

# The corporate governance lessons of Enron

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**Abstract** The failure of the Enron Corporation in late 2001, apart from signalling the largest corporate bankruptcy in the USA, has also thrown up a myriad of questions about the effectiveness of contemporary accounting, auditing and corporate governance practices. There are strong historical antecedents for distrust of the corporation, latterly represented in extreme form by the anti-capitalists. The causes of the Enron failure and the immediate response in the USA are outlined. This is followed by the response in the UK among the accountancy bodies, and the results of a comprehensive survey to assess the impact of Enron. This then leads to a comprehensive series of lessons to be learnt in the form of recommendations under the headings of serving the public interest, accounting and financial reporting, auditing, corporate governance, and education.

Corporations cannot commit treason, nor be outlawed, nor excommunicate, for they have no souls (Sir Edward Coke (1552-1634) Case of Sutton's Hospital, 1612).

We have much to fear from great corporated, moneyed institutions. We are today more in danger from organised money than ever we were from slavery (Henry Ward Beecher (1813-1887) *Proverbs from Plymouth Pulpit*, 1887).

Corporation, noun. An ingenious device for obtaining individual profit without individual responsibility (Ambrose Bierce (1842-1914) *The Devil's Dictionary*, 1911).

There is the veil of corporate personality which protects the individual from any personal liability at all. That is the fundamental principle of our company law (Lord Denning, House of Lords, 15 January 1985).

## Introduction

These quotations from across the centuries all witness to the perils inherent in the body corporate after and before the landmark event of the South Sea Bubble. The theme of corporations lacking soul and conscience is

constant over time, and could easily be accorded book length treatment. History would certainly indicate that Enron will not be the final example of its kind. From the more modest smaller building societies scandals in the UK (Vinten and Greening, 2001) and examinations in England and Wales under the Charity Acts (Vinten, 1997), one moves to global giants such as BCCI (Vinten, 1991, 1992), Maxwell (Vinten, 1992, 1993), Barings, and Marconi. Long-term capital management (LTCM), although small in terms of the élite who founded it, the 100 investors and under 200 employees, nevertheless created a trillion dollar hole in the international banking system (Lowenstein, 2001). Even religious organisations are not exempt with the largest ever US consumer mail fraud being perpetrated in the late 1980s by a radio evangelist. Jim Bakker cheated 150,000 members of his "flock" out of \$158 million (Tidwell, 1993). Lessons are supposedly learnt from each example, often following expensive official enquiries, and they then become part of the archival history of corporate disaster and failure. Indeed this monotonous and repetitive litany seems to have become an industry in itself. The anti-capitalists will certainly find this latest sad episode further grist to their mill.

The intense media interest in Enron suddenly erupted and has continued unabated since. Matters in which their normal interest is minimal, such as accounting standards and procedures, and the role of auditors, became the talk of the



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town. The outcome has been scrutiny of the accounting and auditing profession, and a severe dent in the public's confidence in the capital markets. The total picture is still not fully assembled, with a myriad of investigations ongoing through several agencies. In the USA there has been far from full co-operation from some of the implicated parties, and several have invoked the Fifth Amendment. Even the 212 page Powers Report of February 1, 2002, had limited scope, and only gained a partial view. This was a Special Investigative Committee of the board of directors of Enron. Here is a summary of the facts that are emerging, the investigations that are in train, and the steps being taken in the USA to develop solutions that can help restore the public's faith in the financial reporting system.

### **The current situation in the USA**

On December 2, less than a month after it admitted accounting errors that inflated earnings by almost \$600 million since 1994, the Houston-based energy trading company, Enron Corporation, filed for bankruptcy protection. With \$62.8 billion in assets, it became the largest bankruptcy case in US history, dwarfing Texaco's filing in 1987 when it had \$35.9 billion in assets. The day Enron filed for bankruptcy its stock closed at 72 cents, down from more than \$75 less than a year earlier. Many employees lost their life savings and tens of thousands of investors lost billions.

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According to the Powers' Report, many of the most significant transactions were designed to achieve favourable financial statement results rather than achieve *bona fide* economic objectives or facilitate the transfer of risk. Other transactions were implemented improperly to offset losses. They permitted Enron to conceal from the market huge losses resulting from merchant investments by creating the illusion that they were hedged – that is, that a third party was contractually obliged to pay the amount of any losses. In the result, the third party turned out to be simply an entity in which only Enron had a substantial economic stake. Various investment partnerships had been created and managed by Andrew S. Fastow, Enron's former executive vice president and chief financial officer, and by other Enron employees who worked with Fastow. In connection with LJM2 Co-Investment, L.P. (“LJM2”), created by Fastow, Enron had

announced on October 16, 2001 a \$544 million after tax charge against earnings. There was additionally reduction of shareholders' equity of \$1.2 billion.

Less than a month later came the gigantic revisions to financial statements from 1997 to 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. (“LJM1”) and an additional related party entity, Chewco Investments, L.P. Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow. It was also now revealed for the first time that Fastow received more than \$30 million from LJM1 and LJM2. The Powers Committee subsequently discovered Kopper has received at least \$30 million, two others \$1 million each, and two others \$000,000s. In almost all the transactions there was extensive advice and participation from Andersen. This is particularly apparent from the separate billing, in addition to the normal audit fee of up to \$58 million, of \$5.7 million for advice concerning the LJM and Chewco transaction. David Duncan, the Andersen partner responsible for Enron, was described as a “client pleaser” by the Andersen lawyer at the federal trial in May 2002. Andersen's Professional Standards Group had been raising various substantive issues about the accounting treatment, but obviously not effectively, and the client view tended to prevail after a skirmish with the issues. Symptomatic was Enron's successful lobbying to have Carl Bass removed from the audit. He was unhappy with many aspects of Enron, and was a member of the Professional Standards Group (*Wall Street Journal*, 2002). Ironically the then CEO, Jeff Skilling, had given an interview in February 2001 in which he had stated:

Our business is not a black box. It's very simple to model. People who raise questions are people who have not gone through it in detail. We have explicit answers, but people want to throw rocks at us (McLean, 2001).

At least half a dozen Congressional Committees, the Securities and Exchange Commission (SEC), the US Justice Department, and an investigative panel appointed by Andersen LLP are trying to assess responsibility. Several parties may have contributed – Enron top management and audit committee, their outside law firm, the auditors at Arthur Andersen, investment advisors, and the environment which encouraged the company's highly questionable practices. The challenge for investigators is to sort out the criminal activity (such as the shredding of subpoenaed documents at both Enron and Andersen, possible insider trading, and knowingly falsifying financial documents), from the flaws in the system that allowed Enron to hide debt and losses.

The US General Accounting Office has also played an invaluable role, and has issued a series of timely and insightful reports. One of the most bizarre episodes has been the unprecedented need to litigate the vice president, Dick Cheney, in his capacity as chair of the National Energy Policy Development Group. Only limited information was sought,

but the vice president has seen fit to challenge the GAO's fundamental statutory authority to assist the Congress in connection with its constitutional, legislative and oversight authorities. The NEPG was financed with appropriated funds and staffed mainly by the government department and agency staff allocated to it. It is plain that the upshot of the vice president's stand is that in the future any administration desiring to avoid scrutiny would simply assign such activities to the vice president or a body under the White House's immediate control. It would seem that the whole American Revolution was fought in vain, and the tea at Boston needlessly dumped into the ocean, rather than the eager cups of the Bostonian middle classes.

As a direct result of the Enron collapse, major changes are in store in the regulatory environment. Among the steps that have already been taken are:

- The Securities and Exchange Commission (SEC) has announced plans to create new organisations outside the structure of the American Institute of Certified Public Accountant (AICPA) to oversee auditors of publicly held companies. A disciplinary board would be created to accelerate the investigation of alleged audit failures and provide more transparency, and the current program of firm-on-firm triennial peer reviews for auditors of publicly traded companies would be replaced by an annual quality monitoring process for the largest firms, administered by a new organisation. This new body would have expanded authority to monitor compliance with SEC practice standards and to refer instances of non-compliance to the disciplinary board. Both new entities would have a majority of public members and operate outside the profession's existing self-regulatory structure.
- In response to these proposals by the chairman of the SEC, the members of the Public Oversight Board (POB) announced their intention to terminate the Board's existence no later than March 31, 2002. Currently, the POB oversees the peer review, quality control inquiry, and other activities of the SECPS and the standard setting efforts of the Auditing Standards Board.
- Reversing a longstanding position, the AICPA announced it will not oppose limits on providing certain non-audit services to public company audit clients.
- The AICPA and the 1,200 firms that are members of the AICPA's SEC Practice Section are implementing improved audit standards for detecting fraud, as well as new measures for deterring fraud such as expanded internal control procedures for management, boards, and audit committees.
- The AICPA has participated in interviews with every top national newspaper and dozens of local ones, and has appeared on almost every national cable, broadcast and radio business program. It has provided State Societies and individual AICPA members with

assistance to help them address the ramifications of the Enron collapse with their clients, employers and colleagues. The AICPA has also announced its support for more extensive changes in its self-regulatory structure.

- The AICPA strongly believes that additional reforms need to be enacted to deter accounting abuses and avoid an Enron-type disaster in the future. These include providing a new and improved financial reporting model suitable for companies of the Information Age for which earning assets are not accurately valued by traditional measures.

The AICPA and state Certified Public Accountant societies are working hard on both the national and local levels, with members of Congress, the SEC, and other parties, to fulfil the profession's commitment to the public interest, and regain the public confidence in the nation's CPAs

### **The situation in the UK**

The UK has been the home to a fulsome series of corporate governance reports, which have been replicated throughout the globe (Vinten, 2001a). The Treasury Committee launched an inquiry into the financial regulation of public limited companies in early 2002. The formal terms of reference were:

To examine, in the light of the Enron collapse, the arrangements for financial regulation of public limited companies in the United Kingdom.

Commenting on the Committee's decision, Mr John McFall, MP, chairman of the Treasury Committee said:

The impact of the collapse of Enron in the United States has been felt in many other places, including the United Kingdom. As an American company, Enron is subject to regulation by the relevant United States authorities. Accounting and auditing practice there differs from that in the United Kingdom. Nonetheless, some of the concerns that have been raised, such as how best to ensure the independence and objectivity of auditors, clearly have a resonance in this jurisdiction. The question has also been asked – could a large and unpredicted corporate failure happen in the United Kingdom? At the recent World Economic Forum, Sir Howard Davies, chairman of the Financial Services Authority, said that the honest answer to this question is "yes". We have therefore decided to examine the arrangements for financial regulation of public limited companies, with a view to making recommendations as to how the regulatory regime might be strengthened, thus reducing the risks.

There is the benefit of a number of the submissions having been published on various Web sites. These all set out their wares as if it is the prelude to some kind of shortlist or competitive tendering! The Institute of Chartered Accountants of England and Wales presents a comprehensive but succinct report examining :

- financial reporting and the development and enforcement of accounting standards;
- corporate governance, audit committees, non-executive directors, and internal control and the management of risk, including the role of internal audit;
- audit, its value, inspection and sanctions.

The Association of Chartered Certified Accountants (ACCA) argues for:

- a global set of principles-based financial reporting standards and a global code of corporate governance;
- solutions based on principles agreed and co-ordinated at global level;
- the objectives of financial reporting practice to be expanded to recognise the growing level of concern arising from the globalisation of business;
- the participants in capital markets – both major corporations and institutional investors – should resource an externally administered levy which confers no influence at the regulatory level;
- auditor independence should be revisited towards more transparency;
- regimes for monitoring practice in auditing, financial reporting and corporate governance should be reviewed.

The Chartered Institute of Public Finance and Accountancy has a significant number of members operating in or involved with public limited companies. In commending the UK public sector audit model worthy of further consideration, it reports under the four headings of:

- (1) Auditor independence – most public sector bodies do not appoint their own auditor.
- (2) Audit quality and regulation – “low balling” is avoided, and there are stringent quality reviews, generally incorporating independence rather than peer review.
- (3) Provision of non-audit services – permission is required, but it is more likely that experience gained from the audit of one public sector organisation will benefit another, rather than being within the one organisation.
- (4) Stakeholder reporting – with the wider scope, greater disclosures are made.

### **The UK accounting Web survey**

This can justly claim to be one of the first meaningful inquiries into the views of auditors, and the profession as a whole, since the collapse of Enron. It reported in May 2002. UK auditors admit that Enron could happen here. UK accountants believe that another Enron is inevitable, and that the British system of professional regulation is not equipped to prevent a similar business disaster in this country. The accountancy profession itself has suffered visible damage as a result of the US scandal and will feel the impact in the years ahead: a third of all accountancy students believe Enron has irreparably damaged the public perception of the profession. As a result, many predict that promising graduates will now turn away from accountancy as a career.

The study, based on 294 responses, found that the profession was split over post-Enron measures: respondents in business favour a total ban on accountancy firms providing audit and non-audit services; auditors would prefer to see the introduction of criminal penalties for business

executives who mislead auditors. There are, however, two areas of consensus. First, on the auditor-client relationship, 63 per cent of business respondents, 62 per cent of student and part-qualified accountants and 54 per cent of accountancy practitioners think that the Enron scandal proves auditors are too involved in their clients. The second area of agreement concerns the Big Five global accounting firms, which until recently counted Andersen as a member, that dominate the audit market. The second most effective preventive measure, supported by 37 per cent of all respondents, was a “clampdown on the Big Five cartel”.

### **Key findings**

#### **Why did Enron fail and could it happen again?**

Half of respondents think another Enron is inevitable and that the UK is not immune. One in four auditors believes Enron was a business failure; only 8 per cent of accountants in business agrees. UK accountants, both in business and practice, think auditors are too close to their clients.

**“UK accountants, both in business and practice, think auditors are too close to their clients”**

#### **How can Enron-style business collapses be prevented?**

Criminal penalties for executives who mislead auditors is seen as the most effective deterrent, but support split along territorial lines: 88 per cent of auditors want it; 34 per cent of business respondents disagree. Of business respondents, 36 per cent want to ban firms from providing non-audit services to audit clients; 26 per cent of auditors disagree. A total of 35 per cent of auditors strongly support audit firm rotation. There was widespread support for separation of internal and external audit functions. A significant minority was sceptical about accountancy's self-regulation structure: 25 per cent felt the Accountancy Foundation could not prevent another Enron; a similar proportion felt an externally funded body would be a better solution.

#### **Lasting damage to accountancy's reputation**

A total of 92 per cent of accountancy students expressed discontent with the status quo. One in three accountancy students believes Enron has irreparably damaged the public perception of the profession; one in seven accountancy trainees predicts promising graduates will now turn away from accountancy as a career. A quarter of the respondents identified themselves as auditors. Just over a third of them strongly support audit firm rotation even though many leading professional bodies maintain that this restriction could damage the effectiveness of audit. A complete ban on firms providing audit and non-audit services to the same



client was seen as the most effective safeguard of audit independence, gaining 38 per cent support from business respondents and 27 per cent of accountants in practice. Rank and file accountants hold more radical views than their professional representatives and many are willing to make personal sacrifices in order to protect the long-term integrity of their professional qualifications. The survey provides strong evidence that accountants doubt whether the profession's own reform proposals will prevent another Enron.

### **The lessons - recommendations**

The attempt here is to formulate a comprehensive set of issues that spring out of the Enron affair as it is currently understood, rather than to enunciate everything that might be said in a guide to good boardroom practice.

#### **Serving the public interest**

- State National Audit Offices across the world should follow the US example of investigating matters of public interest, and issuing reports. This means moving beyond the narrow focus of the public sector. Such extension has occurred already in the explicit rather than implicit involvement in value-for-money studies in many jurisdictions. With the move of former state industries into the private sector, state audit has sometimes been retained. Thus the UK Competition Commission continues to "audit" the former nationalised industries to ensure they are operating in the public interest.
- Legislation should specify clear and strict rights of access to relevant agencies for such information as they reasonably deem necessary, to avoid the need for them to initiate legal action on a case-by-case basis. The model of the UK Audit Commission should be adopted whereby it can act in an independent but quasi-judicial fashion to decide any challenges to such powers. This will avoid delaying tactics, and minimise cost.
- Criminal penalties, large fines and strict liability will apply to all those implicated in the shredding or concealment of documentation.
- Jurisdictions, the vast majority, which have not legislated to protect valid acts of whistleblowing should do so forthwith (Vinten, 1994).
- A more inclusive stakeholder model (Vinten, 2001b) should be adopted, rather than the current minimalist model.
- The UK model of the chartered secretary should be extended world-wide where not currently present.
- The law pertaining to fraud needs to be consolidated and rationalised (Vinten, 1990).
- Pensions and employee savings plans require more participant education and safeguards. This is particularly the case where employees are locked into schemes in which material amounts are invested in the employing company or a limited range. Enron had 41 per cent of its

direct contribution scheme invested in its own stock (compare Proctor and Gamble 92 per cent, Anheuser-Busch 83 per cent, Abbott Laboratories 82 per cent, Pfizer 82 per cent, McDonald's 74 per cent).

- Regulation needs to be disconnected from the accounting and auditing profession.

#### **Accounting and financial reporting**

- Principles-based "substance over form" should become the norm. However the proper role for a rules-based approach needs to be debated and determined.
- The USA as a major player needs to move more in line with the rest of the world, with an expedited convergence taking place.
- Three levels of rigour of reporting need to be established as opposed to the present two: large, high risk and/or materiality entities; intermediate companies; small businesses.
- With the complexities involved, as in derivatives and special purpose entities, the near incomprehensibility of accounts to many of the stakeholders, and accountancy itself trying to keep up with the realities of e-commerce and the knowledge environment, steps need to be taken to ensure adequate communication to users. Issues which impact on risk and value need to be made explicit.
- Our more inclusive reporting model presupposes more qualitative data, including that on which board and company performance can be judged.

#### **Auditing**

- "True and fair" or "fairly present" should mean not just conformity with accounting principles, but convey adequately the overall situation.
- Auditors should adopt a stakeholder orientation in addition to the current shareholder one.
- All the ramifications of audit independence need to be assessed and reported on, as does the detail of how the external audit has been carried out and the conclusions drawn. The onus should be on the auditor to indicate how she/he has upheld independence in terms of the threats to it commonly encountered. A threats and risks based model should be adopted.
- The rotation issue needs to be addressed in a balanced fashion, with half-way solutions, such as partial rotation of staff, explored. Joint auditing may also be considered (in Canada large banks require two auditing firms).
- The role of internal auditing should be highlighted, possibly made mandatory at law, and its own independence guaranteed, with protected external reporting in the public interest for matters of concern.

#### **Corporate governance**

- Board members should be properly inducted, trained and developed.
- The pros and cons of different types of corporate governance need to be explored and best practice

disseminated. Thus the UK system has a balanced mixture of types of director, whereas in the US system the "independents" predominate. The UK "independents" may therefore be closer to the action.

- There needs to be more company sponsored practical research on governance, rather than the black box it often is at present.
- National research agendas need to be formulated, with central collection and dissemination of results.
- Although the Turnbull Report report emphasised risk, one needs to put risk in perspective. It is not simply a "policing" matter, but equally weighing up the risk of missing opportunities. Risk is endemic in business and presents opportunity as well as the possibility of sub-optimal performance or even disaster.
- Business ethics is a crucial ingredient, and consideration should be given to appointing a chief ethics officer, an ombudsman, or the Registrar function as in the John Lewis partnership.
- Equally crucial is what has been known as the "tone at the top". A board subcommittee should consider this, or the audit committee with widened remit take this issue on board.
- Institutional investors and organised shareholder/ stakeholder groups should be permitted a voice in the boardroom.
- A diversity of non-executive directors, outside the "old boys" network, and with true independence should be recruited.

#### Education

- Schools should include corporate governance as part of their citizenship education.
- Higher education should teach elements of business ethics and corporate governance as part of all courses.
- Business courses should place more emphasis upon risk and fraud, rather than pretending that fraud never takes place.

#### Conclusion

The issues raised are multi-faceted, and the public and business interest will only be protected if solutions and

amelioration strategies are similarly multi-dimensional. There are unlikely to be simple solutions, but the present fragmentation of approaches needs to be avoided. Globalisation implies that there need to be global principles (rather than standards) covering corporate governance (the 1999 OECD ones providing a model), accounting, auditing and independence. It is to be hoped that the measures adopted may minimise the risk of anything as large as Enron happening in the future, and that due confidence in the capital markets will return. ■

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