

Enron: A Pedagogical model of creative financial management¹

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Abstract

This paper presents a pedagogical model which explores the issues of Business as a Calling for individuals and the Calling of Business for the organization. The inception, growth and more importantly, the recent transformation of Enron Corporation provides the framework to explore these issues. The paper draws mainly from two events. First, an overseas project undertaken by Enron at a time when the company had an identity of a conventional asset based company. The project is the USD 2.4 billion Enron power plant in Dhabol, India begun in 1993.² Secondly its reorganization from a traditional gas-pipeline company to a trading company. The reorganization begins in 1997 when individuals within the organization did not wish to accept this conventional identity, transforming the company to adopt a new identity - that of an asset light company seeking ever-higher returns on investments.

Conventional or not, the question that begs a response is: since its inception did Enron or its leadership respond to the notions of calling of business or business as a calling?

¹ The paper is dedicated to the memory of Sanjay Jaiswal, CFO Consumer Services DSL Division AT&T, to his personal calling to business.

I am grateful to Dean Maines for his suggestions and to Ms. Claudia Gavriluta, Research Assistant St. Thomas MBA program, for her help. I accept full responsibility for any errors or misrepresentations in this paper.

² Ameeta Jaiswal-Dale "Enron in India: A case in international finance" CIBER case collection with ECCH-Babson

Introduction

Since the industrial revolution, companies, for-profit businesses, have come and gone or morphed into other forms to suit the exigencies of the prevalent business environment. Some had long lives and a long history of positive contributions to society, some are infamous, others burn out quickly like meteors while some remain unknown or unrecognized. Regardless of their fate or trajectory, businesses are made up of individuals who are simultaneously producers, consumers and investors and they have the objective of providing goods or services to society. This is an important objective affecting the quality of life of the entire society. It is a responsibility. How many businesses and the individuals at the businesses, view it as a responsibility? But more importantly, do the pedagogical models used at educational institutions highlight this responsibility for future individuals planning their vocations in business? Section I of this paper discusses the notion of societal responsibility for the business and the individual through the concepts of business as a calling and the calling of business. Section II provides factual information of a business – Enron Corporation – from its inception to the present, weaving a rich tapestry of the impact of this business in several parts of the world. Section III then builds a pedagogical case of how Enron failed to adhere to either the notion of the calling of business or business as a calling. Section IV concludes with the integration of personal and organizational vocation as demonstrated by the lessons learnt at Enron.

Section I: Business as a Vocation

For most of us a vocation, a calling, is associated with religion and perhaps the purest of knowledge for example, basic science. Thus only a religious person – a priest, a rabbi, a brahmin – or a scientist is called and has a vocation. The rest of us have either jobs or careers. We can indeed with some ease make the distinction between a job and a career but we pause nonplussed when the question of work as a calling comes up. A job is the means to earn a monetary wage, while satisfying the immediate needs of daily life including some form of leisure. Whereas the career is beyond a mere job, it includes sense of advancement, self-esteem, prestige, social standing and rank. In the daily humdrum existence rarely do we pause to consider work as a calling or to question if it is a calling.

Calling is about identity. The individual may choose to discover that calling, for example business as a calling, or may forego this discovery in pursuit of mere careerism. This individual may be supremely successful in the career but could very well be socially and spiritually dissatisfied because the career is not the calling. And yet, it is quite simple to find calling in one's work. It amounts to finding meaning in the work that is performed in the best interest of the society at large along with the best interest of individual or the organization where the individual is employed. The business may also choose to discover its calling, the calling of business, by respecting every stakeholder who might be affected by a business in its decision making process.

Several distinguished individuals have written extensively on the purpose of business, on business as a calling for individuals as well as the calling of business for organizations. They represent a wide variety of views from economists and political thinkers to philosophers and clergy. Their writings provide a wide array of insights into the subject. John Paul II on the threshold of the new millennium, in his *Centesimus Annus* (1991), shows concern of the proper use of man's principal resource, *man himself*. He speaks of the calling of the individual within the modern economy and within a business, as: "Where as at one time the decisive factor of production was the land, and later capital - - today the decisive factor is increasingly man himself, that is his knowledge, his capacity for interrelated and compact organization as well as his ability to perceive the needs of others and to satisfy them". For him, clearly it is the business, the economic enterprise, comprised of individuals who have to take the responsibility for their actions and the subsequent impact on others. Individual responsibility is further expressed in his views of the free market and in its *raison d'être*, its calling as a free enterprise, a business. "It would appear that at the level of individual nations and of international relations, the free market is the most efficient instrument for utilizing resources and effectively responding to needs. But this is true only for those needs which are solvent, insofar as they are endowed with purchasing power and for those resources which are marketable, insofar as they are capable of obtaining a satisfactory price. But there are many human needs which find no place on the market. It is a strict duty of justice and truth not to allow fundamental human needs to remain unsatisfied, and not to allow those burdened by such needs to perish." Calling of business or the business of calling rests squarely with the individual within the free market where he acknowledges "the legitimate role of profit as an indication that a business is functioning well".

Novak (1996) summarizes his views with four points about callings in general and those in business in particular as:

- Each calling is unique to each individual.
- A calling requires certain preconditions.
- A true calling reveals its presence by the enjoyment and sense of renewed energies its practice yields us.
- Callings are not usually easy to discover.

These points are particularly valid today in this early 21st century era of global business production systems where malaises along with profits can easily cross national boundaries, affecting all either directly or indirectly.

Edmund Malinvaud (2001) discussing work as key to the social question, addresses the notion of the priority of labor over capital by examining the "proper role of finance in business". He concentrates on a select sample of three financial issues:

- A just implementation of just loan contracts.
- Partners in risk taking and risk sharing – insurance and employment contracts.
- Ethics of management between shareholders, workers, creditors and customers.

Malinvaud concludes that in recent times, there has been "analyses developed by modern research in economics". Drawing upon these analyses in recent times he notes that "nothing prevents it (the role of finance) from being fully consistent with the vision of society which is so persuasively taught by the Catholic social doctrine ..."

Alford and Naughton (2001) discussing the purpose of business, raise interesting issues in their interpretation of the shareholder model of organizational purpose. Referring to the shareholder model discussed in the text by Brigham and Gapenski (1991), they conclude that, “under the shareholder model, managers are not responsible to customers or employees in the same sense that they are responsible to shareholders.” The primary and indeed the main objective of the firm, is to maximize shareholder wealth and any pursuit of human development – customer relations, employee relations and others – are pursued not for its own sake but for the sake of maximizing shareholder wealth. Moreover, “finance alone among the business fields explicitly defines the overall end of the business organization through the shareholder model.”³

In their writings several economists of different stripes and affiliations, including Adam Smith and John Maynard Keynes, have clearly stated the purpose and responsibilities of business (and that of managers) along with their models of production, distribution and growth. Adam Smith wrote of “reining in the greatest interests of our own for yet the greater interests of others” in his work *The Theory of Moral Sentiments* written before his economic systems work *The Wealth of Nations*. Keynes says that it was the merest pretense to suggest that an enterprise is “mainly actuated by the statements in its own prospectus, however candid and sincere”. Economist, Joseph Schumpeter (1942) has written an entire treatise on the entrepreneur, the role and responsibilities of this station. Schumpeter summarized the entrepreneur as the person “to act with confidence beyond the range of familiar beacons and to over-come that (social) resistance requires aptitudes that are present only in a small fraction of the population and that defines the entrepreneurial type....” Surely, he was not referring to negative aptitudes of accounting fraud and financial fraud but to nobler ones leading to economic development and better distribution of economic gains (1943).

Finance is derived from economics and uses the data and information from accounting. It provides the framework for economic accountability, more elaborate and more detailed than the mere function of the regular accountant. The notion of shareholder wealth creation is only the base, the yardstick in use, for quantifying economic accountability.⁴ The base provides for a set of performance measures and is not necessarily a value

³ Brigham and Ehrhardt (2002) have since their earlier edition of 1991, (see page 10), introduced a more inclusive notion of the goals of the corporation, indicating that businesses or owners of stock are society – indicating a larger stockholder base representing the society at large as compared to a concentrated stockholder base of a decade or so ago – comprising of stakeholders along with stockholders. As a teacher of finance and a user of the above text, Brigham and Ehrhardt (2002) now in its 10th edition, I along with several other colleagues, am inclined to view the purpose of business today in a light not always expressed clearly in most core finance textbooks. This is not due to deliberate negligence but mostly due to the desire to concentrate on the essential yardstick of measure(s), to quickly drive home a message in 14 weeks of the semester, albeit a partial one. This is a pedagogical error in the teaching of finance, easily rectified in individual classroom situations.

⁴ Economics is a social science and deals with several aspects of an individual’s behavior that can be difficult to rationalize and thus quantify – individual and societal patters / habits of consumption, savings, investments, forecasting. In order to quantify these very human characteristics, a base, a framework that is simple and yet inclusive of many behavior patterns is necessary. See Malinvaud (2001).

proposition for running a business entity. Unfortunately this base has become the pedagogical corner stone in the teaching of the subject and in its implementation in business, implementation that has the potential for catastrophe. Obviously Enron Corporation made this fatal mistake in implementation. The question is, was it a deliberate mistake?

Section II: Enron Corporation

Enron was formed by the merger of *Houston Natural Gas* and the Omaha based company *Inter-North* in the 1985. The company later changed its name to Enron. At its inception, the company was a pipeline hauler of natural gas. By 1999 Enron Corp. was the third largest Global 500 company among the developers of energy infrastructure with profits of \$584 million.⁵ Number one was RAO Gazprom and number two was Sociedad Estatal De Participaciones Industriales with profits of \$1825.8 and \$1412.9 million respectively. On December 2nd 2001 when Enron filed for bankruptcy, it was the 7th largest company in revenues in the USA.

This growth at Enron was mostly a response to the transformation of the power sector in the US and abroad. The power industry was being deregulated all over the world. There was, and continues to this day, a shortage of power in several parts of the developing world including Latin America, China and India. Meanwhile, in the developed world including the US was poised to streamline bloated inefficient public utility sectors by deregulating them. The impact on business would be enormous.⁶ Enron was well aware of this sea change and as any nimble business would, it did its best to position itself to profit from this transformation both in the US and abroad. Ms. Rebecca Mark at the head of Enron International, the division responsible for the development of overseas projects in Asia, Europe and Latin America diversified the company's operations via foreign direct investments fueling rapid overseas growth. Ms. Mark, a protégée of the CEO, had the confidence and support of her mentor at Enron, the CEO Ken Lay.

From a regional Texan company providing pipelines for transporting natural gas, Enron Corp. became an industry leader in the development of energy infrastructure in the US and abroad. This success has brought increased market share, higher share prices, rapid growth and visibility to the top management. Enron's international development portfolio included several projects in the US and abroad. Ambitious projects, heavy in assets were foreign direct investments undertaken all over the globe with *Dhabol, India* (1995) being the first major project of this kind in the history of this industry⁷. Dhabol presented

⁵ Enron's primary activities are managed by its three core businesses: Exploration & Production, Transportation & Distribution, and Wholesale Energy Operations & Services. A new business, Retail Energy Services, is focusing on the significant energy needs of direct end-user customers.

⁶ In the developed industrialized world, electricity accounts for about 15% of operating costs for big firms like Chevron and industries and companies consume on an average about 60% of all power sold. There are no figures available for the developing world as yet. The scope is too large for proper quantification.

⁷ Enron took the plunge with two other strong US companies. They formed a joint venture for investment in India. The team members are – Enron Corp. with 79.93% of equity stake, Bechtel Enterprises Inc. and General Electric's Financial Services with 10.036% each. The *Dhabol* project put Enron in the international

advantages to both India and Enron. Enron found a cost-effective client for its *Qatar General Petroleum Corp.* plant to sell LNG produced by Qatar to fuel the power plant across the Arabian Sea in India, thus gaining entry into the larger Asian Markets to build, own and operate a power station. India, its government officials out of their depth in these types of projects, obtained the largest foreign direct investment in history with financing in place and the promise to sort out the morass of the country's energy sector. Neither party seemed to be too concerned with the notion of undertaking a thorough due diligence of each other's activities. Enron followed its typical modus operandi – first do the deal, lock it in then later negotiate a settlement to its benefit. Until *Dhabol* this business strategy had not publicly failed Enron.⁸

There were several other projects in Enron's portfolio including - *EcoElectrica* the Puerto Rican liquefied natural gas (LNG) project (1999); *Dhabol India* power project with LNG (1995); the oil gasification power project in *Sardinia*, (1999); the 1875 mile long *natural gas pipeline from Bolivia to Brazil* under construction in 1999 and many others. The LNG projects are a first for both the host countries and Enron Corp. These projects had made Enron a leader in power and pipeline among its peers. As far as Enron was concerned these uncharted territories offered great promise. And given the competition they were facing in the deregulated US market, the timing was perfect to undertake Foreign Direct Investment in Asia and Latin America. Enron now had a rich portfolio of assets around the globe with clear expectations of high ROA – return on assets.

High ROAs in projects heavy in assets do not materialize overnight. However, the leadership at Enron – indeed the Board of Enron, the industry analysts on Wall Street, the regular Joe investors in Enron, the employees of Enron and other stakeholders all- wished to see its stock price continue to improve and at a sustainable rate. To achieve this sort of growth encouraged by the stakeholders, another strategy had to be put in place appropriate for an energy market experiencing rapid change due to the forces of deregulation and technological innovation. The catalyst for this new strategy was another protegee of Ken Lay – Jeff Skilling who along with a team of lieutenants set out to transform Enron to a virtual giant.

Section III: Enron a Virtual Giant

By the mid 1990s worldwide, electricity was turning into a commodity, especially in the US, where the industry is almost at the threshold of deregulation. As stated by Fortune Magazine (September 29th, 1997 issue) “the deregulation of the electricity utility business isn't merely uprooting ancient monopolies – it's also creating a whole new industry - power marketing - the buying and selling of electricity on the open market”. It is like trading soybeans or oil or pork bellies. There are electricity options and futures just as

spot-light for the prickly issues of Foreign Direct Investment and Political Risk from host countries. The Enron case had become a benchmark for Multinationals interested in investing in India.

⁸ Enron case was viewed by many as a “litmus test” of the country's willingness to deal with foreign firms. See Jaiswal-Dale (2001)

there are soybean options and futures. And Wall Street is good at it. Already Morgan Stanley traders, who know nothing about running power plants, were becoming the most sophisticated power-marketing players among the financial institutions. After all Morgan Stanley already traded in other energy sources – oil for example. There were several companies, regular utility companies, gas companies like Enron and investment bankers, all vying for a piece of this power marketing pie that was fast becoming global.

Currently the US consumer has no choice but to pay the local utility company whatever rates the company chose to charge. By law nobody else can sell power. But then again, today most utilities are wary of generating all the power their customer base needs. They do not want to be left holding surplus power. They prefer to buy surplus power from other utilities, a practice that started in 1992 when the US government allowed transporting power from one surplus utility to a deficit utility at a mutually acceptable negotiated price. Experienced commodity traders in the utility sector, like Enron, took to this practice like fish to water transforming themselves into a holding company of successful service subsidiaries rather than a asset based producer of goods.

Enron had positioned itself not only to lead this energy trading revolution in the US, but also to incite and ignite it abroad. “Electric power is the biggest American industry ever to be deregulated”, said Mr. Kenneth Lay, Chief Executive of Enron, “its about twice the size of the long distance telephone business and dwarfs the gas, airline, trucking, and railroad industries, which were all once regulated” (Fortune 1997). And in the developing countries, especially populous ones of Asia and Latin America, the need for energy and power sources is likely to be phenomenal in the near future, even at their present pace of economic development.

In 1980’s Enron, originally a regulated gas pipeline company, made its first leap into prominence soon after the deregulation of the pipeline industry. It had a client base of mainly electric companies that bought gas for generator fuel. Once the pipeline industry was deregulated, Enron reaped the full benefit of the 1992 US Government law, by using its commodity trading expertise on its existing client base of electric companies, to help them trade their surplus production. According to Fortune magazine (1997), “now Enron traders are on the phone 24 hours a day, calling up power plant operators to see who needs power, who’s selling it, which transmission lines are at capacity”. Enron bought and sold more power than any company in the power sector through its electricity trading unit, *Enron Capital & Trade Resources*. It was well positioned in the mature US power sector. The leader spearheading this phase of the company’s growth and transformation, with a hand picked team of lieutenants, was Jeff Skilling. As Enron’s President, Jeffrey Skilling was quoted in the Wall Street Journal, January 21st, 2000 as saying - “Enron reaped 80% of its revenues from the regulated gas-pipeline business in 1989 and now derives a similar percentage of its revenue from businesses that didn't even exist inside Enron a decade ago”.⁹

⁹ In its 2000 annual report, Enron explained this new revenue situation in a footnote - “Judgment is necessarily required in interpreting market data and the use of different market assumptions or estimation methodologies may affect the estimated fair value amounts”.

Enron was one of the major traders in electricity futures contracts - buying and selling surplus electricity on its trading floor. These kinds of trading activities were now possible because, approximately 24 states in the US had passed laws that permit consumers to shop for better deals than they can get from their local utilities. Through *Enron Energy Services* the firm offered total energy management for financial / retail institutions, commercial / sports facilities and high technology areas. Enron has established an Internet trading unit, *Enron Online* in November 1999 to facilitate trading for its customers. Trading, buying and selling of contracts, took place with the list of products offered in Enron's current portfolio of products - natural gas, electricity, paper pulp and coal. By the first quarter of 2000 other products were part of this portfolio - petrochemicals, weather-hedging contracts, emission credits and bandwidth. Enron Corp. attempted to make bandwidth a commodity with its recently formed subsidiary, *Enron Communications*. Like a market maker on Wall Street, Enron would buy up pipeline space from other networks, maintaining an inventory that it could then mark up and sell to customers as needed. Owners and users of fiber-optic lines could then trade capacity back and forth, setting prices with standard contracts.¹⁰ Soon Enron's ambitions were no longer assuaged with being a global player for power distribution alone. It wanted to be a global player in water distribution as well.¹¹

In the meantime, the asset heavy foreign direct investments in the power sector were not producing the desired returns, whereas power trading was proving to be immensely profitable. Especially the power plant in Dhabol, India, mired in local politics but more importantly in its own faulty project analysis.¹² At this point it became imperative to move Ms. Mark, who continued to believe in the asset based business model to the power sector, another asset based industry, in order to preserve a model most apt for rapid returns on investments.

In 1998 Enron Corp. spun off a new company, *Azurix Corp.* under the stewardship of Ms. Mark. The objective was to compete in the water supply business with the same intensity as the natural gas and electricity businesses. Enron believed that after telephones, power and gas, water was the next utility to be shaken up by international competition. In July, 1998 Enron paid \$2.2 billion to acquire *Wessex Water PLC*, a British water and sewage company. Ms Mark was named chairman and CEO of the water unit as well as chairman of the international division. She said the company's strategy was to focus on acquiring water assets in Europe and South America. She identified Italy, Germany, Brazil and Columbia as a few regions undergoing the same sort of privatization and consolidation as the electric industry and indicated that the company expects to be a dominant force in the \$300 billion a year international water industry. *Azurix Corp.* was anticipating that water would be a traded commodity much like natural gas or electricity. It also announced that it is launching an exchange, *Water2Water.com*, on the Internet, for buying, selling, storing and transporting water in the West. This exchange will also post

¹⁰ See Fortune Magazine, January 24th, 2000.

¹¹ See also Wall Street Journal, November 9th, 1998, "Water Business is hot as more cities decide to tap private sector".

¹² See Jaiswal-Dale 2001

weather reports; crop and commodity prices, reservoir levels and other water related information. Azurix wanted to create a new market for trading water just like electricity.

The transformation of Enron from an asset based company to an asset light company was complete. It was now a “virtual” giant within the electronic medium of the energy trading sector intending to continue to reap sustained levels of return on assets. Enron reinvented itself from a gas distribution company in the 1970s to an energy generation and transmission assets company in the 1980s and then finally to an energy trading company in the mid 1990s.¹³ Trading that did not need as many assets and long-term energy contracts used in energy trades lends itself more easily to creative market valuation and reporting practices.

Enron’s made good use of changing market and regulatory conditions to exit out of the not yet completely deregulated energy market into the largely deregulated market for contracts – derivative contracts that is. The process of transformation was remarkably edifying.

For this rapid and audacious transformation to take place **within the framework of the current accounting and disclosure practices**, a company would require some creative tools. Enron’s use of creative tools presents a rare pedagogical model of creative financial management. The creative tools were

- Financing using outside partnerships and special purpose entities- SPE - to monetize (give a monetary value) to assets, move debt off the company’s balance sheets and provide financing for implementing the asset light energy trading vision of Messrs Lay and Skilling.¹⁴
- Funding the outside partnerships the SPE, used to move debt off the balance sheet, leading to a conflict of interest.
- Use of derivative contracts to inflate asset values, bury debt and hide speculation.

Messrs Lay and Skilling, with the full accord of the Board of Directors, began using partnerships as a financial vehicle to keep debt off the firm’s balance sheets and create

¹³ Chronology of commodity trading at Enron: Gas in 1989, Electrons in 1994, Bandwidth in 1999 to joined later by pulp, plastics and metals. It did not extract or burn the gas. It did not generate the kilowatt hours. It did not light the fiber –optics. It obtained profits on the trades of these products without ever producing them.

¹⁴ A special purpose entity, formed for a special purpose, has powers limiting it to the purpose it was destined for. Its life is destined to end when the purpose is attained. A corporation wishing to isolate an activity or operation, sections off this activity into the SPE. Assets sectioned off into the SPE provide the backing for the investors in the SPE who then are not affected by the business risks of the originating entity. One example of an operation suitable for an SPE, is the desire to obtain favorable external funding independent of the debt status of the corporation. Another example is securities issued by the SPE containing credit enhancements or guarantees that reduce risk for the purchaser (the external investor) thereby reducing the cost of funding for the company. This form of guarantee will work as long as the company avoids pledging its equity. SPE are temporary containers and can take several forms including partnerships and trusts. They are self-sustained yet legally distanced in terms of management and ownership from the original business. When this distance is not there, then a SPE is no different than a subsidiary.

“price benchmarks, also called estimated fair value, to provide better pricing for Enron’s products. The SPEs was the company’s response to changing accounting rules requiring disclosure of cash flow generated by all operating contracts including trading / derivative contracts. SPEs in the form of partnerships like LMJ Cayman LP and LMJ2 C-Investment LP were formed and managed by Enron’s CFO, Mr. Fastow. Enron was required to maintain a good credit rating to be successful in its energy-trading operations. Enron had to maintain a strong investment grade credit rating. Traditional means of indicating strong investment grade credit through equity offerings that could dilute existing shares and lower the stock price, or through selling assets and converting them to cash which does not earn much, were not acceptable practices at the company. Enron chose to shift its debt off the balance sheet in order to improve its credit ratings.

In the past, Enron had used a publicly traded subsidiary *Enron Global Power and Pipelines* to raise credit via off balance sheet debt. As did other well reputed companies. But Mr. Fastow wished to find a “more cost effective and flexible” means to raise funds (Fink 2002). Using a public entity like *Enron Global Power and Pipelines* meant hassling “with shareholder votes and amendments to charters and the like” when “you can get together with one or two other investors and craft a particular structure to meet your objectives” (Fink 2002). Mr. Fastow did approach some blue chip companies on Wall Street, like DLJ to serve as investors in the partnerships. Some blue chip companies did oblige, among them Merrill Lynch. In 1997 Enron bought back *Enron Global Power and Pipelines* and began looking into private partnerships.

Examples of partnerships and entities - LMJ, Chewco and Braveheart:¹⁵ Enron formed several partnerships besides LMJ as separate entities from Enron, using outside equity. There was only a 3% outside equity requirement.¹⁶ Mr. Fastow managed several partnerships or SPEs transactions millions of dollars with the company Enron while it allowed Mr. Fastow to earn management fees and a part of the partnership profit. Mr. Skilling and other senior officers served as the review team to deter any conflict of interest by Mr. Fastow. The independent accounting / auditing firm Arthur Anderson signed off on key transactions and partnerships. Enron was making capital investments that would not necessarily generate cash flows in the near future. This fact had to be concealed or else it would affect the company’s stock price and growth. For example, the investment in Rhythms NetConnections, a data communications company was managed via the SPE by a swap arrangement involving Enron stock and payment of USD 50 million to the partnership LMJ. The investment, the debt was transferred to LMJ.

¹⁵ Federal investigations reveal that Enron may have as many as 3500 subsidiaries and affiliates, several of them either in the form of partnerships or limited liability companies. With this form of operating structure, it is quite possible that outsiders to Enron were justifiably confused. Andrew Fastow was right, “the rest of the world does not understand

¹⁶ Loopholes in accounting laws regarding consolidated balance sheet accounts made it possible for companies to avoid showing the assets or the liabilities of the SPE on its consolidated balance sheet. Before 2003, the accounting rules required that the consolidated balance sheet accounts reflect the activities of all subsidiaries in which the company had a majority voting interest. Thus with no majority voting interest, the company could own 97% of the SPE without disclosing the assets or liabilities of the SPE on its consolidated balance sheet. See Crawford (2003).

Chewco – short for Chewbacca, the character from the film trilogy of Star Wars – was created in 1997 to keep USD 700 million debt related to energy investments off the balance sheet. Mr. Kopper as head of this partnership. He raised the 3% outside equity from Barclay's Bank in the form of a loan through two paper entities – Little River and Big River LLCs. Barclays in turn required a deposit of USD 11.5 million from an Enron affiliate to ensure repayment of the loan. This meant that Enron was backing the loan and Little and Big River never did have enough of their own money at risk to satisfy the accounting rule of 3% external equity. Besides Barclays Bank individual investors invested USD 5, 800 to obtain returns of USD 1 million when the partnership was terminated. Mr. Kopper received USD 12.6 as remuneration and USD 2.6 to cover taxes.

Braveheart was an entity created to hold Enron's stake in a joint venture with Blockbuster Movies. Enron and Blockbuster were to offer a new service whereby customers would be able to choose, at regular movie rental rates, from thousands of movies from Blockbuster inventory, to be sent via phone lines to their residential TV sets – a good cover for the excess broadband capacity in Enron's inventory and the fledging fibre optics telecommunications unit. A beta test of this service for 1000 customers in 2001 did not produce any revenues. Enron, employing creative accounting, has claimed USD 110.9 as profits spread over fourth and first quarters of 2000 and 2001 respectively. The USD 110.9 million profit nicely covered the losses in Enron's fibre-optics division.

The SPEs served to keep debt off the books but also to created price benchmarks helping Enron provide generous value to a wide range of assets from power plants to the derivative contracts used on its trading floor. Enron Corp. entered into derivative transactions, using contracts such as long -term energy contracts with the SPEs, to hedge the price fluctuations of its assets. Then Enron would mark these energy derivative contracts to market attempting to inflate their prices. There are few publicly traded energy contract market (at the organized exchanges of Chicago and London, the CME and LIFFE) for long term contracts of 24 months or more. With no independent market checks and balances from organized exchanges, Enron was able to create its own market boasting that it had helped pioneer (along with Arthur Anderson) the accounting rules for this type of operation.¹⁷ Enron was not regulated by any regulating agency with regard to its trading practices. It is not a bank or a brokerage and thus will not fall under the scrutiny of SEC or the Federal Reserve. It is not an organized exchange and thus escapes scrutiny by the SEC and CFTC. **Enron truly did make full use of the changing regulatory and market situation- this appeared to be its only calling.**

In brief, by the year 2000, Enron had become a dot.com, a trading house, a broker, a merchantile exchange and a banker, engaged in commodity barter and arbitrage. Even as

¹⁷ For example, Enron sold Quaker Oats a “bundled contract” supplying gas and electricity to 15 Quaker plants reportedly saving Quaker USD 4.4 million but forecasting for itself a USD 36.8 million profit over the life time of the 10 year deal. Using marked to market accounting rules (perfectly legitimate rules) Enron was able to book USD 23.4 million as market value for this deal even before it delivered the first unit of gas or electricity to Quaker. Since the collapse of Enron the Bush Government is examining ways of including firms like Enron under some form of regulatory supervision.

Enron grew to new levels of dot.com sophistication, several of its assets were not freed and produced no returns - for example, the closure of the Dhabol project. These assets would take several years to produce the planned 14 % return. But the company leadership and the market were enamored with the possibility of 30 day returns from the trading floor. It became established practice at the company to write new contracts in its role as the trading house without fully resolving the issue of unproductive assets. This is not a sustainable situation. Individuals in management positions were aware of this dilemma but chose to ignore it since they stood to benefit personally.

As the transformation of Enron demonstrates, it is not the accounting or finance per se that is at fault but its use, authorized by the very guardians of public enterprise. The process of transformation of Enron presents a blatant disregard of the notion of the calling of business organizations and business as a calling for the key office bearers of the organizations and other stakeholders. That is to say, businesses can choose to discover their calling by respecting every stakeholder who might be affected by a business in its decision making process.

Section IV: Lessons from Enron: Integration of Personal and Organizational Vocation

The lesson to be learnt from Enron is that it is not financial theories and tools that are corrupt and inapt but their interpretation and implementation by the stakeholders of organizations. Finance and accounting are one among several sets of tools employed to serve the common good by providing method and clarity for purposes of accountability and disclosure. It is up to the human element of business organizations to use it in an appropriate fashion. There in lies the core of the calling of business and business as a calling.

The following is an excerpt from public documents revealing internal company conversations matters:

Andrew Fastow, CFO, explained his concept of monetization to an in house lawyer at Enron, as booking future revenues immediately:

Lawyer – If you undertake a 10 year deal and suck all the earnings out in one year, you will then need to keep profits coming in years 4 through 10 by doing more of these deals. How will this work if the market changes? Keep booking more deals?

Mr. Fastow's response - Yes, you will have to keep doing more of these deals each year.

No part of finance theory or practice, including the shareholder model, prescribes this concept of monetization to provide a rosy picture of economic accountability. This tool of monetization, as several other financial tools, was implemented to serve the immediate exigencies of Enron and all those stakeholders who wish to continue to sustain the inflated bubble of high returns on Enron's investments and stock price.

Organizations like individuals are subject to this same interpretation of calling as an identity. To what extent is the calling of the organization compatible with that of the individuals that comprise it? The downfall of Enron Corporation involves several key individuals within the organization. It also involves other organizations within the larger

global society including reputable business institutions, governments and regulatory agencies. After all, it is the era of globalization of business operations and business organizations touch many lives worldwide.

Michael Novak (1996) illustrating the notion of what is a calling offers the following quote from Kenneth Lay as a good way to mull over examples from the lives of others: *Kenneth Lay, chairman and chief executive officer of the largest natural gas company in the United States (and one of the largest in the world), Enron Corp of Houston, some time ago announced publicly his company's vision: "To become the first natural gas major –the most innovating and reliable provider of clean energy worldwide." His greatest inward satisfaction, however, has a somewhat different focus. "In my case", Lay confided, "I grew up the son of a Baptist minister. From this background, I was fully exposed to not only legal behavior but moral and ethical behavior and what that means from the standpoint of leading organizations and people. I was, and am, a strong believer that one of the most satisfying things in life is to create a highly moral and ethical environment in which every individual is allowed and encouraged to realize their God-given potential. There are few things more satisfying than to see individuals reach levels of performance that they would have thought was virtually impossible for themselves."*

Ken Lay offered this view of *greatest inward satisfaction* around 1996 and by 1997 as the leader of Enron, he has already embarked on a path of no return by encouraging Jeff Skilling to *realize his potential* for earning quick profits. The transformation of Enron took place under his leadership as CEO. Lay was responsible for fostering an inappropriate culture of internal cutthroat competition, greed, studied arrogance and outright disregard for the larger society. For example, losses were not allowed at Enron, you did not recognize them. Even as he spoke to Novak (1996) Lay was aware and endorsed the creation of the SPE, special purpose entities – the vehicles used to take debt off the balance sheet, tampering with full disclosure practices.

Are we to believe that Ken Lay has erred in his calling, that he did not truly understand it or that he was not sincere about it since his earliest involvement with the company?¹⁸ With the approval of the Board of Directors and Ken Lay, the CEO of Enron, two individuals and their business philosophies were put to the test to produce the highest

¹⁸ The pattern of covering losses began very early at Enron. It began in 1985 when Lay merged his company Houston Natural Gas with InterNorth. (Mr. Michael Milkin and Drexel Burnham raised USD 2.3 million for the merger, Mr. Milkin profiting personally from the merger) At the time of the merger, trading operation of soon to be named Enron Oil, with the blessings of president Borget and vice president Mastroeni, set up a scam using two sets of books running phony trades via Cayman Island partnerships successfully for two years. The future business model for Lay started with Enron Oil, a cash cow, used to cover the debt incurred in the merger of Houston Natural Gas and InterNorth. On the books meant for public disclosure, it was success story with USD 52 million in revenues, but another set of internal books showed a USD 142 loss with no data to provide further explanations. Arthur Anderson, in-house auditors hired in 1993, were obviously comfortable with the lack of reconciliation between these two sets of books. The US Treasury Department did raise questions regarding large trades at Enron Oil. Later Borget and Mastroeni pleaded guilty to faulty tax returns and Lay explained the USD 85 million loss (not the USD 142 million carried on the books) to the press as an embarrassment. Lay was forgiven by the government and the financial markets. No further explanation of this loss was reported in subsequent annual reports.

returns for the company. Returns defined in the narrowest sense of the term – return on investment and return on assets.¹⁹ Mr. Skilling believed that the company should own an asset as long as it takes to learn the details of the business. Then it is more profitable to sell the asset altogether if another possibility came along to earn more money. He advocated just this approach and proved it possible with the transformation of Enron from an asset based company to an asset light company. The Board, the CEO and other stakeholders were loath to disregard this philosophy in the face of a climbing stock price and profits – at least on paper.

Ms. Mark believed in a more traditional and capital intensive approach involving generating plants, distribution network and other elements that form the skeleton of a global energy system. Ms. Mark's philosophy was challenged. She had to bow out to another venture – water- to prove that her approach was just as viable. She failed for several reasons, some internal and some market driven, and left the company in 2000 with a golden parachute. Ms. Mark had tried too hard to replicate her success with power generation in the water business and Skilling's success of the trading model. It did not work. Water remains an emotional issue and will not move where it does not wish to go. Water is not as readily privatized as electric grids and phone companies. Meanwhile the Skilling model flourished until it spiraled out of control.

Novak (1996) in his discussions with a wide array of business leaders, including Ken Lay, finds four recurrent themes as the moral nature of business: *1) Business is able to build praiseworthy forms of community. 2) A life in business is creative; it can transform the conditions of human life dramatically and for the better (or the worse). 3) Business is a source of endless personal challenge, testing intellectual and moral mettle in the crucible of practicality. 4) Those practicing it often see business as a way of giving back to society, both through the goods and services it produces and in philanthropy, through the new wealth it generates.*

Enron passed the test for all four recurrent themes in a larger sense of the term. The company built community in Houston with its sponsorship of several noteworthy causes including a stadium. It built community in Dhabol, India with the free medical services provided to the local villagers. Enron's business offered personal challenges to some of its employees, was creative with a strong will to transform society through a more convenient use of technology. Then why did the company fail? Perhaps because it did not pay attention to the corporate responsibilities discussed by Novak (1996) or because as Arthur Levitt, former SEC Chairman said there was a "happy conspiracy" among all the stakeholders – security analysts on Wall Street, accounting firms, investment bankers, Board of directors of the company and company executives and finally the investing public. Otherwise put by the Federal Reserve Bank Chairman Alan Greenspan, Enron's

¹⁹ Even economists like Freidman who espouse unfettered free markets, do not espouse free and unfettered irresponsible behavior. Freidman (1970) states "In a free enterprise, private property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom".

failure did not denote a structural problem in the US economy; it was a failure of corporate governance. And corporate governance will right itself when values like integrity achieve a market value high enough to compete against market hype.

John C. Bogle, Founder and Former Chairman of the Vanguard Group in his acceptance speech at the University of Rochester, upon receiving the honorary doctor of laws degree on graduation day, summarizes the essence of the pedagogy for the business school. A pedagogy based on business as a calling which has a responsibility to teach the right decision making tools, like the use of the derivative contracts. But also has the responsibility to caution against the improper use of derivative contracts to inflate asset values, bury debt and hide speculation. It is important that the business practitioner not exploit the societal lack of understanding of these potentially powerful instruments and the good faith of the regulatory agencies.

As William F. May (1992) says, “academicians, while hardly among the most highly paid of professionals, bestow great power, inasmuch as they train, accredit and ordain most other members of the ruling class”. It is up to the business schools, their curriculums as to how they choose to ordain these members using their own sets of in house values or those of organizations like the Caux Roundtable (199). It is also how the larger body of stakeholders chooses to ordain itself.

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