

MANAGEMENT CONTROL PRACTICE AND CULTURE AT ENRON: THE UNTOLD STORY

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ABSTRACT

At the time of its demise in 2001, the Enron Corporation could boast of its comprehensive, state-of-the-art management control and governance systems. Yet these controls were rendered ineffective in the company's last few years. This paper identifies the radical change in Enron's corporate culture that took place from the Lay-Kinder era (1986-1996) to the Lay-Skilling era (1997-2001). It argues that this was a major cause of neutralizing these controls, which in turn proved to be a major factor in Enron's fall into bankruptcy. The paper draws on Schein's (1993; 1996; 2004) framework of cultural practice to develop our analysis. Thus, it supports Simon's (1990; 1995) urging to more meaningfully include corporate culture in management control research studies. The paper contributes to the literature by drawing attention to the rich but untold story of Enron's governance and control and also extends the research linking corporate culture and control systems.

JEL Classification: M41

Keywords: Enron; Management control systems; Organizational culture; Enculturation; Jeff Skilling

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 (Bryce 2002, 215).

INTRODUCTION

The motivation for this paper stems from the conundrum that during the period of Enron corporation's spectacular rise during the latter part of the 1990s and early 2000s and its sudden demise, Enron had in place a comprehensive, state-of-the-art management control and governance system. In fact, *Fortune* magazine gave Enron its "No. 1 in Quality of Management" award in 1999. Yet these controls proved to be ineffective in Enron's last few years. This paper attempts to explain how this breakdown happened and draw out some vital lessons for management control practices in general. While Enron's financial accounting "irregularities" and its "audacious" use of special purpose enterprises (SPEs) have been the focus of a vast number of academic (e.g. Abdel-khalik 2002; Benston and Hartgraves 2002; Healy and Palepu 2003) and popular media articles, as well as sundry government investigations, little attention has been given to Enron's management controls and governance mechanisms.

What seems to have been overlooked is that during Richard Kinder's term as President from 1986 to 1996, Enron operated with a highly effective management control system. With CEO Ken Lay providing the inspirational leadership role, and Kinder closely monitoring business operations and cash flows, Enron could boast of its family-like, collegial corporate culture featuring respect for all employees and for financial results. Kinder left in 1996, when it appeared certain that he would not get the CEO appointment, a position he coveted. Instead, Lay and the board of directors picked Jeffrey Skilling to take over the reins as President and CEO. As one insider put it, this would prove to be the worst single mistake Lay made in his career (Bryce 2002, 118). Enron's corporate culture, on Skilling's watch, underwent a change, one that rendered Enron's sophisticated governance and controls ineffective.

The paper draws on Schein's (1996; 2004) ideas about corporate culture to inform our observations about Enron's management controls and to enrich the existing knowledge base concerned with the relationship between corporate culture and management control. For Schein, researchers of organizations have persistently, "underestimated the importance of culture in how organizations function" (1996, 229). Thus, our paper also responds to Simons (1990; 1995; 2000) urging to include corporate culture in management accounting and control systems research.

The paper makes two major contributions to the field of management accounting and control systems. First, it draws attention to the untold but rich story of management control practices at Enron. Second, it extends the

literature and theory on culture based studies of these systems. In doing so, we relied on the vast database of research, articles, books, official inquiries and government investigative committee reports, available regarding the modus operandi of Enron's executives and managers during the company's somewhat short, and ultimately inglorious, history to document Enron's culture and its role in the management control process. Our assumption was that we can learn a lot from both success and failure experiences. The Enron saga illustrates both.

This paper draws on a vast archival database of public information and insider accounts concerning Enron's development from its incorporation in 1985 until its demise in 2002. This includes accounts by former Enron employees (e.g. Cruver 2003; Swartz and Watkins 2003; Watkins 2003a, b, c), SEC filings, Enron's Annual Reports, official reports (e.g. Joint Committee on Taxation, Senate Finance Committee 2003; Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate 2002), web sites, newspaper and magazine reports, journal articles, books, and other data sources that are available regarding the recent spectacular rise and fall of Enron. The status of the data should be treated as similar to that relied on by historians and the narrative that follows should be seen as a genealogical account of Enron's management control system and governance procedures during the existence of the company.¹

The paper is organized as follows. The next section provides an overview of recent research in the area of management control systems, noting the under-representation of culture within control system frameworks. This is followed by a review of Edward Schein's research into organizational culture, with its particular emphasis on the role of leadership. Section 3 presents the methodology used in this study. Then a detailed investigation into the control systems and prevailing organizational culture at Enron during (i) Richard Kinder's tenure as President from 1990 to 1996 and (ii) Ralph Skilling's tenure as President from 1996 to 2002 is presented. Drawing on this analysis, Section 5 discusses the important relationship between organizational culture and management control systems. The final section summarises the major themes of the paper and suggests avenues for future research.

¹ Numerous management accounting articles published in refereed journals have relied on similar databases. Toms (2002), for example, relied extensively on sources such as newspaper articles in the *Oldham Standard* and the *Oldham Chronicle* in the nineteenth century, Directors' reports, the trade magazine the *Textile Manufacturer*. Similarly, Walker (2004) relied heavily on nineteenth century newspaper articles in the *Financial Times*, the *Spectator*, the *Law Times*, the *Daily Courier*, the *Liverpool Mercury* and the *Economist*.

MANAGEMENT CONTROL SYSTEMS

Management control systems, involving tools such as budgets, performance measures, standard operating procedures and performance-based remuneration and incentives, seek to elicit behavior that achieves the strategic objectives of an organization (Kaplan 1984; Merchant 1998). Recent research in management accounting and control systems has focused on several specific management control devices such as: the balanced score card, risk management controls, the French *tableau de bord*, ERP, MRP, EVA, and VBM systems, value chain analysis systems, relative performance evaluation benchmarking. Numerous distinctive elements of management control systems have been identified in the accounting literature (see Ouchi 1979; Modell 1995; Merchant 1998; Whitley 1999; Chenhall 2003). Key management accounting control systems dimensions and their respective sources are presented in Table 1. As Table 1 reflects, however, there is limited consistency in the way that management control systems have been characterised in the prior literature and many researchers have focused on singular aspects and simple distinctions and taxonomies.

INSERT TABLE 1 HERE

As Table 1 reflects, however, there is limited consistency in the way that management control systems have been characterised in the prior literature and many researchers have focused on singular, micro aspects and simple distinctions and taxonomies. In contrast, a cultural approach allows the researcher to account for how these various control systems are mobilized in idiosyncratic ways when embedded in unique organizational cultures. Simons (1990, 1995) has repeatedly urged researchers to incorporate culture in their analyses of management control systems.

In his levers of control framework, Simons (1990; 1995) offers an integrative framework of management control that has attracted the attention of both practitioners and academics and has spawned a growing amount of research. Simons postulates that four complementary control systems – beliefs systems (core values), boundary systems (behavioural constraints), diagnostic control systems (monitoring mechanisms) and interactive control systems (involving top management support) – work together to benefit firms.

With respect to Enron, there have been numerous attempts to portray the firm's demise as the consequence of a few unethical, "rogues" or "bad apples" (the phrase used by President Bush) acting in the absence of any controls (Conrad 2003). However, at the time of its demise, Enron featured many of the formal accoutrements of

management control identified by Simons. Indeed, prior to 2001, the company was lauded as an excellent corporate citizen with exemplary ethical and control practices (Sims and Brinkmann 2003). Numerous Harvard Business School case studies and Gary Hamel's (2000) popular book *Leading the Revolution* (Hamel was also a paid advisor to Enron) praised the flexibility and control of the Enron business model and commended it to others.² Enron's control regime comprised elements corresponding to each of Simons' levers of control, including its exacting formal code of ethics, an elaborate performance review regime and bonus regime, Risk Assessment and Control group (RAC) as well as the conventional powers held by the Enron Board and various Board committees (such as the audit and compensation committees). For example, a typical deal required approval from the finance department (for external funding), the portfolio management department (for portions of the deal that would remain on Enron's balance sheet), the risk management department (for approval of the customer's credit risk and of risks of price and interest-rate changes), and the legal department (for contacts and analysis of legal risks) (Hamel 2000, 213-214).

ORGANIZATIONAL CULTURE, LEADERSHIP AND MANAGEMENT CONTROL

We selected Schein's framework of social/cultural practice for three reasons. First, it has been drawn on to advantage in the organizational, administrative, and institutional theory fields where it has shown great promise to further these disciplines. As yet, however, it has drawn little attention in management accounting and control research. Second, Schein's framework seemed valuable for extending and fleshing out Simon's important but relatively undeveloped ideas relating to culture and control. Third, and more pervasively, it forefronts the role of leaders in the enculturation process (Sims and Brinkmann 2003). This is important in the Enron case since both Kinder and Skilling, as Lay's alter ego leader partner, each championed a different organizational culture during their respective tenures as President.

In this study, culture is defined using Schein's (2004) widely cited definition:

A pattern of shared basic assumptions that the group learned as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way you perceive, think, and feel in relation to those problems.

² The following quotation is typical:

Controls form the cauldron in which Enron's innovative energies circulate. The heat comes from Enron's ambition to transform global energy markets and from the chance individual deal-makers have for personal wealth accumulation (Hamel 2000, 214).

Schein also argues that, “the term culture should be reserved for the deeper level of basic assumptions and beliefs that are shared by members of an organization, that operate unconsciously, and that define in a basic ‘take-for-granted’ fashion an organization’s view of itself and its environment” (2004, 6).

Schein (2004) divides organizational culture into three levels. The first level relates to *visible artefacts*. These refer to visual organizational structures and processes. Artefacts have surface-level visibility which can be easily discerned (but are sometimes hard to understand). Artefacts include language, technology, products and styles (clothing, manners of address, myths and stories). The second level entails *espoused values*; that is, public rationalizations for behaviour. In Enron’s case, these are espoused in its Code of Ethics. Espoused values are central to social validation and are typically determined by influential leaders and coalitions within organizations and may conceal underlying reasons. Schein’s final level is *basic assumptions and values*. He argues that the core, or essence, of culture is represented by basic underlying assumptions and values, which are difficult to discern because they exist at a largely unconscious level. Schein defines basic assumptions as fundamental beliefs, values, and perceptions that:

have become so taken for granted that one finds little variation within a cultural unit. . . . What I am calling basic assumptions are congruent with what Argyris has identified as “theories-in-use,” the implicit assumptions that actually guide behavior, that tell group members how to perceive, think about, and feel about things . . . Basic assumptions, like theories-in-use, tend to be nonconfrontable and nondebatable (Schein 2004, 18).

This paper, then, mobilizes Schein’s mechanisms of culture schema to analyze the radical shift in Enron’s culture and its management control systems during Jeffrey Skilling’s tenure as President from 1996 to 2001. It seeks to enrich the governance and control literature by downplaying the view that operating constraints and contextual factors are rigidly deterministic. Rather, we foreground the effect of leadership and organizational culture on control system design and use.

Leadership and Culture

For Schein (2004), leadership is critical to the creation and maintenance of culture; there is a constant interplay between culture and leadership. Leaders create the mechanisms for cultural embedding and reinforcement. Cultural norms arise and change because of what leaders tend to focus their attention on, their reactions to crises, their role modelling, and their recruitment strategies. Schein (2004, 231) outlines six primary mechanisms which are available to organizational leaders and dominant coalitions (the social network of individuals having the greatest influence on the selection of an organization's goals and strategies) to create and reinforce aspects of culture:

1. What leaders pay attention to, measure, and control  regular basis.
2. How leaders react to critical incidents and organizational crises.
3. Criteria by which leaders allocate scarce resources.
4. Deliberate role modelling, teaching and coaching.
5. Criteria by which leaders allocate rewards and status.
6. Criteria by which leaders recruit, select, promote, retire and excommunicate organizational members.

Schein's theorizing clearly suggests a strong link between executive leadership actions and the nature of an organization's culture. Leaders' visions provide the substance of new organizational culture.

Schein (1996) stresses the need for research dealing with organizational culture, arguing for increased attention to cultural aspects of organizations. He also acknowledges that, even with rigorous study, researchers can only make statements about elements of culture rather than explicating culture in its entirety (Schein 2004). According to Schein, deciphering an organization's culture is a highly interpretive and subjective process that requires insights into historical as well as contemporary activities. A number of first-hand descriptions and reports about Enron were available to the researchers including rich accounts of language, customs and traditions. Detailed and intimate accounts of life within Enron are now accessible through the vast and ever burgeoning archival database relating to the firm. In accessing this archive of primary and secondary accounts, we focused our analysis around accepted "rules of the game", the climate of group interaction, shared meanings and shared knowledge for socialization (paradigms, habits of thinking and acting). In addition, a number of secondary cues were available in the public sphere including published, publicly announced espoused values, and visible cultural artefacts such as corporate mission statements, corporate metaphors and important symbols. Through the interpretation and systematic comparison of first-hand narratives by key Enron employees (Cruver 2003; Swartz and Watkins 2003; Watkins 2003a, b, c) and observers (such as Fortune business writers McLean and Elkind 2004) as well from various espoused values and visible artefacts from archival sources, the aim is to make sense of the relationship between Enron's culture and its control systems.

One author and two research assistants coded over 5,000 documents into 53 nominal variables. This process highlighted key factors, events and influences in Enron's demise and permitted the construction of culture and enculturation matrices (Bernard 2002). We did not regard individual accounts and fragments of data as indicative of cultural features, but rather interpreted them as part of a wider corpus of data. Our data analysis was

characterized by a hermeneutic, iterative process of going back and forth from critical reflection to various data sources, and from part to whole, searching for key themes and patterns, and questioning, redefining, or buttressing the key themes and patterns identified with further evidence (Kets de Vries and Miller 1987). Before addressing the management control issues, it will be helpful to situate these in the light some background regarding Enron's historical development.

BACKGROUND: THE ENRON CORPORATION

Enron Corporation came into being in the middle of a recession in 1985 when the Houston Gas Company merged with Internorth Inc. of Omaha Nebraska. Kenneth Lay engineered the merger as CEO of Houston Gas, and garnered several million dollars worth of stock options when Internorth paid what some thought was a handsome premium for Houston Natural Gas. The new company was born with \$12.1 billion in assets, 15,000 employees, the nation's second largest pipeline network, and a towering amount of debt. It reported a first year loss of \$14 million.

The next two years were precarious ones for Enron as it teetered on the verge of bankruptcy. In spite of a hostile greenmail takeover attempt by Irwin Jacobs and a Moody's Investment Service debt rating of "highly speculative", Enron survived and in 1987 reported \$5.9 billion in revenue and a \$53.7 million profit from on-going operations. At the time Enron was a typical natural gas firm owning mainly hard assets such as debt-ridden pipelines and refining equipment. With assets in Texas, Oklahoma, California, Florida, and Western Canada, Enron had all the traditional trappings of a highly leveraged, "old economy" firm competing in the regulated energy economy. This strategy did not excite the stock market.

The hard assets, nevertheless, proved to be the platform for building a revolutionary kind of energy company. Lay's strategic vision entailed transforming Enron into an exciting, new energy trading company, innovating new ways of servicing the rapidly expanding energy market, not only in the USA but also eventually worldwide. With his extensive experience and background as a senior executive in the gas business, vast knowledge of economics, energy technology and regulation, as well as his mastery of energy business politics (both local and in Washington), Lay was ideally suited to lead Enron into the new energy markets era.

By the year 2000, Enron was a totally different company, although still carrying a very large load of long- and short-term debt. In fact, 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. These included its political connections; its sophisticated organizational structuring; its highly skilled technical workforce of financial instruments traders

specializing in the energy sector worldwide; its state of the art, on-line, computerized, web-based information system; and its expert accounting knowledge at applying GAAP and minimizing income taxes. Enron had emerged as an archetype of fast track, new-knowledge companies operating in the global information economy.

Enron's emerging strategy centred around the idea that it would slowly divest its "hard assets" and shift resources into building the world's leading, sophisticated financial instruments "carpentry shop" platform for trading energy contracts in the gas, electricity, coal and hydropower markets. With Lay spearheading the movement in 1989, several large pipeline companies, the merchant bank Morgan Stanley, and a prestigious law firm, successfully put in place Skilling's idea of a Natural Gas Clearinghouse (NGC) as the vehicle for an organized but unregulated spot market in gas. In the years to come, Enron would build its empire around trading financial contracts of various kinds for gas and other energy sources. By the mid-1990s, Enron had "morphed" into a Wall Street-like investment bank, devising and trading in exotic financial instruments and financing large energy projects around the world. As one observer put it, "Enron was the child of deregulation" (Fox 2003, 11). Even though Enron increasingly relied on the intellectual capital of its trading operations for most of its profits, hard assets still had an important place in Enron's strategy. The tactic was to get a physical presence in some business (such as broadband communication or water plants), learn the details of that particular business, and then build a trading operation around it. This was the context in which Richard Kinder's management controls played a vital role in Enron's early success.

The Lay-Kinder Era: 1990-1996

Ken Lay was a hands-off, removed manager who focused on the big picture. A master of public relations, he vigorously worked the corridors of power in Washington and in Houston.³ As a personal friend of the Bush family and other powerful Houston politicians and industrialists, and with many influential Washington government contacts, Lay could successfully play the role of "Mr. Outside," while his alter ego, Richard Kinder, played the part of "Mr. Inside". As one observer put it, "Kinder ran the company ... While Lay gave speeches and posed for pictures" (Bryce 2002, 114).

³ Lay's political influence ran so high that there was much speculation in Washington that he would be appointed to the cabinet and it was rumored that he harbored the ambition to be Secretary of the Treasury. Lay's lobbying efforts eventually bore fruit. In 1994, the federal government opened the door to deregulation (although it shifted much of the decision-making to the individual state legislatures). After a six-year debate in the Texas Legislature, deregulation was approved in 1999.

Kinder joined Enron's executive team in 1986 and immediately headed up an urgently needed cost reduction campaign aimed at improving Enron's cash poor and debt heavy financial situation. With a well-earned reputation for understanding operations and saving money, he performed this task very well. He oversaw Enron's various operations and drove employees at all levels to meet quarterly financial performance targets; "Kinder's job was making sure Enron worked, and he was good at it" (Bryce 2002, 20). Kinder consistently paid attention to, and measured, financial performance. He demanded that business unit leaders meet their earnings target. When market analysts queried him about Enron's ability for sustained earnings growth, he replied, "Blood will flow in the streets of Houston before we miss our numbers" (Bryce 2002, 116). Kinder kept his promise. During his term as President from 1990 to 1996, Enron's revenues rose from \$5.3 billion to \$13.38 billion, while reported earnings increased from \$202 million to \$584. Kinder was a master at "making the trains run on time" (Bryce 2002, 112).

Kinder's control style was both people and numbers oriented. Every Monday morning, Kinder held a meeting in the boardroom, where every Enron business unit leader was "expected to show up, ready for a grilling" (Bryce 2002, 111). Kinder insisted that they come prepared with their numbers, plans, and strategies. He possessed an almost photographic memory and could instantly recall facts and figures of transactions even though they had been made years earlier. As one Enron manager remembered, "You could give him a budget number and explain where it came from and he'd say 'that's not what you told me last year.' And then he'd go to his desk and retrieve the year-earlier budget and prove you wrong. It was amazing" (Bryce 2002, 112). As one business unit leader explained, "Rich didn't care if you had a great story. He wanted to know several things: How do you plan to make money? How do you secure your risk? And how do you assure your cash flow? It's a simple focus but it can encompass a lot of things. You could give him a one-page deal and he would pick out the one number you can't explain...He was impossible to bullshit," and if managers "lied to him about their numbers, Rich would eat them for lunch" (Bryce 2002, 112).

During these face-to-face meetings, the data supporting managers' budgets and strategic plans were debated and frequently challenged by Kinder. Such information formed the basis for a continuing agenda. Kinder also demanded up-to-the-minute reports from the business group heads who soon learned to gather and analyze important information before the meetings in anticipation of Kinder's questioning. "Kinder would sit in that room with his yellow pad and he knew every god-damned thing happening in that company," said one former 20-year Enron executive (Gruley and Smith 2002, A1). Control was ongoing, dynamic, and stringent. Kinder's leadership

sought to instill a systematic, rational, results-oriented focus. He rewarded and promoted managers (and allocated resources to projects and deals) that survived his scrutiny.

Kinder, known throughout the company as “Doctor Discipline,” understood intimately the details of every part of Enron from gas fields, to pipelines, to trading energy options, futures, swaps and derivatives. He focused hawk-like on expenses and cash flows and also kept a close eye on employee levels. In 1990 Enron employed nearly 7,000 people and reported about \$200 million in profit. By 1996, Enron reported over \$600 million in net income but had added only 500 more employees. Kinder continued to require managers to present him with details of their strategies, plans and proposals. Then he would zero in on any weak points and demand explanations.

Kinder personally handled all Enron’s relationships with bankers, Wall Street analysts and bond rating agencies. And, in view of Enron’s chronic heavy debt load, he closely monitored cash levels and cash flows. In fact, cash management was so important for Kinder that all business group managers were given a budget target for cash flow (as well as for profits) and the bonus system he orchestrated was tied to meeting both. As one executive recalled, “it wasn’t enough just to get into a new business, you had to have a strategy that was going to be a natural outgrowth of your existing business. [Kinder] was a detail person. He wanted to know if there were growth areas, it had to be logical, thought out and have a good reason behind it. Kinder would bring business unit leaders who submitted overly optimistic proposals down to earth with his frequently used line, ‘Let’s not start smoking our own dope’” (McLean and Elkind 2004).

Kinder’s controls exhibit many of the theoretical characteristics of Simons’ (1995) interpersonal, interactive management control style. Under this control style, top management pay a great deal of attention to the business managers’ various control reports such as strategic plans, capital expenditure proposals, operating budgets, statistical reports on operating logistics, and financial results - and then challenge and debate the information. At Enron, Kinder scheduled regular face-to-face meetings with business unit managers to question, review, discuss and debate the information and assumptions underlying the data in such reports and documents. Operating managers, in turn, were motivated to schedule meetings with their managers and to gather and interpret additional information to use as ammunition in anticipation of having to respond to Kinder and defend their thinking and actions. The process engendered a lot of organizational learning and cross-functional communication, as new ideas emerged, and innovative rethinking ensued (Bisbe and Otley 2004, 711).

Moreover, Lay and Kinder proved to be a complementary top management team. One senior executive observed, Lay “had the ability to take prima donnas and get them to hover around a common theme ... While Lay was inspiring the troops, Kinder kept the egos and the budgets in balance” (Bryce 2002, 117). Elements of Enron’s culture, however, were to undergo a radical change under Jeff Skilling’s reign as President and CEO as he instantiated a very different management control style.

The Lay-Skilling Era: 1996-2002

Jeff Skilling held a reputation in high school as a scholarly, high achieving student but with a penchant for somewhat dangerous activities, a characteristic that resurfaced later at Enron. Turning down Princeton for his undergraduate education, he went to Southern Methodist University where he earned an applied science and business degree and then took a job at the First City National bank. Finding it boring, after two years he left and went to the Harvard Business School where he excelled as a top scholar, thriving on the highly competitive, tough-minded, give-and-take of the classroom case method discussions. Upon graduation in 1979 he joined the McKinsey & Company consulting firm in Houston, where his intellect and tenacity impressed many clients, including Ken Lay.

Skilling had a large influence on the evolution of Enron’s strategic business model. While working in the 1980s as a consultant in the gas industry, Skilling noticed a paradox in the gas market. Although the demand for gas was strong and gas reserves were plentiful, the short term demand and supply situation was chronically out of balance. Skilling proposed forming what he called a “Gas Bank” which was simply a trading ledger that facilitated buy and sell orders for long-term gas contracts. The Gas Bank allowed gas producers to enter into long-term selling contracts enabling them to rationalize their exploration and drilling programs. At the same time, it enabled users, mainly public utilities and industrial plants, to enter into long-term buying contracts which secured their gas needs at a fixed price, thus enabling them to make plans for capital expenditures.

Lay liked the idea and in 1989, building on its large holdings of gas, Enron launched the Gas Bank. It proved an instant success, and by 1990 Enron had signed contracts with 35 producers and 50 large gas customers. The Gas Bank also made loans for new facilities to gas-fired plants. This resulted in an overall industry wide increase in the consumption of gas, which also brought more business to Enron’s pipeline and trading operations. In 1990, Enron was selling 1.5 cubic feet of gas a day at an average price of \$3.50 per 1,000 cubic feet and buying it for \$1.20, thus netting a neat \$2.30 spread. This success, along with the 1990 launching by the New York Mercantile Exchange (NYMEX) of a gas futures exchange, moved Lay to hire Skilling as head of its trading operation, Enron

Finance Corporation (EFC). With Skilling leading the way, Enron's business model shifted in a few short years from a gas trading and pipeline company to become mainly a Wall Street-type financial engineering trading platform operating in financial commodities of all kinds. In 1996 (the year Kinder departed Enron), trading operations (wholesale and retail) accounted for 91 percent of reported revenues, 54 percent of income before tax and 62 percent of identifiable assets. By 2000, trading operations accounted for 99 percent of income, 88 percent of income before tax and 80 percent of identifiable assets, while reported revenue increased from \$11,904 million in 1996 to nearly \$100,000 million in 2000 – a tenfold increase. Enron had in large part morphed into a full-scale Wall Street trading corporation specializing in the financial engineering of derivatives, options and hedges.

Enron's business strategy evolved out of the Gas Bank idea and by 1996, a number of different groups were involved in its trading operations. The Physical Trading Desk dealt mainly in real gas contracts by working the spread between buy and sell orders. The Financial Trading Desk dealt in options, futures, and swaps of financial contracts (but not in physical gas trades) often capitalizing on the Physical Trading Desk's proprietary knowledge of pricing spreads. And in 1992, Skilling created the Internal Research Group (including PhDs in math and physics) who built highly sophisticated mathematical models to support the Financial Trading Desk's complex deals, and staffed it with experienced traders from Wall Street firms. While dealing in options, futures, swaps and derivatives was common on Wall Street, Enron was the first to bring these skills into the energy markets where it already had extensive experience and knowledge.

Management Control under Skilling

There have been many attempts to portray Enron's demise as the result of a few unscrupulous individuals acting in the absence of any formal controls (Conrad 2003). However, it should be noted that Enron featured many of the formal trappings of management control that have been identified in prior research. Key elements of Enron's control system included its exacting formal code of ethics, elaborate performance review regime, bonus regime, Risk Assessment and Control group (RAC) as well as the conventional powers held by the Enron Board and various committees.

Enron's Code of Ethics

Enron's code served as a behavioural control intended to prohibit a range of unethical behaviours. The Code stressed the following four key pillars:

Communication: We have an obligation to communicate. Here, we take the time to talk with one another ... and to listen.

Respect: We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment.

Integrity: We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.

Excellence: We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be. (Enron Values, Enron Annual Report 2000)

The Code, which was to be signed and annually re-affirmed by every Enron employee, 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. However, the reality of Enron's business practices flew in the face of the Code. 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 and in May 25, 2006 a jury found both Lay and Skilling guilty of fraud and conspiracy. Enron's tax department, which operated as a profit centre, worked closely with large Wall Street banks, accounting firms and prestigious legal firms in creating nearly 900 offshore partnerships in tax havens. As President, Skilling made several well documented ruthless public comments⁴ and bribery and corruption were recurring features of Enron's global operations.⁵ The juxtaposition between the Code and Enron's business practices did not go unnoticed by many employees. As one later reflected, "the contrast between Enron's moral mantra and the behaviour of some of Enron's executives is bone chilling" (Cruver, 2003, p. xii).

Enron's Performance Review System

Another vital link in Enron's management controls was the Peer Review Committee (PRC) system that Skilling devised, better known inside Enron as "rank-and-yank." PRC featured two basic motivational forces – fear and greed. Skilling wanted to keep only "the very best," meaning those who produced their profit and volume target

⁴ For example, in a public address in California during the State's 2000 rolling electricity blackouts, when Enron trades was making vast profits on energy trading in the area, he callously joked, "at least when the Titanic went down the lights were on." In another example, during a telephone conference call with investment analysts across the country, Skilling called a major Wall Street banker an "asshole" after being asked why Enron was not reporting balance sheet items of price risk management assets and liabilities as is customary for investment firms.

⁵ For example, the World Bank cancelled a \$100 million Enron water project in Ghana because of "corruption concerns." And, in the case of Enron's UK Azurix water project, strong allegations were made by a civilian watchdog committee that the company had paid a \$5 million bribe to senior officials. Allegations of bribery surrounding Enron's widely publicized Indian Dabhol Power project were also widespread (see Bryce 2002).

– so every six months one or two out of every ten employees were dismissed. This weeding out process, and the fear factor it engendered, was at the heart of PRC and it worked as follows.

Each employee received a formal performance review every six months. While the employee got to select five co-workers, superiors or subordinates to give feedback to the committee, the employee's boss had to be one of the reviewers. In addition, anyone else could also provide feedback data and submit scores to the individual's supervisor if they so desired. Formal feedback categories included straightforward matters such as: innovation, product knowledge, client relationship skills, intellectual curiosity, dependability, teamwork, communication, loyalty and especially revenue generation. All these data were collected on a web site for the PRC members to use when assigning a final mark from one to five to the employee under review (whose photo was displayed on a screen). The bottom 15 percent, no matter how good they were, received a "1" which automatically meant redeployment to "Siberia," a special area where they had two weeks to try to find another job at Enron.⁶ If they did not – and most did not – it was "out the door."

The process as it actually worked, not surprisingly, featured a lot of backroom negotiation. Employees being reviewed by the PRC made side deals with selected volunteer reviewers whereby they would give each other high scores. One manager described his conversation with another manager when he broached the subject of an imminent PRC as follows: "I was wondering if you had a few minutes to talk some PRC." She replied, "Why – you want to cut a deal?" "Done," I said – and just like that we cut our deal" (Fox 2003, 622). Business unit managers also made deals with each other, exchanging bad scores for both employees they wanted to dispose of, and for rivals they wanted to discredit. And, if one manager wanted to give a "5" to some employees in his group, and another manager wanted to keep all of her employees, then they would cut a deal to reach the combined 15 percent required as above. Former employees Fusaro and Miller (2003, 52) argue that 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 subcultures running counter to the organizational tone set by Enron's hierarchy.

⁶ Most of those receiving "1" chose to accept a severance package rather than stick it out. Furthermore, those in categories "2" and "3" were effectively put on notice that they were liable to be yanked within the next year (Swartz and Watkins 2003).

This punitive environment brought the consequences of dissent sharply into focus. Tourish and Vatcha (2005, 474) argue that this resulted in an “identification-with-the-aggressor syndrome” where those at the receiving end of aggression assume an aggressive posture themselves. In pitting employees against each other, the rank-and-yank system acted to stress the imagined weaknesses of individuals and to obfuscate organizational problems. In sum, this led to an erosion of employee confidence in their own perceptions and, most crucially, to further compliance with the organization’s leaders in a way that strengthened conformist behaviour. The cut-throat nature of the performance evaluation thus became undiscussable: as Tourish and Vatcha (2005, 471) put it, the prevailing culture fostered by the PRC rendered “the undiscussability of the undiscussable also undiscussable.”

The Bonus Regime

The competitiveness the PRC created was exacerbated by Enron’s bonus regime, a key mechanism aimed at aligning individual and corporate goals. Under Skilling, the PRC database was used to determine employee bonuses by arraying all employees on a bell curve. This, along with how well the individual’s business group had performed in producing profits and revenue, determined each employee’s bonus for the period. Bonuses could range from 10 to 26 percent of take-home pay. Not surprisingly, employees relied on several tactics to manipulate the system.

For example, traders had to calculate the forward price curves for business groups that originated long-term contracts. Sometimes they would change the price projections at the last minute before the contracts were signed in order to favour their short-term trades at the expense of the originators’ long-term contracts. Another tactic (related to the fact that traders were competing for jobs and bonuses with those sitting next to them in the same trading group) involved sabotaging their neighbours’ deals or even stealing their trades and positions when their neighbours left their posts. As one executive commented later, the bell curve “... had a hard Darwinian twist ... [it] made a humongous difference on Enron by instilling a competitive streak in every employee” (Fox 2003, 84).

Suspicion and ultra-competitive behaviours led to considerable secrecy and suspicion within Enron. This secrecy, which fostered the deceit with respect to the company’s true financial position, extended inside the company to its various divisions, such that no one besides top management had any kind of picture of the financial health of the company as a whole. As Fowler (2002, 14) put it:

“Every division and business unit was like its own silo, separate from all the other businesses,” said the former CEO of one of the divisions. “It was decentralized and not heavy on teamwork, with all of the divisions in competition with each other for resources.... But since most only saw their part of the business,

they assumed the problems were isolated. You understood your piece of the business and maybe what the guy next to you did, but very few understood the big picture,” a former broadband worker said. “That segmentation allowed us to get work done very quickly, but it isolated that institutional knowledge into the hands of very few people.”

Risk Assessment and Control Group

Another 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 for managing Enron’s overall risk. Every deal put together by a business unit had to be described in detail in a Deal Approval Sheet (DASH), which included a description of the original information, economic data, a cash flow model, the deal’s value, internal rate of return and net present value, risk component, a Financial Approval Sheet (FASH) and an authorization page. In principle, RAC had taken the place of Kinder’s Monday morning control meetings with business group heads.

RAC analysts were required to conduct an independent assessment of each DASH, and deals required various levels of approval from numerous departments. As one manager described it, “Signatures were usually all over [the Authorization page], including legal, origination, accounting, finance, and RAC; and on top of that was an approval hierarchy that took big deals to the top level. Some deals were big enough to require additional approval, even from the board of directors” (Cruver 2003, 81). Often, however, approval signatures came *after* the deal was transacted. A major reason for this was that the sundry business groups were under intense pressure from top management, especially Skilling, to push deals through. In 2000, nearly 1,000,000 trades were made through EnronOnline with a notional value of \$336 billion. At its peak in 2001, Enron was making as many as 1,200 different types of trades worth billions of dollars of transactions every day. Margins on each trade, however, had narrowed dramatically by 2001 as competitors copied Enron’s trading strategy. Where Enron’s traders used to make about five cents on the dollar per trade, this dropped to one cent, largely because competitors were now copying Enron. Not surprisingly, then, Skilling’s mantra became “volume! volume! volume!”

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. Crucially, mark-to-market accounting as instantiated by Enron, the total revenue from a deal got reported at the time the deal was made. So in the case of a five-year electricity or gas supply contract, for example, the entire revenue for the five years was recorded in the first quarter. For Enron business managers, this meant they had to constantly increase their volume of deals in order to meet their quarterly budgets and collect bonuses. Even though very knowledgeable risk management personnel staffed the RAC Group, as time went by they became more and more reluctant to turn back projects that looked bad, especially 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.⁷ Moreover, they were not inclined to reject proposals for fear of certain repercussions from Skilling. Over-valued deals became the cultural norm rather than the exception. The high degree of subjectivity in the proposed deals, the increasing shortage of staff to assess the growing flow of deals, the push from the top for high volume deals, and the twisted PRC process combined to render the RAC control process largely ineffective. The new culture led to the perversion of the RAC.

Enron’s Shifting Corporate Culture under Skilling

Under Skilling’s direction, then, Enron’s corporate culture began to take on all the characteristics of a combative Wall Street trading organization and ultimately compromised formal controls and espoused values. As one executive later reported, “Traders are mercenaries. Their job is to kill. And mercenaries, by definition, don’t have any loyalties ... With traders, it’s rape, pillage, and plunder all the time. They don’t care about the shareholders or the business strategy or the long-term interests of the company. They just wanted to make deals and get their bonuses” (Bryce 2002, 124-125). The Enron trading floor was said to mirror Skilling’s personality – ultra competitive, highly individualistic and highly tolerant of risk. Recruitment practices supported this ethos.

Recruitment and Orientation Rituals

By the mid-1990s, Enron had established a reputation as an exciting, dynamic place to work. As it grew, it hired many of the gas industry’s and Houston’s most talented professionals. Employees saw Enron as different than the giant, sluggish companies where “some employees could go at half-speed and hide in the bureaucracy” (Bauder 2002). Employees were provided with substantial autonomy and those who delivered their profit targets were handsomely rewarded with bonuses that sometimes reached one or two million dollars. Moreover, Enron had cachet for employees since it became the pride-and-joy of Houston, which had always been seen as the poor cousin of Dallas.

By the late 1990s, Skilling created his shopping list for job candidate characteristics: a very smart, sharply dressed extravert who could become a ruthless trader (Fowler 2002). Skilling hired only the “best and the brightest”

⁷ For example, in June 1999, Skilling transferred risk-management specialist Vince Kaminski out of Risk Management because “he was acting like a cop, trying to kill deals” after Kaminski had expressed concerns about a set of proposed hedges (Behr and Witt 2002).

traders, investment bankers, information and computer experts, programmers, and financial engineers, most of whom were graduates of prestigious universities. As one insider commented:

Skilling didn't really want eggheads. He wanted people like himself – ambitious, driven, self-made, with something of an edge. You had to be glib, you had to be aggressive and most of all, you had to be able to sell. You also had to have a healthy disrespect for the established order – how else could you keep innovating? ... In turn, Skilling engendered a kind of loyalty that, even in the early years, was almost cultlike (Swartz and Watkins 2003, 57).

As part of his Analyst and Associates' Program, Skilling would hire from 250 to 500 newly minted MBAs annually from the top business schools in the country (Zellner and Anderson 2001). Fastow was also involved. In order to get help with his partnership deals, Fastow also hired from the elite business schools, enticing recruits with \$20,000 signing bonuses and incentive plans that could double their salary. These bright and aggressive persons would be given great authority and the ability to make \$5 million deals on their own (Byrne et al. 2002). Promotions and transfers came quickly, without providing time to learn industry details.

Employees were continually exposed to exaggerated claims about the organization. In 2000, 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." Craig and Amernic (2004) have highlighted the persistence of hyperbole and hype in Enron's internal and external discourse. This extended to metaphors drawn from war, sport and extremism. Extreme wealth and ostentatious consumption was visibly available to those employees who achieved targets. 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 nature of this indoctrination has been compared by two insiders to "a religious tract from a New Age megachurch" (Swartz and Watkins 2003, 103). Cruver (2003, 37) notes that the prevailing climate of visible conformity extended to visual artefacts such as dress and appearance.

The first thing I noticed about Enron traders is that they all looked very similar: A goatee was fairly common; otherwise they maintained a clean-cut yet outdoorsy look; and if they didn't wear some version of a blue shirt every day, then it was like they weren't on the team ...

Swartz and Watkins (2003, 193) note that this also extended to language: "No one at Enron would ever 'build consensus,' they would 'come to shore,' as in 'We have to come to shore on this' ... Everyone [used] the term 'metrics' and anyone who used the term 'numbers' or 'calculations' was a 'loser', the most popular Enron label of

all.” Enron’s socialization process was referred to “Enronizing” with people who didn’t fit in called “losers”, “damaged goods” or “shipwrecks” (Roberts and Thomas 2002).

Performance Targets, Stock Options and Mark-to-Market Accounting

When Skilling came on board, he negotiated a lucrative employment contract that included salary and substantial bonuses based on the performance of Enron Finance Corporation (later the Enron Gas Services Group). Between October 1998 and November 2001, he sold 1,307,678 Enron shares with a gross proceeds value of \$70,687,199. Another vital plank in Enron’s strategy was the move, at Skilling’s request, to switch its corporate accounting from traditional *historical cost* to *mark-to-market* accounting, a method that was already in widespread use throughout the banking and finance industries. In the second half of the 1990s, Enron would rely heavily on mark-to-market accounting, along with the use of special purpose enterprises (SPEs), to “massage” its reported quarterly and annual earnings up or down as need be in order to meet analysts’ earnings expectations.

While mark-to-market accounting provided better asset values for its contracts, more importantly, it permitted recording profits from long-term deals immediately rather than, as for traditional accounting, at the culmination of the contract. This meant that profits got recorded in the quarter in which the deals were signed, even for 20-year contracts. This had the effect of emphasizing short-term results since Enron’s financial traders now had to start each quarter with a blank trading book and a new profit target. For Enron to continue to increase reported earnings at its current rate, an ever greater volume of deals was necessary. This put even more pressure on the traders for short-term output. In the words of one Enron executive, “you put yourself in a position where you had to kill to eat” (Fox 2003, 42).

Enron’s accounting manoeuvres, much publicized later, were part and parcel of the egregious violations of its much vaunted Code of Ethics. The majority of the ever increasing flow of deals demanded by Skilling involved over-the-counter trades of sophisticated, long term derivative-like contracts woven into a confusing web of subsidiaries, SPEs, investment bankers loans, and complex accounting entries. This meant that the mark-to-market accounting for them was up to Enron’s traders to determine the market prices, which they “manufactured” according to complex Black and Scholes-type valuation models which involved a host of subjective assumptions about their long-term risk and volatility parameters. And given that the traders “... were continually pressured to meet targets and show ‘as much profit’ as possible ... Enron had the freedom (and the talent) to book trades at the *extreme edge*

of what they could get away with” (Cruver 2003, 274). The new culture encouraged dubious accounting practices for these deals.

Manipulation and Avariciousness

In 1999 and 2000, Enron electricity traders, along with those in other companies like Dynegy, Reliant Resources and CMS Energy, actively engaged in a variety of highly dubious schemes to drive up electricity prices in California and reap huge profits for themselves. One such tactic, “round-tripping,” involves one trader selling electricity contracts to another trader (either internally or externally) at a “set” price, while the latter simultaneously sells the same electricity back to the former at the same price. The effect is to give the impression that demand has soared thus driving prices up since these trades establish the price of the last trade in the market, setting an artificially high benchmark price for the next regular trade.⁸ Enron traders, using their own proprietary computerized trading networks, on one occasion round-tripped more than 11 million megawatts of electricity, making nearly 98 percent of its trades to other Enron groups at prices spiking to \$2,500 a megawatt hour.

Enron also engaged in “congesting” by deliberately overloading specific power lines. For example, its traders targeted the California Power Exchange (CPE). CPE had managed the State’s electricity market and posed a large threat to Enron’s trading operations in California. In May 1999, Enron traders submitted a bid to CPE for 2,900 megawatts on the transmission line running from the central California valley to San Diego that had a capacity to handle only 15 megawatts. This overload shut the line down, thus artificially boosting demand and driving prices up. In another version of congesting, one that Enron traders referred to as the “Death Star” project, Enron scheduled power movements over lines they knew were overloaded and collected “congestion payments” for calling them off with the result that Enron got paid for moving energy to relieve congestion without actually moving any energy or relieving congestion. Finally, the “Get Shorty” project involved falsifying information regarding standby inventory of energy, and then collecting payments for standby power generation capacity they did not have, but rather would buy later at lower prices to cover their obligations if and when needed.

Such dubious tactics, carried out by other energy firms as well, eventually drove CPE into bankruptcy leaving Enron as the key player in California. With electricity prices soaring, and in the wake of the infamous California “black-out,” the California State Government, led by Governor Davis, legislated a cap on prices. Seizing

⁸ Round-tripping is technically not illegal in unregulated markets.

the moment, Enron and other traders exploited this opportunity by buying California electricity at the capped price and selling it to other states that had no price caps at a large margin of profit and at the same time exacerbating the California shortage. This, along with round-tripping and sham congestion, at one point caused the price of electricity for public utilities to rise from \$30 per kilowatt-hour to a spike of \$1,500 per hour. In the face of severe criticism from California politicians and government officials who were accusing Enron of price gouging and unfair business practices that contributed to, if not caused, the black-outs, Enron accountants shifted large amounts of profits (\$1.5 billion according to Fox 2003, 220) to an account for “Future Contingencies” in order to deflate reported quarterly earnings. While such a practice is considered to be dubious accounting in many quarters, both Lay and Skilling admitted they were aware of the reserves but considered them proper in that they did not directly violate GAAPs.

The increasingly instrumental and aggressive nature of Enron’s corporate culture was also manifested in Enron traders’ “trash talk” during the California electricity crisis and black-outs of summer 2001 (recorded in taped transcripts and email files published by the Federal Energy Regulatory Commission in 2004). In a recorded conversation, Enron traders gloated about how much money they took from “Grandma Millie” in California. Another reveals plots to deliberately drive prices up by shutting down power plants, “If you took the steamer down, how long would it take to get it back up?” The reply was, “Oh it’s not something you want to just be turning on and off every hour. Let’s put it that way.” The reply, “Well, why don’t you just go ahead and shut her down.”

Thus, Enron proved to be a key player in creating artificial energy shortages and manipulating prices in California during 1999 and 2000. For Enron this meant profits of nearly \$46 billion, according to some estimates. Yet the means of accomplishing this concerned some Enron employees. One Enron manager later put it this way:

The contrast between Enron’s moral mantra (as stated in its Code of Ethics manual) and the behaviour of some of Enron’s executives is bone chilling. Indeed, the Enron saga teaches us the limitations of corporate codes of ethics: how empty and ineffectual they can be. Long touted as crucial accoutrements to moral rectitude, codes are useless when words are hollow – when executives lack either the dedication to espoused values or the ability to make defensible ethical decisions (Cruver 2003, xii).

Former Enron employees state that by 2001, “Enron had become less a company than a collection of mercenaries” (Streitfeld and Romney 2002, 2) and that “there wasn’t anything they wouldn’t try to make money” (Streitfeld and Romney 2002, 7). This mercenary posture extended beyond national borders. In India, Enron executives paid local law enforcement officers to suppress legitimate and peaceful opposition to its power plant near Mumbai (Tourish and Vatcha 2005). Even in the company’s final hours, remaining executives furiously grasped at what remained. Watkins (2003c, 436) recalls:

In January, we all found out that a handful of executives paid themselves gargantuan retention bonuses the week before bankruptcy. There was an \$8 million amount, a \$5 million amount, a couple \$1.5 million, lots of \$900,000 and \$700,000 ... And then they had the gall to stand up at floor meetings and tell handfuls of people, you know, "last Friday was your last paycheck, I'm so sorry, this is so heart wrenching for me," you know, with all that money sitting in their pockets. So something went horribly, horribly wrong with the culture.

Obscene Compensation

Compensation was another powerful shaper and emblem of Enron culture. Compensation plans were designed with one purpose in mind: to enrich the executives, not to enhance profits or increase shareholder value (McLean 2001). "Those who closed major deals were paid up to 3% of the value of the entire deal, payable when it was struck, not when the project actually began earning money" (Fowler 2002). Traders could earn as much as \$1 million annually (Coy and Anderson 2002). In the Energy Services (ES) Division, for example, executive bonuses were tied to the values of the deals struck. But under the circumstances, the value of the deal had to be estimated; the incentive plan thus used a market valuation formula for the estimate that was provided by the person making the deal. Eventually, the inflation in deal value spawned by the bonus program at ES was dropped (Fowler 2002). For stock option incentives, instead of the usual fixed waiting or vesting period, Enron added the option that if profits and stock prices rose enough, the vesting schedules would be rapidly increased, meaning the executives could get their hands on the stock more quickly (Barnes, Barnett and Schmidt 2002). One employee recalled recommending trying to win a lucrative energy management contract for a public school district, noting that it might take a year or more to bring the project to fruition. The manager rejected the idea because it would take too long; he needed projects that could be done in three months or less for bonus purposes (Fowler 2002).

Perks and rewards were lavish and flowed with champagne. Skilling handed out large pay cheques, bonuses and stock options to traders who successfully 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. John Pai cashed \$250 million in Enron stock over three years. As one observer put it, "the excess was obscene. We were just pissing money away" (Bryce 2002, 134).⁹ Six analysts were flown to

⁹ In spite of this deteriorating cash situation, stock options remained a mainstay of Enron's remuneration packages. For example, from January 1999 through July 2001, 18 senior executives and 9 board members cashed stock options in the amount of \$1.2 billion. In spite of Enron's chronic and serious debt situation and its inadequate cash flow stream, during Skilling's reign as CEO and president, Enron also paid out multi millions on office buildings in Houston and London.

Colorado for a skiing weekend after closing one deal (Barnes, Barnett and Schmidt 2002). Lay and Skilling's expansion of Enron's fleet of jets also took its toll on the company's cash position.¹⁰

Moreover, these executives manipulated quarterly earnings announcements. At the 2006 trial of Lay and Skilling, prosecutors charged them with making statements during 2000 intended to mislead Wall Street players about the true conditions of Enron's financial earnings and its financial position. Evidence emerged during the trial that Skilling had requested last minute changes to quarterly earnings per share (EPS) releases so that Enron's figures would "meet or beat" the analysts' consensus figure. According to testimony at the trial, Enron's investor relations executives including Koenig, under instructions from Richard Causey, Enron's chief accounting officer, carried out such orders. Paula Rieker, manager for investor relations, who helped write the "scripts" for such releases, testified that in January 2000, Enron officers were prepared to report quarterly EPS of 30 cents to match the analysts' consensus number (Barrionuevo 2006). Just before Enron's conference call to analysts, she said, the analysts' consensus had risen by one cent to 31 cents and Mark Koenig, executive Vice President for investor relations, informed her that Skilling and Causey had decided to change the numbers to meet the new consensus. Accordingly, Wesley and Colwell, chief accountant of Enron's wholesale energy trading unit, transferred 7 million dollars to a profit account from a reserve contingency account set up in a prior period as a reserve for possible future contract settlements. Consequently, Rieker "modified" the news release to report 31 cents.¹¹

The Subversion of Formal Management Control Systems Under Skilling

Thus, as enumerated, Enron featured many of the formal accoutrements of management control that have been identified in prior research including the elaborate performance review regime, bonus regime, Risk Assessment and Control group (RAC) as well as the conventional powers held by the Enron Board. Perhaps the centrepiece of the formal control regime was the company's emphatic Code of Conduct. Yet the reality of Enron's business

¹⁰ During Kinder's era, Enron's fleet was limited to five small economical jets with a cost of \$1,500 per flight hour. As soon as he left these were sold and replaced with expensive jets with a per flight hour cost of \$4,200. Moreover in 2001, Lay got board approval for a \$41.6 million new Gulf Stream V, allegedly for non-stop flights to Europe, Asia, and South America. The plane, however, was essentially reserved for Lay, his wife and other Enron board members for personal trips.

¹¹ Similarly, Investor Relations officer Paula Rieker testified that for the June 2000 quarterly release, Enron officers had planned to meet analysts' consensus figure of 32 cents, but at the last minute Skilling told him that "he wanted to beat earnings by 2 or 3 cents. Four days later, Enron reported 34 cents. Analysts were never told about the sudden change" (Barrionuevo 2006).

practices flew in the face of the Code. Moreover, Enron's board of directors waived compliance with the Code on a number of occasions to permit conflict of interest transactions with SPEs.

In practice, the PRC system worked to encourage "entourages" or "fiefdoms" (Dallas 2003) of loyal employees who gravitated towards powerful players for protection. The PRC was a powerful mechanism for preventing the emergence of subcultures running counter to the organizational tone set by Enron's hierarchy. Members of the Risk Management and Assessment Group who reviewed the terms and conditions of deals (and who were largely inexperienced recent MBA graduates) as well as internal auditors, were fearful of retaliation in the PRC from persons whose deals they were reviewing (Chaffin and Fidler 2002; Dallas 2003). At best, control was compliance-based, seldom encouraging employees to follow either the letter or the intent of laws (Dallas 2003).

This punitive environment brought the consequences of dissent sharply into focus. Enron's culture has been characterised as "ruthless and reckless ... lavish[ing] rewards on those who played the game, while persecuting those who raised objections" (Chaffin and Fidler 2002, 4-5). Led by Skilling's cavalier attitude to rules, top management conveyed the impression that all that mattered was for employees to book profits. In sum, this led to an erosion of employees' confidence in their own perceptions and, most crucially, to further compliance with the organization's leaders in a way that strengthened conformist behaviour. Former employees have noted how "loyalty required a sort of group think" (Chaffin and Fidler 2002, 2) and "that you had to 'keep drinking the Enron water'" (Stephens and Behr 2002, 2). A myth of smooth, flawless operations was perpetuated with problems "papered over" (McLean 2001, 58). The net effect of the rank-and-yank system was to decrease the likelihood that employees would raise objections to any illegal or unethical behaviour of powerful players. The competitiveness the PRC created was exacerbated by Enron's bonus regime. As one insider put it, "sure, the culture at Enron was treacherous, but that was the point" (Swartz and Watkins 2003, 56). Ultimately, the overestimation of profits and underestimation of costs was endemic to the organization.

DISCUSSION

When Kinder left in 1996, a very different corporate climate came to pervade Enron, one that effectively neutralized and subverted his extensive and well-designed diagnostic control and governance structures that were in place. In short, the transformation of Enron's corporate culture and shift in control style were at the heart of Enron's demise.

As Enron rapidly grew into market areas where it did not enjoy a comparative advantage (such as fibre optics and broadband markets), its mercenary corporate culture combined with subverted controls meant that Enron lost its ability to keep track of relevant risks, often taking large positions and encountering unforeseen risks. Skilling was able to bring together a constellation of structural factors that enabled the Enron expansion and re-branding: deregulation, the high-tech investment bubble, enhancements in technological capabilities and a hungry and increasingly expectant investment community. That is, although he was abetted by favourable developments in Enron's institutional environment, it was the agency of Skilling that was able to bring these elements together in a coherent package and craft a culture celebrating creative deal making, innovation and entrepreneurial and mercenary practices. The emerging cultural climate at Enron in turn had an effect on Skilling. A former executive officer observed:

Over the years, Jeff changed. He became more of a creature of his own creation. His hubris came to outweigh some of the more attractive parts of his personality. He became more intolerant, more opinionated, more bombastic. Jeff was always right, and that got worse. He had a little bit of a God syndrome (Stephen and Behr 2002, 4).

Table 2 summarizes the key differences in Enron's control systems, strategy and operating environment under Kinder and Skilling.

INSERT TABLE 2 HERE

To date, the role of culture in the operation of performance management systems has only been touched upon in research (Chenhall 2003). This has generally been at the level of national culture (see Harrison and McKinnon 1999 for a review) with very little work assessing the impact of organizational culture on the operation of performance management systems. Individuals are affected by a range of cultural differences beyond those of the nation in which they were brought up. Simons' notion of belief systems represents an important exception, emphasizing the role of an organization's published vision, mission statements, credos and statements of purpose (Simons 1990; 1995). Our approach, however, extends beyond this notion of formal belief systems. Rather than focus on physical artefacts and espoused values, we stress the role of basic assumptions and values in management control.

Numerous methods were used by Skilling to reshape organizational culture in a way that celebrated attempts to exploit and "bend the rules" in order to maximize reported financial returns. Table 3 identifies some of the primary and secondary ways through which Skilling and a dominant coalition within Enron was able to embed

elements of this culture. Table 3 features many of the mechanisms for cultural manipulation discussed by Schein: elimination of dissent (and therefore the promotion of a homogenous and insular group mentality), the accumulation of power at the centre, exaggerated claims about corporate missions, and the restriction of negative information (and embellishment of positive information) were all present at Enron under Skilling. An extreme performance-oriented culture that both institutionalized and tolerated deviant behaviour came into being. The enculturation process effectively acted to reduce the range of decisions available to Enron employees to alternatives assessed to be compatible with Enron's mission. The lauding of "creative risk-taking" and "revolution" led to legal and ethical boundaries being stretched, circumvented, and even broken. 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 result was social contagion¹² and the normalization of deviancy: the social pathologies promoted by Skilling and Lay became widespread and ultimately toxic in Enron.

INSERT TABLE 3 HERE

Underplaying the role of culture in management control systems results in under-specified models of corporate management. The Enron collapse suggests that control frameworks that focus primarily on formal systems such as Simons' levers of control model, fail to take account of the potentially critical role of shared meanings, accepted norms and rules that may in practice act to influence or even undermine formal systems in practice. The widespread attachment to shared, albeit unwritten, values certainly makes an organization more cohesive. The case expands on Simon's conceptualisation of belief systems, with its emphasis on espoused values and visual artefacts rather than basic assumptions.

While culture should not be seen as placing totalizing, unmediated constraints upon human subjects (Alvesson and Willmott 2002), in the absence of counter-discourses that interpret enculturation processes as intrusive or offensive, we can anticipate not only instrumental compliance but also increased identification with the cultural values. Accordingly, dominant management control system research should incorporate organizational culture as a powerful lever for guiding organizational behaviour, by informally approving (or prohibiting) patterns

¹² Demski (2003, 67) has also introduced the possibility of contagion or "herding" in the context of corporate malfeasance at Enron.

of behaviour. The Enron demise indicates that organizational culture provides shared patterns of cognitive interpretations or perceptions, so organization members know how they are expected to act and think. From a managerial viewpoint, cultural control presents a less obtrusive, and potentially more effective, means of organizational control than methods that rely upon external stimuli.

The prescriptive literature on cultural change must also be careful to avoid adopting an overly sanitized, normative perspective that classes 'strong' organizational cultures as 'good', by pacifying uncertainty and creating stability (e.g. Aaltio-Marjosola 1994). An organization's shared history and stability can contribute to the internalization and institutionalization of specific attitudes in individuals. Once employees over-align themselves with a company – and invest heavy commitment in organizational routines and the wisdom of leaders – they are liable to lose their original sense of identity, tolerate and rationalize ethical lapses that they would have previously deplored, find a new and possibly corrosive value system taking root, and leave themselves vulnerable to manipulation by organizational leaders to whom they have mistakenly entrusted many of their vital interests (Tourish and Vatcha 2005). The Enron demise points to numerous risks associated with strong 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 disabled the company's elaborate web of controls.

CONCLUSION

The motivation for this paper stemmed from the puzzle that while at the time of its demise Enron had in place all the trappings of an extensive, state-of-the-art set of management control and governance systems. Yet, these systems failed to keep the company on a sound trajectory. The paper, following Simon's urging to include culture in such research, adopted Schein's cultural framework for investigating this issue. Our investigation, relying on the vast archival database available regarding the Enron saga, indicated that these controls were systematically ignored, thwarted, and even corrupted by many of the company's managers and executives during the its final years. This led us to conclude that the core values, norms, and dispositions of the new culture that emerged during the Lay-Skilling era ran counter to the principles and tenets of sound management control. The paper thusly contributes to the literature by, first, introducing and using the Schein framework for management control and governance research

and, second, bringing into the light the neglected story and attendant lessons that the Enron debacle has for understanding of management control and governance systems.

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Table 1 Dominant Conceptualisations of Management Control Systems in the Accounting Literature

Dichotomous Conceptualisation	Source
Action vs Results Controls	Merchant 1998; Ouchi 1979
Formal vs Informal Controls	Whitley 1999; Merchant 1998; Modell 1995; Amigoni 1978
Tight vs Loose Controls	Whitley 1999; Merchant 1998; Amigoni 1978
Restricted vs Flexible Controls	Bisbe and Otley 1994
Impersonal vs Interpersonal Controls	Whitley 1999
Diagnostic vs Interactive Controls	Simons 1990, 1995; Bisbe and Otley 2004

Table 2 Differences between the Kinder Era and Skilling Era at Enron

	Kinder Era (1990-1996)	Skilling (1996-2000)
Strategy	<ul style="list-style-type: none"> ▪ Predominantly a physical pipeline and gas exploration business steadily expanding into the shiny new world of energy trading 	<ul style="list-style-type: none"> ▪ Expand Enron's energy trading expertise into a range of new commodities to sustain earnings growth. Skilling envisioned taking on markets ranging from paper goods to metals to broadband capacity.
Management Control Systems	<ul style="list-style-type: none"> ▪ Personal, interactive 	<ul style="list-style-type: none"> ▪ Impersonal, formal, diagnostic
Operational priority	<ul style="list-style-type: none"> ▪ Cash flow and meeting earnings targets 	<ul style="list-style-type: none"> ▪ Margin and volume
Operating Environment	<ul style="list-style-type: none"> ▪ Regulated 	<ul style="list-style-type: none"> ▪ Deregulated
Technology	<ul style="list-style-type: none"> ▪ Focused on Enron's asset-rich liquid-gas pipeline operations 	<ul style="list-style-type: none"> ▪ Focused on online trading of a range of commodities
Work force	<ul style="list-style-type: none"> ▪ Range of employees primarily focused in traditional gas energy trades and vocations 	<ul style="list-style-type: none"> ▪ Recruitment of hundreds of MBA students with limited practical experience from top programs throughout the United States
Accounting	<ul style="list-style-type: none"> ▪ Consistent with GAAP conventions for companies in the gas sector 	<ul style="list-style-type: none"> ▪ Mark-to-market valuation ▪ The complexity of Enron's business model made their balance sheet opaque to the markets. ▪ Off-balance sheet entities, self-created partnerships run by several members of Enron's own top management, most particularly by CFO Andy Fastow. ▪ Irregular treatment of derivatives

Table 3 Culture-Embedding Mechanisms at Enron under Skilling

Schein's Primary Culture-Embedding Mechanisms	Primary Embedding Mechanisms at Enron	Secondary Articulation and Reinforcement Mechanisms at Enron
1. What leaders pay attention to, measure, and control on a regular basis	<ul style="list-style-type: none"> ▪ Mercenary, profit-centred style of management reflected in strategic agendas, key performance metrics and corporate memos ▪ Almost exclusive focus on key metrics relating to stock price and earnings 	<ul style="list-style-type: none"> ▪ Tight organizational hierarchy and structure
2. How leaders react to critical incidents and organizational crises	<ul style="list-style-type: none"> ▪ Developing consensus and reaching goals by means of social removal of members who deviate from the culture ▪ Mercenary public remarks, casual comments and ridiculing ▪ Restricting negative information and maximizing positive information 	<ul style="list-style-type: none"> ▪ Organizational systems and procedures that restricted feedback
3. Criteria by which leaders allocated scarce resources	<ul style="list-style-type: none"> ▪ Performance appraisals and incentive system based almost exclusively on transaction volume and size ▪ Profligate spending and disregard for mounting debt 	<ul style="list-style-type: none"> ▪ Narcissism, highly visible consumption, braggadocio and excess ▪ Exaggerated claims for the Enron vision
4. Deliberate role modelling, teaching and coaching	<ul style="list-style-type: none"> ▪ Charismatic role modelling, teaching, and coaching predicated on a pragmatic, "doing" orientation to risk ▪ Dramaturgical events, such as annual conferences and academic forums, where Skilling self-promoted in an exaggerated, sometimes theatrical manner (e.g. dressing up as Darth Vader at a corporate retreat and fostered this moniker) 	<ul style="list-style-type: none"> ▪ Design of physical space, facades, air planes and buildings ▪ Skilling led an opulent lifestyle characterized by conspicuous consumption
5. Criteria by which leaders allocate rewards and status	<ul style="list-style-type: none"> ▪ PRC system which fostered strong competition between organizational members ▪ Nepotism and favouritism for successful dealers ▪ Distributive negotiation focus of the bonus regime 	<ul style="list-style-type: none"> ▪ Myths, stories, legends of outstanding (and well rewarded) performance
6. Criteria by which leaders recruit, select, promote, retire and excommunicate organizational members.	<ul style="list-style-type: none"> ▪ "Rank and yank" performance evaluations that quickly excommunicated members deemed not to fit in ▪ Intense recruitment rituals, designed to engage employees in a process of affiliation. ▪ Top down communication and very limited upward communication ▪ Cronyism and group think reflected in physical artefacts and cultivation of obscure jargon 	<ul style="list-style-type: none"> ▪ Formal statements of organizational philosophy, values, and creed