**MANAGEMENT CONTROLS: THE ORGANIZATIONAL FRAUD TRIANGLE OF LEADERSHIP, CULTURE AND CONTROL IN ENRON**

[*Clinton Free*](javascript:void(0);), [*Norman Macintosh*](javascript:void(0);), [*Mitchell Stein*](javascript:void(0);). [**Ivey Business Journal Online**](http://proquest.umi.com/pqdweb?RQT=318&pmid=57399&TS=1334236553&clientId=14844&VInst=PROD&VName=PQD&VType=PQD). London: [Jul/Aug 2007](http://proquest.umi.com/pqdweb?RQT=572&VType=PQD&VName=PQD&VInst=PROD&pmid=57399&pcid=37856661&SrchMode=3). 1 pgs

**Abstract (Summary)**

This article draws on a vast database of [public records](http://proquest.umi.com/pqdweb?index=0&did=1399135231&SrchMode=2&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1334236525&clientId=14844), testimonies at the various **Enron**-related trials and insider accounts concerning Enron's rise and fall to answer the question: how did a sophisticated and comprehensive set of **management controls** fail to prevent and detect widespread and continued corporate-wide **fraud**, information manipulation and dishonesty. This article focuses on the cultural environment surrounding Enron's **management control** systems, and the influence of a powerful-risk taking **culture** on Enron's **controls**. **Enron** [offers](http://proquest.umi.com/pqdweb?index=0&did=1399135231&SrchMode=2&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1334236525&clientId=14844) a number of important insights for managers. Firstly, it underlines the vital role of top **management leadership in** fostering **organizational culture**. Secondly, within organizations, the impact of **culture** and **leadership** on even most the sophisticated **management control** system must not be overlooked or minimized. Finally, the **Enron** saga speaks to the importance of not abandoning professional integrity.

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Almost faster than you can say mark-to-market [accounting](http://proquest.umi.com/pqdweb?index=0&did=1399135231&SrchMode=2&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1334236525&clientId=14844), management controls disappeared once Jeff Skilling became CEO of Enron. The rest is sad history and a shareholder's worst nightmare come true. These authors document the subversion of Enron's management controls and suggest the lessons managers can learn from the worst financial collapse in U.S. corporate history.

The collapse of Enron has been described as offering the same sort of opportunity for reflection for the [business](http://proquest.umi.com/pqdweb?index=0&did=1399135231&SrchMode=2&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1334236525&clientId=14844) community as the Challenger disaster did for the engineering profession or September 11 did for political scientists. This article draws on a vast database of public records, testimonies at the various Enron-related trials and insider accounts concerning Enron's rise and fall to answer the question: how did a sophisticated and comprehensive set of management controls fail to prevent and detect widespread and continued corporate-wide fraud, information manipulation and dishonesty.

Introduction

Throughout the Enron post-mortem, financial accounting irregularities and the audacious use of special purpose entities for off-balance sheet [financing](http://proquest.umi.com/pqdweb?index=0&did=1399135231&SrchMode=2&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1334236525&clientId=14844) purposes have been the focus of attention. Seldom acknowledged is the fact that Enron had in place a comprehensive, state-of-the-art and award-winning management control and governance system, and that during Richard Kinder's term as president from 1986 to 1996, Enron operated with a highly effective management control system.

This article focuses on the cultural environment surrounding Enron's management control systems, and the influence of a powerful-risk taking culture on Enron's controls. Robert Simons' work on management control underscores the need to incorporate culture in understanding management control systems. Research conducted by leading organizational psychologist Edgar Schein also suggests that a strong link exists between executive leadership actions and the nature of an organization's culture. Accordingly, in this article we highlight the critical role that leadership and culture play in the success and effectiveness of management control systems within organizations.

Enron provides a blueprint of how insufficient attention to changes in leadership and culture can undermine what, at least on the surface, appears to be a state-of-the-art management control system. While many companies may claim to have sophisticated management controls, the ultimate effectiveness of such controls is highly dependent on an organization's culture and leadership. The perversion of this control infrastructure under the leadership of Jeffrey Skilling offers vital lessons about the operation of management control systems in large, complex organizations. Understanding these lessons is crucial in ensuring that Enron's plight is not replicated.

The collapse of Enron

Enron Corporation was born in the middle of a recession in 1985, when Kenneth Lay, CEO of Houston Gas Company, engineered a merger with Internorth Inc. The new company, which reported a first year loss of $14 million, consisted of $12.1 billion in assets, 15,000 employees, the nation's second-largest pipeline network, and a towering mountain of debt. Enron was a typical natural gas firm with all the traditional trappings of a highly leveraged, "old economy" firm competing in the regulated energy economy. Teetering on the verge of bankruptcy in its early years, Enron had to fight off a hostile takeover attempt. It also incurred embarrassing losses on oil futures, which its traders in New York covered up in their reports to the Houston headquarters. Its old economy strategy did not excite the stock market. This would change dramatically, however, during the 1990s, when Jeffrey Skilling replaced Richard Kinder as the CEO.

Richard Kinder, known throughout Enron as "Doctor Discipline", was both people and numbers oriented. He held a meeting in the boardroom every Monday morning where he interrogated every business unit leader, frequently challenging their strategic plans and numbers. He focused hawk-like on expenses, cash flows, and employee levels. Cash management was so important for Kinder that he gave all business group managers a budget target for cash flow and profits, with bonuses tied to meeting both targets. While Kinder demanded performance, he was also realistic, often telling business unit leaders who submitted overly optimistic proposals not to start "smoking our own dope." As well as demanding discipline with respect to numbers, he was also people oriented, creating a collegial, family-like environment, with a respect for all.

With the appointment of Skilling as CEO, Enron's culture would begin a radical transformation. By 2000 it had become "the star of the New Economy," emerging as a paragon of the intellectual capital company with an enviable array of intangible resources, including political connections, a sophisticated organizational structure, a highly skilled workforce of sophisticated financial instrument traders, a state-of-the-art information system and expert accounting knowledge. In 1999, Enron was named by Fortune as "America's Most Innovative Company," "No.1 in Quality of Management," and "No. 2 in Employee Talent." An army of scientists, business people and academics sat rapt as Skilling - "The #1 CEO in the USA" - proselytized at technology and leadership conferences across the United States about how Enron was not only embracing innovative theories of business but also making a lot of money doing so.

However, in late 2001 Enron announced that because of accounting errors it was reducing its after-tax net income by a total of over $1 billion and its shareholders' equity by $1.7 billion. On December 2, 2001, Enron, with assets of $63.4 billion, became the largest corporate bankruptcy in U.S. history, triggering a collapse in investor confidence and opening a Pandora's Box of issues relating to corporate governance, accounting and regulation.

Commentary on the Enron scandal has tended to focus on a number of financial reporting issues including auditor independence, special purpose entities (SPEs) and the appropriateness of its accounting. A host of solutions have been proposed with respect to these issues, including greater shareholder empowerment, shareholders' boards of trustees, privileging accounting principles over accounting rules, a reduction of outside regulation of accounting practices and requiring auditors to judge the substance of disclosure (and, of course, most notably the Sarbanes-Oxley legislation). However, the role of management control systems - and more importantly, the affect of leadership and culture on such systems - in the Enron collapse has largely been overlooked.

The organizational fraud triangle

How fraud occurs within organizations can be understood by examining the elements that comprise such actions. At an individual level, SAS No. 99 (Consideration of Fraud in a Financial Statement Audit) issued by the Auditing Standards Board indicates that the occupational fraud triangle comprises three conditions that are generally present when a fraud occurs. These conditions include an incentive or pressure that provides a reason to commit fraud (personal financial problems or unrealistic performance goals), an opportunity for fraud to be perpetrated (weaknesses in the internal controls), and an attitude that enables the individual to rationalize the fraud. While the fraud triangle focuses on individual-level constructs of fraud, such as localized instances of cash or other asset appropriation by employees, the Enron example highlights fraud at the organizational level - systemic organization-wide fraud and corruption. At the organizational level, leadership, organizational culture and management control systems form the three points of the organizational fraud triangle shown below.

The fraud triangle illustrates that the most important lessons from Enron lie in the way that a corporate culture championed by CEO Skilling overcame a sophisticated and widely lauded set of management controls and in the importance of carefully balancing the core concepts of leadership, organizational culture and control within organizations. Organization-wide fraud is only possible when these three variables are configured in a way that enables - and even fosters - manipulation and fails to prevent compliance failure. The linkages presented in the diagram above provide managers in other organizations important, yet largely untold, insights into Enron's demise.

Linkage 1: Enron's sophisticated management controls at the time of its collapse

Controls form the cauldron in which Enron's innovative energies circulate (G. Hamel, Leading the Revolution, Harvard Business School Press)

Management controls refer to the tools that seek to elicit behavior that achieves the strategic objectives of an organization, such as budgets, performance measures, standard operating procedures and performance-based remuneration and incentives. While Enron's demise has been portrayed as resulting from a few unscrupulous rogues or 'bad apples" (the phrase used by President Bush) acting in the absence of formal management controls, Enron featured all of the trappings of proper management control, including a formal code of ethics, an elaborate performance review and bonus regime, a Risk Assessment and Control group (RAC), a Big-5 auditor, and conventional powers of boards and related committees. This control infrastructure was widely lauded right up until the demise of the company.

The three core pillars of Enron's management control system were the risk assessment and control group, Enron's performance review system and its code of ethics.

Risk Assessment and Control Group: An integral part of Enron's management control system was the Risk Assessment and Control group (RAC). RAC was responsible for approving all trading deals and managing Enron's overall risk. Every deal put together by a business unit had to be described in a Deal Approval Sheet (DASH), which was independently assessed by RAC analysts. Deals required various levels of approval from numerous departments, including approval from the most senior levels, even from the board of directors.

Enron's Performance Review System: Another vital link in Enron's management controls was the Peer Review Committee (PRC) system. The intention of the PRC system was to align employee action with the company's strategic objectives, retaining and rewarding superior performers on a fair and consistent basis. Under the PRC system, every six months each employee received a formal performance review, based on formal feedback categories including revenue generation, and was assigned a final mark from one to five (the employee's photo was displayed on a screen). Feedback came from various sources including the employee's boss, as well as from five co-workers, superiors or subordinates that the employee selected. The bottom 15 percent, no matter how good they were, received a "5" which automatically meant redeployment to "Siberia," a special area where they had two weeks to try to find another job at Enron. If they did not - and most did not - it was "out the door."

Code of Ethics: Enron's code served as a behavioral control intended to prohibit a range of unethical behaviors. The code stressed the following four key principles: communication, respect, integrity and excellence, and included phrases such as "we treat others as we would like to be treated ourselves", "we do not tolerate abusive or disrespectful treatment" and "we work with customers and prospects openly, honestly and sincerely". The code, which each employee signed on joining Enron and annually re-affirmed, proved to be of wide interest - so much so that the political history division of the Smithsonian National Museum of American History acquired it for its permanent exhibit of exemplary business practices.

Enron also had in place the usual corporate governance mechanisms including a well-credentialed board of directors, an audit and compliance committee, a Big-5 external auditor (the ill-fated Arthur Andersen), an office of the director of financial disclosure, a chief risk officer's office, a finance committee, and the SEC's normal oversight. In sum, the control infrastructure within Enron was carefully designed, comprehensive and cutting edge. How this infrastructure was systemically subverted, marginalized and ignored under the leadership of Jeffrey Skilling offers key insights for practitioners and regulators alike.

Linkage 2: Jeff Skilling's role in crafting corporate culture at Enron

By mid-2000, Jeff Skilling had achieved his goal: Almost all the vestiges of the old Enron were gone. In its place, Enron had become a trading company. And with that change came a rock-em, sock-em, fast-paced trading culture in which deals and 'deal flow' became the driving force behind everything Enron did. (R. Bryce, Pipe dreams: Greed, ego, and the death of Enron, Public Affairs)

As Edgar Schein argues, leadership is critical to the creation and maintenance of culture; there is a constant interplay between culture and leadership. Within companies, cultural norms arise and change due to what leaders tend to focus their attention on, their reactions to crises, their role modeling, and their recruitment strategies. Leader's visions provide the substance of new organizational culture. To understand how the management controls at Enron were subverted, we must not only recognize the nature of Jeff Skilling's tenure as company CEO, but also Enron's shift to a Wall Street-type options and futures trading firm (i.e., a financial engineering shop). Schein's leadership framework outlined in the diagram below charts how Skilling's agency was instrumental in creating an environment that came to pervade and degrade Enron's management controls.

Skilling's leadership style had emerged over a number of years. As early as high school Jeff Skilling held a reputation as not only a scholar, but one with a penchant for somewhat dangerous activities, a characteristic that resurfaced later at Enron. After thriving at the highly competitive Harvard Business School, where he excelled as a top scholar, Skilling joined the Houston office of McKinsey & Company, where his intellect and tenacity impressed many clients, among them Ken Lay.

Skilling impressed Lay when he proposed forming a "Gas Bank", which took advantage of the fact that the short-term demand and supply for gas was chronically out of balance. The idea proved an instant success and moved Lay to hire Skilling as head of its trading operations, Enron Finance Corporation (EFC). Eventually, in 1996, Jeffrey Skilling would replace Richard Kinder as the CEO of Enron. Under Skilling's reign as President and CEO, a very different management control style ensued and elements of Enron's culture and operations underwent a radical transformation.

Within a few short years, Enron's business model shifted towards a Wall Street-type financial engineering trading platform operating in energy futures but also expanding into financial commodities of all kinds. By 2000, trading operations accounted for 99 percent of income, 88 percent of income before tax and 80 percent of identifiable assets; reported revenue increased from $11,904 million in 1996 to nearly $100,000 million in 2000 - a tenfold increase. Enron morphed into a full-scale Wall Street trading corporation specializing in the financial engineering of derivatives, options and hedges involving commodities such as broadband, fibre optics and paper goods.

Skilling's leadership style

Many Enron insiders have commented on Skilling's footprint on Enron's emerging organizational culture. Moreover, as outlined in the diagram below, Edgar Schein's leadership matrix highlights how Skilling's leadership was critical in fashioning an organizational culture valorizing risk taking, a mercenary approach to profit making and a win-at-all costs trading approach.

Skilling's leadership style and vision were evident in a number of characteristics and traits that exemplified Enron's culture. Skilling exercised control over almost all facets of the organization, particularly regarding its accounting procedures, which where designed to "massage" reported earnings in order to meet analysts' expectations. Earnings management was accomplished largely using special purpose entities (SPEs), accounting "reserves for contingencies" and mark-to-market accounting, which recorded profits from long-term deals immediately and, therefore, emphasized short-term results. These accounting maneouvres, used widely in the banking and finance industries, meant that to continue to increase reported earnings at its current rate, an ever-greater volume of deals were necessary. This form of "cowboy capitalism" put enormous pressure on the traders for short-term output.

The importance of earnings in Skilling's leadership style is unmistakable, especially in the reactions to critical incidents and organizational crises. For instance, evidence emerged at Skilling's 2006 trial that Skilling and Richard Causey, Enron's chief accounting officer, had decided to change the numbers to meet the new analysts' consensus, which had risen from 30 cents to 31 cents. Accordingly, Wesley and Colwell, chief accountant of Enron's wholesale energy trading unit, transferred $7 million to a profit account from a reserve contingency account set up in a prior period as a reserve for possible future contract settlements.

Another critical trait of Skilling's leadership style was the importance of rewards and status. Compensation plans, a powerful shaper and emblem of Enron culture, had one purpose in mind - to enrich the executives, not to enhance profits or increase shareholder value. For stock option incentives, Enron added the condition that if profits and stock prices increased sufficiently, vesting schedules could be rapidly advanced, meaning executives could get their hands on the stock more quickly. Skilling handed out extremely large pay cheques, bonuses and stock options to traders who met their earnings targets; in 1999, Enron granted 93.5 million stock options compared with 25.4 in 1996. John Arnold, a gas trader, booked $700 million in 2001, took his $15 million bonus and left Enron. Lou Pai cashed $250 million in Enron stock over three years.

Skilling's leadership style also included deliberate role modelling, teaching and coaching, which involved exposing employees to exaggerated claims. In 2000, for instance, Enron draped a huge banner at its entrance, enjoining employees to engage in the process of transforming Enron "FROM THE WORLD'S LEADING ENERGY COMPANY - TO THE WORLD'S LEADING COMPANY." The pervasiveness of hype extended to the use of metaphors drawn from war, sport and extremism. On bonus day, upscale car dealers set up shop around the Enron headquarters building showing the latest most expensive Mercedes, BMWs, Aston Martins, Alpha Romeos and the like.

The final characteristic of Skilling's leadership style was borne out in how Enron recruited, selected and promoted employees. Skilling's shopping list for job candidate characteristics described a very smart, aggressive, glib extravert who could become a ruthless trader. Skilling hired only the "best and the brightest" traders, investment bankers, information and computer experts, programmers, and financial engineers, most of whom were graduates of prestigious universities. As part of his Analyst and Associates' Program, Skilling would annually hire from 250 to 500 newly minted MBAs from the top business schools in the country. Promotions and transfers came quickly, without providing time to learn industry details. Those who did not produce deals were quickly redeployed and soon after, often, terminated.

Linkage 3: The Way in Which Corporate Culture Came to Subvert Management Controls at Enron

Skilling used numerous methods to reshape organizational culture in a way that celebrated attempts to exploit and "bend the rules," often through the subversion of management controls. Under Skilling, an extreme performance-oriented culture that both institutionalized and tolerated deviant behaviour emerged. The lauding of "creative risk-taking" and "revolution" led to not only stretching, but also circumventing and breaking legal and ethical boundaries. Resistance to bad news created an important pressure point on information sharing internally and externally. Fierce internal competition coupled with huge incentives led to private information, deceit and extensive efforts to bolster short-term performance. The culture that evolved under Skilling, and its impact on Enron's control systems, strategy and operating environment can perhaps best be understood by the comparison, as illustrated below, to that which existed under Richard Kinder.

As Enron entered market areas where it did not enjoy a comparative advantage, its mercenary corporate culture combined with the subverted control infrastructure meant that Enron lost its ability to keep track of relevant risks. Skilling was able to bring together a number of structural factors that enabled the Enron expansion and re-branding of its corporate image: deregulation, the high-tech investment bubble, enhancements in technological capabilities and a hungry and increasingly expectant investment community. Although there were favourable developments in Enron's institutional environment, Skilling largely brought these elements together in a cohesive package and promoted a culture celebrating creative deal making, innovation, entrepreneurship and mercenary practices.

The PRC system, meanwhile, worked to encourage private networks of loyal employees who gravitated towards powerful players for protection. Even though very knowledgeable risk management personnel staffed the RAC Group, over time they became increasingly reluctant to turn back projects that looked bad, since the corporate ethos held that the driving force of its business model was its ever-growing flows of deals. Rejecting them often meant "political death" for RAC members since the project proposal people could lose their bonuses and so would take revenge during the PRC process. Moreover, they were not inclined to reject proposals for fear of real repercussions from Skilling.

As former employees Peter Fusaro and Ross Miller highlight in What Went Wrong at Enron: Everyone's Guide to the Largest Bankruptcy in US History, Enron's 'rank-and-yank' machinations created "an environment where employees were afraid to express their opinions or to question unethical and potentially illegal business practices. Because the rank-and-yank system was both arbitrary and subjective, it was easily used by managers to reward blind loyalty and quash brewing dissent." The PRC was a powerful mechanism for preventing the emergence of any subcultures that might run counter to the mercenary organizational tone set by Skilling's leadership.

Enron's bonus regime, a key mechanism aimed at aligning individual and corporate goals, exacerbated the competitiveness of the Skilling-designed PRC as employees used several tactics to manipulate the system. An important consequence of this, and one that would play a big role in Enron's demise was that traders started to push through over-valued deals. Sometimes they would change the price projections at the last minute before signing the contracts in order to favour their short-term trades at the expense of the originators' long-term contracts. Skilling's PRC had a Darwinian nature since it instilled a competitive streak in every employee.

Thus, the reality of Enron's business practices flew in the face of its Code of Ethics. By mid-2006, some sixteen Enron accounting and finance managers, including CFO Andrew Fastow, had pleaded guilty to various criminal offences, including fraudulent accounting practices and manipulating quarterly earnings reports. The contrast between Enron's moral mantra and the behaviour of some of its executives was startling.

What Enron clearly demonstrates is that once employees align themselves with a particular corporate culture - and invest heavy commitment in organizational routines and the wisdom of leaders - they are liable to lose their original sense of identity, and tolerate and rationalize ethical lapses that they would have previously deplored. Once a new and possibly corrosive value system emerges, employees are rendered vulnerable to manipulation by organizational leaders to whom they have entrusted many of their vital interests. The Enron demise, then, points to numerous risks associated with degenerate cultures: the risk that a culture motivating and rewarding creative entrepreneurial deal making may provide strong incentives to take additional risks, thereby pushing legal and ethical boundaries; resistance to bad news creates an important pressure point of culture; and internal competition for bonuses and promotion can lead to private information and gambles to bolster short-term performance. At Enron, these risks ultimately subverted the company's elaborate web of controls.

Lessons for Managers

Enron offers a number of important insights for managers. Firstly, it underlines the vital role of top management leadership in fostering organizational culture. The footprint of Jeffrey Skilling is conspicuous in all accounts of Enron's organizational culture. Enron's plight also highlights the vulnerability of rank and file employees to prevailing cultural norms, morals and sanctions. Particularly in the absence of counteracting forces or dissenting opinions, increasing identification with an organization's cultural values is likely. Andy Fastow, the former chief financial officer of Enron, responded to a scathing cross-examination by stating, "Within the culture of corruption that Enron had, that valued financial reporting rather than economic value, I believed I was being a hero." During his trial, Mark Koenig, Enron's former head of investor relations, told jurors "I wish I knew why I did it. I did it to keep my job, to keep the value that I had in the company, to keep working for the company. I didn't have a good reason."

Secondly, within organizations, the impact of culture and leadership on even most the sophisticated management control system must not be overlooked or minimized. It is often too easy to consider cultural and management control systems separately, with cultural being a soft issue and management controls a hard one. Managers must always remember that a culture created through a reckless and overly aggressive leadership style can lead to individuals taking actions that can subvert even state-of-the-art management controls. Organizations need to distinguish more carefully between leadership styles such as that of Kinder, which expected high but fair performance and those that demand excessive and ultimately unattainable levels of performance.

Finally, the Enron saga speaks to the importance of not abandoning professional integrity. Perhaps, the most important lesson for managers to take away is to use personal cultural capital to find a working environment that matches one's personal values and principles. If they don't match, one should leave and find a company that does. As with the Challenger disaster in our epigraph, Enron should be a wake-up call for managers in all organizations.

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