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Enron's Lessons for Managers

July 12, 2004



Like the *Challenger* space shuttle disaster was a learning experience for engineers, so too is the Enron crash for managers, says Harvard Business School professor Malcolm S. Salter. Yet what have we learned?

by Martha Lagace, Senior Editor, *HBS Working Knowledge*

Some events mark a generation. If a marker is a source of deep learning about ourselves, as Malcolm Salter believes it is, then the Enron crisis is exactly that for business people.

Political scientists have the Bay of Pigs; engineers have the *Challenger* disaster. And now managers have Enron, a tragedy and a point of departure for thinking more carefully about the institutions humans have created to organize our economic lives, according to Salter.

In a wide-ranging talk with Harvard Business School alumni on June 4, weeks before former Enron CEO Kenneth Lay was indicted by a federal grand jury, Salter discussed Enron's legacy: What happened, why, and what has been learned?

"I want to stress one point: Enron is all about us," said Salter.

"It's not just about some *dumbkops* in Houston. If it were just about some *dumbkops* in Houston, then it's [just] an odd duck or a five-legged cow; it doesn't really make sense. I think that Enron's pathologies are not unique, save in their collective occurrence and collective impact. Very few of us who engage in competitive endeavors have not in some way been subject to or affected by these social pathologies that became so widespread and so toxic in Enron."

Salter, a specialist in corporate strategy and corporate governance who is also writing a book on Enron, said he is trying to operate as a sort of forensic analyst. Forensic scientists usually fill out a simple form containing the subject's cause of death and time of death. His own task for Enron is complicated by the fact that the patient was constantly evolving long before it collapsed. Its business model, control system, and culture were in continuous motion, and by 1997 these factors were exacerbated by bad luck, incompetence, and the entrance of Jeffrey Skilling as COO.

Putting aside the matter of business models and controls, "The main story," he said, is a case of "ethical drift."

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reported funds flow were attributed to accounting violations, he added. Third, Enron's debt was underestimated by one half: \$10 billion reported versus \$22 billion actual debt. However, these

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factors, he continued, were "dwarfed" by bad strategy and management.

Incompetence before fraud

Salter said Enron's legacy of corporate reforms in the U.S. since its fall is deep and wide and not necessarily reassuring. Steps to curb Enron-like corporate abuses, such as the shift from a principles-based corporate governance system to one that is rules-based, may not address the core of the problem, he warned. In Great Britain, the accounting system is typically a principles-based system.

"Here, we've got a rules-based system where we get more and more rules in a larger and larger code with smarter and smarter people figuring out how you can push the outside of the envelope."

Other new rules, such as the documentation of internal controls as dictated by the Sarbanes-Oxley Act, are turning out to be extremely expensive to implement.

The new rules for the corporate governance system highlight three assumptions, he said:

1. The minimal standards of fiduciary responsibility are not sufficient anymore.
2. The internal control systems are broken.
3. The best response to the above is to strengthen externally imposed controls by improving the flow of information to capital markets, by shifting power to shareholders, and by setting limits on self-dealing.

But the new rules will not prevent Enron-style debacles, he continued.

"The big headline about Enron is that before fraud, there was terminal incompetence. As a matter of fact, if you look at a lot of the fraud cases, before fraud there was terminal incompetence. When we teach the governance and ethics course [at HBS], the point I make is that you can have great values, but if you don't have the competence [to implement them], forget it. You need both character and competence. If you don't have the competence, you're going to get yourself in real deep trouble."

"Enron is a case about how a team of executives, led by Ken Lay, created an extreme performance-oriented culture that both institutionalized and tolerated deviant behavior. It's a story about a group of executives who created a world that they could not understand and therefore could not control.

"It's a story about the delinquent society—and I use that phrase intentionally—that grew up around the company, and here I'm referring to the collusion of Enron's various advisors and financial intermediaries. And most importantly, Enron is a story about how fraud is often preceded by gross incompetence: where the primary source of that incompetence is inexperience, naiveté, an ends-justify-the-means attitude toward life, and so on. And most importantly, an inability to face reality when painful problems arise."




Malcolm S. Salter

Pride goes before a fall

Before fraud, he said, there was impressive innovation but it gave way to hubris and reckless gambling of assets. Its hubris was to attempt to commoditize electric power, water, and broadband, despite what Salter called critical points of difference from natural gas. (Electric power and water are politically sensitive at the local level, for instance, and are difficult to transport over long distances, among other differences, he said.) Deceit and denial fostered ethical drift. Enron's ethical drift was further motivated by a desire to manage the credit rating and to manage the need for cash and earnings volatility, in violation of GAPP and SEC rules. The result, according to Salter, was "emotional contagion and the normalization of deviancy."

Among the lessons he highlighted for other managers still shaken by the Enron debacle were the importance of humility and accurate self-assessment. The Enron executives were amateurs trying to play a professional sport, he said. They used "turbo incentives" but turbo incentives also require turbo controls. The innovation they sparked at the beginning was real, but it flew out of their hands. As amateurs, Salter said, "they unknowingly released forces and became subject to forces they could not understand."

"They confused success with excellence," he concluded. "It was a point of confusion here." 

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ABOUT FACULTY IN THIS ARTICLE:

[Malcolm S. Salter](#) is the James J. Hill Professor of Business Administration at Harvard Business School. He has been a member of the faculty since 1967. His teaching and research focuses on issues of corporate strategy, organization, and governance.

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