The failure of corporate governance at Enron

Investors in both the US and Australia have lost billions of dollars as a result of recent corporate collapses. **BRENDAN O'CONNELL** and **LAURIE WEBB** show how a failure of corporate ethics and governance led to Enron's demise.

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The recent collapse of Enron is one of the greatest financial scandals in modern US history. Investors have lost billions of dollars amid allegations of insider trading, document shredding by auditors, conflicts of interest by Wall Street stock analysts, and financial statement fraud.

The repercussions of this event will be felt in US courts for many years, and there is little doubt that changes will be made to accounting standards, regulation of the accounting and securities professions, and pension requirements as a consequence. For example, US Congress recently passed the Sarbanes-Oxley Act which provides major changes to regulation of the accounting profession and corporate disclosures (see box story).

Yet just 12 months ago this Houston-based energy company ranked as the seventh largest in the US in terms of revenue, and appeared to be very profitable. Under the leadership of its charismatic and politically well-connected chief executive, Kenneth Lay, Enron had evolved over 15 years from a traditional gas pipeline company into the world's largest energy trader.

Accounting failures

The source of much of the accounting irregularities that precipitated significant earnings write-downs by Enron was its so-called special purpose entities (SPEs) and how these structures were treated for accounting purposes[2].

While many companies, including Australian ones, legitimately use SPEs for purposes such as securitisation of mortgages and other receivables, in Enron's case it appears that the company used some of these SPEs to hide debt and to manage earnings to meet stock analysts' quarterly earnings expectations.

Many of the SPEs were treated as off-balance sheet for US GAAP purposes, and domiciled in countries characterised by low disclosure requirements and minimal tax obligations.

Enron has now disclosed that these SPEs contained several billion US dollars of debt. These SPEs appear to have been carefully structured to avoid consolidation and minimise disclosures.

Recent testimony to US Congress by former Enron CEO, Jeff Skilling, indicates that key SPEs were operated by Enron's chief financial officer, Andrew Fastow. As noted by the Powers Report (2002, p.4), "many of the most significant transactions apparently were designed to accomplish favourable financial statement results, not to achieve bona fide economic objectives or to transfer risk" and "that these partnerships were used to enter into transactions that it could not, or would not, do with unrelated commercial entities."

Moreover, it would seem that some transactions were implemented to offset losses. The LJM Partnerships are a prime example of how these SPEs were utilised to achieve favourable accounting outcomes for Enron.

Example of Enron SPE and related transactions

During 1999, Enron entered into business relationships with two partnerships in which Fastow was both a manager and an investor. Fastow persuaded Enron's Board that LJM would enable Enron to achieve outcomes that it could not accomplish through alternative structures[3].

For example, with LJM2, he argued that this SPE would offer Enron a supplementary prospective purchaser of assets that Enron wished to sell, and that Fastow's knowledge of the firm and the various assets for sale would allow Enron to move opportunistically and incur lower transaction costs (Powers Report, 2002, p.10). Enron undertook at least 20 separate transactions with the LJM partnerships between June 1999 and 2001.

Dealings between Enron and these two partnerships "resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense" (Powers Report, 2002, p.9).

There were two primary types of transactions involving LJM1 and 2: asset sales and "hedging" transactions (Powers Report, 2002, p.11). In regard to the former, Enron sold assets to LJM that it sought to eliminate from its balance sheet.

In many cases, these transactions occurred adjacent to balance date. There appear to be significant questions as to whether any transfer of risks and rewards associated with these asset sales actually occurred. For example, at the end of the third and fourth quarters of 1999, Enron sold seven assets to these partnerships. These dealings allowed Enron to achieve off-balance sheet treatment and to book a profit in some cases.

However, transactions that took place following these sales appear to cast some doubt on their validity. Specifically, Enron repurchased five of the seven assets sold to the two partnerships shortly after balance date (Powers Report, 2002, p.12). Moreover, Fastow represented to Enron's Finance Committee that these transactions produced profits to Enron of $229 million in the second half of 1999[4].

The Power's Report (p.12) alleges that, in three of these dealings where Enron ultimately repurchased LJM's interest, Enron had contracted beforehand to shield these partnerships against any potential losses. These guarantees by Enron call into question the accounting treatment of these transactions as bona fide sales and suggest that the LJM partnerships operated as a mechanism to assist Enron in earnings management around balance date.

In using these partnerships as "hedges", Enron swapped its own shares to LJM1 in return for a promissory note (Powers Report, 2002, p.13). Through the use of options, LJM1 ostensibly took on the risk that the price of shares in an Enron investment, Rhythms NetConnections Inc., would fall.

The principle was to hedge Enron's investment in Rhythms by enabling Enron to offset any losses on Rhythms if that company's share price declined through counteracting payments emanating from the LJM options. Moreover, if LJM1 were obligated to reimburse Enron as a consequence of obligations arising from the Rhythms options, the transferred Enron shares would comprise the major payment source (Powers Report, 2002, p.13).

It would now appear that these transactions were simply designed to enable Enron to achieve hedging gains for accounting purposes that offset losses in the value of their investments. The reality of these hedge transactions was that Enron did not avoid the risk of loss, because it had provided much of the capital with which LJM1 would reimburse Enron.

Accounting for SPEs

To appreciate Enron's accounting issues, it is useful to see how SPEs are treated under US GAAP. There does not appear to be an accepted definition of SPEs to differentiate them from other legal entities. The US Financial Accounting Standards Board (FASB) has utilised the notion of entities whose activities and powers are significantly restricted by their charter (Powers Report, 2002, p.37-8).

An SPE may adopt any legal form such as a trust, corporation or partnership. In many cases, it might be contentious whether an entity satisfies the definition of an SPE. Important considerations include the intended length of operation of the entity and any limitations placed on its activities (Powers Report, 2002, p.38).

There is a presumption in favour of consolidation of an SPE that can be overcome if two tests are met. First, an independent party should make a considerable investment in the SPE, and that outlay must entail significant risks/rewards of ownership throughout the term of the transaction.

The SEC historically has adopted the position that 3% of total capital is the minimum to satisfy this external ownership stake test (Powers Report, 2002, p.39)[5]. Investments are not deemed to be at risk if the "parent" company provides any form of credit comfort to the SPE investors.

The second condition to preclude consolidation is that the external investor must effectively control the SPE. This is a subjective test as control is not merely a function of majority ownership or influence over the routine operations of the SPE, but instead hinges on the comparative rights of investors.

The literature on partnership control rights is often utilised as guidance for this evaluation. For example, in the case of Enron, it is debatable whether Fastow effectively controlled the LJM partnerships.

He was the general partner of both partnerships, and had management authority over them. However, both partnership agreements limited the general partner's investment authority, and required approval of certain investment decisions by the limited partners. Furthermore, the LJM2 partnership agreement provided for removal of the general partner, without cause, by the advice of an advisory committee and agreement of the limited partners (Powers Report, 2002, p.76).

Disclosures of partnerships

Many commentators have described Enron's disclosures relating to the SPEs as inadequate and difficult to understand. For example, their proxy statement disclosures did not communicate the nature or extent of Fastow's financial interests in the LJM partnerships.

It would appear that key personnel deliberately structured the SPEs in such a way as to minimise disclosures. For example, the Powers Report (2002, p.8) indicates that both Enron's in-house counsel and its longstanding outside counsel, Vinson & Elkins, advised Fastow that his participation in Chewco would require both disclosure in Enron's proxy statement and approval from the Chairman and CEO under Enron's Code of Conduct of Business Affairs.

Contrary to this advice, Kopper, an Enron employee who reported to Fastow, was substituted as the proposed manager of Chewco[6].

Auditors and their clients

The Enron case highlights the close relationships between many audit firms today and their clients. In the year prior to its bankruptcy, Enron paid a total of US$52 million in fees to its auditor, Arthur Andersen (Enron SEC Filings, 2001). Of these fees, some $25 million related directly to the audit, with the balance related to tax advice and general consulting.

Large non-audit service fees are not unusual in the US. For example, Disney paid PricewaterhouseCoopers $8.6 million for the audit and $32 million for other services in the year 2001. The figures paid to KPMG by Motorola Inc. for the same period were $3.9 million and $62.3 million respectively.

Similar business arrangements between auditors and their client are also common in Australia although they do not exhibit the same magnitude or the extremes of the US examples.

A selection of three large listed Australian companies indicates the differences. BHP Billington in 2001 had audit expenses of $A6.1 million and other services of $A5.7. Southcorp revealed audit fees of A$1.6 and other services of A$1.8 in their 2001 accounts whereas the large retailer, Coles Myer for the same period showed audit fees, $2.6m, and other services, A$6.7m.

Notwithstanding these lower Australian figures, it is clear that the performance of non-audit services is a lucrative activity for accountants in both countries, and these large payments create a public perception that the independence of a firm's auditors is impaired by these additional revenue sources.

Former SEC Chairman, Arthur Levitt, unsuccessfully sought to severely restrict non-audit services in the US in 2001. While some reforms were passed into law, such as disclosure of these payments in firms' proxy statements (a practice that has occurred in Australia for many years), the accounting profession lobbied US Congress successfully to avoid a total ban on most of this lucrative consulting area[7].

However, as a consequence of the recent public outrage at the Enron collapse, the Sarbanes-Oxley Act has now prohibited auditors from providing many types of consulting services to their audit client (see box story).

Unlike the US, which was deeply wounded by the Enron affair, in Australia there appears to be no "shoot from the hip" responses to the Enron or HIH failures. The principal contribution to the reform process in Australia has come from the Ramsay Report on the Independence of Australian Company Auditors that predated the Enron disclosures (October 2001).

The recommendation of the report in respect to provision of non-audit services by audit firms to their clients is:

(a) revised and updated professional ethical rules;
(b) mandatory disclosure of non-audit services and the fees paid for these services;
(c) Strengthening the role of audit committees; and
(d) establishing an Auditor Independence Supervisory Board which would have among its functions, the task of monitoring the adequacy of disclosure on non-audit services. The Ramsay Report proposes that the regulation of non-audit services be dealt with under professional ethical rules, updated to reflect IFAC proposals.

Links between the auditors and key personnel of the client, the so-called "revolving door", have also been highlighted in the wake of Enron. A number of prominent accounting and finance executives at Enron were former employees of its auditor, Arthur Andersen.

The Public Oversight Board (POB) and others argue that these linkages provide potential opportunities for unscrupulous executives to exploit both their personal relationships with auditors and intimate knowledge of the audit methods.

This issue was also raised in recent high-profile financial statement fraud cases such as HIH and Cendant. In 1996, the SEC recommended a one-year time ban on former audit partners joining their clients. This law was not passed on the grounds that it unfairly restricts employment opportunities.

The Sarbanes-Oxley Act has now barred any accounting firm from providing a public audit for a company whose senior financial executives previously worked for that accounting firm in the previous two years.

Accounting profession oversight

The Enron scandal also calls into question the level of oversight of the accounting profession itself. In the US, a body called the POB is responsible for overseeing quality control and peer reviews of accounting firms.

Just a few months ago, Arthur Andersen successfully passed a peer review by its Big 5 rival, Deloitte and Touche (Abelson and Glater, 2002). The POB has been criticised in the past as being under-funded and incapable of adequately overseeing audit quality.

The new Chairman of the SEC, Harvey Pitt, has announced that he intends to create a new body of outside experts, supported by strict regulatory guidelines, to replace the Public Oversight Board (Abelson and Glater, 2002).

In Australia, there is presently no equivalent to the POB. The accounting profession has rules and ethical requirements that must be adhered to for the member to enter and retain membership of the profession. However, there is no existing requirement for a mechanism which ensures compliance with standards of audit independence.

Audit committees

The collapse of Enron also highlights the lack of effectiveness and independence of some audit committees. Under New York Stock Exchange rules, audit committees must comprise directors who possess financial literacy.

While the audit committee of Enron included a retired Stanford University accounting professor and an economist, market analysts have questioned whether these individuals possessed the

SUMMARY OF SARBANES-OXLEY ACT

US President George Bush acted quickly to allay market concerns following recent corporate collapses. The result was the passing of the Sarbanes-Oxley Act of 2002 by Congress. The following is a summary with particular attention to the provisions most likely to be of interest to issuers, management and directors.

1 Disclosures. The Act requires new or more expeditious disclosures and directs the SEC to issue rules requiring other disclosures.

- Quarterly CEO/CFO certification of periodic reports.
- Quarterly CEO/CFO certification and report on internal controls.
- Annual management reports on internal controls.
- Financial statements must reflect auditors' material adjustments.
- Quarterly disclosure of off-balance sheet transactions.
- Other quarterly disclosures regarding finance-related procedures: senior finance code of ethics, Audit Committee financial expert, non-audit services provided by auditors.
- Disclosure of changes to or waivers of the senior financial officer ethics code.
- Section 16(a) stock transaction reports within two business days, with next-business-day Internet posting by issuer and SEC.
- Regular SEC review of disclosures.
- Rules coming for "real time disclosures" and pro forma financials.

2 Audit Committees. The Act establishes new rules for the composition and duties of Audit Committees. Audit Committees also will be affected by regulations applicable to auditors, and some of the disclosure rules noted above.

- Independence (under a new definition of the term).
- Inclusion of a "financial expert" as a member.
- Auditor appointment and oversight.
- Restrictions on non-audit services.
- Financial statements must reflect auditors' adjustments, with auditors protected from improper influence.
- Reports by CEO and CFO to Audit Committee of significant control deficiencies and any management fraud.
- Timely reports to the Audit Committee by auditors of critical accounting policies and discussions with management.
- Complaint/whistleblower procedures.
- Legal and other advisers.

3 Other corporate governance provisions. The Act also establishes new rules affecting other areas of corporate governance. In particular, several provisions affect officer and director compensation and stock trading.

- CEO and CFO disgorgement of bonuses and stock profits upon a restatement.
- No loans to directors or executive officers.
- No trading during individual account plan blackout periods.
- Disclosure duties for attorneys.
- New crimes and enhanced penalties. The Act establishes new crimes and increases the maximum penalties for certain existing crimes.
- False certification of periodic reports.
- Securities fraud.
- Destruction of corporate audit records.
- Destruction or alteration of records to impede a federal investigation or bankruptcy case.
- Tampering with records or otherwise impeding an official proceeding.
- Retaliation against informants.
- Penalty enhancements.

4 Provisions affecting securities or other civil litigation and SEC administrative enforcement. The Act contains a few provisions that will or may affect private securities litigation. It also creates two new private civil actions, and expands the SEC's remedies in administrative and civil actions.

- Statute of limitation for private securities fraud actions lengthened.
- Individual debts from securities judgments, orders, or settlements non-dischargeable in bankruptcy
- Administrative complaint and civil lawsuit for informants.
- Shareholder action for disgorgement of profits for trading during blackout periods.
- SEC temporary freeze order against "extraordinary payments".
- Lower standard for SEC officer and director bar.

5 Federal regulation of auditing firms. A new entity called the Public Company Accounting Oversight Board will regulate and oversee auditing firms.

- Registration.
- Auditing and professional standards.
- Inspection.
- Investigation, discipline, and sanctions.
- GAAP largely unaffected.

7 Analyst conflicts of interest. The Act requires the SEC or SROs to adopt rules addressing conflicts of interest involving securities analysts.

detailed knowledge and expertise of sophisticated derivatives and financing activities to discharge their duties effectively (Lavelle, 2002).

Questions must also be raised about the true independence of this committee. Wendy Gramm, wife of Texas republican senator Phil Gramm, chaired Enron's audit committee. Her husband received US$80,000 in political campaign funding from Enron and associated employees in the period since 1993.

Moreover, Enron and the Charitable Foundation of its CEO, Ken Lay, donated US$50,000 to a research centre at George Mason University headed by Wendy Gramm (Lavelle, 2002). Another audit committee member, John Wakeman, was the beneficiary of a US$6,000 per month consultancy contract with Enron. Moreover, his cancer research centre at the University of Texas had received $332,150 in funding from Enron-related parties since 1999.

Under existing SEC rules, there is no ban on financial arrangements between the company and its board members, and only the consulting fees of Wakeman from the above l ist would need to be disclosed in proxy statements.

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Corporate ethics

Perhaps one of the most amazing and damning revelations of this scandal is that Enron's board overrode clauses of the company's Code of Conduct of Business Affairs as they related to conflicts of interests to approve the creation of several partnerships between the firm and senior executives (Kunen, 2002).

For example, the Board of Enron approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. According to Congressional testimony by Skilling and others, the Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were conducted on terms fair to Enron.

It would appear that much of this oversight was not followed through by those delegated this task.

Lawyers and investment analysts' conflicts of interests

Much of the media attention pertaining to Enron has centred on the role of their auditors and certain senior executives. There has been little analysis of the role of Enron's lawyers, Vinson and Elkins.

It is clear that Enron's management and Board relied heavily on the advice of Vinson and Elkins in structuring their SPEs and associated transactions.

The firm also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings (Powers Report, 2002). However, there is no evidence whatever at this point to suggest that Vinson and Elkins in any way aided Enron in potentially illegal activities such as financial statement fraud.

Recently, four prominent Wall Street analysts testified that 10 out of 15 prominent stock analysts who monitor Enron listed the firm as a "strong buy" as late as November 8, 2001 (US Senate Governmental Affairs Committee, 2002)[8].

These analysts also confirmed that their firms[9] had been the recipient of significant earnings from Enron for providing a range of services including underwriting Enron securities issues and investing in the Enron's LJM partnerships.

They testified that their company rules dictated a "Chinese Wall" be built between analysts and investment banking activities. However, they also indicated that they would occasionally go "over the wall" to be informed about Enron-related business acquisitions or dealings, and that their bonuses were tied to overall firm profitability.

Notwithstanding these comments, these analysts stressed that their investor recommendations were solely based on their own objective analysis of publicly available data at the time. Like many other financial statement users, analysts appear to have been deceived by the opaque accounting practices and limited disclosures of Enron.

Accounting rules on SPEs

Accounting standards pertaining to off balance sheet structures are also likely to change in coming months. For example, SEC Chairman, Harvey Pitt, has announced that greater disclosures of related party disclosures will be required and far greater external party ownership in SPEs will be required for off balance sheet treatment to remain.

Firms will need to meet a test of "sufficient independent economic substance" for SPEs to avoid consolidation. Some industry experts have asserted that it will be very difficult for existing SPEs to be restructured to avoid consolidation under the new rules (KPMG, 2002, p.6).

Conclusion

The Enron failure has been a savage indictment of the corporate governance practices of some US executives and boards of directors. It has revealed a singular lack of observance of fundamental ethical behaviour on the part of those parties involved.

In an editorial on the Enron failure, The Economist (February 9,

2002) warned that "… if corporate America cannot deliver better governance, as well as better audits, it will only have itself to blame when the public backlash proves both fierce and unpleasant".

An even more damaging outcome for both corporations and investors alike is the likely imposition of further regulatory measures that could well satisfy legislators but not immeasurably improve the standards of corporate governance.

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NOTES

1 Much of this paper was prepared while this author was employed at the E. Claiborne Robins School of Business, University of Richmond, Virginia.

2 At the time of writing, there is little objective evidence concerning the motives of Enron management in establishing the SPEs. Accordingly, this section is largely based on testimony at recent US Congressional Hearings into Enron and material contained in the Powers Report (2002), an in-depth report prepared by Enron's Board of Directors subsequent to the company's failure.

3 Based on testimony provided by Skilling, McMahon and Watkins at the Senate Commerce Hearing into Enron (Tuesday, February 26, 2002).

4 Enron's overall reported profits for the same period were $549 million.

5 At the time of writing, the SEC has foreshadowed that the 3% minimum will be increased to 10% in the wake of Enron.

6 Unlike Fastow, Kopper was not a senior officer of Enron, so his role in Chewco would not require proxy statement disclosure (but would require approval under Enron's Code of Conduct).

7 According to the Centre for Responsive Politics, the US accounting profession contributed $53 million to congressional and presidential candidates between 1990 and 2000 with $14 million of that in 2000 alone (the year that the SEC began to openly question non-audit service fees). The big five CPA firms were all among the top 20 corporate donors to George W. Bush's presidential campaign with Ernst and Young and Andersen, his fourth and fifth biggest donors with $179,949 and $145,650 respectively (Labaton, 2002).

8 On October 16, Enron had been forced to restate its third-quarter earnings to reflect a loss of US$638 million. A further earnings restatement, relating to the previous 4 years, followed on November 8. The company filed for bankruptcy protection on December 2.

9 The firms represented at this hearing were J. P. Morgan Securities Inc., Lehman Brothers Inc., Credit Suisse First Boston and Citigroup Salomon Smith Barney.