

Corporate Governance In a Post-Enron Environment

Presentation by
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1) How and Why did Enron Happen?

- Twenty years of U.S. restructuring/reorganization limited the viability of cost-based strategies.
- Need to “compete” with, and seek same inflated valuations, as high-flying Internet & tech companies.
- Low interest rates throughout late 1990’s helped to perpetuate an already overheating economy.
- Insufficient income/revenue growth created need for ever more aggressive accounting/business practices.
- Board and Wall Street asleep at the wheel.

- Enron traded energy, at first. It was good at trading energy. It created an online (energy) market... Trading energy was a fine business idea, possibly even a groundbreaking one. It was not, as Enron had us believing for a while, the be-all and end-all of corporate creativity.
- The people at Enron were smart, but not as smart as they thought they were. They tried to trade it all: energy, "weather derivatives," broadband access, water, news.... (and they) failed. They lost, according to Newsweek's estimates, \$2 billion on broadband, \$2 billion on water, \$2 billion on a Brazilian utility and \$1 billion on an electricity plant in India.
- To hide their debt, Enron engaged in "aggressive accounting." They created partnerships with nominally independent companies. Those companies were headed by Enron execs, and backed, ultimately, by Enron stock. But Enron did not count their "partners'" debt as its own, using "off-balance-sheet" accounting. Enron also found ways to count loans from banks as "profit."

Who Was Responsible (beyond mgt.)?

- **Andersen signed off on Enron's books and helped structure its deals.**
 - They accepted consultancy fees, while acting as an "external auditor". Most of the so-called Big Five accounting firm have similar conflicts.
- **Enron's board received detailed briefings as early as four years ago about the partnerships whose losses triggered company's bankruptcy.**
 - Minutes, covering 4 board meetings and 3 meetings of the board's finance committee, suggest board members approved aggressive accounting actions, including moving debt off company books.
- **Enron's law firm, Vinson & Elkins, investigated alleged irregularities.**
 - They asked few real questions, failed to talk to key witnesses and blessed Enron's controversial partnerships. V&E issued their report one day before Enron restated its financials because of those partnerships...

Was There a Conspiracy to Commit Fraud?

- While certainly extreme and clearly over the line, it appears unlikely the Enron cover-up began as a widespread conspiracy to commit fraud.
- Rather it seems mostly a case of a business strategy not delivering expected results (quickly enough) and a short term solution getting totally out of hand.
- A widening circle of basically good people appear to have gotten swept up in the pressure to behave in a manner mandated by the “frenzy of greed” that characterized U.S. business practices at the time.

Was Enron Unique?

- Paul Krugman notes “(U.S.) corporate profits grew rapidly between 1992 and 1997, but then stalled; after-tax profits in the third quarter of 2000 were barely higher than they were three years earlier.”
- However, “the operating profits of the S&P 500-- ... (large) companies reporting to investors -- *grew 46%* -- over those three years”.
- Paul Krugman believes the main reason was that “... after 1997 companies made increasingly aggressive use of accounting gimmicks to create the illusion of profit growth.”
- “Corporate leaders were desperate to keep their stock prices rising, ... anything short of 20% profit growth was considered a failure.”
- “Why were they desperate? In a word: *options*.”

Source: Paul Krugman, New York Times, Pg. A21, May 21, 2002

2) What are the Repercussions?

- Desire to Assign Blame for What Transpired
- Decreasing Investor Confidence
- Retreat to Simplicity & Easy-to-Understand Models
- Increased Call for Corporate Transparency
- Review of Bank/Analyst Audit/Consult Relationships
- Return to Fiscal Conservatism and Practices
- Call for Increased Regulation and Scrutiny
- Political Fallout and Maneuvering on all Levels

Investment Losses Increase Uncertainty and a Desire to Place Blame

- The carnival has ended and the mess must be cleaned up.
- Michael Lewis, author of Liar's Poker, recently commented: “We have arrived at the beginning of the end of a process that seems to be psychologically necessary after every stock market bust. Huge sums of money can't simply have been lost by greedy little investors. Someone must have taken them.”
- Consequently, there is a witch-hunt for anything that smacks of the excesses of the 1990s – bloated CEO bonuses, large debt build-ups by companies, and bad corporate practices.
- It is a time for finger pointing and apportioning the blame.

Retreat from the “Options Revolution” that Dramatically Changed Face of U.S. Business

- *"There are cases where you can use equity to impact your income statement -- the most egregious, or the one that's used by every corporation in the world is executive stock options ... what you do is you issue stock options to reduce compensation expense and ... increase your profitability."*
Senate Testimony by Jeffrey Skilling, Enron CEO
- The granting of stock options had been seen as an almost “magic” tool to align management interests with shareholders without causing undue strain on corporate balance sheets.
- Other nations such as Japan moved to liberalize regulations so they could also promote use of options as a compensation tool.
- Today, however, there is a realization that options can distort management behavior and financial statements.

Regulators Call for Changes in Accounting and Auditing Standards

- In an SEC Public Statement on Accounting, Chairman Harvey L. Pitt stated:
 - *Today, disclosures are made not to inform, but to avoid liability.*
 - *Financial disclosures are dense, impenetrable. We have called for plain English financial statements.*
 - *Corporate governance.. and role of Audit Comm. are.. in need of review.*
 - *We need more prompt action by the FASB, the nation's accounting standard setter.*
 - *There is a need for reform of the regulation of our accounting profession. We cannot afford a system ... that facilitates failure rather than success.*
 - *Accounting firms have important public responsibilities...The Commission cannot, and... will not, tolerate this pattern of growing restatements, audit failures, corporate failures and investor losses. Somehow, we must put a stop to a vicious cycle that has been in evidence for far too many years.*

Bush Administration Outlines Reform Plan

- President Bush outlines plan to hold executives more accountable through independent audit system and better access to financial information.
- CEO's required to attest to the accuracy of financial disclosures.
 - To punish accounting abuse, top executives would be forced to forfeit bonuses and other compensation. In extreme cases, they could be barred from serving as officers or directors for other public corporations.
- Accounting firms would be subject to unprecedented oversight.
- The president would require top executives to disclose when they buy or sell company stock within two days. Currently, executives can wait a year or more without disclosing personal transactions.
- But Bush balks at a proposal by Paul O'Neill to prohibit executives from using insurance coverage to pay legal costs arising from misconduct.
- Plan stops short of blocking auditors from consulting work for audit clients.
- White House officials said most of Bush's proposals could be carried out by the SEC within its existing authority.

Lieberman Counters Emphasizing Public & Private Responsibility -- Stronger on Principles than Details

- Public Sector:
 - **SETTING A BETTER EXAMPLE:** The Federal Government has to set its own better example of integrity transparency.
 - **CRACKING DOWN ON EXECUTIVE MISCONDUCT:** Develop better tools to fight corporate misconduct.
 - **ADDRESSING ENDEMIC CONFLICTS OF INTEREST:** Take concrete steps to root out other finance industry conflicts of interest.
 - **SAFEGUARDING WORKERS' RETIREMENT:** Employees and retirees need new protections.
 - **ENHANCING PUBLIC TRUST:** Create Task Force of Advisors— to guide/monitor government's post-Enron rules for corporations.
 - **SPREADING INFORMATION:** Facilitate the rapid and reliable spread of accurate information.

- Private Sector:
 - **INFORM INVESTORS AND EMPLOYEES:** Clear and clean information is the oxygen investors breathe. It cannot be compromised.
 - **MAKE ETHICS A FRONT BURNER PRIORITY:** Adopt voluntary codes of ethical conduct and produce annual social responsibility reports.
 - **BROADEN STAKEHOLDER INCENTIVES:** Create cultures with clear chains of command and shared responsibility for important decisions.
 - **EXERCISE INDIVIDUAL JUDGMENT:** Ultimately, ... human conscience ... must guide our actions.
 - **BUILD MARKETS FOR ETHICS:** Broaden ... understanding of cost and benefit to take into account not only short-term shareholder values, but longer term societal values.
- *Each of us is a private ethical actor, with real moral capital to expend. We should take that responsibility seriously by building markets that reward good corporate ethics and create clear penalties for those who do the wrong thing. If we exercise our market power ... we'll communicate to businesses that ... cut corners and exploit loopholes that unfairly pocketing an extra penny in the short run will result in dime and dollar losses in the long run.*

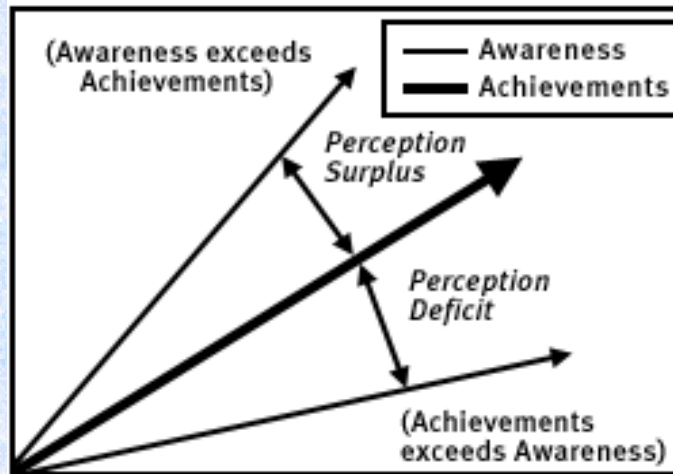
The Call for More Consumer, Shareholder and Stakeholder Activism is Certain to Result in More Litigation, Tension and Scrutiny

- Institutional Shareholder Services (ISS) highlights trend toward more “Good Government at Gunpoint”
- Notes opposition to board-backed deals and actions
 - HP/Compaq, ATT/Comcast, Loews’ Tobacco Tracker, Pharmacoepia/Eos Merger Pulled
- Stanley Works move to locate out of U.S. also gaining attention
- Proxy battles, shareholder referendums, annual meeting actions and investor and stakeholder scrutiny on rise.
- In 2001, 171 cases settled for \$2.7 billion, with 511 new suits.*

* Source: ISS 2002 Proxy Season Preview

Requiring Corporations to Pay More Attention to Investor/Public Relations to Advance their Interests ...

Efficient Communications Matrix



Achievements vs. Awareness

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KWR's Efficient Communications Approach



... Understanding that Perceptions Often Equal or Lead Reality

3) How Has Enron Effected Corporate Governance Practices?

- Need for Disclosure has Increased Dramatically
- Investment Banks Reevaluate Basic Business Model
- Accountants Need to Walk a Much Finer Line
- Boards Under More Pressure than Ever Before
 - Audit Function in Particular Under Intense Scrutiny
- Changes in Options and Compensation Treatment
- Active Regulators and Law Enforcement
- Many Proposed Changes Under Discussion

“Investors tell companies creative accounting will no longer fly”

(Business Week Mar 4, 2002)

- El Paso: Took off balance-sheet partnerships and put them on balance sheet to improve transparency
- IBM: Expanding information on intellectual-property income and impact on of company's pension plan
- Tyco: Weekly conference calls on accounting issues
- Worldcom & Quest: More disclosure and Q&A
- GE: Providing detail on how company's individual units--including GE Capital--churn out their earnings

Investors Insist on More Transparency:

Basic assumption of trust has been violated

- Cisco: Under pressure to disclose more about adjustments to sales due to customer discounts
- Nortel: Investors want it to release its cash-flow statement with quarterly earnings
- Amazon: Shareholders are pressing management to disclose things like monthly figures for the change in sales in major categories, like books and electronics

The N.Y. Attorney General Brings Suit Against Merrill Lynch and other Investment Banks

- Merrill Lynch e-mail demonstrated that analysts promoted technology companies they did not believe in while earning investment banking fees.
- At least four more Wall Street investment banks were subpoenaed to produce documents in a state investigation of allegations that stock analysts promoted companies so their firms could collect banking fees.
- Stock analysts continued to recommend Enron and many other firms until they went bust or showed dramatic declines.

Merrill Settlement Avoids the Worst, but Will Still Effect Investment Banking Practices

- Under the settlement* announced on May 21st, Merrill Lynch & Co. will:
- Pay a \$100 million penalty, \$48 million of which will go to New York state. The balance will go to other states that sign on to the agreement.
- End compensation for analysts through investment banking revenue. Analysts will be rewarded solely on the quality of their stock research.
- Prohibit analysts from being evaluated for bonuses and compensation by investment bankers.
- Create an investment review committee to approve research recommendations with independence from banking.
- Divulge in research any company from which ML receives revenue.
- Appoint a monitor, approved by Spitzer, to assure compliance.
- Goldman appoints Gerald Corrigan as research ombudsman.

* SOURCE: New York Attorney General's Office

Both Government and Private Sector Move to Change Treatment of Options

- Levin-McCain Bill would require stock option tax deductions to be reflected as an expense on a company's income statement.
 - Intense resistance by technology industry and other interests. *“Options legislation would bring on a tech industry depression”* Headline from S.J. Mercury News, 3/25/02
- SEC Comm. Harvey Pitt calls for shareholder approval of option plans after disclosures that Enron executives sold \$1.2 billion of shares before its bankruptcy.
- Greenspan & O’Neill have both express concern over options.
- Standard & Poor's (S&P) announces plan to treat stock options as expense against earnings. This is expected to lower estimated earnings for S&P 500 companies by an average of 10 per cent this year.
- The NYSE announced it may require its companies to get approval from shareholders for executive options award plans.

Audit Function Increasingly Critical

- Warren Buffett told an SEC forum this month that external auditors "are not going to volunteer the shady stuff," unless they are forced to do so.
- James F. Reda, of the National Association of Corporate Directors, notes "... you're not going to open Pandora's box, because ... that takes time."
- Outside directors now spend an average of 150 hours a year on preparation, travel and meetings, according to Reda. "To be an audit committee member probably requires an extra 100 hours," he figures.
- Reda recommends audit committee members be paid perhaps \$8-10,000 more than the average annual director compensation of about \$75,000.
- But Charles Elson, director of the Center for Corporate Governance at the University of Delaware, disagrees. He notes "If you pay them more, theoretically, you subject them to greater liability".

Business Ethics Magazine Outlines Four Principles

- Ensure auditors really audit by making them fully independent.
- Bar law-breaking companies from government contracts.
- Create a broad duty of loyalty in law to the public good.
 - *Today a corporate duty of loyalty is due only to shareholders, not to ... other stakeholders, and Enron behaved accordingly... Such piracy against the public good would be outlawed under a state Code for Corporate Citizenship, proposed by Robert Hinkley, formerly a partner with Skadden, Arps. His change to the law of directors' duties would leave the current duty to shareholders in place, but amend it to say shareholder gain may not be pursued at the expense of the community, the employees, or the environment.*
- Find truly knowledgeable directors: Employees.
 - *If Sherron Watkins had been on the Enron board, the whole scandal might have been averted.*

Financial Executives International Form Task Force to Examine Post-Enron Issues

- FEI has formed a task force -- including financial executives from major multi-nationals -- to examine the issues arising from the Enron bankruptcy. The 15,000 member organization is also updating its Code of Ethics.
- The group will issue recommendations in next 60 days, and forward them to Congress and the SEC. The FEI Task Force identified four principal areas:
 - Strengthening financial management & commitment to ethical conduct.
 - Improving corporate governance & effectiveness of audit committees.
 - Rebuilding confidence in the accounting industry & effectiveness of the audit process.
 - Modernizing financial reporting & reform of the accounting standard-setting process.

A key question is whether this and similar actions are being done more to enhance governance or subvert potential regulatory action.

The Debate Continues and is All-Consuming

- Kevin Pianko, audit partner of Richard A. Eisner & Company, LLP emphasizes that the separation of the consulting practice areas from the audit practice areas goes directly with the issue of audit independence.
- Kristin Nimsger, legal consultant, notes “It will be critical for companies to ... maintain strict, corporate-wide data management policies to protect themselves in a pending or impending lawsuit and/or investigation.”
- Consultant Dean McMann stated “With Enron’s collapse focusing attention on ... forced rotation of auditing firms is an option lawmakers might consider .. to keeping auditing separate from other services,”
- Professor Don Moore comments “The current structure of auditing firms makes auditing independence impossible even among the most honest & well- intentioned auditors,” believing a dramatic overhaul of audit system is necessary.
- Stressing self-regulation Professor Jonathan Duchac said “The most valuable trait that auditors and accountants bring to the table is their ability to interpret accounting standards and exercise professional judgment,”

4) What is the Impact on Directors?

- “... When the stock is rising and shareholders are getting rich, there is little incentive for the board ... and investment community to question the executives ... closely. The board is at fault for permitting the suspension of Enron's own code of conduct to permit the conflicts ... inherent in the off-books corporations ... A few analysts recommended (to) ... stay out of Enron, but not many.”
- **“... boards ... need to pay closer attention to ... management and the way the company is making money. In too many American companies, board members are expected to approve what management proposes-or to resign. It must become acceptable and mandatory to question management closely. There is little chance the U.S. governance rules will be changed to make boards responsible to employees as well as to the shareholders. However, board members would be foolish not to pay more attention to how employees and customers and business partners are treated. These greatly affect the long-term value of the shareholders' investment.”**

Source: Interview with Kirk Hanson, Executive Director of the Markkula Center for Applied Ethics, in Nikkei (Japan) newspaper.

Enron Fallout Causes D&O Premium Surge

- Companies whose market caps exceed \$1 billion will see their premium bills jump more than 50 percent, according to published reports citing Willis Group Holdings Inc., the third-largest insurance broker.
- In fact, the price of policies has jumped from \$5,000 to \$10,000 to between \$25,000 and \$30,000 for every \$1 million of coverage for the first \$50 million, Willis says.
- In 2001, the number of suits filed against companies and their officers and directors jumped to a record 500, according to James Newman of Securities Class Action Services.
- From 1996 through 2000, there were between 200 and 300 class action suits filed each year.
- The average settlement has grown, too, up to \$25 million in 2000 from \$17.5 million in 1999.

Source: CFO.com, Feb. 22, 2002

Simply Increasing Diversity & Number of Independent Directors Unlikely to be Sufficient

- Alan Greenspan recently noted he is not convinced independent, non-executive directors provide better oversight, mainly because they won't, in practice, be independent. He stated:
- "The boards ... appointed by shareholders are in the overwhelming majority of cases chosen ... by the CEO. The CEO sets the business strategy ... and strongly influences ... the accounting practices that measure ... ongoing ... success or failure. ... auditors are generally chosen by the CEO or by ... CEO-chosen directors. Shareholders usually perfunctorily affirm such choices."

- ***This View is Born Out by the Many Ind. Directors on Enron Board***
 - Robert Belfer, Chairman, Belco Oil & Gas Corporation
 - Norman Blake, Chairman, President and CEO, Comdisco
 - Ronnie Chan, Chairman, Hang Lung Group
 - John Duncan, Former Chairman, Executive Committee of Gulf & Western Industries
 - Wendy Gramm, Former Chairwoman, US Commodity Futures Trading Commission
 - Ken Harrison, Former Chairman & CEO, Portland General Electric
 - Robert Jaedicke, Former Dean, Graduate School of Business, Stanford University
 - Kenneth Lay, Chairman, Enron. Resigned Jan. 24 2002
 - Charles Lemaistre, President (emeritus), University of Texas
 - John Mendelsohn, President, University of Texas, Anderson Cancer Center
 - Jerome Meyer, Wilsonville, Chairman, Tektronix
 - Paulo Ferraz Pereira, Former Pres./CEO, State Bank of Rio de Janeiro, Brazil
 - Frank Savage, Chairman, Alliance Capital Management International
 - Jeffrey Skilling, Houston, Texas. President & CEO, Enron. Resigned August 2001
 - John Urquhart, Former SVP, Industrial and Power Systems, General Electric
 - John Wakeham, Former UK Secy. State for Energy & Member House of Lords
 - Herbert Winokur, Former Sr. EVP, Penn Central Corporation
- **Enron's board of directors as of Friday February 1, 2002**

Nor is Relying on Overly Restrictive Regulation

- In a Feb. 11th statement, the Business Roundtable said: “We must all take care that responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth.”
- The group, chaired by International Paper CEO John Dillon, said corporate boards must ... select and oversee competent and ethical management who understand the company's operations and risks taken in the normal course of business.
- Their statement noted “No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporation.”
- Alan Greenspan emphasized the difficulties of defining the right policy mix in his March 26th Stern School speech, noting:
 - *“Crafting the rules to provide the proper mix of regulatory and market-based incentives and penalties has never been easy. And I suspect that even after we get beyond the Enron debacle, crafting and updating such rules will continue to be a challenge.”*

Recruitment Will be More Selective & Difficult...

- *CFO Magazine* notes “In the wake of the Enron scandal, shareholders are tightening the screws on audit committees. Now all they have to do is find executives who are willing to serve on the things.”
- “Companies should consider board members with corporate finance or Wall Street experience,” argue institutional investor Bert Denton, “rather than wooing former senators.”
- At the very least, corporate stakeholders, will spend the next year meticulously reevaluating the makeup of audit committees.
- The delay in passing new statutes is probably good news, says Bob Williamson, CFO, vFinance Inc. Williamson doesn’t think heaping new rules on audit committees is the answer. “The rules are already in place; we just have to figure out how to enforce them effectively. When someone runs a stop sign, you don’t change the law, you enforce it.”

... As Requirements Change ...

- Michael Hartzmark, Chairman & CEO of Cragar Industries in Phoenix, said that when he came into the company in 1993, he had a board that was based on "cronies and investors." Two of the board members were since replaced
- "I was an academic and very naive about the resources needed to make the company successful," he said. "Having a board that had more input was critical and was part of why the company floundered."
- "A good-old-boy network is not the appropriate way to choose members of the board," said Hartzmark.

... Threatening to End the Day of the Gentleman Director

- Lord Wakeham, the former Tory Energy Secretary who now chairs of the Press Complaints Commission, faces the humiliating prospect of a British inquiry into his role in the Enron scandal.
- This could result in him being heavily fined and stripped of his professional qualifications. He could also lose lucrative directorships with four other companies.
- Wakeham, who was an Enron director, has been summoned to appear before a Senate committee to explain his role in the £55 billion collapse... Wakeham was a key member of Enron's board audit committee...
- Last night America's main trade union organization, the AFL-CIO, which represents thousands of Enron workers who lost their jobs and saw ... their pensions crumble, said it intended to launch a formal complaint about Wakeham to the Institute of Chartered Accountants ...

5) How Do Board Members Position Themselves Moving Forward?

- Financial literacy and an “inquiring mind” is more important than ever -- particularly on the Audit Committee.
- Board Membership requires more responsibility than ever before and should not be seen as a retirement hobby.
- Directors need to be actively involved in understanding a companies business -- its operation, finances & management.
- Directors cannot simply rely upon the word of management, auditors, and outside professionals.
- Directors must be independent and able to represent the interests of shareholders as they relate to other stakeholders.
- Directors must seek to balance short term performance pressures with the need to sustain and expand value over the long term.

Legal and Ethical Justification are not Necessarily Synonymous

- “The fact a proposed action is legal does not mean it is right. Social responsibility focuses on doing good in the external world. While environmentalism, philanthropy, and volunteerism are important, they are not to be confused with business ethics, which prevents harm and avoids risk within the corporation... In other words, structures and strategies are needed to develop an internal ethical culture that will guide ethical business activities.”

“Sustainability and not Profits Alone Key to Good Corporate Governance”

- World Council for Corporate Governance (WCFCG) recently organized the 2nd Intl. Conference on Corporate Governance in Mumbai which was attended by 416 business leaders and policy makers from 20 countries.
- The Conference felt that most corporate collapses are the outcome of a short sighted focus on immediate returns for the few rather than sustainable growth of the corporation. Sustainability has to be the ultimate end game of the business.
- WCFCG is, therefore, launching a worldwide movement to change the corporate culture from short termism to sustainability through good corporate governance practices.

Source: <http://www.wcfcg.net/>

Directors Must Seek to Ensure the Maintenance of Checks & Balances and Act in Good Faith ...

- Rather than serve as a rubber stamp to the often aggressive instincts of management, Directors have a responsibility to adopt a more detached perspective that seeks to balance the often contradictory concerns of short vs. long term, social vs. profit, shareholder vs. stakeholder, legal vs. ethical, regulatory vs. market and a wide range of other interests.
- ***These issues I maintain are not new -- they are common sense. A director is not expected to be an expert in all aspects ..., all that is required is diligence and informed judgement.*** Jacqueline Quamina, Republic Bank TT, Feb. 2002

... As Enhanced Corporate Governance Assumes an Increasingly Prominent and Important Role...

- “In an age where capital flows worldwide ... as quickly as information, a company that does not promote a culture of strong independent oversight risks its very stability and future health.” *Kumar Mangalam Comm. on Corp. Gov., (India) 10/99*
- “Continued emphasis will be placed on corporate reform. Without restructuring the corporate giants ... economic reforms cannot be completed. The times have changed.” *President Kim Dae-Jung (Korea) 8/99*
- “The economic turmoil had, within less than a year, taught corporate Malaysia that corporate governance or rather the lack thereof, can exact a heavy toll from the markets.” *High Level Finance Committee on Corp. Governance, (Malaysia) 2/99*
- “We must brace ourselves for the fact ... in the new environment in which we must operate, the bar or standard of performance has been raised ... This we can ascribe partly to the (Asian) crisis, and partly to the forces of globalization.” *Jaime Augusto Zobel de Ayala, President Ayala Corporation (Philippines) 2/99*

... Not only in the U.S., But all Over the World