

Reading 2: Enron Chapter 5

So far in the book, Brian Cruver has managed to survive the arduous recruitment process and gained a foothold in “the Death Star”, the Enron headquarters building. He has been working eighty to one hundred hour weeks on the basis that Enron is well known as “the millionaire factory” because of the very generous stock options given to employees – many have become “paper millionaires” by the age of thirty. Meanwhile his new wife sits at home alone.

However, to stay that long in the company was hard. You had to survive the twice-yearly “Peer Review Committee” (PRC) in which your colleagues directly above, below and to the side of you would anonymously vote upon your performance in the previous six months in a range of categories. This would be reduced to a score of between one and five. Every worker would be publicly displayed on a large billboard with their rating. 15% of employees were guaranteed to get the worst rating (which was 5), upon which they were “redeployed” which meant being put on dog’s duty doing the worst jobs (what Enron called “rank and yank”). They then had to reinterview for staying employed with Enron during which they would be repeatedly publicly humiliated and treated as scum. If they survived that for six months, they might be allowed back into a project team again assuming they survived the next PRC. If you think that this is terrible, some form of this process is in fact fairly common practice in the world’s leading corporations and universities (e.g. my most recent university, St. Andrews University). This is how people in the most elite institutions live their lives daily.

Enron posted incredible revenues making them one of the largest companies in the world thanks to *mark-to-market* accounting which allowed them to post all the profits of a ten year contract at current market prices e.g. if they signed a contract to supply gas to someone for ten years, they could book the profit at the price of gas right now. This is entirely legal and the banks did exactly the same recently – they booked the profit from insuring mortgages at the price at the time giving a huge profit. Unfortunately, then insuring mortgages started to look more likely to fail because the economy was faltering (therefore more people would be likely to default on their mortgage), so then their price dropped which meant that hitherto profits suddenly became massive losses – just like what happened to Enron, the collapse of which partially caused the 2001/2002 recession.

Everyone **knew** that the credit crunch was coming, but we carried on regardless. I had an entire ten credit module in my Economics & Management course at St. Andrews just on Enron alone because it was so obviously coming.

As this chapter begins, “the market” has been clamouring for more transparency in how Enron generated its accounts, and because of this the share price had dropped from \$90 to about \$34 though Enron was still considered the one tonne gorilla in the energy industry. Because Arthur Anderson, then one of the world’s leading accounting firms (which was destroyed by the Enron affair and no longer exists), had signed off on the accounts, everyone had the excuse to trust that the accounts must be sound. You will see frequent reference to a friend of Brian’s, “Bickers”, who works for a ratings agency which evaluates how safe a publicly listed company is – on the basis of these ratings, pension funds invest and banks decide how expensive loans will be so if you drop a rating (e.g. from ‘AAA’ to ‘AA’), you will automatically lose a large amount of capital AND your borrowing costs will rise, so it is very important to keep these rating agencies happy. However, just at the start of the chapter a major surprise emerges ...

1. Easier Questions:

Q1.1: What is the difference between a recurring and non-recurring charges? (circa p. 117)

Q1.2: Who was Andy Fastow? What was his job? (circa p. 126)

Q1.3: What is a Special Purpose Vehicle (SPV)? What are they used for? (circa p. 128)

Q1.4: Why did the fall in Enron’s stock price mean that the SPV’s had to be declared? (circa p. 129)

Q1.5: Why was the 75% fall in stock price considered so important to Enron staff? Why did they accuse the CEO, Ken Lay, of smoking crack? (circa p. 135)

Q1.6: Why do you think that Brian Cruver was on blood pressure medicine and had been banned from drinking caffeine, plus that he was seeing a psychiatrist? (circa p. 137)

Q1.7: How much would Enron be worth had they booked trading profits to the accounts instead of mark-to-market contracts? (circa p. 140)

Q1.8: Do you think that the fact that so many analysts invest their own money in their share investment recommendations might cause a problem? (circa p. 144)

Q1.9: Why did all the Enron employees keep coming to work despite that they had no work to perform and just spent the day writing their CV's and doing phone interviews for new jobs? (circa p. 148)

2. Harder Questions:

Q2.1: Why was the Wall Street Journal's commentary upon Enron during the chapter important to events happening in that chapter?

Q2.2: Why do you think that offloading debt from the balance sheet into SPVs is such a commonplace activity?

Q2.3: Do you think that the failure of Enron was a case of group denial or did planned wrongdoing actually take place? (Remember, hindsight is a wonderful thing!)

Q2.4: Do you think that those high six-figure salaries for working at the top of large multinational corporations is worth it?

3. Really Hard Questions (just for any of you who find this course too easy! I don't expect anyone to answer these):

Q3.1: As is obvious from the chapter, employees of any company spend a lot of time communicating with employees in other companies via Instant Messaging, email and telephone and they usually speak about non-work related matters. Given this, where does the boundary delineating one company from another begin and end? In what ways are corporations different from the accounting firms which audit their accounts? How are competitors in the same field of production in any way different when their employees are for the most part homogenous, came from the same business schools, and trade workers frequently?

Q3.2: Considering this chapter and its wider implications, do you think in your opinion that the credit crunch is punishment for the moral corruption which may be rife at the top of our society today?