THE IMPACT OF THE ENRON ACCOUNTING SCANDAL ON IMPRESSIONS OF MANAGERIAL CONTROL

ERIC J. NEUMAN
Ross School of Business, University of Michigan
Ann Arbor MI 48103

INTRODUCTION

The story of Enron is well-known to most Americans as "perhaps more than any company, Enron [has become] a symbol of corporate excess and fraud" (*Wall Street Journal*, 2003). Allegations against Enron and the former independent auditing firm Arthur Anderson include creating off-the-books partnerships to hide debt and to increase executives' wealth, shredding documents, and obstructing justice. From August 2000 when Enron's stock traded for its all-time high until the stock was delisted in December 2001, investors lost $64.2 billion.

Two main concerns of the investing public to fall out from this scandal were (1) the appearance of managerial malfeasance, and (2) the claim from top executives that they were not aware of what had been happening. The first concern is clear from the allegations themselves. Executives were charged with generating accounting schemes to make Enron appear more profitable than it really was in order to reap personal rewards. This profit drove up stock price but also put Enron's shareholders, unbeknownst to them, under enormous risk. The second concern comes from the executives' own accounts. The very top executives in question claimed that the misdeeds were done without their knowledge because the entire business was too complex for them to be aware of every detail. In a 2004 interview Ken Lay stated, "I cannot take full responsibility for criminal conduct that I was not aware of" (France, 2004). Likewise, during congressional testimony in 2002 Jeffrey Skilling testified, "Enron Corporation was an enormous corporation. Could I have known everything going on everywhere in the company?" *(The Financial Collapse of Enron - Part 2,* 2002, p. 115).

Together, the concerns illustrate two of the biggest fears for shareholders: (1) that managers' interests are not aligned with those of the owners (Eisenhardt, 1989; Fama & Jensen, 1983; Jensen & Meckling, 1976) and (2) that managers are mere figureheads for their firms and lack real control (Pfeffer, 1981; Pfeffer & Salancik, 1978). If the investing public were assured that the problems illuminated by the scandal only applied to those firms directly involved, then they could rest easy. However, if investors had any reason to doubt the integrity of *any* firm, then the scandal only fans the flames of these fears and makes them quite salient. One can argue, then, that what moderates these fears is the level of trust that owners have that managers are in fact (1) acting in the interest of the owners and (2) able to exert control.

Yet the aftermath of the Enron scandal suggests that this trust has been compromised. The General Social Survey (Davis, Smith, & Marsden, 2002) asks its respondents to report how much confidence they have in the people running major companies. Recent results show that confidence decreased sharply following the Enron scandal. Responses of "A Great Deal" fell from an average of 25.6% in 1994-2000 to 17.3% in 2002; "Only Some" went from 58.4% to 62.7%; and "Hardly Any" rose from 11.7% to 17.9%. Faced with this sudden and intense public scrutiny and subsequent drop in investor confidence, top managers throughout the corporate world had to decide whether and how to react and bolster their image. One way that managers enhance images of their own effectiveness is through public justifications of firm performance.

THE STRATEGIC ASPECT OF ORGANIZATIONAL ACCOUNTS

The most common finding in studies using performance statements is that their attributions follow a self-serving pattern: managers attribute positive outcomes to themselves and negative outcomes to external factors such as nature or competition (Bettman & Weitz, 1983; Salancik & Meindl, 1984; Staw, McKechnie, & Puffer, 1983). Such a pattern allows managers to portray themselves in the most positive light to their constituents. Yet there are instances in which managers may wish to deviate from the typical self-serving pattern. Salancik and Meindl (1984) demonstrated one interesting way in which managers strategically shift their pattern of attribution in order to foster an illusion of control. They found that compared to stable firms, management of unstable firms were three times as likely to break from the self-serving bias and *accept* blame for negative outcomes. Accepting blame served as a very strong—although risky—signal to owners that the managers' decisions and behaviors are consequential.

Immediately following the Enron scandal, I predict that firms will have shifted the way in which they account for firm performance by tailoring their message to these changed perceptions. The scandal serves as an exogenous shock for a natural experiment that that allows me to compare causal attributions of performance offered by managers immediately after the scandal to similar causal attributions of performance given before the scandal. To determine which particular firms will be affected by the Enron scandal and how their attributions will change, I draw on three core perspectives of organizations that are particularly relevant to these problems: resource dependence theory, agency theory, and social distance.

HYPOTHESES

Resource Dependence Theory

Using Pfeffer and Salancik's (1978) notion of dependence (p. 51), managers are quite dependent on shareholders because managerial compensation is frequently tied to stock price and investors have a great deal of discretion over where they invest their capital. If shareholders were concerned with whether managers had sufficient control over their firms, how might this concern affect how managers account for firm performance? Although managers are limited by their dependencies, they can try to address the concern themselves by increasing their *perceived* amount of control (Pfeffer, 1981). Following Salancik and Meindl's (1984) argument, managers can construct an illusion of control by not only taking credit for success but by accepting blame for negative outcomes. This not only addresses investors' worries that managers lack control but also addresses the dependency the firm has on the shareholders by boosting their perceived power. To the extent that one would expect the Enron scandal to be on the minds of most top management teams, one might expect to find the effect regardless of firm characteristics.

Hypothesis 1a. *Following the Enron scandal, managers will take more credit for positive outcomes than they did immediately prior to the Enron scandal.*

Hypothesis 1b. *Following the Enron scandal, managers will accept more blame for negative outcomes than they did immediately prior to the Enron scandal.*

Yet beyond this main effect for change, resource dependence theory predicts that certain firms will be more likely than other firms to exhibit this change. For instance, institutional investors such as mutual funds, pension funds, and bank trusts control a sizeable portion of publicly-traded U.S. corporations. If it were true that investors perceived management lacking control over the operations of their corporations, then during the height of the coverage on the Enron scandal, management of firms that are owned by groups with a high concentration of shares will have had a greater need to assert their control.

Hypothesis 2a. *Following the Enron scandal, the more shares owned by the five largest institutional investors, the more likely managers are to take credit for positive outcomes.*

Hypothesis 2b. *Following the Enron scandal, the more shares owned by the five largest institutional investors, the more likely managers are to accept blame for negative outcomes.*

Agency Theory

Contrary to the resource dependence perspective, an agency theory perspective suggests that if owners are concerned that managers' interests are not in congruence with their own and that managers will act in ways that will prevent profit maximization and potentially threaten the company's existence, then owners must believe that such managers have a *great deal* of control over the firm. According to this point of view, the pattern of accepting blame found by Salancik and Meindl (1984) and predicted to increase by resource dependence theory will not occur. In order to show the appropriateness of their conduct, managers will (a) emphasize their role in positive outcomes, and (b) minimize their role in negative outcomes. To the extent that one would expect the Enron scandal to be on the minds of most top management teams, one might expect to find this effect regardless of firm characteristics.

Hypothesis 3a. *Following the Enron scandal, firms will take more credit for positive outcomes than they did immediately prior to the Enron scandal.*

Hypothesis 3b. *Following the Enron scandal, firms will accept less blame for negative outcomes than they did immediately prior to the Enron scandal.*

Yet much like resource dependence theory predicts interactions in addition to main effects, agency theory also predicts that certain firms will be more likely than other firms to exhibit this change. Managers of firms with weaker mechanisms for controlling managerial misalignment will have more of a need to demonstrate that they are acting properly. In particular, this trend should be observable for firms whose managers own fewer shares in the firm or whose board is composed of many firm insiders.

Hypothesis 4a. *Following the Enron scandal, the smaller the percentage of the firm owned by management, the more likely they are to take credit for positive outcomes.*

Hypothesis 4b. *Following the Enron scandal, the smaller the percentage of the firm owned by management, the more likely they are to deflect blame for negative outcomes.*

Hypothesis 5a. *Following the Enron scandal, the smaller the percentage of outside directors a firm has on its board, the more likely managers are to take credit for positive outcomes.*

Hypothesis 5b. *Following the Enron scandal, the smaller the percentage of outside directors a firm has on its board, the more likely managers are to deflect blame for negative outcomes.*

Social Distance

For scandals such as the one involving Enron and Arthur Andersen, any relationship that a firm has to one of the alleged parties to the scandal may give it reason to adjust its own behavior. I use the term "social distance" to describe the strength of such relationships that a firm has with those involved in the scandal. In general, the shorter this social distance, the more a firm's constituents will perceive their own firm to be linked to Enron and the more likely the firm will be to react to this by changing how they attribute their own performance. Thus, this concept of social distance serves as an intensifier for previous hypotheses.

I operationalize a firm's social distance to Enron three different ways. First, boards of directors are seen as governance mechanisms which are supposed to monitor and prevent managerial malfeasance such as that discovered at Enron. The scandal may have caused shareholders of other firms to wonder whether their own board had been vigilant in its watch, and this should be more salient for firms closer to Enron via interlocking directorates.

Hypothesis 6a. *Following the Enron scandal, the shorter the directorate path between a firm and Enron, the more likely the firm's managers are to take credit for positive outcomes.*

Hypothesis 6b. *Following the Enron scandal, the shorter the directorate path between a firm and Enron, the more likely the firm's managers are to deviate from their previous attribution pattern for negative outcomes.*

Second, the scandal may have been more salient and influential to managers of firms located near Enron. Not only was it likely that news coverage of the events was greatest near the site of Enron's headquarters in Houston, Texas, but social circles are tight among the managerial elite (Mills, 1956; Mizruchi, 1996). Even if managers of other firms headquartered near Enron had no business relationship with managers from Enron, they likely knew (or at least knew of) their counterparts at Enron, which could have led them to react.

Hypothesis 7a. *Following the Enron scandal, the closer a firm's headquarters are to Houston, the more likely the firm's managers are to take credit for positive outcomes.*

Hypothesis 7b. *Following the Enron scandal, the closer a firm's headquarters are to Houston, the more likely the firm's managers are to deviate from their previous attribution pattern for negative outcomes.*

Third, the actions of Arthur Andersen in the scandal likely affected its other clients. Members of the Andersen team at Enron were accused of not following U.S. GAAP rules, of shredding documents, and of obstructing justice, and they did not fulfill their fundamental role of independence as they allowed Enron executives to employ "creative" accounting practices such as off-the-books partnerships. Following the scandal, shareholders of other firms who employed Arthur Andersen may have wondered if unreported misdeeds and interdependent auditing were happening at their firm, too, which would have forced the firms' managers to react.

Hypothesis 8a. *Following the Enron scandal, firms who employed Arthur Andersen as independent auditor will be more likely to take credit for positive outcomes.*

Hypothesis 8b. *Following the Enron scandal, firms who employed Arthur Andersen as independent auditor will be more likely to deviate from previous attribution patterns of negative outcomes.*

METHOD

Data and Sample

To test my hypotheses, I compared the attributions given by firms in their press releases of quarterly earnings statements (QES) issued during the first full quarter immediately following the break of the Enron scandal (1/1/2002-3/31/2002) to attributions given by the same firms in their press releases of QES during the same quarter in 2001. My population was the S&P 500 as of November 1, 2001, a time when the Enron story was beginning to break. I am in the process of analyzing all available firms but will report results here on the first 35 firms that I have analyzed to completion. The sample did not differ from the remaining firms in the sampling frame on any of the independent or control variables in the statistical models.

I extracted causal attributions (i.e., statements with an outcome and its cause) from each press release. Two coders rated each outcome on a 6-point favorability scale (1="completely negative", 6="completely positive") and each cause on a 6-point local of causality scale (1="completely internal" to 6="completely external"). On both scales, the coders were highly reliable (Cronbach's $\alpha > 0.9$). I averaged ratings across coders and dropped 5 attributions (< 1%) for which the coders disagreed on the outcome's favorability, leaving 583 total attributions.

Measures

Following my hypotheses, I labeled outcomes as either positive or negative according to the midpoint of the favorability scale and analyzed them separately. I further divided statements by year (2001 or 2002), thus creating four mutually exclusive groups. I computed each firm's average locus of causality score for each of the four groups to create four dependent variables. My interest in the *change* in attribution patterns after the Enron scandal (i.e., 2001 vs. 2002) yields two additional dependent variables: the difference in average locus of causality for positive statements and for negative statements.

Independent variables correspond to my set of hypotheses. Percentage of firm's shares owned by the top five institutional investors (H2), percentage of firm's shares owned by management (H4), and whether the firm used Arthur Andersen as its independent auditor (H8) are from the Compact Disclosure database. Percentage of outside directors on a firm's board (H5) and geodesic (i.e., shortest path) via directorate interlocks from a firm to Enron (H6) were graciously provided by Jerry Davis. The geographic distance between each firm and Enron (H7) comes from mapping each firm's zip code (extracted from Compact Disclosure) into latitude and longitude, which I then used to compute the spherical distance between each firm and Enron.

Attribution patterns depend heavily upon whether a firm has good or bad news to report. I control for this by including dummy variables for whether the firm reported quarterly earnings per share that met analysts' expectations. Both actual earnings per share and estimated earnings per share (in the form of analysts' consensus earnings estimate) come from the IBES database.

Analysis

Because the managerial attributions from year to year may not be completely independent, I verified that this was not an issue before deciding to model the data with ordinary least squares. I examined positive and negative statements separately, and for each type of statement I analyzed three models: 2001 statements, 2002 statements, and the difference between them. Support ranged from strong (nonsignificant coefficient in 2001, significant coefficient in 2002 and difference models) to moderate (nonsignificant coefficient in 2001 and 2002 and significant coefficient in the difference model) to weak (nonsignificant coefficient in the 2001 and difference models and significant coefficient in 2002).

RESULTS

Overall, firms took credit for positive outcomes but with no difference between 2001 and 2002, indicating no support for H1a and H3a. Negative outcomes also exhibited the self-serving pattern. In 2001, firms tended to assign blame for negative outcomes, although not significantly different from the causality scale midpoint. However, in 2002 firms more strongly deflected blame for negative outcomes. This result was marginally different from the previous year, which indicates no support for H1b and moderate support for H3b.

For positive statements, several hypotheses received support. As predicted by H2a, firms with a higher percentage of their shares owned by their top five institutional investors were more likely to take credit for positive outcomes post-Enron. Although the variable is not a significant predictor for the 2002 statements, its sign changed from 2001 and is a strong predictor in the difference models. H4a received moderate support. Firms with a higher percentage of shares owned by their managers were more likely to take credit for positive outcomes in 2002, although the difference was not significant compared to 2001. The coefficient for percentage of outsiders on a board was negligible in 2002 but was a marginal predictor of taking credit in 2001, thus yielding coefficients in the opposite direction as predicted in H5a. For social distance, the geodesic via directorate interlocks and geographical distance to Enron headquarters are negligible, yielding no support for H6a and H7a. However, the models show strong support for H8a. Whether firms used Arthur Andersen as their independent auditor is not a predictor of causality in 2001, but is a strong predictor of causality in 2002, and this difference is significant.

For negative statements, few variables were significant in any of the models and Hypotheses 2b, 4b, 5b, 6b, 7b, and 8b were not supported.

CONCLUSION

Despite being preliminary analysis, evidence suggests that managers changed their public posturing following the Enron scandal as firms more strongly deflected blame and certain firms took more credit for success in 2002 as compared to 2001. The strongest predictor of change was whether a firm had employed Arthur Andersen. Such firms took more credit and accepted more blame in 2002 compared to 2001, consistent with Salancik and Meindl's "illusion of control" argument (1984). This reaction suggests that these managers responded to the court of public opinion regarding Andersen's role in the scandal as the image of Andersen employees shredding documents around the clock has become the prototype of fiscal malfeasance.

Also, implicit in this study is its focus on social mechanisms. Resource dependence theory and agency theory yielded plausible explanations for the same phenomenon (i.e., that certain managers would take more credit for positive outcomes following the Enron scandal than they did in the previous year), and the question became which set of mechanisms served as a better explanation. What this study did—and what future studies must continue to do—is focus on the boundary conditions between the two theories. In this era of the corporate perp walk, agency theory's concern about self-interested behavior must be taken seriously. Two problems with agency theory, however, are that it considers self-interested behavior to be a constant rather than a variable (Perrow, 1986) and that it ignores the environment in which the self-interested behavior takes place and has influence. I have attempted to broaden the concerns of agency theory by addressing not only the managers themselves but also those who react to possible self-interested actions: the investing public. By doing so, the Enron scandal serves as an instance of when and to whom the threat of self-interested behavior matters. Future efforts would benefit from a similar, more inclusive approach to understanding organizational behavior.

REFERENCES AVAILABLE FROM THE AUTHOR