

Enron: an examination of agency problems

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Abstract

In 1912 it was an iceberg that brought about the demise of the Titanic, 89 years later it was the submerged components that sank the “unsinkable” Enron vessel. The lessons of that fateful voyage cast a stark metaphoric reminder of the difficulties inherent in maintaining the goal congruence of those at the helm with those owners who financed the voyage.

The speed and stealth with which the vessels careered into the highly volatile and obscured surroundings of a Bull market made the stakes even higher. As those in the boiler room were asked to stoke the fires for “full steam ahead”, faithfully oblivious to the ubiquitous catastrophes about to unfold, those seeking immediate gains placed enormous pressure on decision makers for high-risk decisions. Decisions made at the expense of longevity, at all costs and with contempt for responsibilities owed to those from whom faith had been entrusted.

This article examines how information asymmetry and opportunistic behaviour of agents (executives, auditors and legal firms) and the inability of the principals (owners and agents) to control it, made the Enron collapse more catastrophic. The loss of thousands of jobs, millions of dollars of employee’s superannuation funds, including the losses borne by shareholders, creditors and analysts floats like debris around the Enron remains. As the morning light painstakingly illuminated each piece of Enron debris revealing a seemingly unending expanse of revelations and questions remain regarding significant contradictions and failures in the key mechanisms of capitalism; namely market efficiency and corporate governance. This has left us all with the surreal feeling that the enormity of the ramifications of Enron may never be fully revealed.

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1. Enron—the case unfolds

Unquestionably, the Enron implosion in the US has wreaked more havoc on the accounting profession, shareholders, stakeholders and the US economy than any other case in the US. Between the Enron and WorldCom Collapses, it is estimated that the cost to the US economy will be US\$ 64 billion in 2002 (Davis, 2002).

Using the US Federal Reserve model developed to estimate the size of these effects, it is estimated that 17% of the decline in share prices is attributable to investor concerns about fraud and mistreatments of earnings as a result of these corporate collapses. Gross domestic product (GDP), as a result, will decline by 0.67% for the next 24 months (Davis, 2002). This reduction in GDP will translate into US\$ 35 billion of lost production, US\$ 62 billion reduced GDP and 4500 direct job losses over the period. These estimates do not account for the devastating losses to Enron employees who lost their superannuation funds, which were fully invested in the corporate stock.

On the back of these quantifiable losses in the US economy come the difficult to quantify problems that are now insidious in the US market. Public perception, loss of confidence in the reliability of financial reporting, and the perception that the scandals are now etched in the centre of the system rather than at the periphery (see, Davis, 2002) precipitate greater problems for the accounting profession and the US economy in general. In direct response to the Enron Collapse, the US have enacted legislation with far reaching frameworks encompassing corporate responsibility, audit independence and heightened financial disclosure (see, Sarbanes-Oxley Act, 2002¹).

In light of the recent spate of large corporate collapses such as Nortel and WorldCom, it is telling to examine the problems inherent in the Enron collapse in order to capture the critical agency problems that provide insight into the symptoms apparent in all these very public and significant collapses. The very gap of goal incongruence that agency theory attempts to minimise through management remuneration may have become the catalyst that brought down these market giants.

According to some commentators (see, Byrne, 2002; Parker, 2002; Thomas, 2002), the motives and attitudes behind the decisions and events leading to Enron's eventual downfall appear simple enough: most notably, that individual and collective greed are born in an atmosphere of market euphoria (or Bull market). Greed in this sense relates to differences in principals' and agents interests. As the fundamental assumptions of agency theory encapsulate, and Enron illustrates, owners are interested in maximising return on investment, while managers have a wider range of economic and psychological needs (Wolk and Tearney, 1997).

The purpose of this paper is to explore the nature of the relationship between stakeholders and managers and how this relationship failed. How mechanisms designed to ameliorate/prevent agency problems were circumvented at Enron. Fundamental issues of how, when Enron managers were pursuing Machiavellian ends, the market was not signalling Enron's financial demise effectively, prophesied by Fama (1970, 1991) in his assessment of the efficient market hypothesis? Whilst the company made high-risk deals, including some outside the company's typical asset risk control process (see, Thomas, 2002), there was no

¹ For a thorough discussion and details of the Sarbanes-Oxley Act see, Oconnell and Webb (2002).

indication of any concerns within the market. It was as if the premise of Enron as a “faith stock”, and the desire of employees, analysts, individual investors and other stakeholders to believe that the Company was too good to be true created a false confidence in its stock (Gordon, 2002).

2. Agency theory

Agency theory, a premise often associated with Jensen and Meckling (1976), was first predicated by Alchian and Demsetz (1972) who emphasised that activities of firms were governed by the role of contracts to facilitate voluntary exchange. Agency theory explains how best to organise relationships in which one party (principal) determines the work, which another party (agent) performs. Agency problems are created when the shareholders (principals) hire managers (agents) to make decisions that are in the best interests of the shareholders. These theoretical postulations continue that in general people are self-interested and will therefore have conflicts of interest in any cooperative endeavours (Jensen, 1994).

It naturally follows, then that some decisions of managers are motivated by self-interest, which reduces the welfare of the principal. As both parties can experience losses due to problems of conflict of interest, there is a strong motivation to minimise these agency costs of cooperation. Through monitoring and bonding, the costs of writing and enforcing contracts are minimised. Therefore, agency theory provides a theoretical foundation to understand human organisational arrangements including incentive compensation, auditing and many bonding arrangements.

Where incomplete information and uncertainty exist, agency theory posits that two agency problems follow: adverse selection where the principal cannot determine if the agent is performing the work for which s/he is paid, and moral hazard where the principal is unsure as to whether the agent has performed their work to their ability.² Incentives and monitoring mechanisms are proposed as safeguards against opportunism (see, Jensen and Meckling, 1976) in the agent/principal relationship. Opportunistic behaviour is assumed in agency theory, and is perceived as self-interest seeking. Thus, the expectation is that the economic actors may disguise, mislead, distort or cheat as they partner in exchange (Wright and Mukherji, 1999).

According to agency theory, information asymmetry occurs where management (agents) have the competitive advantage of information within the company over that of the owners (principals). This results in the principal's inability to control the desired action of the agent. Information within an organisation is critical, and management working at the “coal face” of the operations of the company are privy to essential information that can be manipulated to maximise their own interests at the expense of the principal (Godfrey et al., 2003).

As a result of the potential conflict between agent and principal, agents are motivated to contract with owners to minimise the goal incongruence of the two parties. It is argued in agency theory that agents seek monitoring contracts because in the absence of such a contract, owners price protect heavily. Hence, agents engage in bonding activities to reduce the totality of costs imposed on them. The costs incurred in monitoring agency contracts

² For detailed discussion see, Godfrey et al. (2003), Jensen and Meckling (1976).

reduce the manager's compensation, therefore there is incentive for the agents to minimise these costs by refraining from conflict with the principal (Godfrey et al., 2003; Wolk and Tearney, 1997).

The agency relationship provides a vehicle to analyse the Enron story where we can explore aspects of the practical implementation of mechanisms designed to overcome agency problems and how these erode in a ripe environment.

3. Imminent danger on the Enron horizon

The story of Enron's collapse started in 1985 with the deregulation of natural gas pipelines (Thomas, 2002), and the demise of exclusive rights to them. This provided an opportunity for Enron to reinvent its business with new strategies generating cash flows and profits. Jeffrey Skilling, a young consultant, saw deregulation in the market as an opportunity to sell a new product and a new paradigm for the energy giant—the energy derivative. This new business model entailed buying gas from network suppliers and selling it to a network of consumers, contractually guaranteeing both supply and price (Thomas, 2002).

The CEO of Enron was so impressed with Skilling's talents that he created a new business division in 1990 to bring Skilling's leadership to the Company permanently. With Skilling's input, Enron's new business image was seen as young, arrogant and aggressive and before long its corporate culture reflected these values. Only the brightest traders were recruited and subsequently pampered with top salaries, bonuses, including concierge services and a company gym (Thomas, 2002).

Skilling rewarded achievement with merit-based bonuses that had no ceiling, permitting traders to "eat what they killed" (Thomas, 2002). During 1998, Andrew Fastow was promoted to Chief Financial Officer (CFO). Skilling oversaw the trading operations and Fastow managed financing through ever-complicated means. So began, the opportunism of greed to attain ever-increasing profits for short-term gains. Emanating from this came wider divide of information from the Principles of Enron and their agents.

Fastow's complex financing through special purpose entities (SPEs) and stock options were carefully structured to avoid consolidation and disclosure whilst minimising tax obligations (O'Connell and Webb, 2002). This created a wider inequality, or gap, between the financial information communicated to management and that disclosed and reported to Enron's owners, employees and stakeholders. The objectives sought by management were to achieve favourable accounting numbers to enhance the perception of their performance at the expense of bona fide economic objectives and transparency of financial information for the owners and stakeholders.

Despite costly monitoring and bonding efforts, this kind of information asymmetry is presumed to prevail between the principal and the agent in agency theory (Donaldson, 1990). There is an expectation that the agent will capitalise on this asymmetry, opportunistically pursuing selfish goals and risk reducing strategies, which are harmful to the interest of the principal (Wright and Mukherji, 1999). Enron becomes an examination of this phenomenon precipitated by the agent/principal relationship and magnified by the escalation of opportunism. This is no more evident than the erosion of Enron's financial information, which became more readily available to the agents and less available to the principals.

This occurred through ongoing misrepresentation of financial reports and inefficient monitoring strategies that were becoming progressively harmful to the principal. Opportunistic strategies were also evident in the use of the SPEs. These were used to avert the negative performance indicators due to the non-performance of assets and the inability to attain finance associated with the company.

As Enron became a market leader or ‘bright light’ in the US market, the internal culture darkened. Skilling instituted the Performance Review Committee (PRC), which became known as the harshest employee-ranking system in the country (Thomas, 2002).

Ironically, Enron based its employee values on the principals of respect, integrity, communication and excellence (“RICE”). However, employees soon learned, the only meaningful performance measure was the relentless pursuit of profit at any cost (Thomas, 2002). Survival of the PRC was the motivating force as all the new “young guns” vied for “earnings on the board” and “doing deals” (Thomas, 2002).

4. Enduring opportunism

Opportunism is argued to be subject to a “. . . spiral reinforcement process” (Wright and Mukherji, 1999, p. 299) also evident in the Enron case. This process is where opportunistic executives create a culture of self-fulfilment and only those who are prepared to act in a like-minded manner remain in the employ of the company. Opportunism escalates with the development of this culture. To counter this, principals and agents engage in further formal contracting, bonding and monitoring efforts which in turn increase costs to the company. These spiralling costs in turn have a direct impact on the viability and profitability of the corporation.

The development of this culture demonstrates how some earnings-based compensation schemes can provide agents with incentives to develop the company into a hedge fund, where the managers take leveraged bets in high-risk markets in an effort to produce disproportionately high profits. The downside seemed only for the employees and the owners. This typifies the criticism that traditional performance measures motivate dysfunctional behaviour by causing managers to focus on the short-term gains at the expense of the long-term viability of the company (Lambert, 2001). Where earnings-based compensation plans are well written and planned, however, they can, and do provide long-term incentives. Sadly this was not the case within Enron.

Fierce internal competition between staff escalated within this culture to prize the short-term gratification above the long-term potential of Enron. Paranoia flourished (see, Thomas, 2002) as trading contracts were developed with highly restrictive confidentiality clauses to protect self-interest and the coveted ratings of the PRC. Secrecy and minimal information disclosures became a cultural corporate mechanism of survival. The maintenance of control over questionable transactions that transcended the corporate codes of conduct were cloaked in shrouds of secrecy and did not provide the optimal environment under which Enron’s principals could monitor the activities of their agents. Nor under which stakeholders could understand the nature of the underlying economic substance. And so, the spiral reinforcement process capitulated the breakdown process of the effective agency monitoring mechanisms.

4.1. Market dynamics

During the 1990s, the Bull market experienced around the globe and in particular the US, was the longest in history. The high turnover of leadership within Enron due to the brutality of the PRC and the new “arrogant culture” had “weeded out” the more conservative and cautious, leaving Enron with inexperienced and impetuous practitioners in a highly volatile environment.

During the late 1990s and 2000 Wall Street demanded double-digit growth in most ventures. Practitioners eager to “prove themselves”, were determined to deliver (Thomas, 2002). The culture of being “best” at all costs provides distinctive agency problems for the owners of Enron. Whilst the owners desired strong returns on investment and profits, an aggressive culture would appear to be congruent with these ends. However, this culture prized short-term gains at the expense of long-term stability and would indeed force a divide in these congruencies. This emphasised the exacerbation of agency problems precipitated by principles neglecting effective agency monitoring mechanisms using short-term incentives to gain long-term outcomes.

Enron incorporated “mark-to-market” accounting principles for the energy trading business in the mid-1990s. This method, whilst permissible under US GAAP, prescribes an adjustment to fair market value for outstanding energy related contracts on the balance sheet at the end of each quarter. Unrealised gains or losses as a result of these fair market values were added to the income statement of the period.

The difficulty with this application was that there was considerable subjectivity in the prices upon which to base the valuations. Companies having these types of derivative instruments were free to develop and use discretionary models based on their own assumptions and methods (Thomas, 2002). With the arrogance of Enron executives firmly entrenched, exacerbated by the erosion of monitoring mechanisms of the principles (owners), these valuation estimates are highly likely to have been overstated especially with the continuous pressure to beat analysts’ quarterly expectations (O’Connell and Webb, 2002; Thomas, 2002).

Creating more damage to Enron’s hull, was the advent of competitors into the market all following Enron’s lead. New market entrants eroded the competitive advantage that had provided such high returns for Enron. In an effort to maintain their market dominance the company started to rely on increased borrowings, this resulted in the company becoming more like a speculative hedge fund rather than an energy trading company (Thomas, 2002). So devastatingly common in the excitement of the Bull market, Enron management were raising the stakes and the arrogance to fulfil their short-term greed.

The company’s risk management policies, which were already greatly compromised began to have little significance as the culture of Enron was, as one Enron employee put it; “good deal vs. bad deal? It didn’t matter; if it had a positive net present value, it could get done even if not aligned with strategic goals of the company” (Thomas, 2002, p. 46).

With the world economy heading into a recession in the early part of 2001, Enron’s fate would most certainly have been obvious to the executives privy to its secrets. The company’s high level of debt was increasing to unsustainable levels as the energy market dampened, and the stock option rights to its SPEs were becoming burdensome as the stock prices started to fall in a ‘Bear’ market.

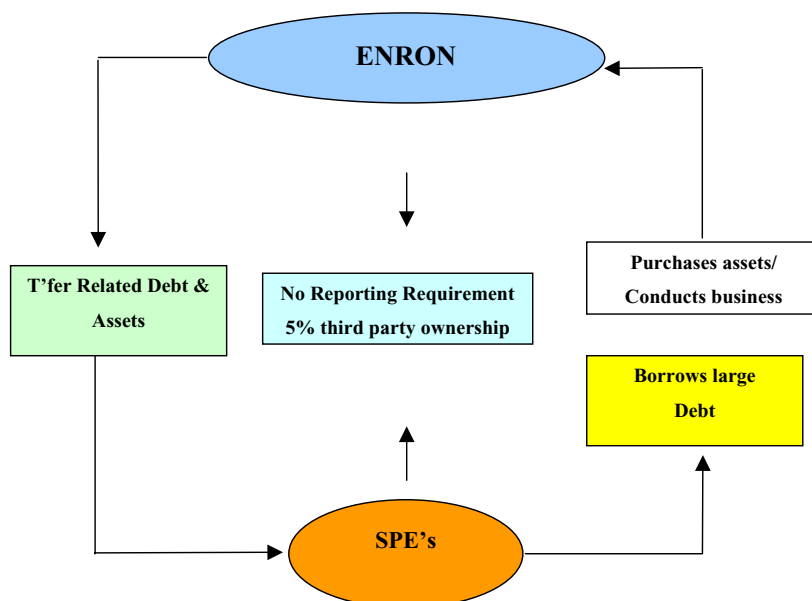


Fig. 1. The legitimate economic benefits of special purpose entities (SPEs).

SPEs are used legitimately for economic benefits, so as to collateralise assets, share risk and obtain more favourable financing (Dye, 2002). By using SPEs such as limited partnerships with outside parties, a company is allowed to increase leverage and return on assets without having to report debt on its balance sheet.

As Fig. 1 illustrates, the company contributes hard assets and related debt to an SPE in exchange for an ownership interest. The SPE then borrows large sums of money from financial institutions to purchase assets or conduct other business without debt or assets showing on the company's financial statements.

Fastow (CFO) was lobbying the ratings agencies to provide Enron with more positive credit ratings to attract investors and raise much needed capital (an early sign of the liquidity crisis looming). At the same time he took the use of the SPEs to "... new heights of complexity and sophistication" (Thomas, 2002, p. 44). This sophistication in the use of SPEs included capitalisation with a variety of hard assets and liabilities, also complex derivative financial instruments, Enron shares and Enron share options.

By transferring troubled assets to the SPEs, the losses were kept off Enron's books magnifying the obliteration of agency monitoring mechanisms and any critical signals of the company's instability. The partnership investor in the SPE was compensated with promised issues of additional Enron shares. However, as the value of the assets fell, Enron began to incur larger and larger obligations to issue its own shares in the future.

This problem was magnified by the fall in value of the Enron shares. Though thousands of SPEs were created, the most important from an agency perspective was that of Cayman LP and LJM2 co-Investment LP, two companies run by Fastow himself. Through these entities, Fastow was paid more than US\$ 30 million in management fees (a sum well in

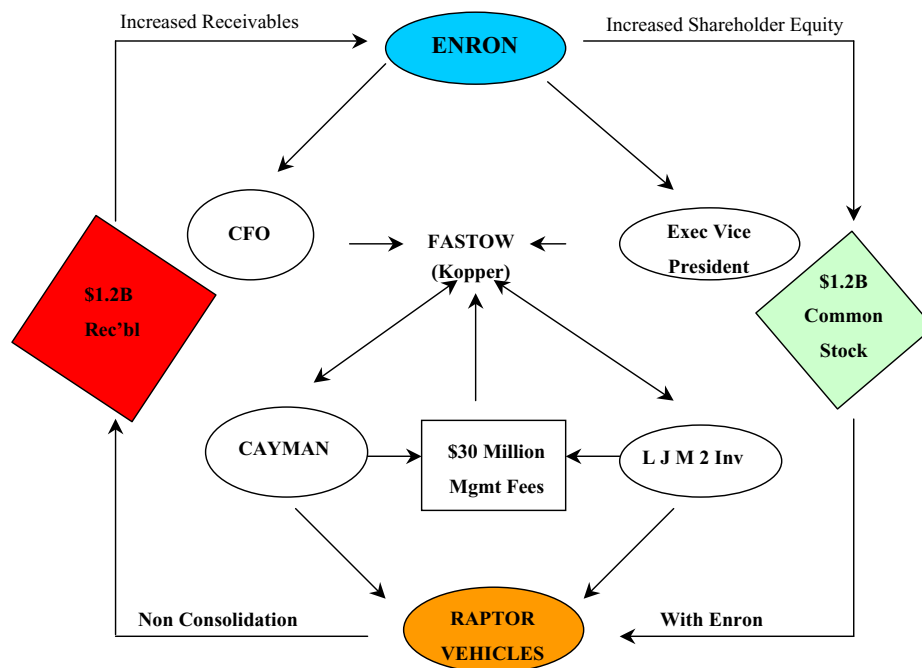


Fig. 2. Simplified structure of the asymmetry of information between agents and principal in Enron.

excess of his Enron salary). These unquestionable conflicts of interest are now a matter of public record and shown to be the direct result of calculated subterfuge of transactions that removed connection to his position (Powers Report, 2002). Their existence illuminated Fastow's quest for self-interest above the interests of the owners. Again, the information asymmetry between the shareholders/owners and the agents/executives was problematic, and without proper disclosure of these related party transactions, the shareholders had little way of knowing that these SPEs were in conflict with their interests.

The LJM partnerships (controlled by Fastow) invested in another group of SPEs known as the Raptor vehicles. The purpose of these vehicles was to hedge Enron investments in a bankrupt company. Enron issued common stock in exchange for a note receivable of US\$ 1.2 billion to capitalise Raptor. A diagrammatic representation of this relationship is provided at Fig. 2.

Enron used this transaction to increase its notes receivable (assets) and simultaneously to increase its shareholders equity. This gave the impression of a much more favourable financial position for Enron than reality and reliable reporting would have provided. Importantly these SPEs were never consolidated into the Enron financial statements, though vague reference was made to them in a deliberately confusing manner within the footnotes of the 2000 financial report (O'Connell and Webb, 2002).

The *Wall Street Journal* cast doubt on the quality of the company's earnings and the business purpose of these SPE transactions in light of the lack of understandability of the

disclosures in the financials. This signalled a change in market perception as analysts and others were starting to question the quality of Enron's reported income numbers.

5. The market conundrum

As agency theory is premised on the EMH,³ it is pertinent to remain aware of market limitations as well as its strengths. EMH suggests in an efficient capital market, information is fully incorporated into the price of shares and new information is quickly impounded into the share price. This hypothesis therefore assumes that shares are fairly priced and their expected returns equal their required returns. It follows then, that it is impossible on average to earn economic profits by trading on information in the market because shares are fully and fairly priced, investors should not exert time or expense trying to find mispriced (under/over valued) securities as their prices fully react swiftly to any new information in the market.

The Enron case seems to demonstrate these EMH limits in a new way (Gordon, 2002) and how manipulation of accounting information by agents (managers) had an influence on the market reaction. The escalation of Enron's share prices on shrinking profits during the early 2000s indicates how the market can ignore the "... handwriting on the wall" (Gordon, 2002, p. 1238). Why was it when Enron was asset strapped, and being swallowed up in debt, that the share price remained steady?

The failure of markets to adequately assess Enron's earning prospects was a double-edged sword. Even if Enron lacked candour, or its agents actively misled the market about its true financial condition, the constant release of information to sophisticated market participants in a semi-strong capital market should have alerted stakeholders to the company's murky finances. This is especially pertinent where those stakeholders were contracted for the express purpose of ameliorating agency problems through monitoring—the auditors. As a direct result of information in an efficient market, the market should never have placed such a high value on Enron's stock.

Enron's demise demonstrates the limitations of the principle/agent relationship and one of the key mechanisms of capitalism—the market. Principles (managers) deliberately manipulated information to present a false picture to the principles (market). The financial structure of the company was highly complex, and the use of "off balance" sheet entities, such as the SPEs to hide the devaluing assets, made it difficult for anyone outside the company to truly understand Enron's financial condition. However, Gordon (2002, p. 1237) raises an interesting point, "... but they [market] also knew they did not know".

Enron was regarded as a "faith stock", and as such, the company revelled in its information asymmetry. In an efficient market, market signals should have alerted stakeholders that Enron was a "lemon" stock rather than a "faith" stock. However, because of the failure of agency monitoring mechanisms, partly brought about by the short-term greed of the

³ The EMH further suggests three forms of market efficiency are possible: weak, semi-strong and strong form. The consensus in the literature suggests the US has a semi-strong capital market (Godfrey et al., 2000; Gitman et al., 2002). Semi-strong indicating that all publicly available information is similarly already incorporated into asset prices, thus a firm's financial statements are of no help in forecasting future price movements and securing high investment returns (see Milgrom, 1981).

principles (demanding higher returns), the foreseeability of this imminent monumental collapse was veiled in deceit and subterfuge.

Enron's auditors certified the financial statements were "fairly presented". Adding to the cataclysmic events leading to the breakdown of agency monitoring mechanisms was that Arthur Andersen, were both accountants to Enron and their auditors. Though, it is not unusual for auditors to sell non-audit services to their clients in the US and around the world, it created a perception that independence of Enron and its auditors were impaired (O'Connell and Webb, 2002). Cross selling audit and accounting services created additional information asymmetry between the owners and executives of the company. The credibility of Andersen's certification was severely compromised and combined with Andersen's other failures, resulted in the demise of the 'Big 5' and emergence of the 'Big 4'.

The most important guarantor of an accountant's independence is their right of tenure (Gordon, 2002). The removal of an auditor is a material event, which requires disclosure, and such action may cause as much harm to the sanctioning company (officers and directors) as to the accounting firm. This notion changes markedly when the accounting firm begins to cross sell consulting services to the same company.

The significance of cross selling, Gordon suggests, was not in the raising of the stakes in the relationship or that the accountant needs to please its client, but rather that Enron now had available to it, a repertoire of "... low visibility sanctions" (Gordon, 2002, p. 1237) to discipline the accountants/auditor's behaviour. Andersen were receiving from Enron US\$ 25 million in audit fees and US\$ 27 million for non-audit services (Benston and Hartgraves, 2002). Therefore, at the discretion of Enron executives, the removal of Andersen from non-audit services (more lucrative to the Houston office of Andersen than audit) would have been a less visible, and therefore more probable event. Sanctions including failure to renew non-audit contracts (worth US\$ 27 million) could have been used by Enron management as leverage in gaining influential auditor decisions/outcomes.

Similarly, the very purpose of the external audit, according to agency theory, is that the audit is an instrument for ensuring that financial reports financials have been subject to independent scrutiny (Wolk and Tearney, 1997). Consulting can create a culture undermining the capacity of auditors to make arms length judgements about financial disclosures. The true depth of this opaque association may never be revealed as Andersen's shredded telling documents purposefully to confound any enquiry.

6. The death throws of a corporate giant

The questions this raises about the "signalling" within the market cannot be overlooked. Sophisticated investors, as stakeholders in the EMH know of the potential problems associated with these conflicts of interest. In light of the diminishing value of Andersen's independence, it is interesting to note that Enron's share price should have declined, however it did not.

It was not until Enron's high-risk deals began to unravel as under-performing investments created huge cash shortfalls for Enron in March 2001. Enron executives failed to recognise that the market was beginning to perceive the company with greater scepticism, eroding trust and company reputation (Thomas, 2002). Whilst senior management were selling their

stock in the Bull market, collecting hundreds of millions of dollars, the price of the shares fell.

On 14 August 2001, Skilling the then CEO resigned, as shares slipped below US\$ 40. US\$ 40 was the magic number under which he was aware that Enron would not be able to meet its debt commitments or, indeed, recover (Eichenwald and Henriques, 2002; Thomas, 2002).

The Raptor hedging arrangements could not be sustained. These arrangements required the issuance of 58 million Enron shares to offset the equity losses, which would severely dilute the earnings. So Raptor was terminated, culminating in a reversal of US\$ 1.2 billion entry to assets and equities requiring disclosure. These signals indicated to the market the enormity of the problems with Enron. By December 2001, Enron had been handed over to administrators and so unravelled the fastest and largest corporate collapse in US history (Eichenwald and Henriques, 2002). As with the disbelief of the sinking of the “unsinkable” Titanic, this demise of the Flagship of the US corporate market sparked questions and reverberations throughout, as to how such a fall of an icon (empire) was possible.

Agency theory provides a theoretical framework to establish an understanding of how Enron collapsed. An examination of the independence of the Enron audit provides us with insights into the breakdown of monitoring activities, which are espoused to limit aberrant activities of the agents. The independent audit represents, the bastion of safeguards implemented by principals in the agency relationship to monitor the agent or manager (is the independent audit). Wolk and Tearney (1997) point out that audit attempts to give assurances to owners and outsiders regarding governance of the enterprise by the management. An audit is intended to minimise agency costs. It does so because independent specialist auditors can monitor the managers’ behaviour, reporting more effectively and efficiently than the principals (Godfrey et al., 2003). Andersens were appointed as the external auditors of Enron. Their role, therefore was to represent the interests of the owners by independently verifying and monitoring Enron’s activities. Interestingly, the external auditors should minimise agency problems as the audit increases information symmetry between principal and agent. Ironically, Andersens as part of their consulting role, advised Enron on the legal and technical requirements for establishing the SPEs so as to veil the losses and high risks of the company.

Unethical behaviour, Dye (2002) asserts, threatens not only the reputation of the company, but also of the whole market. Without the trust of the market, capital availability and market liquidity is threatened. In an effort to encourage ethical conduct by agents, principals structure contracts, which include management incentive programs. Agency theory advocates that in order to reach goal congruence between principal and agent, that only viable incentives are those, which the agent perceives to be positive. However, Enron highlights those positive incentives for the agents (large stock options) may not be viable for the principal.

7. Executive compensation and incentives

As previously discussed, the potential conflict between agent and principal motivates the parties to contract to minimise the goal incongruence of the two parties. The Enron

Company provided contractual incentives for its executives, management and employees through share bonuses, linked to performance, so why did its management misuse the complex financial transactions?

One answer, according to [Barrier \(2002\)](#) is where a culture of high risk begins to entrench itself and step over the line of acceptability. It then bypasses strategic objectives, and aggressively pursues positive financial performance at all costs. Here, the cultural mentality of a corporation like Enron crosses over at some point moving into unadulterated manipulation of balance sheet and income information. To put the problem succinctly, the more you get away with, the more often you will do it. There is no better indication of such flagrant contempt than the following two facts. Enron paid its executives US\$ 100 million in retention bonuses just days prior to its collapse, and in the year leading up to this had made US\$ 745 million in payments and stock options to its senior executives ([Dolbeck, 2002](#)). To reduce the incidence of such behaviour, [Magee \(2001\)](#) suggests that when designing contracts for agents, it is just as important to include actions you do not want, as well as those you do wish the agent to take. For example, [Healy \(1985\)](#) suggests contracts should limit the amount of profit that bonuses will be paid on to reduce short-termism by agents.⁴

According to agency theory, principals and agents have conflicts because of differing risk preferences. Principals may be risk neutral because they can diversify their risk across firms and other investments ([Eisenhardt, 1989](#)). In contrast, agents are said to have an aversion to risk, therefore differing goals to the principal. If left unchecked, the agent will manage the firm according to their own goals ([Donaldson, 1990](#)). The tools put in place to promote management accomplishment within Enron, ironically grew to become the self-serving objective of management. Whilst information asymmetry grew, management appeared to escalate their risk taking efforts aware that this would enhance the perception of their performance with little chance of being exposed. These risks were ultimately taken on behalf of the owners and would have continued undetected as long as they produced acceptable returns ([Thomas, 2002](#)).

Where a conflict between owner and manager occurs, it can be mitigated, arguably, by financial reporting ([Wolk and Tearney, 1997](#)). In an efficient market, it is often muted that the market can see through management manipulation ([Abdel-Khalik, 2002](#)). However, some necessary assumptions must exist for this premise to be effective. Investors must be willing and able to decipher the information, and financial reports must be a fair and faithful representation of management's accomplishments. Whilst it is generally understood that the demand for financial reports can provide a method of governance over agents, misrepresentations can occur where there is high latitude in keeping assets and debt off the balance sheet, and where provisions of GAAP are arbitrary and flexible ([Revsine, 2002](#)). One suggested solution to address the concern arising from poor quality financial statements is to strengthen and tighten the provisions of GAAP. However, narrowing the approach may be counterproductive, where business activities and financing are already moving faster than accounting standards and where corporate greed and excesses are to be prevented. [Heathcote and James \(2002\)](#) have suggested preparers and legislators need to re-examine the purpose and function of traditional accounting and what it is attempting to describe and achieve.

⁴ A good example of short-termism, according to [Healy \(1985\)](#), is to reduce maintenance expenditure on plant and machinery, which will increase current profits at the expense of shortening the useful life of these assets.

In the agency model, contracts should provide a way to provide incentives for the manager to attain goal congruence with the owners by making the manager a part owner of the business through bonus shares (Henderson and Peirson, 2001). Management compensation schemes have revealed share options are a popular aspect of executive remuneration (see, Gordon, 2002), however, Enron highlights the fallibility of relying on stock options. They are popular because of two fundamental reasons; first they are not recorded as an expense for the issuing company; and second they can produce a tax deduction for the option holder when exercised. However, where option grants are very large and exercisable in the near term, as with Enron, a positive swing in the share price made the Enron executives immediately very rich. Managers with a rich load of options have incentives to produce short time gains and get the share price high by any means necessary, fraud included (Gordon, 2002). This is in direct opposition to the interests of the principal. So, options that are issuable only on the basis of a history of sustained profits may have been a more equitable solution.

The limitations of an incentive program were illuminated in Enron. Whilst incentives do encourage senior executives to take risks (see, Heathcote and James, 2002), when you have management compensation or bonus schemes such as Enron's, based on a budgeted or accounting profit figure, you clearly have an incentive to undertake "earnings management" (Heathcote and James, 2002). This is particularly relevant where the increase in share price is a performance indicator, where actions are encouraged to increase share prices because of positive and sustainable outcomes. Share options included in executive compensation within Enron have demonstrated that their promise encourages executives to manipulate short-term results while allowing the company to hide their true costs (White, 2002).

8. Conclusion

Whilst the floating debris of the Enron catastrophe has now disappeared, the flagship's hull has settled in its resting place on the ocean floor, blended inaccessibly miles below among the unlit seascape. However, its wreckage lays not only as a darkened symbol of opportunistic arrogance and greed, but also as a representation of the inadequacies of corporate governance, auditor independence, accounting standards and the latitude permitted within US GAAP.

As scrutiny and accusations become more intense in the courtrooms over the coming months, more questions may be raised than answered as to how a collapse of such proportions could have occurred so dramatically and quickly. Where were the alarm bells when the enormity of Enron's financial woes were recognised by those privy to the information? It appears that Enron's lessons will be a catharsis for all stakeholders in the financial accounting market.

In an effort to prevent such market catastrophes from happening again, the US congress has demanded major improvements manifested in the codification of the Sarbane's Oxley Act (2002), and the allocation of additional resources to the Securities Exchange Commission. These measures are quantifiable as they seek to enhance governance and additional responsibilities for corporate directors and management. However, it is the control of the enigmatic nature of human behaviour, which presents the difficulties of predictable outcomes to all future market participants. How it is possible to prevent all opportunistic

behaviour of self-interested agents of these proportions again? Whilst agency theory posits that these problems can be mitigated through monitoring, contracting and performance measures, these were circumvented by the greed and narcissism of Enron. The pressure applied by Shareholders to maximise returns worked against the long-term interests of the principles by neglecting effective agency monitoring mechanisms. Paradoxically, this occurred whilst implementing other monitoring mechanisms that exacerbated the agency problems. This leaves us with reminders of the inherent tacit dimensions of existent corporate culture and the ability to control it. Perhaps this becomes one of the greatest challenges for legislators, politicians, and market participants attempting to control pervasive corporate activities such as those that befell Enron.

Like the darkness shrouding the physical evidence of the Titanic hull, the veil of intrigue and flagrant disrespect for pursuing justice has fallen over the Enron facts. No more evident than during the shredding of thousands of Enron documents by the Andersons' management. Whilst the mortality and fallibility of human beings is an unquestionable truth, the invaluable historical significance and contribution these papers may have made to the development of accounting history and the nature of corporate management in the future cannot be underestimated. However these actions remain evidence to the perpetuation of opportunism even after Enron lessons. These papers had the potential to provide enlightenment for a historically renowned problem for generations forthwith.

The profoundness of observations made by the economist [Smith \(1995\)](#) long ago heralded the foreseeability of the magnitude of the task to resolve conflict within the joint stock company. He claimed in 1776 that agency problems between owners and managers posed such an obstacle as to make it questionable whether the modern corporation with its separation of ownership and control was a viable institution. In light of the Enron and other major corporate failures, how prophetic these words reign.

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