Corporate Governance: Lessons from Recent Crises

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Learning from Enron

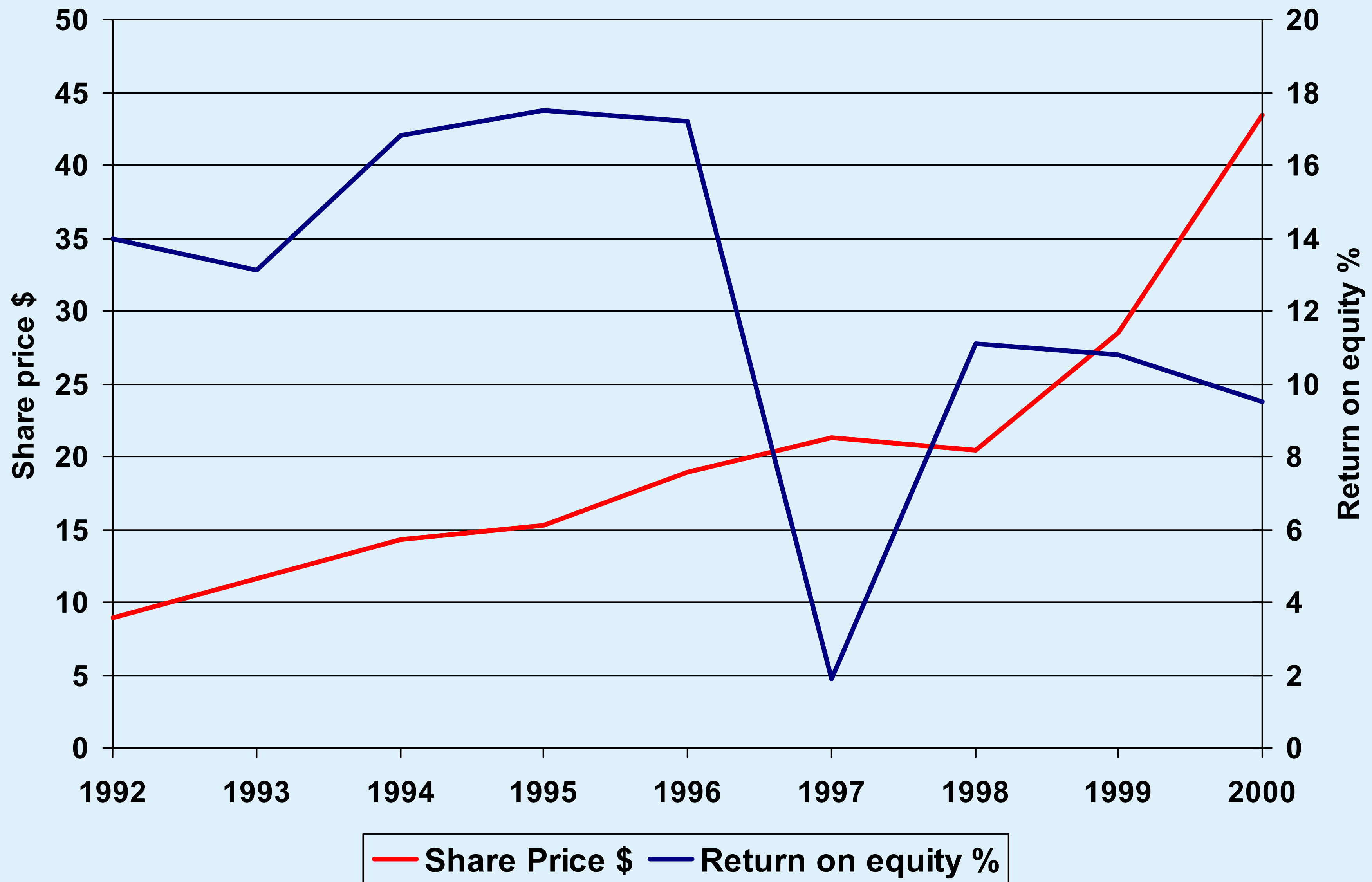
- Enron as board failure
- What *really* went wrong at Enron?
- ‘The learning board’

Enron as board failure: ‘intelligent gambling’

- Permitting high-risk accounting
- Allowing 50% of assets to be shifted into off-balance sheet entities
- Waiving the ethics code to allow self-dealing transactions
- Ignoring directors’ conflicts of interests
- Failing to monitor executive compensation

Enron’s business plan

- Enron was not a normal utility company; it was an energy trader acting as a market intermediary in the chain of supply. It aimed to out-compete traditional, vertically integrated forms of organisation through sophisticated forms of risk management.


Enron's Share Price and Return on Equity 1992-2000
Share price $
50
45
40
35
30
25
20
15
10
5
0
Return on equity %
20
18
16
14
12
10
8
6
4
2
0
1992
1993
1994
1995
1996
1997
1998
1999
2000
Share Price $
Return on equity %

Enron’s business risks

- To be successful Enron’s strategy required a physical market presence with an energy trading ‘overlay’
- Enron’s comparative advantage lay in its access to liquidity and knowledge of the energy sector
- Retaining the confidence of capital and credit markets was essential

‘Asset lite’

- ‘The fundamental advantage of a virtually integrated system is you need less capital to provide the same reliability…It’s very hard to earn a compensatory rate of return on a traditional asset investment… In today’s world, you have to bring intellectual content to the product, or you will not earn a fair rate of return …’ Jeffrey Skilling, *BusinessWeek Online* February 2001

Enron’s use of off balance-sheet accounting

- Enron’s use of special purpose entities created a false impression of earnings growth
- A number of SPEs were set up without a genuine outside investor
- When these were wound up (on Andersen’s advice) in the autumn of 2001, the restatement of Enron’s earnings shook market confidence

Waiving the ethics code

- Enron’s CFO, Andrew Fastow, set up certain of the SPEs which dealt with Enron
- The board, on the advice of the then chair/CEO Ken Lay, waived Enron’s ethics code to permit Fastow to enter into these ‘self-dealing transactions’
- The restatement of earnings following the consolidation of Chewco’s accounts with Enron’s shook market confidence at a critical time

Ignoring directors' conflicts of interests

- Although Enron had many non-executive directors, most of them could not be characterised as independent because they were paid salaries as consultants separately from their directors' fees
- In addition, Enron indirectly made gifts to directors, in the form of support for their academic and medical charities
- Board members lobbied for regulatory changes which directly benefited Enron's business plan

Approving unmonitored executive compensation

- Andrew Fastow’s remuneration from his SPEs ($40 million) was not disclosed at the time and was only revealed through a telephone conversation with the head of the remuneration committee
- Kenneth Lay regularly drew down $millions from a personal line of credit granted by the board
- Board members and senior employees profited by $millions by cashing in share options as the company’s stock was falling in 2001; at the same time other employees were prevented from moving their pension plans out of Enron stock

Enron and risk

- Enron’s audit committee was told by Arthur Andersen in 1999 that Enron’s accounting practices ‘pushed limits’ and were ‘at the edge of’ acceptable practice
- Internal Andersen documents described Enron’s approach as ‘form over substance transactions’; an Enron director described it as ‘leading edge’

‘Rank and yank’

- ‘ideally you’d have every plant you own on a barge’ (Jack Welch, CEO of GE)
- ‘The rankings were on a forced curve…You had to be innovative or your performance got slapped down a lower rank. I wondered how innovation was measured in the accounting and legal departments’ (Brian Cruver, former Enron employee)

Who bore the residual risk of Enron’s failure?

- Public pension funds with substantial holdings in Enron stock
- Enron employees whose pensions were tied up in Enron stock held in s. 401(j) pension plans
- Pensions blackout prevented employees moving their investment out of Enron stock, while senior managers were exercising stock options worth $millions.

Realigning corporate governance

- ‘It is time for another effort to realign the system to function more in shareholders’ interests. Companies need stronger non-executive directors, paid enough to devote proper attention to the job; genuinely independent audit and remuneration committees; more powerful internal auditors; and a separation of the jobs of chairman and chief executive. If corporate America cannot deliver better governance as well as better audit, it will have only itself to blame when the public backlash becomes both fierce and unpleasant’ *Economist*, September 2002

But will it work?

- ‘Corporate governance is big business…It’s a growth industry. But it’s not clear whether it’s going to be an industry that creates wealth or destroys it… stockholders might not only have to shoulder the costs of the bureaucracy created by the new regulatory environment; they might also have to make do with less capable, less results-oriented CEOs – and more humble returns on their investments’ *Canadian Business*, June 2002

The learning board

- The board’s task is not just to monitor senior managers but to engender an ethic of accountability and trust within organisations
- Boards must equip themselves with the means needed to assess and control risks to the company’s long-term sustainability

Shareholders as fiduciaries

- Institutions own 80% of UK equities
- Large pension funds cannot costlessly exit the UK market
- ‘Focus funds’ aim to take a proactive stance in corporate engagement
- Socially responsible investment standards penalise corporations which pollute and harm
- Voting is increasingly regarded as a ‘fiduciary asset’ held on behalf of beneficiaries

The power of shareholder activism

- ‘No matter how much money Exxon, Mobil or Philip Morris spend and give to persuade the public of their attentiveness to public concerns, the perception that they have inadequate concern for the environment and make products hostile to human welfare will in the long run depress the value of their stock. Price earnings multiples are an implicit calculation of the risk that current earnings and cash flows can be maintained and enhanced for an indefinite number of years. Discounts are applied to industry P/Es for companies and managements that are perceived as being contumacious’ (Robert Monks, 2001).

The end of innocence

- ‘There is no such thing in my mind… as an innocent stockholder. He may be innocent in fact but socially he cannot be held innocent. He accepts the benefits of the system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare’ (Louis Brandeis, 1913)