40 Accounting Scandals and Implications for Directors: Lessons from Enron

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Abstract

We analyze the Enron case to identify the risk factors that potentially led to its collapse and specific issues relating to its aggressive accounting and high-light the lessons for independent directors. In Enron, the interactions between external stimuli, strategies, corporate culture, and risk exposures possibly created an explosive situation that eventually led to its demise. Much of the post-Enron reforms have been directed towards regulating the roles and responsibilities of executive directors and auditors. However, the role of independent directors has received relatively lesser attention. Independent directors should analyze the risks of their companies and understand the pressures that arise from market conditions and firm-specific policies and incentive structures. They also need to close the information gap between executive directors and themselves. A post-Enron era also requires independent directors to change their focus. Traditionally, independent directors have to strike a difficult balance between maximizing returns and minimizing risks. Independent directors may now have to focus on the management of risks, the design and functioning of an effective corporate governance infrastructure, and the moderation of the power bases of dominant executives. Practically, they may also have to reduce the number of independent director appointments to enable them to focus more effectively on a fewer companies.

Keywords

Accounting scandals • Audit committee • Corporate governance • Hedging • Independent directors • Incentives • Risks • Sarbanes–Oxley Act • Special purpose entity • Volatility

40.1 Introduction

The recent spate of accounting scandals raises serious concerns about the opportunistic use of accounting procedures and policies to camouflage fundamental problems in companies. The series of corporate collapses also highlight the failure of corporate governance mechanisms to prevent and detect accounting irregularities. The convergence of several factors, including competitive pressures, conflicts of interest, lack of market discipline, and inherent limitations of accounting standards resulted in an explosive situation whereby managers use aggressive accounting practices to present financial statements that do not reflect economic reality. In this essay, we analyze the Enron case with the objective of determining the risk factors that potentially led to its collapse and specific issues relating to its aggressive accounting and highlight the lessons to be learnt for corporate governance from the perspective of an independent director.

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C.-F. Lee and A.C. Lee (eds.), *Encyclopedia of Finance*, DOI 10.1007/978-1-4614-5360-4_40,
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40.2 The Competitive Environment and Incentives for Aggressive Accounting

Enron was formed as a result of merger of two companies in 1985. The merger was funded by debt and pressure had existed from the start for the new company to reduce its debt burden. At about the same time, deregulation of the natural energy industry exposed Enron to substantial operating and price risks arising from the increase in gas supply and volatility in spot prices. However, deregulation also increased opportunities for more flexible and innovative contracts to be drawn up between the producer and buyers. To survive, Enron had to capitalize on these opportunities and became a primary market player through its development of the idea of a Gas Bank. Under this scheme, Enron facilitated the market for energy contracts by buying gas from suppliers and selling to buyers. In acting as an intermediary, Enron guaranteed both the supply and the price, and assumed the related risks in return for transaction fees. Innovations were subsequently extended to markets for basic metals, pulp and paper, and broadband products. Its diversification strategy also included investments in other countries in South America, Europe, and Asia. The business and geographical diversification created new risks for Enron. Its heavy investment in projects such as broadband network assets would pay off only in the long term. However, an immediate debt burden from these acquisitions placed pressure on Enron's balance sheet that was already weighed down by existing debt (Powers et al., 2002).[1]

Although Enron began as an operator of energy-related assets, by the end of the 1990s, the firm had divested a significant portion of its physical assets in what is known as an "asset light strategy" (Permanent Subcommittee on Investigations of the Committee of Governmental Affairs, 2002)[2] and was primarily focused on its trading and financial activities relating to physical energy commodities. Effectively, the company was transformed from a natural gas supplier into an energy trader and intermediary. It offered specialist services in price risk management strategies and market-making activities. Its dominance in the market for energy contracts gave Enron a first-mover advantage in exploiting information economies of scale. However, the lucrative profits it enjoyed attracted other entrants to the industry and Enron's profit margins began to erode by the end of 2000. Further, as a trader, Enron was compelled to maintain an investment grade rating in order to lower its counter-party risk.

Against this backdrop of competitive pressures, Enron's senior management developed incentive schemes that turned the firm environment into a highly competitive internal market place. An internal ranking system administered by the company's Performance Review Committee became a means of allocating bonus points and determining dismissals. The entire process was described as a "blood sport" (Chaffin and Fidler, 2002) and former employees believed that the basis for reward was largely determined by whether a deal could be reported as revenue or earnings rather than commitment to the company's core values of Respect, Integrity, Communication, and Excellence. Enron's annual incentive awards and the long-term incentive grants are closely tied to company performance measures and stock prices. The annual incentive bonus was pegged to a percentage of recurring after-tax profit, while its long-term incentive grants provided for accelerated vesting provided Enron achieved performance targets linked to compounded growth in earnings-per-share and cumulative shareholder returns.[3] A Senate report on the Enron collapse concluded that Enron's Board of Directors approved lavish and excessive executive compensation and failed to stem the "cumulative cash drain" arising from its incentive schemes.[4]

Hence, Enron appeared to react to risk by creating an environment that generated new risk exposures through its business strategies and reward system that focused on short-term results. Figure 40.1 summarizes the competitive pressures at Enron.

40.3 Aggressive Accounting Practices

Enron's accounting practices resulted in removing the liabilities of its balance sheet, improving profitability, and reducing profit volatility. These desired accounting effects were achieved through structuring numerous complex and "innovative" transactions. Many of these transactions involved dealing with special purpose entities that Enron set up in partnership with related parties. The investigating Senate Committee described these practices as "high-risk accounting." The manner in which certain transactions were reported was deemed to be at variance with their true economic substance. The main question that underlies these practices relates to the issue of whether Enron had retained the risks that were purportedly transferred to the special purpose entities.

40.3.1 Effectiveness of "Hedging" Transactions

An example included the entering into transactions that were purported to hedge the volatility of its "marked to market" investments. The hedging transactions were entered into between Enron and a special purpose entity (SPE).[5] A hedge is effective only if a loss suffered by a hedged party is transferred out to an outside party. In its first hedging transaction, Enron transferred its own stock to the SPE in exchange for a note. The intention of the hedge was to

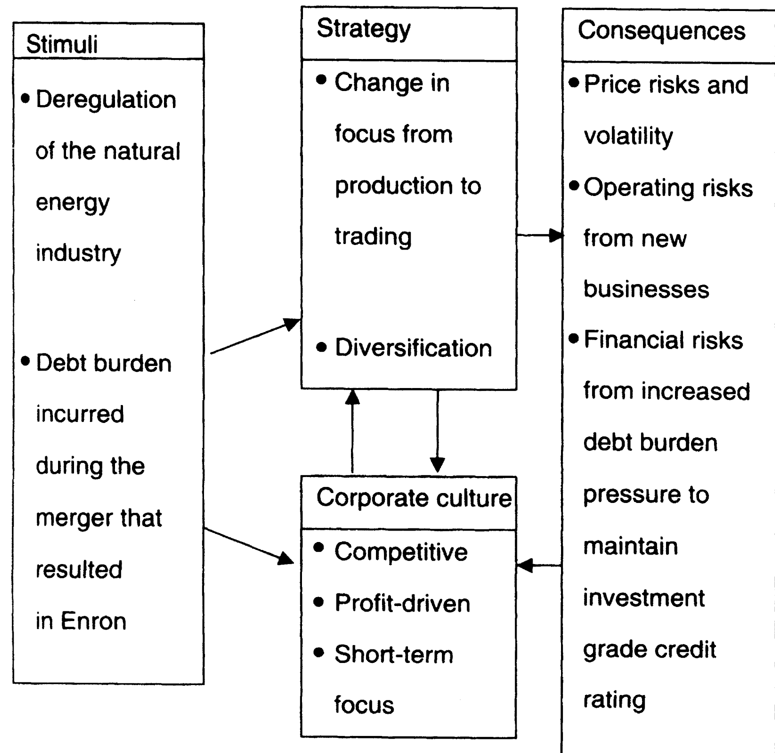

Fig. 40.1 Competitive pressures at Enron

transfer losses to the SPE, through the exercise of an option, should the stock price of a profitable "merchant" investment decline. The SPE purported to take on the risk of price volatility of the investment and to compensate Enron for the loss on its investments.

However, cash was available to the SPE only if the latter sold the Enron stock. Since the SPE was financed by Enron's stock, the transaction was effectively a self-hedging arrangement as the creditworthiness of the SPE was tied to Enron's fortunes. When Enron's stock fell in value in late 2000 and early 2001, the SPE faced a liquidity crisis and could not honor its obligations under the option. Hence, the "hedge" was ineffective because the counter-party's risk was inextricably intertwined with Enron's risk and the hedge did not constitute a true economic hedge.

40.3.2 Control and Risks Relating to Unconsolidated Entities

There are two broad approaches in accounting for an SPE. If an SPE is controlled by an investing company, the assets and liabilities of the SPE are consolidated entirely on to the investing company's balance sheet. Alternatively, if it is not under the investing company's control, it is treated as an investment in a separate entity, with off-balance sheet treatment of the SPE's assets and liabilities. Under applicable accounting rules in the United States, an SPE could receive off-balance-sheet treatment only if independent third-party investors contributed at least 3 % of the SPE's capital. Some of Enron's dealings raised serious questions about whether this rule was effectively met.

For example, from 1997 to 2001, Enron did not consolidate an SPE called Chewco. In 1997, Enron and the California Public Employees' Retirement System (CalPERS) were joint venture partners in an off-balance sheet investment vehicle called Joint Energy Development Limited Partnership (JEDI). To enable CalPERS to cash out its investment in JEDI in order to invest in a larger Enron venture, Andrew Fastow, the then Chief Financial Officer at Enron, and others at Enron formed an SPE called Chewco to buy CalPERS' interest in JEDI. Thus, Enron was able to continue accounting for JEDI as an off-balance-sheet entity on the basis that the holdings by Enron staff members and related parties constitute outside capital at risk. According to SEC investigations,[6] Fastow, secretly controlled Chewco. Hence, a serious question arose as to whether Enron, through a related party, had effective control over major operating and financial policies of Chewco. Further, Enron and its related SPEs provided guarantees and cash collateral on bank funding to Chewco, indicating that equity at risk was effectively borne by Enron rather than independent third parties. In November 2001, both Enron and its auditors, Andersen, concluded that Chewco was an SPE without sufficient

outside equity and should have been consolidated. The retroactive consolidation of Chewco from 1997 to 2001 had an astounding effect on the financial statements. Profits decreased by a total of $405 million over the period of restatement and additional debt of $711 million was recognized on the balance sheet in 1997.[7]

40.4 The Role of Corporate Governance

Theoretically, Enron had in place an impressive array of corporate governance mechanisms. Outside directors were well respected and highly qualified individuals in the fields of accounting, finance, and law. The Board of Directors had several committees to review various aspects of the company's policies and operations. There was separation of the offices of the Chairman and Chief Executive Officer. The external auditors were a Big Five accounting firm. However, following the company's massive financial collapse, serious doubts arose as to the effectiveness of these institutional arrangements. The Senate Investigating Committee found that the Enron's Board failed to safeguard Enron shareholders and contributed to the collapse of the company by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-balance-sheet activities, and excessive executive compensation.[8] Further, the Board was also found to have failed to ensure the independence of the company's external auditor, Andersen who provided internal audit and consulting services as well.[9]

Many valuable lessons can be learnt from the Enron case to prevent the derailing of the effective functioning of governance mechanisms. We focus our discussion on the role of independent directors. Much of the post-Enron reforms have been directed towards regulating the roles and responsibilities of executive directors and auditors. However, the role of independent directors has received relatively less attention than that of other corporate governance agents. We discuss below some implications of the Enron collapse on the role of independent directors.

1. What is the primary role of independent directors? The multiple roles that independent directors have to undertake require them to strike a difficult balance between maximizing returns and minimizing risks. Their purview is wide, ranging from activities that have a "profit" focus to others that have a "defensive" focus. Independent directors potentially find themselves in an identity crisis. For example, if an independent director has to operate within an Enron-type environment, the director is confronted with an aggressive risk-taking internal environment. The question arises as to whether the independent director should act as a thorn in the managers' flesh or go with the flow of an aggressive managerial style for the sake of profit maximization?

   The lesson from Enron is very clear that it does not pay to sacrifice the defensive role when risk factors are overwhelming and the long-run survival of the company is at stake. While post-Enron legislation such as the Sarbanes–Oxley Act of 2002 is primarily directed towards establishing mandates for insiders, audit committee board members and external auditors, much less is said about the responsibilities of independent directors per se. However, the implicit responsibilities of independent directors are clearly reinforced by laws that impose fiduciary duties on directors to act in good faith, with reasonable care, and in the best interest of the corporation and its shareholders. The Conference Board also reiterates directors' role to monitor management and to ensure their ethical and legal compliance (The Conference Board, 2003).[10]

   Hence, independent directors owe a primary duty of care to outside investors. Their priority should be towards establishing and ensuring a corporate environment and infrastructure wherein managerial stewardship is executed without compromising the long-run interests of the firm and its stakeholders. They, more than anyone else, are best placed to limit the excesses of a dominant Chief Executive.
2. Independent directors have to bridge the information gap between executive directors and themselves. The Conference Board emphasizes that directors need to understand, among other things, the business strategies they approve, the risks and vulnerabilities arising from the strategies, growth opportunities, debt levels, and company's capital allocation of the companies under their purview.[11] Following the Enron experience, independent directors are well advised to understand the internal dynamics, managerial incentives, and power bases within the corporate environment and to adopt a healthy skepticism of strategies that potentially advance managerial interests over that of external investors. They should be keenly aware of the threats posed by dominant Chief Executive Officers and key personnel and the risks of opportunistic managerial behaviour.
3. Greater commitment in terms of time and effort are expected of independent directors to meet the governance objective. Independent directors must take a proactive role in governance and not rely solely on external auditors, legal counsel, or key executives to provide them the necessary assurance. For example, when the Enron Board was asked why they moved so quickly in their approval of an unusual hedging transaction, the response was that the company had obtained a fairness opinion from an outside accounting firm.[12] On another proposal, the Board relied on the company's legal counsel

to advise if anything was amiss on a particular memorandum. Had the directors reviewed the memorandum for themselves, they would have noted that key company executives were involved in the arrangement that gave rise to conflicts of interest.[13] Interviewed Board members told the investigating Senate Subcommittee members that they assumed that the then Chief Executive Officer had actively reviewed and approved the fairness of the unusual business proposals and the compensation controls.[14] Enron's directors were also found to have knowingly allowed Enron's use of "high-risk" accounting without enforcing restraint.[15] Hence, the Senate Report underscores the principle that evidence of a suspect transaction or activity that is known to a director must be questioned and examined diligently and thoroughly, regardless of the views of other experts.

The implications for independent directors are enormous. The days when an independent director held several of such appointments concurrently are likely to be over. Independent directors may have to be selective in choosing appointments so as not to spread themselves too thinly. They must also be prepared to commit resources and time and change the mindset that their appointment is a "part-time" one. They may also have to assess the risks of companies to determine if they are willing to undertake the fiduciary responsibility of monitoring such a company.

Conclusion

The Enron case has painful lessons for the business community. A seemingly successful company was apparently derailed through the use of highly risky transactions and aggressive accounting that temporarily boosted profits and reduced debt. The question arises as to why the corporate guardians of Enron did not prevent these transactions from occurring. Following Enron and other accounting scandals, a re-examination needs to be carried out of the role and responsibilities of independent directors. This paper suggests that significantly greater challenges are posed to independent directors in a post-Enron world to understand more of the risks, accounting practices, and managerial opportunism existing in the companies under their purview and to take a more proactive role in governance, which inevitably requires a substantial commitment of their time and resources.

Notes

1. Hereinafter referred to as the "Powers Report."
2. Hereinafter referred to as the "Senate Report," p. 7.
3. Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, 2 March 2001, EDGARPlus(R).
4. The Senate Report, p. 3.
5. Details of the hedging transactions are found in The Powers' Report, pp. 13–15.
6. Securities and Exchange Commission, Litigation Release 17762, 2 October 2002.
7. The Powers' Report, p. 42.
8. The Senate Report, p. 11.
9. The Senate Report, p. 54.
10. Hereinafter referred to as The Conference Board Report.
11. The Conference Board Report, p. 9.
12. The Senate Report, p. 27.
13. The Senate Report, p. 28.
14. The Senate Report, pp. 30–31.
15. The Senate Report, pp. 14–24.

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