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Enron: CG Issues[1]

Flaws in Corporate governance

On paper, Enron had a model board of directors comprising predominantly outsiders with significant ownership stakes and a talented audit committee. In its 2000 review of best corporate boards, *Chief Executive* included Enron among its top five boards[i]. Collapse of Enron may be construed as failure of corporate governance in particular the board of directors of Enron. The board failed miserably in its oversight responsibilities. The board had no clue of what the executives were doing. The directors failed to understand the related party transactions between Enron and SPEs. The board flawed in implementing proper systems of control and risk management. The company extensively relied on derivatives for its business, the company's Finance Committee and board did not have comprehensive background in derivatives to grasp what they were being told.

Audit committees of companies usually meet for just a few times during the year, and their members typically have only a modest background in accounting and finance. Enron's audit committee had more expertise than many. It included eminent academicians and senior corporate executives. Enron's audit committee was later criticized for its brief meetings that would cover large amounts of material. In one meeting on February 12, 2001, the committee met for an hour and a half. Enron's audit committee did not have the technical knowledge to properly question the auditors on accounting issues related to the company's special purpose entities. The audit committee failed to review the related party transactions with the SPEs.

Ethical standards of the company had come down to a very low level with employees indulging in self-dealings. Senior executives were selling their holdings in the company while others were buying more and more. Extravagances were rampant. Employees were putting self interest ahead of the corporate interest.

Stakeholders of the company including creditors, credit rating agencies and regulators (mainly Securities Exchange Commission) remained silent spectators until the scam became too evident. They failed to question the wrong accounting policies and faulty business model adopted by Enron.

The collapse of Enron could have been averted had the company had a whistle blower policy in place. Sherron Watkins, one of the employees of the company had raised concerns about some of the accounting concerns in Enron in 1996 but no notice was taken of her concerns and she was shifted to another department. Only in 2001 when she raised the matter of extensive frauds at SPEs again more vociferously that the scandal came to the surface.

Failure of the financial audit

Enron's auditor firm, Arthur Andersen, applied reckless standards in their audits. The auditors' methods were questioned as either being completed solely to receive its annual fees or for their lack of expertise in

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properly reviewing Enron's revenue recognition, special entities, derivatives, and other accounting practices[ii]. Andersen's auditors were pressured by Enron's management to deviate from the established auditing and accounting standards. The auditors bowed to the pressure ostensibly because of a conflict of interest arising from the significant consulting fees generated by Enron. In 2000, Arthur Andersen earned $25 million in audit fees and $27 million in consulting fees. Although Andersen was equipped with internal controls to protect against conflicted incentives of local partners, they failed to prevent conflict of interest. "The evidence available suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal contracts over the related-party transactions"[iii].

Dwindling investors' confidence

As time passed, a number of serious concerns confronted the company. In late 90s Enron faced several serious operational challenges, namely logistical difficulties in running a new broadband communications trading unit, and the losses from constructing the Dabhol Power project, a large power plant in India. There was also mounting criticism of the company for the role that its subsidiary Enron Energy Services had played in the power crisis of California in 2000–2001. In early 2001, burst of internet and telecom bubble in the US questioned company’s expansion into the telecom sector. With a slowing US economy and bearish stock market, the share price of Enron started falling.

The sudden departure of Skilling in August 2001 combined with the complexity of Enron's accounting books made proper assessment difficult for stock market. In addition, the company admitted to repeatedly using "related-party transactions," which some feared could be too-easily used to transfer losses that might otherwise appear on Enron's own balance sheet. A particularly troubling aspect of this technique was that several of the "related-party" entities had been or were being controlled by CFO Fastow. When that became too evident, Fastow was sacked in October 2001. As the month of October came to a close, serious concerns were raised by some observers regarding Enron's possible manipulation of accepted accounting rules; however, analysis was claimed to be impossible based on the incomplete information provided by Enron. While this was underway, one employee of the company Watkins alerted certain board members about the widespread financial improprieties and frauds in the company.

With dwindling investors’ confidence the downfall of Enron was accelerated. In November, 2001 banks started cancelling Enron’s credit facilities, and rating agencies downgraded company’s credit ratings. These constrained the financial position of the company further. It was clear by that time that Enron could no longer survive the shattered confidence. With failed deal of possible acquisition of Enron by a rival firm Dynegy, Enron was left with no alternative but to file bankruptcy in early December 2001.

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[i] Gilan and Martin 2002

[ii] Paul and Palepu (2003)

[iii] Cornford (2004)