



DM Extra!

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Timely Commentary on Critical Events
and Regulatory Developments

The Rise and Fall of Enron: Principles for Director Focus

On December 2, 2001, Enron, a diversified energy company that reported \$100 billion in annual revenues for 2000, and seemed poised for continued growth as the nation's seventh largest company, filed for bankruptcy protection in U.S. federal courts. Even now, in early 2002, the governance issues highlighted by the Enron situation are demanding director attention.

Enron Summary

Busy directors may want a summary of what allegedly happened in this case (based on press reports). In brief, for many years, Enron's **financial reporting practices**, although they were largely based on generally accepted accounting principles (GAAP), gave the impression that the company was larger, more

Enron: A Commentary

The recent failure of Enron Corporation has highlighted the importance of good governance. What are the lessons learned? As the only U.S.-based association for corporate directors, NACD has an obligation to articulate them. We also feel the call to respond to future events concerning companies and regulators.

For this reason, we are issuing a new series of commentary and analysis as part of *DM Extra*, supplementing our regular monthly publication, *Director's Monthly*.

What can responsible corporate directors say about the Enron situation? In light of the human cost of this situation, it is tempting to want to find, blame, and punish culprits. But this is not the task before us as directors.

The failure of any large corporation involves a vast tableau of events, some more visible than others. At times like this, the names of individuals and companies come up, and media reports naturally tend to focus on them. The fall of Enron came from a variety of causes, some attributable to the actions of individual persons and firms, and some attributable to features systemic to American financial markets. Directors need to be aware of both these dimensions, but they also need to focus on their own actions.

Each and every one of us needs to ask: *How could we have done a better job in this situation or a similar situation?* Directors, especially audit committee members, need to keep their focus on principles, not personalities. Above all, they need to respect and enforce correct governance and ethical principles.

I recommend that all directors read the following "DMX" feature. As always, I welcome your comments. ■

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profitable, less leveraged, and more secure than it really was. (Company revenues included funds flowing through from transitory transactions, company losses and debts were hidden in partnerships that did not appear on any financial statements, and the company did not disclose prominently enough its total exposure to risks.) A senior manager blew the whistle on the inappropriate accounting, but it appears that she reported this issue only to the CEO, not to the board, which never heard about it.

Compounding the problem was an excessive degree of **complexity** in the company's finances and basic structure. When third quarter 2001 financial disclosures stated that the company had been significantly overstating revenues, stock prices fell, hurting

investors, including Enron employees via the company's **retirement plans**. Those looking for someone to blame had no lack of candidates. Some Enron senior executives, including one who was overseeing the company's internal audit staff (reportedly outsourced in part to the external auditor) had a personal interest in certain risky transactions. They allegedly sold their stock even while encourag-

ing employees to hold theirs, raising **conflict of interest** and **insider trading** issues. The major auditing firm that approved Enron's financial statements also provided internal auditing consulting services, raising **auditor independence** issues. Media reports claim that the audit firm did not retain (*i.e.*, shredded) documents believed to be material, reportedly in violation of the firm's own document retention policy.

Finally, the board members, including some who had apparent conflicts of interest, did not seem to provide vigorous **oversight** of the auditing and reporting process. Indeed, the company had a **code of ethics** but the audit committee, which reportedly met less often than the compensation committee, voted twice to suspend it in order to approve certain transactions.

The Enron case has triggered witch-hunts in the media and on Capitol Hill, as culprits are sought and exposed. Lost in the drama is a focus on governance principles. Indeed, some commentators have questioned the value of the most basic governance benchmarks (such as qualified, independent audit committees), since Enron met many of them. (Indeed, *Chief Executive* magazine ranked Enron as one of the nation's five best boards in 2000.)

Enron Action Steps for Directors

Directors need not lose their faith in governance principles. Indeed, imbedded in the account above (and highlighted in bold) are some basic issues for director focus. Directors can be a practical part of the solution to the problems that led to Enron's collapse. Here is a list of action steps, followed by suggested resources, including those available through nacdonline.org.

Understand financial reporting practices.

Directors can be more critical of what their companies are reporting, and how they are reporting it. Director financial literacy is encouraged by new stock exchange listing requirements stemming from the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, co-chaired by John C. Whitehead and NACD director Ira M. Millstein. For a copy of the report, visit amex.com or nyse.com. Directors can also identify areas needing improvement in GAAP, and suggest them to the Financial Accounting Standards Board (FASB)—especially during comment periods on related issues. The basic premise, mission, and staffing of the FASB form a strong bulwark against chicanery. Many of the issues coming to light in the Enron case were foreseen by the FASB and are already agenda items. Rather than joining the chorus of complaints (many unfounded) about the FASB, directors should visit the FASB's search-friendly website at fasb.org and see all the many initiatives the board is undertaking at this time. For example, the FASB's Business Reporting Research Project, which has a steering committee and seven working groups, has been looking at, among other things, "voluntary disclosures of various types of information...that have not been recognized in the financial statements."

Recognize, and, if appropriate, reduce corporate and board complexity. Directors can strive to create an atmosphere for discussion that encourages common-sense questions that may sound too simple for a complex entity. In the words of NACD director Thomas R. Horton, "Anything too complicated to understand is too complicated to govern." If directors ask sensible questions and do not understand the answers, something is wrong, and they need to get to the bottom of it. They need to exercise not only due care and due loyalty, but also what NACD director Gwendolyn S. King has called

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“the duty of curiosity.” This curiosity can extend to financial transactions, or to the oversight of past and pending mergers and acquisitions—a common source of complexity. Here, the Securities and Exchange Commission sec.gov has been an important resource. One of the missions of past chairmen and of the current Securities and Exchange chairman Harvey Pitt, has been to make financial reporting as “transparent” as possible—thus exposing the exact nature of financial transactions, however complicated. For an excellent summary of the SEC response to the collapse of Enron, including the accounting issues involved in reporting complex structures, see the Gibson Dunn client memo of January 15, 2002, entitled “SEC Issues Statement Cautioning Companies About Financial Disclosures and Pro Forma Numbers.” Obtain copies by visiting the NACD website or gibsondunn.com. The 18-member Enron board itself was very large, making clear communication difficult.

Protect retirement plans. Directors can look into the design and management of companies’ retirement plans, and can become familiar with the basic provisions of the Employee Retirement Incomes Security Act of 1974 (ERISA). This is particularly important in light of the fact that the Justice Department has begun a criminal investigation into the handling of Enron’s retirement plan, in addition to the civil investigations being conducted by the SEC (based on securities laws) and the Labor Department (based on ERISA). To oversee retirement plans adequately, directors can ask these questions: What kind of plan does this company have? Can employees make their own investment decisions? If so, are employees provided with the proper education regarding the diversification of their investments? If not, do plan managers make sound decisions for long-term returns of the plans? On this last point, directors may want to read Michael Stolte, “Retirement Fund Management: Strengthening the Board’s Position,” *DM* May 2001, pp. 1-6. A good website for information and guidance useful for retirement plan oversight is psca.org, the site of the Profit Sharing/401-k Council of America.

Set and follow policies and rules pertaining to conflict of interest. Directors can exercise their duty of loyalty by restricting their pay to fees for director service, declining consulting fees, for example. Pay for service other than directorship, however merited and legal, can create conflicts of interest—or at the very least, blind directors to the conflicts that others, such as auditors, may have. Nominating committees need to keep

potential conflicts of interest in mind as they recruit and assign directors. Having the committee focus on governance as well as nominations (even to the point of renaming the committee a “governance committee”) can help. So, too, can limiting the number of directors on a board. Furthermore, to ensure auditor independence, directors can insist that both external and internal auditors report to the audit committee, and are free of conflicts of interest. NACD resources on conflicts of interest include Thomas Bakewell, “Handling Conflicts of Interest at the Board Level,” *DM* February 2001, pp. 7-10.

Refrain from improper insider trading. Directors and senior management should always be vigilant about their timing when they sell their stock—and even more so in light of the Enron situation. Meanwhile, the Securities and Exchange Commission is conducting its own investigation of possible insider trading at Enron. *DM* warned about insider trading issues back in 1997, when author Richard Rosen, writing on “Institutionalizing Policies and Procedures to Minimize Risk,” *DM* June 1997, pp. 5-8, urged companies to write blackout policies (bans on buying or selling stock during certain periods above and beyond requirements of securities laws) in plain English and have directors sign them. (These policies must be drafted with care, however, to prevent the retirement plan melt-down described above.)

Ensure auditor independence. Directors must also exercise vigilance in ensuring that the auditor is fulfilling its mission in a competent and independent manner. When voting to continue retaining the auditor, directors can consider competing firms, rather than staying uncritically with the same auditor for decades. Furthermore, directors should exercise caution when outsourcing the internal audit function. See, for example, Curtis Verschoor, “Questions Directors Should Ask Before Outsourcing the Internal Audit Function,” *DM* December 1996, pp. 5-7. On the regulatory front, directors may wish to express their views on, participate in, or for that matter even oppose, the SEC’s new efforts, announced January 17, 2002, to form a new Independent Oversight Board to provide quality checks of audits, currently performed by peer firms.

Issue, improve, and enforce internal document retention policies. Directors can ensure that the corporations they serve set and enforce sound

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document retention policies, and that these are followed closely. Although in the Enron case, the document retention issue involved an auditing firm, it is clearly relevant to all kinds of business entities. Document retention is an extremely complex matter involving a number of issues, including information needs, disclosure obligations, privacy issues, and client-advisor privilege. It is not simply a matter of keeping records on all transactions at all times. The document closest in relevance to directors are minutes of board meetings. On this topic, see Charles R. McCarthy, Jr., “The Chronicling of Corporate Minutes, Continued: A Retrospective Look at Van Gorkom,” *DM* September 1999, pp. 6-10. See also “Sample Board Minutes,” in the article by Richard Rosen cited above. In this area, advice of a qualified attorney is recommended.

Educate and empower the board to detect and ensure correction of inappropriate financial reporting.

Directors can become adept at “Getting Behind the Numbers,” to cite the title of an NACD handbook teaching the fundamentals of accounting in order to enhance director financial literacy. Of course, if the reporting had been more straightforward (going beyond GAAP minimums), Enron’s difficulties would have been more obvious to all concerned—the internal auditors, the

external auditors, the audit committee, and investment analysts. But the audit committee cannot wait for new regulations and rules to come down from the SEC and the FASB. Nor can directors wait for managers to become more forthcoming about voluntary disclosures. They must ask for and intelligently analyze relevant information. The [Report of the NACD Blue Ribbon Commission on Audit Committees](#) (NACD: 2000) contains useful recommendations and an excellent checklist of “red flags” directors can use.

Former FASB Chairman Dennis Beresford, Ernst & Young Executive Professor at the Terry College of Business, University of Georgia, summarizes related issues in “Directors’ Responsibilities for the Quality of Financial Reporting,” *DM* February 2002, pp.1-6. Directors would be wise to heed his advice.

Embrace corporate ethics by creating a climate of integrity and responsibility, expressed in both written codes and living example. Directors and CEOs need to build a strong ethical culture that can ensure correct behavior when policies are unwritten, unclear, or unenforced. This may be the most important lesson in the Enron situation for all participants involved, including directors. Were there times that Enron directors noticed an anomaly but chose to ignore it because it conformed to GAAP and did not violate securities laws? Have we as directors cast a blind eye over financials? NACD has published a great deal on the subject of ethics, including Dawn-Marie Driscoll and W. Michael Hoffman, “Building a Values-Based Culture Through Codes of Ethics,” *DM* February 2000, pp. 1-6. Directors and CEOs seeking ideas for implementing ethics programs in their organizations can visit [ethics.org](#), the official site of the Ethics Resource Center of Washington, D.C., which has provided valuable research for our publications over the years. Board self-evaluation can also serve a purpose here, as explained in the [Report of the NACD Blue Ribbon Commission on Board Evaluation](#) (2001) co-chaired by NACD chairman B. Kenneth West and NACD director Robert E. Hallagan. But websites and books can go only so far. A simple sense of decency, combined with a climate of candor, openness, and trust, is more valuable than all the technical knowledge a director can accumulate in a lifetime.

In conclusion, directors can exercise active oversight of corporate financial reporting and the many other areas highlighted by the Enron case. Indeed, many boards are already responding to the situation by reviewing and revising current board and company policies. In parallel surveys conducted jointly, the NACD and The Institute of Internal Auditors will be surveying their members to find out how they are actively responding to the Enron case. The results of this survey, combined with NACD’s ongoing discussions with members, advisors, and sponsors, will add considerably to our body of useful governance knowledge and practice. ■

Click here for NACD publications that pertain to board leadership in all types of crisis situations: www.nacdonline.org/publications.

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