a fundamentally flawed organizational architecture

The financial debacle of Enron is a typical case of the failure of corporate governance that stemmed from the flaws in the organizational structure. The previous section mentions that a weakness in one element of the organizational architecture can lead to the failure of the corporate governance system. However, a research of Brickley, Smith and Zimmerman [3] indicated that all the three architectural elements at Enron were at fault. As a matter of course, such a weak foundation could not prop a whole empire of complicated transactions.

Delegation of decision-making authority

Principally, the delegation of decision-making authority should ensure that decision makers really have knowledge, experiences and information needed to make good decisions [3]. However, there was clearly inappropriate delegation of decision-making authority within Enron. For example, the company's management did not acquire enough skills to radically shift the company to new risk-taking business areas [3]. Even the management did not understand properly creative and unconventional products and practice, not to mention its inability in managing risks. The company's chief financial officer is an exceptionally important position for any company, especially for a giant like Enron, but it was assigned to a person who did not have a professional accounting qualification [8]. Without the ability to control risks, the CFO designed excessively risk-taking financial schemes that eventually brought the company down [9]. The delegation of decision-making should be accompanied by the appropriate degree of control at higher levels [3]. This was not seen at Enron. There was too much leeway assigned to young, inexperienced managers without the necessary controls [10]. As an established rule for monitoring, the board members are expected to supervise the senior management's actions and decisions. If the board members do not have the ability to foresee the future consequences of decisions, serious moral hazards occur [11]. The reality at Enron shows that the board was generally ineffective and did not have such ability. For example, by waiving a code of conduct stipulation, the board allowed the CFO to create private offshore partnerships that would conduct business with Enron [5]. As a result, the CFO was in a position to control both sides of transactions and earn much money at Enron's expense [12]. Even an employee sent the chairman anonymous memos pointing to fraudulent transactions giving rise to a conflict of interest, but the board did not see any problem [13].

Performance evaluation

Performance evaluation refers to measurement systems which are designed to measure the performance of the company and evaluate the contribution of employees for compensation purposes [3]. It is required that the applied accounting system should create measures consistent with the underlying economic performance. Nevertheless, performance at Enron was gauged primarily on the basis of short-term earnings growth [3]. There were at least five types of fraudulent manipulation in accounting practice found [14], which all aimed to book huge capital gains and profits. Kim and Nofsinger [5] mentioned one of the most noteworthy examples to indicate the practice of accounting fraud at Enron:

> *Enron would also enter into contracts to sell energy to a customer for 30 years. Then they underestimated the cost of providing that energy, thereby overestimating the annual profit of the contract. Enron would also book all thirty years of these inflated profits in the current year. This made Enron appear incredibly profitable over the short-term but was detrimental to its longer-term financial health.*

Compensation plan
A compensation plan identifies how employees are compensated. A compensation plan is considered to be appropriately designed when the company has identified its concrete strategic objectives and these objectives have been factored into the design of the incentive plan [3]. As such, it would provide decision makers with cost-effective incentives to motivate their value-adding effort. As mentioned earlier, the delegation of decision-making authority at Enron was inappropriate while the company's strategy was wrongly identified. As a result, the company's compensation incentives would have hardly been created in a cost-effective way. Actually, Enron developed a compensation plan that put an emphasis on stock and stock option rewards, offering enormous compensation to its top employees on the basis of short-term earnings growth [3]. This encouraged management to engage in transactions that were excessively exposed to risks [3]. Another problem associated with the compensation plan at Enron was the existence of strong financial ties between the company and the board members. Board members were also paid fees in the form of stock and stock option (Petra 2006). One member of the audit committee even received a consulting fee from the company (Petra, 2006). This practice actually created the situation of interest conflicts and weakened the independence of the board. This also explained partly why the Board loosened its monitoring role.

Problems of ethics
Brickley, Smith and Zimmerman [3] indicated that implementing a code of ethics is not enough to assure ethical behavior in today's business life, but it should be reinforced by an effective organizational architecture. Clearly, the organizational architecture at Enron contained in itself deep-rooted flaws. Thus, unethical behavior standards were inevitably violated. As analyzed above, at Enron, the compensation plan and the performance measurement systems were based on short-term accounting earnings, and a flatter hierarchy of management permitted freewheeling decision-making [3]. Such an organizational architecture gave birth to a corporate culture geared toward heightening individual initiative where employees even sabotaged one another, certain executives even arranged bogus transactions to meet performance targets [15], and the CFO even made money at the expense of the company. More dangerously, Enron's organizational architecture encouraged excessive risk-taking decisions beyond its risk-managing ability. And the vicious circle was leading to more serious breaches of ethical behavior and its failure started here. Many bad business deals pressured the company to do something about its finances [15]. Gradually, Enron slipped from rule bender to rule breaker [15]. Finally, it illegally cooked the books with hope to meet the investors' expectation and maintain its credit rating. The biggest unethical behavior was its systematically concealing the truth to mislead the public investors. When the truth became obvious, Enron ended in a bankruptcy filing quickly and it was too late for investors. A nearly total market value of its stock was evaporated in a short time and the asset of $1 billion in terms of employee retirement accounts was driven right away [3].

3. Flaws in the organizational architecture at Enron led to the breakdown of the whole corporate governance system

As mentioned above, external monitors play important roles in providing the public investment community with authentic information and unbiased opinions about the financial status of the companies. In the case of Enron, the situation of artificial profit and real loss was glossed over for a long time as the external monitors failed either to provide the authentic information or express unbiased opinions. In other words, the whole corporate governance system failed at Enron. Why did this happen? The efficiency of external monitors much depends on their independence and the quality of information disclosed by the companies. The external monitors have their own monitoring mechanisms but are interrelated and reinforcing to each other too. For example, the financial statements that are audited by the auditor are then used by the security analysts and banks to evaluate the financial position of a company. Thus, the failure of the auditor would easily create a domino effect, causing the failures of other monitors. The following will briefly present how each monitor failed its monitoring mission to Enron.

Failure of auditors
Arthur Anderson acted as Enron's external auditor. The failure of Arthur Anderson was much due to its financial tie with the company. Not only being Enron's external auditor, it also functioned as the internal auditor and a tax consultant to the company, creating a unique integrated audit system in auditing Enron [11]. Its auditing fees represented only 30% of the total fees received from Enron [12]. Clearly, the independence of Arthur Anderson was totally compromised by its financial interest in Enron. This explains why Arthur Anderson easily ignored all the questionable accounting practice at Enron, thus failed to provide unbiased opinion about Enron's financial statements. Arthur Anderson was even involved in structuring some transactions, which were merely vehicles for Enron to manage its earnings [11].

Failure of security analysts
Security analysts largely relied on the audited financial statements to evaluate Enron's business activities and financial health. They would hardly have doubted about the cooked figures that had been audited by a famous public auditing firm like Arthur Andersen. Though the numbers presented by Enron were extremely complicated and difficult to understand, most analysts of Wall Street firms gave positive recommendations to Enron stock [11]. Such recommendations actually contributed to inflating Enron's stock price and encouraged many investors to buy and hold Enron stock for long time [11]. Thus, the failure of Arthur Anderson actually led to the failure of security analysts.

Failure of banks
Similarly, the investment banks seemed to be misled by Enron's financial statements as well. The evidence is that they actively participated in structured deals that Enron aimed to hide its financial troubles [5]. However, their lucrative business with Enron might have also overshadowed their monitoring role. The investment banks probably suspected the distortion in Enron's financial statements [5], but they never questioned. According to Cunningham and Harris [12], they were afraid

that the disclosure of truth would have put Enron's stock and their ability to profit from Enron business at risk.

Failure of regulators

In the United States, SEC is the main regulator in the stock exchange market, enforcing that public corporations tell the public true about themselves. It seems to be a powerful and effective monitor but it may face work overload, labor shortage and being under-financed [5]. Therefore, the financial statements submitted by Enron for public disclosure were not timely reviewed [11]. Whatever information provided by Enron was then made available straight to the public without any proper scrutinizing. This again shows that SEC had to rely much on the auditing job of Arthur Andersen and therefore failed to detect the problems of Enron sooner.

4. Lessons and implications

Clearly, the failure of Enron stemmed from the flaws in its organizational architecture. This first deteriorated the efficiency of the internal monitoring mechanisms and caused breaches in ethical behavior. Consequently, this led to the failure of the whole system of corporate governance. This implies that any corporate governance system really needs to function on the foundation of a well-designed organizational architecture. Furthermore, it is also important for companies to customize their organizational design to reflect their business strategies as well the need that actually arises from the changes in the business environment. Several important lessons for the practice of corporate governance can be drawn here. Firstly, the delegation of decision-making authority should be accompanied by the appropriate degree of control at higher levels. Secondly, the performance management and compensation plan should be consistent with underlying economics, not on the basis of short-term accounting earnings. Thirdly, the independence of all the monitors should not be compromised by any type of financial tie. Finally, the monitors should have knowledge, skills, experiences and capacity to fulfill their monitoring missions.

5. Conclusion

The corporate governance system consists of a number of interconnected and reinforcing monitoring mechanisms in order to align the interests of executives and shareholders. Among monitoring mechanisms, the executive compensation and the board play the decisive role in forming a sound corporate governance system. Their monitoring principles are factored into the company's organizational architecture. Thus, it is an important facet of corporate finance. A well-designed organizational architecture is characterized by the mutually consistent relationships among decision authority, performance evaluation, and compensation. This is the foundation for creating shareholder value and ensuring ethical behavior. This would underpin the whole corporate governance system as well. The debacle of Enron much stemmed from the flaws in the organizational architecture, not from the general failure of the corporate governance system.

ACKNOWLEDGMENTS

The author would like to express the great gratitude to Dr. Nguyen, T. Phuc by giving the supports.

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