Financial Accounting
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Lecture – 21
Corporate Governance: Enron Case

Namaste. In our last two sessions, we have discussed on Corporate Governance. If you remember, first we discussed about what is governance; what are the major principles and what is a governance structure. In the last session, we had discussed on various global models of governance. The dominant model is Anglo-US model, then we also have a German-Japanese model, Chinese model and we discussed the salient features of ancient Indian model.

Today, we will discuss about a very interesting case which is known as case of Enron. This happened in 2001, one of the biggest corporate frauds and one of the very striking case of failure of governance. A company, which was shown to be extraordinarily good company, highly successful, following all norms but, was completely a fraud. So, we will just see what it was. After this case major changes were made in the governance mechanism all over the world.

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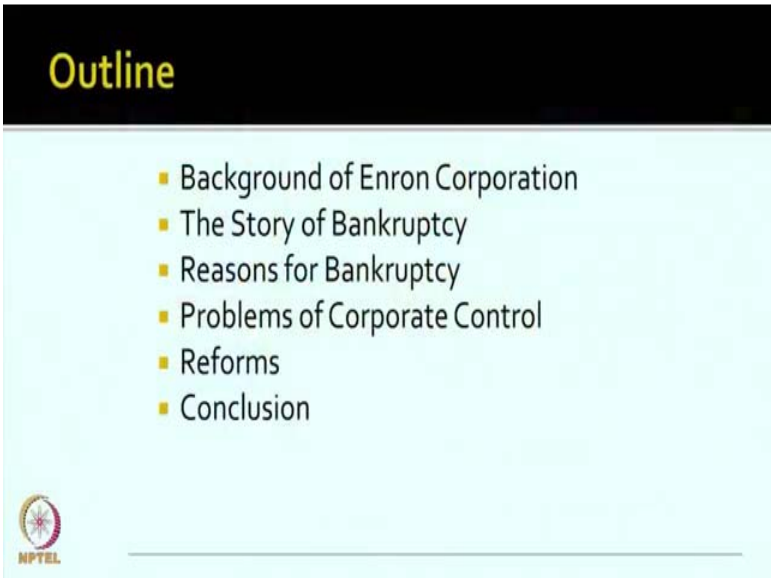

So, we will try to discuss both the things first on the Enron case. Now, we will just see what is a background and what was the story of the bankruptcy of Enron.

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Now, Enron was a energy giant. It was mainly involved in the supply of power in USA, later on it went into manufacturing and it also started power plants all over the world or many of the plants were in progress when the company collapsed.

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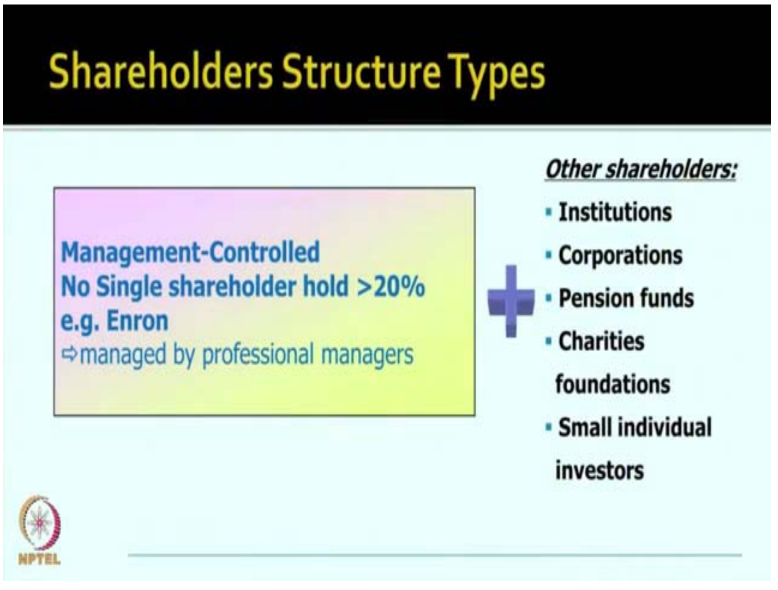

Now, this was a professionally managed company. So, no shareholder had more than 21 percent stake 20 percent stake and normally, it is argued that professionally managed companies are better than those which are under some group.

So, the major shareholders were various institutions, corporations, banks, charities, small investors and so on. It was an American company on paper a very good team of management was in charge of the company.

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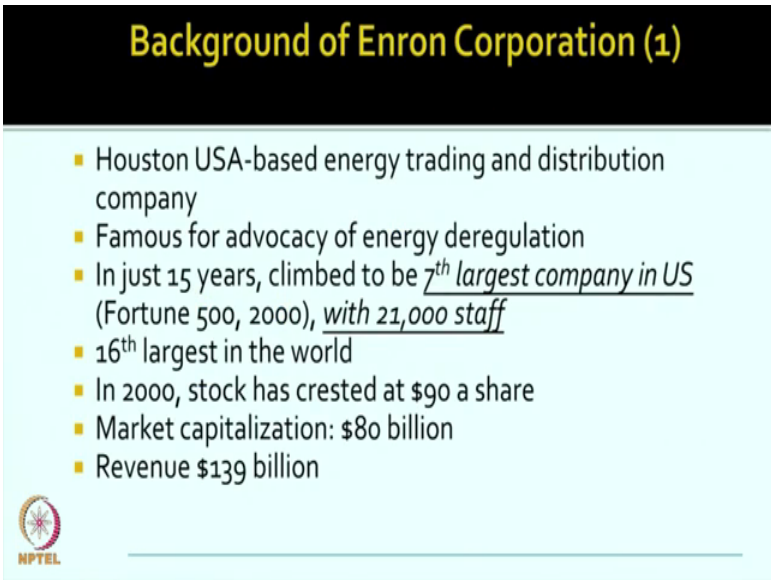

It was based in Houston, mainly into energy trading and distribution and they had also started energy manufacturing. And, it was very famous for advocacy of energy deregulation. So, they wanted lot of freedom for distribution and they had spent a lot of energy on advocacy for their costs. In just 15 years of its existence, it became a very important company it became the seventh largest company with 21000 employees, seventh largest in US and sixteenth largest in the world that was the clout of Enron. And, in 2000, the stock price reached a level of 90 dollar.

So, within 8 to 9 months time stock price grows strong 40 dollar to 90 dollar and the market capitalization was 80 billion. Remember, it is a big amount especially in 2001 and the revenue was 139 billion. So, it was one of the large and very highly successful US companies.

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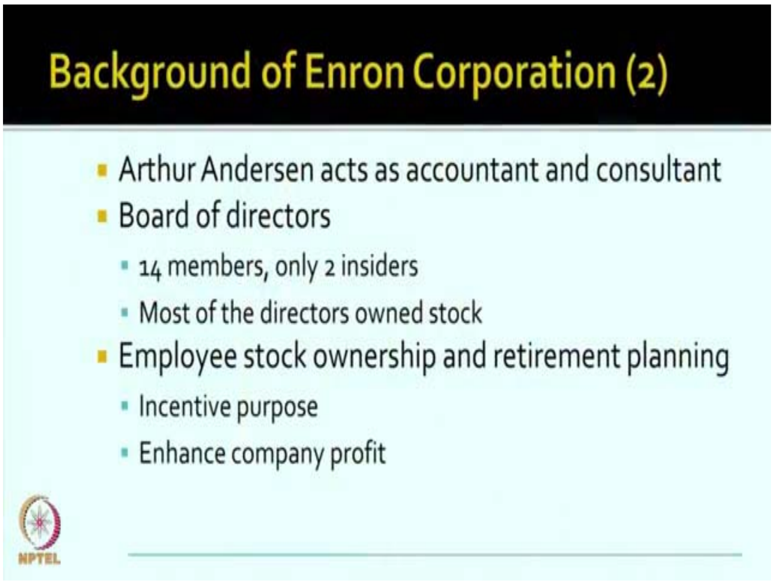

Their auditors were Arthur Andersen. They also used to be consultants. The board had 14 members of which only 2 were insiders which were also executive directors. All other board members were from different families and different groups, they were all professionals. Most of the directors also had some stock in the company and planning that at the time of retirement they were given lot of stock options.

So, that not only during their period of company's employment; in future also they will make a lot of money from the company stocks that is how the arrangement was. On paper it was a very strong on solid arrangement.

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But, in reality there were many bad practices happening. So, Andrew Fastow who was a CFO, Chief Financial Officer of the company had created certain partnerships which were condor and raptors. So, the major employees of the company have created some partnership firms and the main company Enron was allowed to invest in those firms. So, they were making private business wherein only they were the owners.

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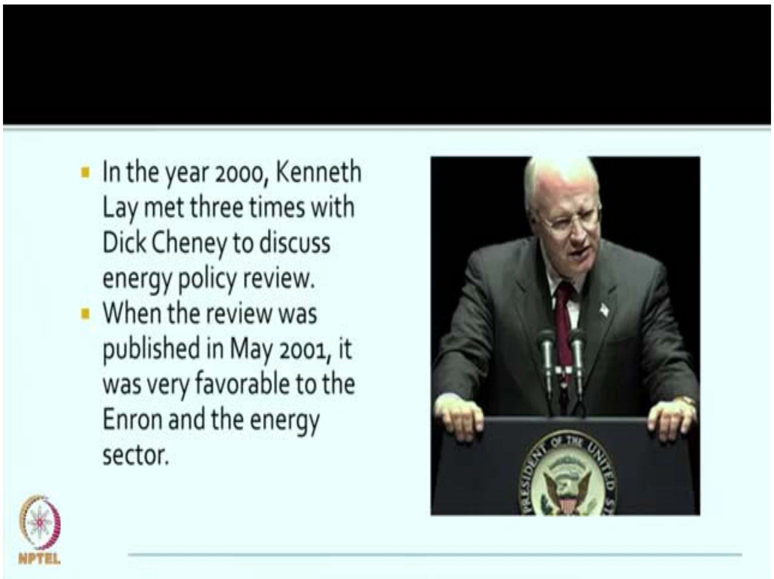

Now, in year 2000, Kenneth Lay who was the chairman of the company three times met with Dick Cheney. Keep in mind, Dick Cheney was a very important politician. He was the secretary of the state of US and the meetings were mainly for discussion on energy policy and the energy policy which was declared in may 2001, was very much in favor of energy sector particularly favoring Enron.

So, Enron had a huge political clout and they could manage the policies of US government for the benefit of their company.

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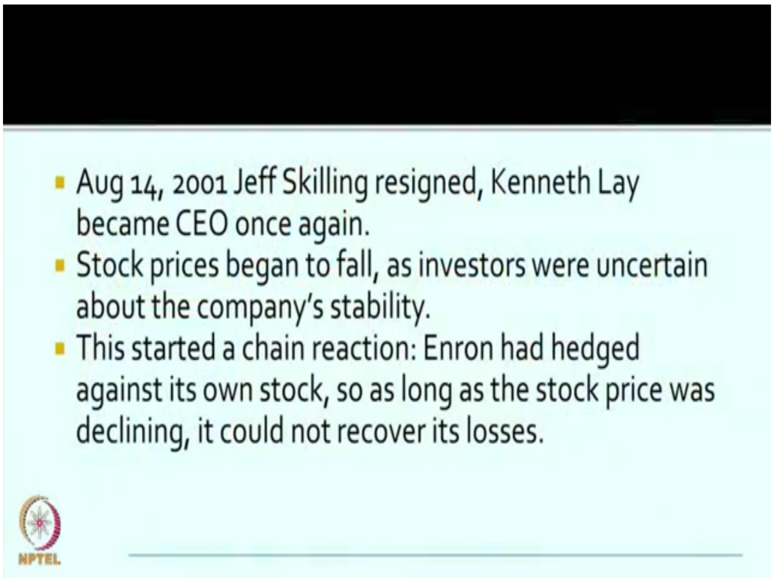

On August 14, 2001 see within just 1 year this Jeff Skilling resigned as a CEO and Kenneth Lay again became the CEO. Now, here the stock market treated it as a wrong news because the CEO has resigned; that means, something is wrong with the company. The stock prices began to fall because now investors were worried about the stability of the company.

Immediately there was a chain reaction. There was a hedging done by Enron against its own stock and as the stock prices declined the hedging led to more and more lost to Enron. Already they were suffering losses in operations, further losses because of stocking prices that led to bankruptcy of company within a very short period of time.

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You can just see in December 2001 they became bankrupt. This is a movement of stock price. In Jan; this is 2000 actually, Jan 2000 the stock price was 40, it reached to 70 eventually by the end of 2000 it reached 90 and by the end of 2001, it just crashed to 1 dollar from 95 to 1 dollar and company became bankrupt and had to be closed. So, you can see such as a short period of time very large company can totally collapse because of failure of governance, because of corrupt people who were in charge they were duping the company, they were duping each other, but ultimately it lead to fall of the company.

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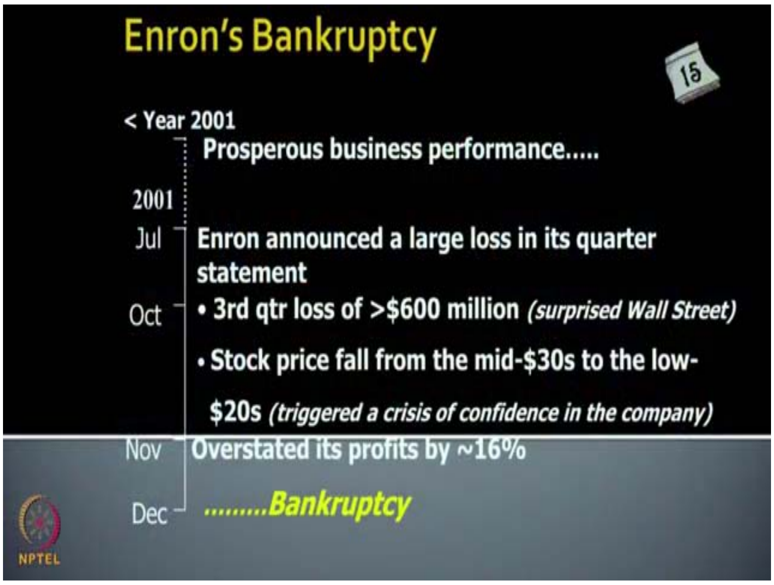

Now, this is the process of their bankruptcy or how it happened. Now, it was a very much prosperous business as they were reporting till July. Now, till their earlier quarter it was a profit making but the July quarter was the first time they reported a huge loss third quarter October end there was a loss of more than 600 million which was extremely surprising the stock prices fell from 30 to 20 and it November it came to be known that they were overstating their profits for so many years and in just one month in December Enron became bankrupt.

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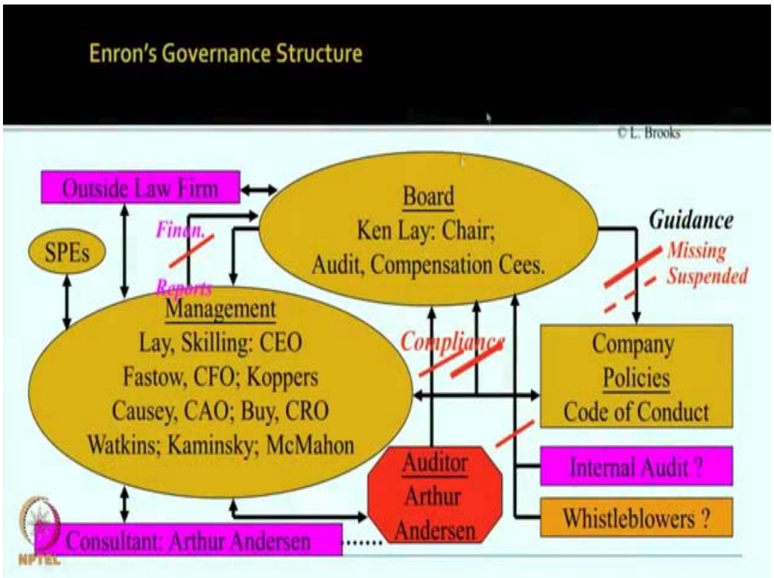

Now, this is their governance structure very complicated ah. Of course, there are shareholders and there is a board. So, board consists of Ken Lay was the chair. There were audit and compensation committees. Management had skilling lay was the CEO, Fastow was CFO, then Causey was CEO and there were other people in the team. Company's policies and code of conduct were in place which was supposed to regulate both the board and management, but proper guidance was not there.

The auditors who are supposed to be overlooking everything they had multiple relationships. Apart from being auditors they were also consultants and making huge amount of money and in a way allowing the company to manipulate their accounts. There were also outside law firms who were part of the consultants, they were getting lot of financial rewards from the company. So, they were also not doing a proper function as an independent professionals. Other functional like internal auditors and whistleblowers also proved to be failures ok.

There were CPs, SPs that is partnerships made by the managing team who were making profit at the cost of company.

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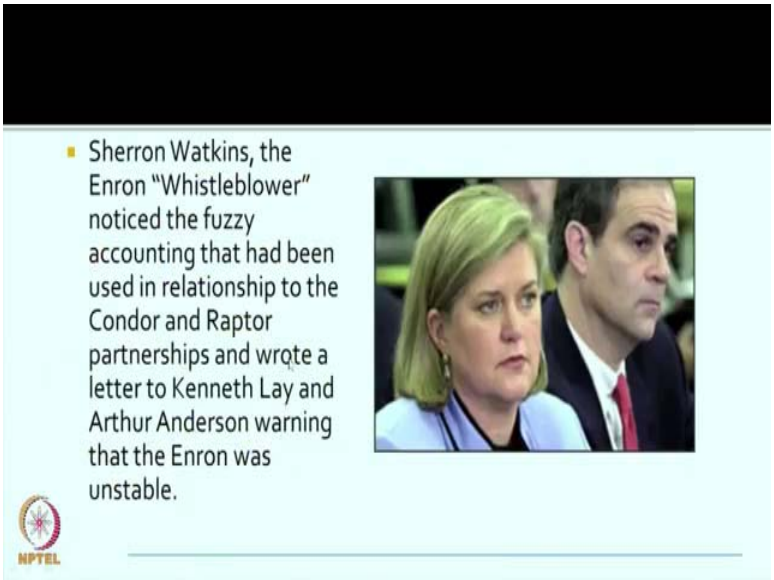

Now, Sherron Watkins she became very famous as a whistleblower. She noticed the fuzzy accounting of the company. She is an outsider, she found out that these partnership condor and raptor were being misused by the company. She rose to the rose and written to the both the chairman Kenneth Lay and auditors Arthur Andersen about the unstability and within very short period market came to know about this and company collapsed.

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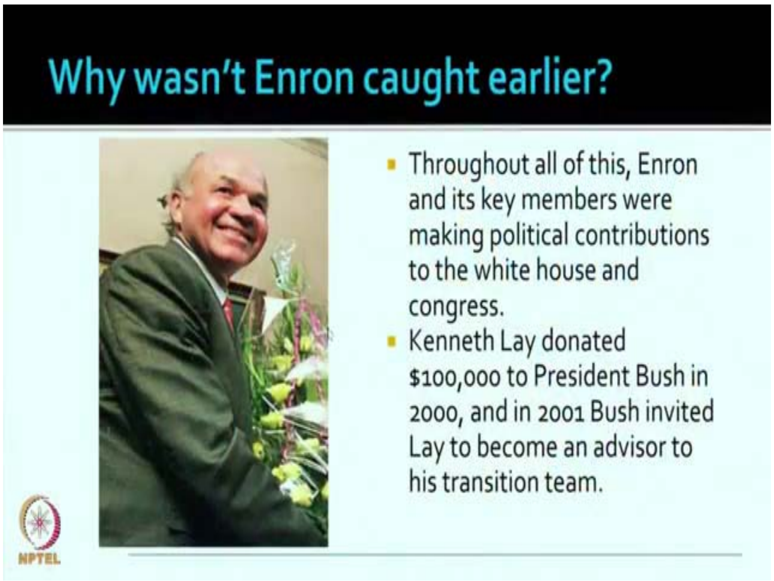

Now, he is the person in charge Kenneth Lay. Throughout this, he was in charge of the company in different capacities and was making lot of political contributions. He had donated more than 1 lakh dollars to President Bush and in 2001; Bush had invited him to become advisor of his transition team.

So, many people who might feel that there is a lot of corruption in India keep in mind there is much more political corruption in US and Enron is a very striking case because Enron was a very big donor to both the major parties in US and indirectly their malpractices were getting a cover up.

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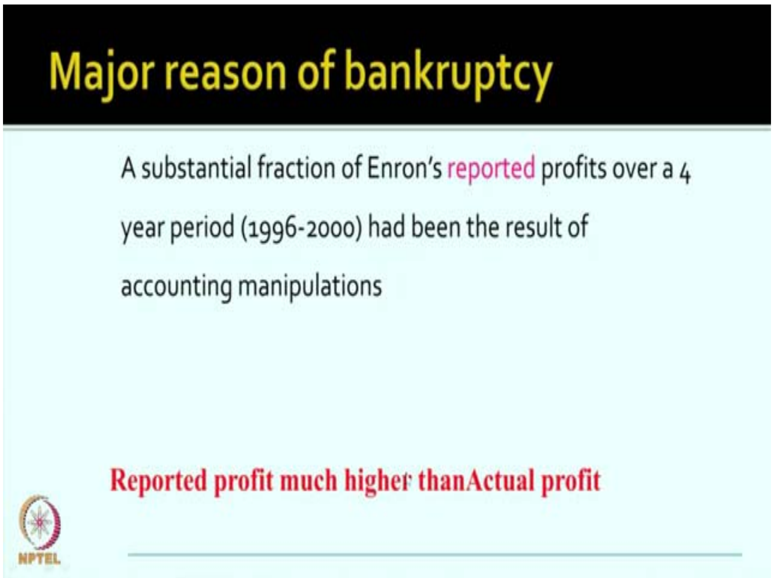

Now, what were the reasons? What was the accounting fraud? See, the actual profit was much less, but the reported profit was very high and this was not just in 2000, this was happening in last four years from 96 to 2000 continuous accounting manipulations were done and thus profits were overstated.

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Now, these are some of the accounting malpractices. One is we have seen an overstatement of profit, bad accounting policies in the form of lower depreciation, not making provisions where it was necessary, not stating various possible risks which could be contingent liabilities requiring provisions, then there were large number of global subsidiaries. So, at several places in the world they had started so called power manufacturing plants and lot of money was being invested there on paper and these plants were nothing much, but they were giving a lot of royalty to Enron. So, there was an internal income.

In the books of Enron, they would report it as a profit and in the books of subsidiaries; they will show it as a capital expenditure. When the company busted it came to be known that most of the plants had nothing in that, they were all going to be perpetually in loss. But, for 3 to 4 years they were showing these expenditures as capital work in progress because see power is the nature of industry is such that it takes a long time of a gestation before you invest and the power production starts that gestation period was used to play with the accounting there.

If you remember, the plant of Enron was has had also started in India at Dabhol near Ratnagiri and there was very big fraud both corporate fraud as well as political fraud done by Enron in India as well under one of it is subsidiaries such a practice was done by several of it is global subsidiaries. But, in US books it was reported as a profit mainly coming from internal income.

So, in short time trying to summarize there was conflict of interest with auditors the most reputed auditors in the world at that time were Arthur Andersen. The biggest audit firm today you might have heard of Big Four the major audit firms even bigger than that was Enron had a of very high respect, but they were into multiple conflicting roles. They were auditors, they were also consultants they were getting automatic renewals and they were party to the fraud. So, this relationship was affecting the independence of auditor.

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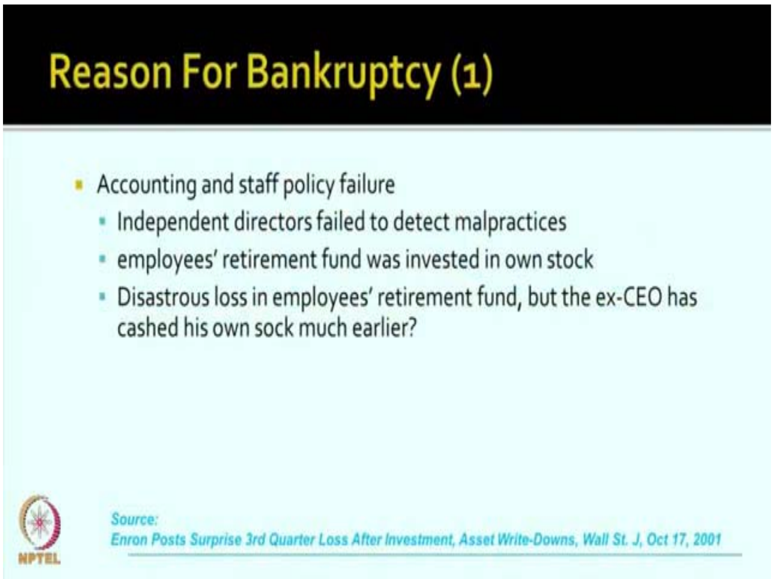

Now, there were also accounting and staff policy failure. Independent directors failed to detect malpractices. We have just discussed that on the board you have got executive directors, non-executive directors and there are also independent directors. In Enron there is a professionally managed company. So, there was nothing like promoting group. Several respectable people like accountants, lawyers or corporate professionals were on the board, but they failed to detect the malpractices.

Company had a big retirement fund. It was invested in their own stock, that money was also used to play with the stock prices. It caused disastrous loss to employees retirement fund because when the company collapse the employees lost job, their retirement money was also affected, but the ex CEO was smart enough here already in cashed in his own stock before. So, people at the helm knew that there are malpractices and they had made money while the employees and small shareholders were losing substantially.

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There was a political confusion as well. There was a very strong relationship with Enron and political parties. So, government, US government failed in proper monitoring.

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There was what is known as managerialism. So, managers had built up their own empires. They were making lot of profit officially from the company as remuneration and also from their partnerships.

There was conflict in the board. So, Enron's board failed to control and oversee it. The board was also benefiting from various other relationships. Board members are supposed to be independent, but they were taking money from Enron in the form of consultancy and other fees. So, there was lack of independence of board.

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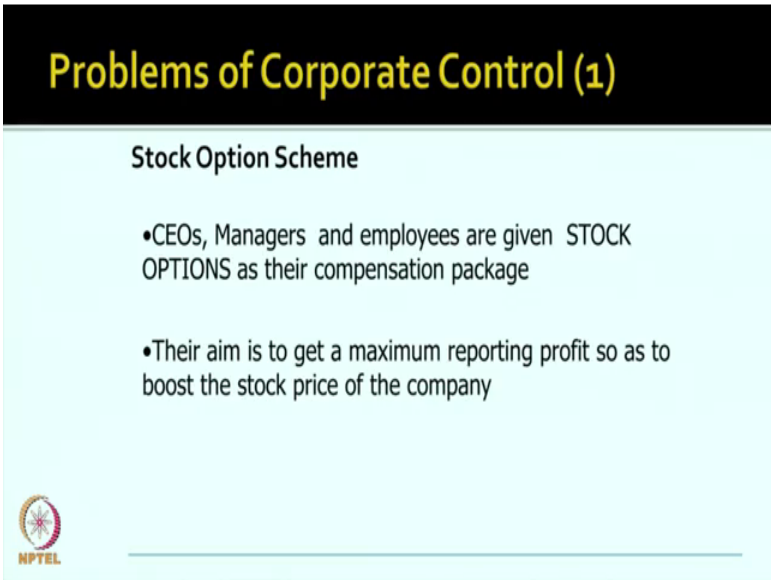

There were stock options schemes. So, CEOs, managers, employees they were very happy because they were making a lot of money from stock options. So, they had every on paper this is a good incentive that they should perform well for better profit, but it was being misused to manipulate profit, show higher book profit which will in turn book boost the stock price of company in the short term, but for a short period they used to get a lot of money.

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Control and management was overlapping. We have already seen that there were corporate partnerships. There so, there was no independence. Private firms partnership firms were valid investment for Enron. So, Enron was making investment in those firms and they were making profits from both the ways. We have already seen this.

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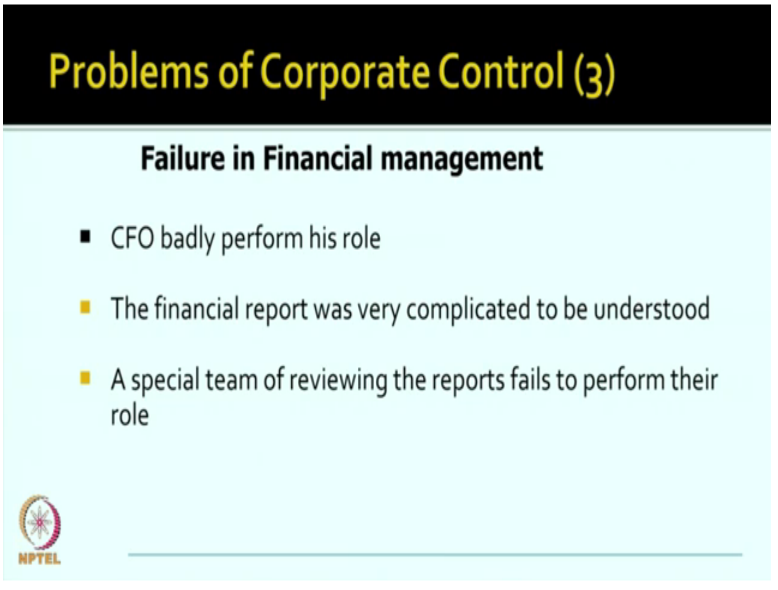

Now, there was also failure of financial management. CFO had done a very poor job. The financial reports, their balance sheet and P and L were extremely complicated. So, even experts in finance could not understand what they have written there, there were no proper notes, there were no proper details. So, deliberately the accounts were made in a confused in a confusing manner. Now, special team of reviewing the reports also failed to perform their job.

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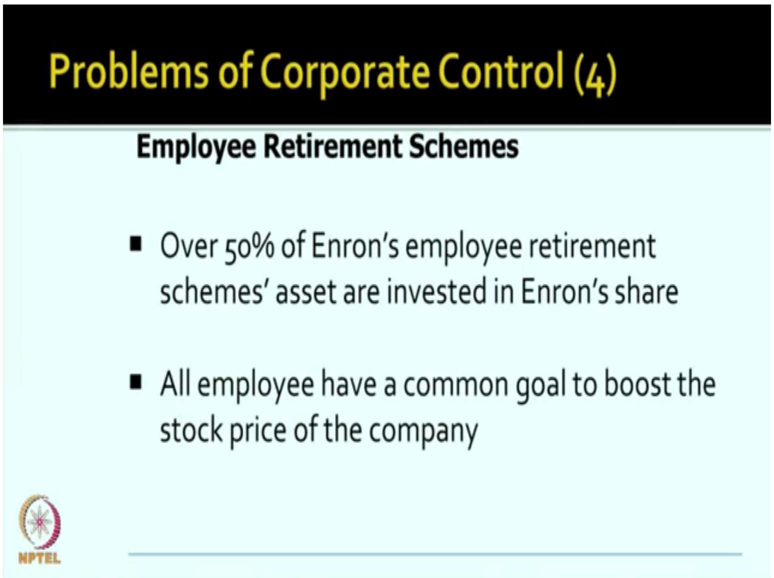

We have also already seen this that more than 50 percent of their retirement money was invested in their own stock. So, the common goal have become to boost stock prices rather than really to boost the performance of the company.

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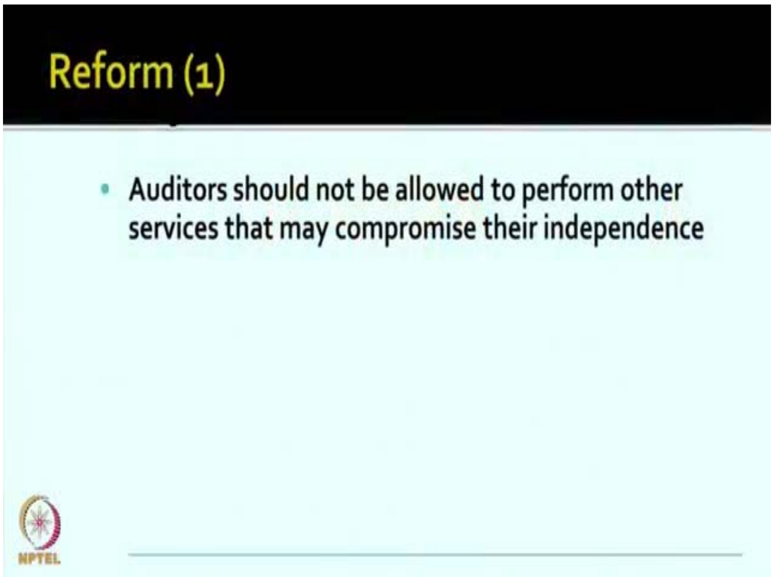

Now, after this many reforms were suggested. One of it was auditors should not be allowed to perform other services because it compromises on their independence.

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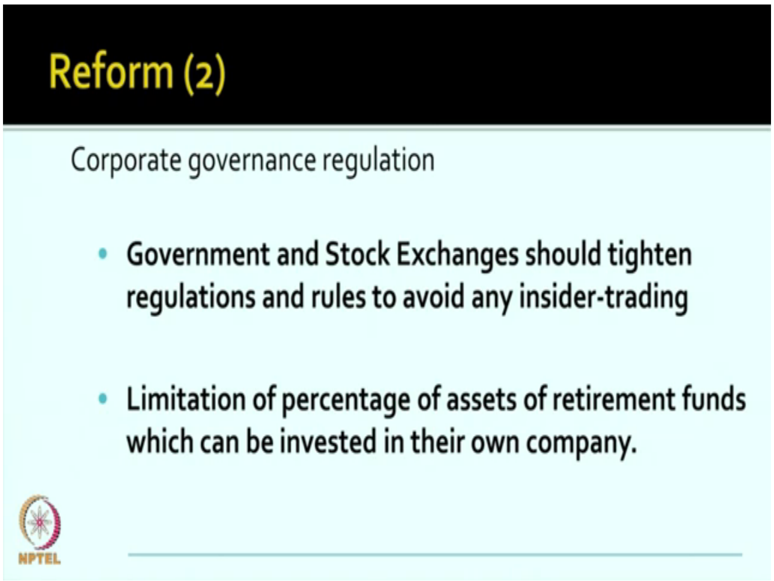

Then government and stock exchanges need to be very cautious and they need to tighten their rules to avoid insider trading because people at the helm of Enron were also involved in insider trading in their stock prices. And, the percentage of assets of retirement funds what can be invested in their own stock also need to be checked.

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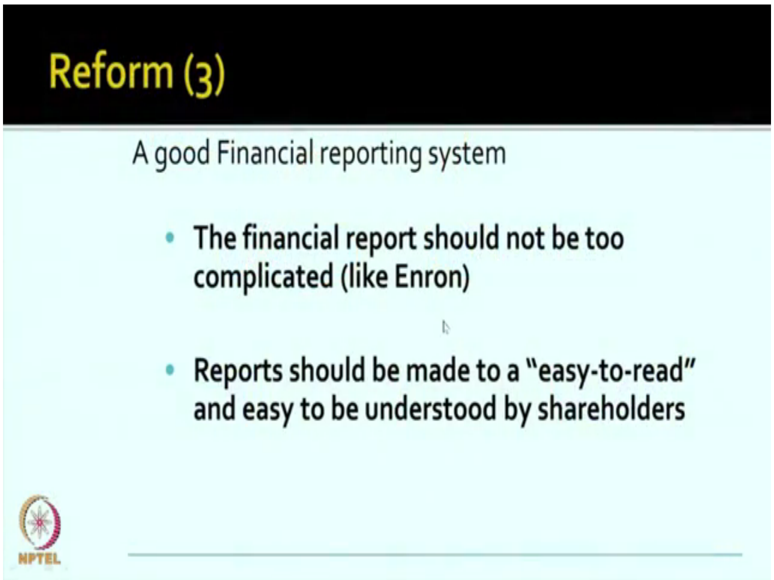

Need for a better accounting reporting financial reporting system. I think we have discussed the formats of P and L and balance sheet. Indian formats are much better, much more transparent compared to US formats. Now, the US also has changed their format, but overall there is need to be less complicated reporting so that the balance sheet P and L cash flow are easy to read. So, these were the reforms which were suggested.

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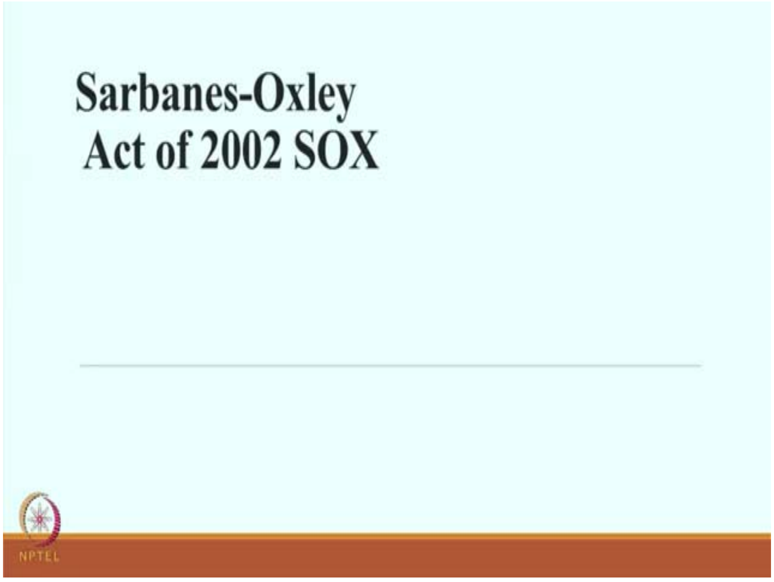

Now, we look at the laws which were changed and some new changes in the law some new changes in the law brought particularly because of Enron problem. But, also because there were several other companies in US facing such things that law popularly known as SOX or Sarbanes-Oxley Act. It is a very big act, it is an American law, but it has affected regulation in other countries also.

So, I have tried to just in summary tell it has significantly affected the way the audits are done, the way the corporate governance is done not only in US, but also in other countries.

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Now, this is a brief history. So, Sarbanes and Oxley are the names of the two congressmen who are brought in this law and this is about the public company accounting reform and investor protection act. The other name for it is Corporate and Auditing Accountability and Responsibility and Transparency Act. I just named the rate read the names because now, you will understand what is the content of the act.

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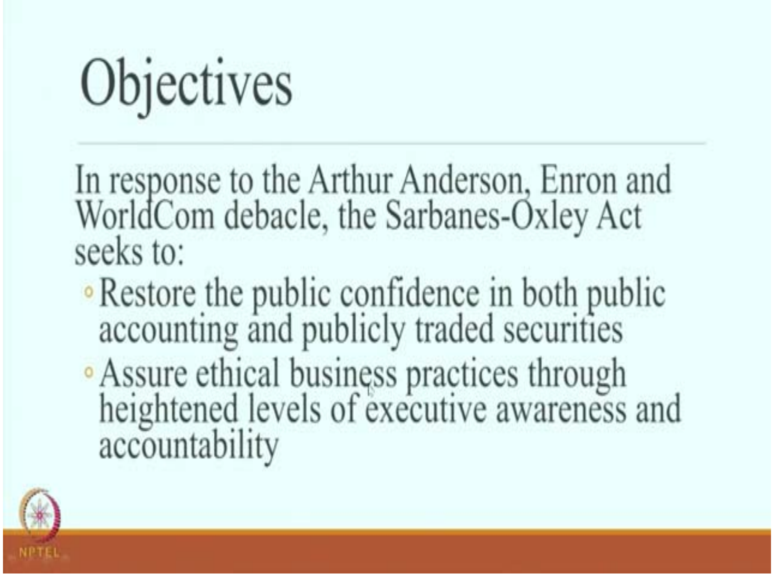

So, the major objective was to restore public confidence because after Enron the confidence was lost and assure ethical business practices because of too much of greed the morals were forgotten so, they are somewhat emphasized. The major fraud of Enron we have also seen. There was also major fraud in world com one other big US chain.

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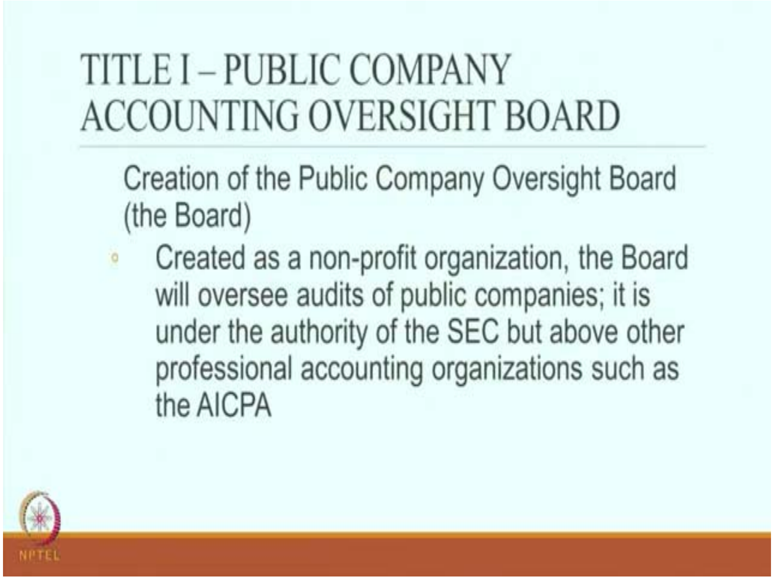

Now, here are some of the major provisions of law are discussed, but we will just go through them. So, a new board known as Public Company Accounting Oversight Board was created. This is in a way regulator on auditors created as a nonprofit organization under the authority of SEC. So, the professional body like AICPA equivalent to Indians ICAI. They do not have much say now; it is a public accounting oversight board which is mainly to as an oversight on auditors.

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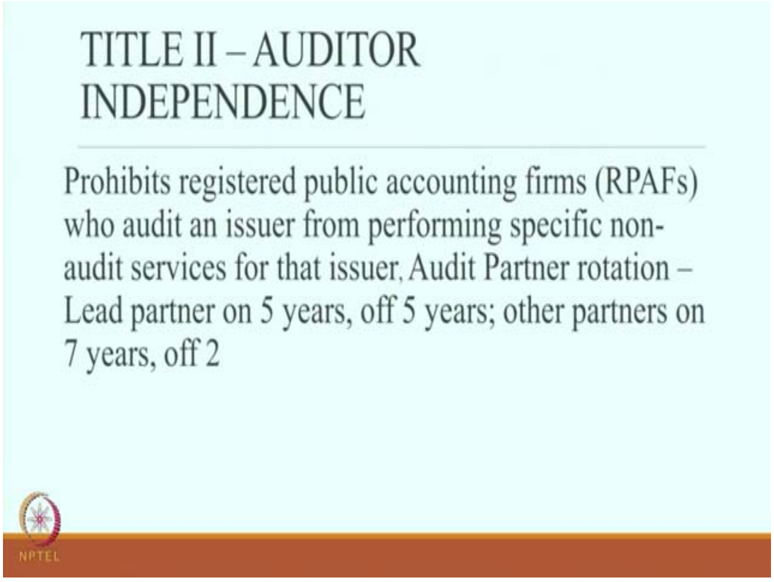

Now, the auditors independence. Now, it prohibits auditors from taking other services like consultancy and also necessitates rotation of audit partners.

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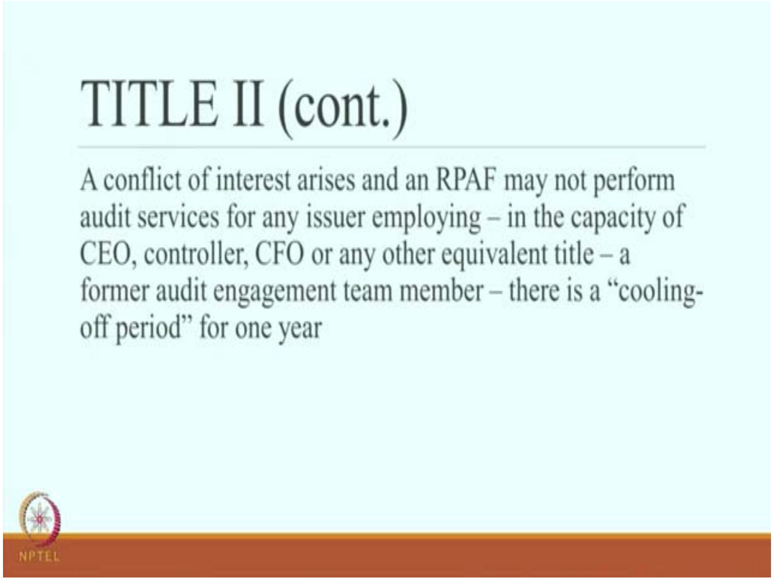

Any conflict of interest should be avoided. So, same person who has say resigned as CEO or CFO should not get audit engagements.

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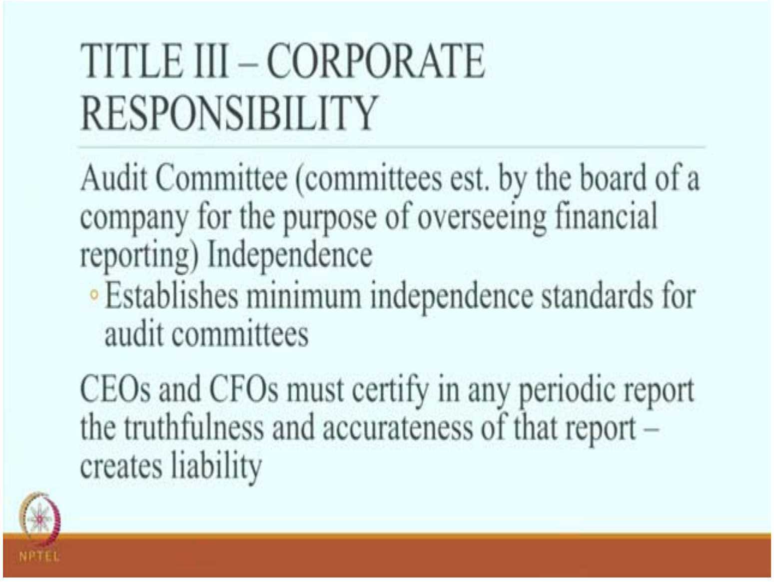

Then, the corporate responsibility; it establishes minimum independence standards for audit committees. Then CEOs and CFO must certify the periodic reports for truthfulness and accuracy.

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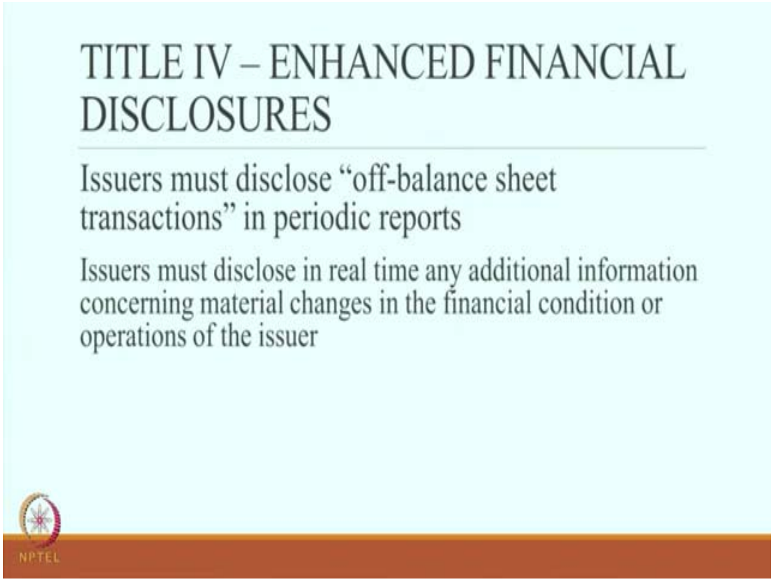

Enhanced financial disclosure; so, new accounting standards were brought in for disclosure of off-balance sheet transactions and the real time disclosure became necessary.

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Now, analyst conflict of interest; analysts operate in stock market. They also have conflict of interest with the company. So, improvement of objectivity of research and providing investors with useful and reliable information was one of the objectives.

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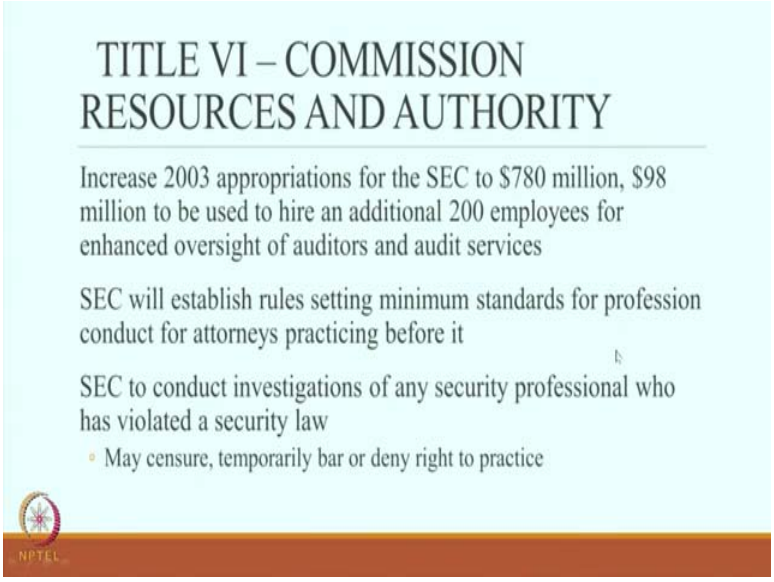

Commission resources and authority; so, SEC created a commission to properly oversee the functioning under the law.

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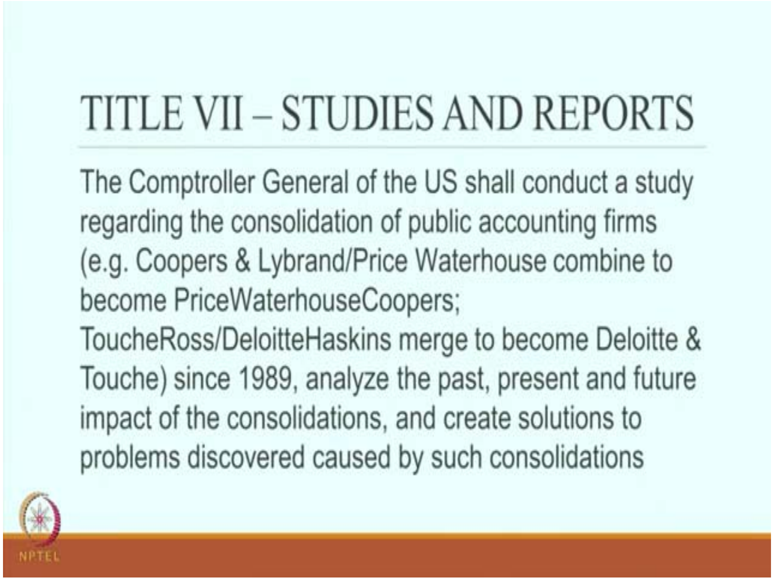

Studies and reports; the Comptroller General of US which is a public body they conducted a study on consolidation of public accounting firms. So, lot of accounting firms like Price Waterhouse Coopers and they created a kind of monopoly. So, the studies were done on the impact of that.

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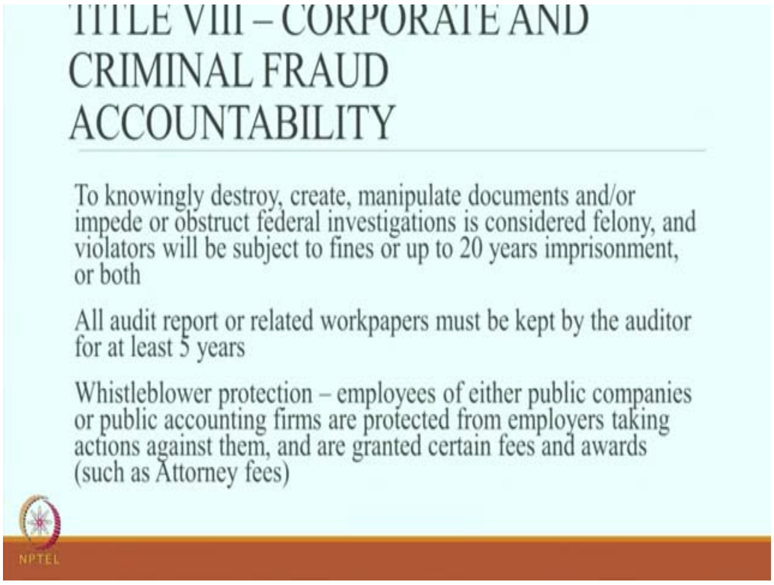

Corporate and criminal fraud accountability; now, generally the white crimes go unaccounted, they do not get much of penalty, but their penalties were increased.

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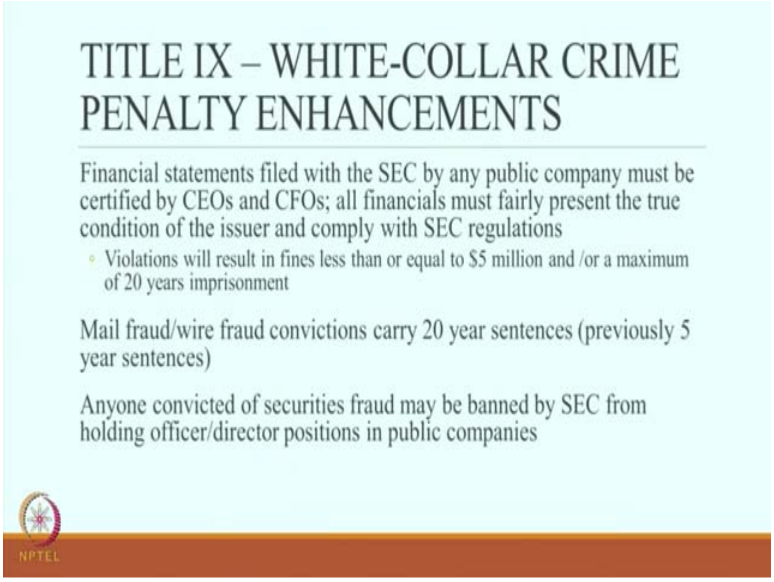

So, white collar crime penalty enhancement was done.

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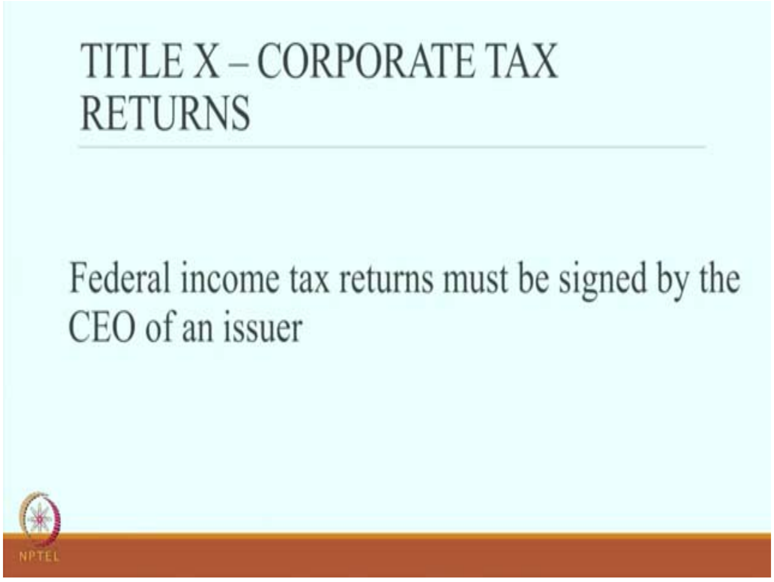

Corporate tax return must be filed by CEO to make the CEO more accountable.

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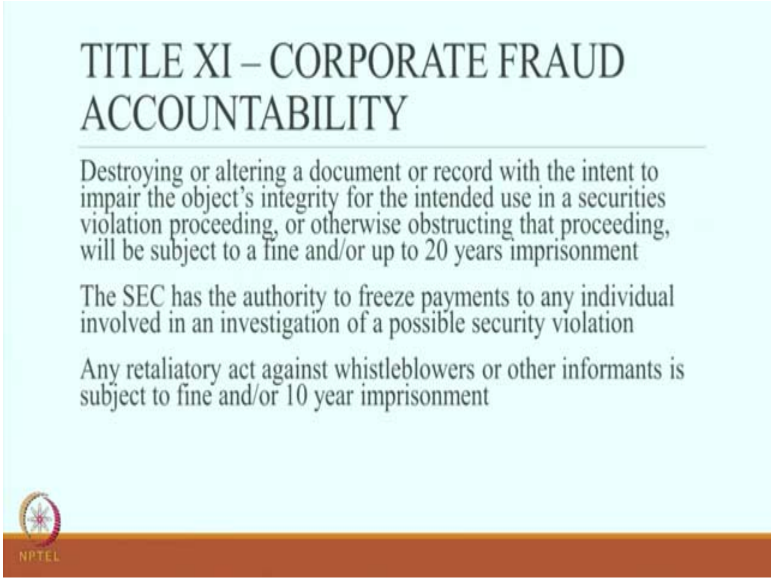

Corporate fraud accountability was also enhanced.

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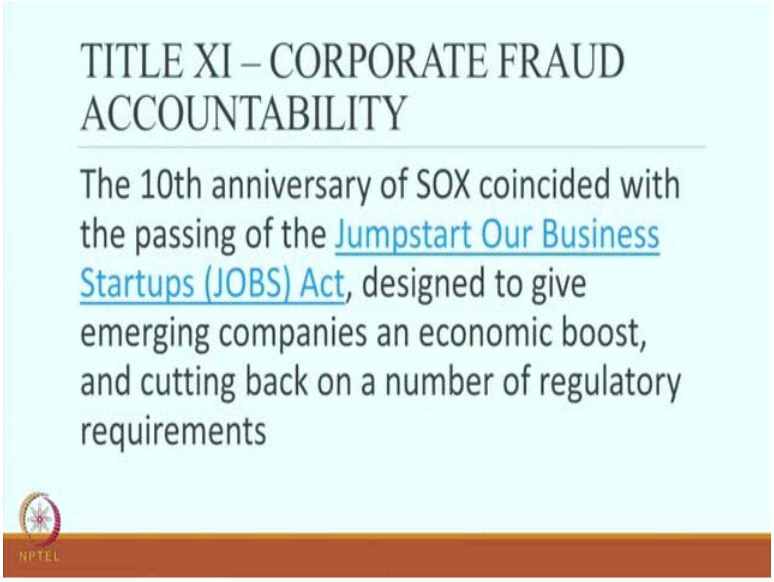

There was also an amendment later on known as JOBS Act to make SOX Act kind of diluted and kind of symbols for small companies.

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This is applicable to US and also to all international companies who have listed any equity or debt in US that is why it has become a kind of global act. It also is applicable to all audit firms.

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There were also some criticisms that it is bringing in too much of control.

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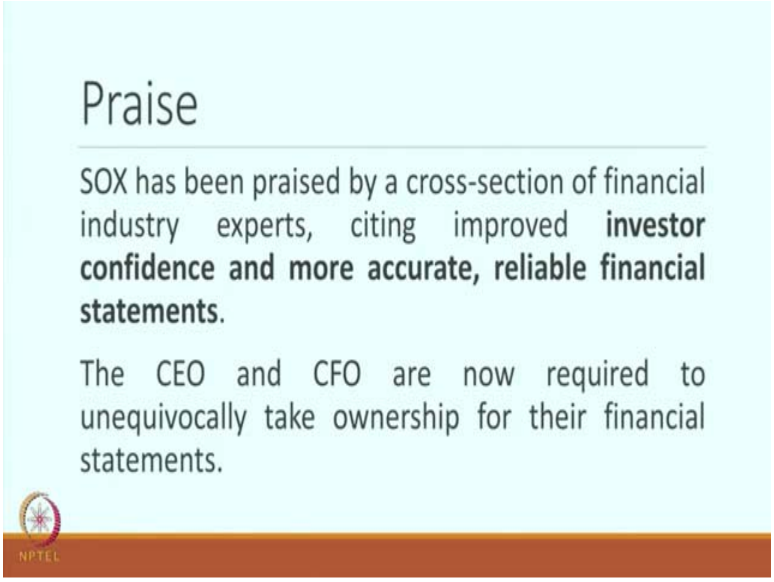

But, overall it is liked and it is praised for better investment confidence and also for more accurate and reliable statements.

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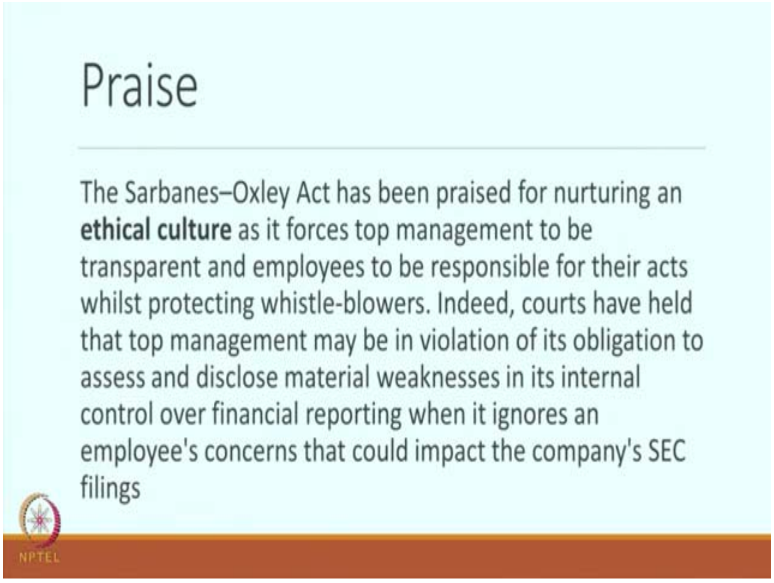

So, the whole purpose was to nurture ethical culture. We also already seen how in Indian system we emphasize on ethics and moral. Under the act in US also emphasize was on ethical culture.

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Now, the similar acts were introduced by many countries in the world for example, C-SOX. Then in Germany, in Japan, South Africa and several countries similar laws have been introduced.

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Including some changes were also made in India and corporate governance laws and rules today have been made much more stricter.

So, with this we will stop our discussion on corporate governance we have discussed what the governance is, we have also seen the various global models, then we discussed

Enron case as a striking example of governance failure and we have seen the reforms mainly through SOX and such other loss.

So, with this we will stop. Namaste.