Annexure D1

Enron

Corporate Governance Issues

The role of a director, as described by Agatha Christie in her novel *The Seven Dials*, is hopefully no longer appropriate:

"[Coote] got me in as a director of something or other," declares one character. "Very good business for me – nothing to do except go down into the City once or twice a year to one of those hotel places – Cannon Street or Liverpool Street – and sit around a table where they have some very nice new blotting paper. Then Coote or some clever Johnny makes a speech simply bristling with figures, but fortunately you needn't listen to it – and I can tell you, you often get a jolly good lunch out of it."

Part 1 – Executive Summary

1. On December 2, 2001, Enron Corporation, then the seventh largest publicly traded corporation in the United States, declared bankruptcy. That bankruptcy, the largest in US history at that time, sent shock waves throughout the world. Thousands of Enron employees lost not only their jobs but a significant part of their retirement savings; Enron shareholders saw the value of their investments plummet; and hundreds, if not thousands of businesses around the world, were turned into Enron creditors in bankruptcy court and are likely to receive only a small portion of the dollars owed to them.

2. The implications for directors, managers, board committees, investment analysts, asset mangers, pension funds, the accounting profession, regulators, politicians and the man on the street have been enormous. The manner in which business leaders conduct their business affairs is now under much closer scrutiny: with corporate governance practices at the forefront of this scrutiny. Remuneration policies are now being questioned far more frequently and closely; in a nutshell, business practices will never be the same.

3. In a report compiled by the Permanent Subcommittee on Investigations of the Committee On Governmental Affairs, United States Senate entitled "The Role of the Board of Directors in Enron's Collapse"; the Board was found to have failed in its duties in the following areas:

   - Fiduciary failure,
   - High-risk accounting,
   - Inappropriate conflicts of interest,
   - Extensive undisclosed off-the-books activity,
   - Excessive compensation,
   - Lack of independence.

   The report was scathing in its findings of the role of the Board of Enron; in particular in the way it failed to execute its fiduciary duties.

4. What has been learned from the multi-billion dollar Enron lesson? Enron has shown that it was not merely an individual or group of individuals that destroyed the 7th largest corporation in the United States. This was the same as was the case with Nick Leeson and Barings Bank. Both cases clearly illustrate the dangers of weak systems and controls, acceptance by directors of what was being fed to them by management; both masked by the apparent success and profitability of the entities.

5. Accountants failed by not deciding how to account for energy contracts. Auditors failed by not maintaining their integrity and independence. The company failed by not giving enough real power to their risk committees and internal controls.

6. For each of these groups, the thing they failed at was not something of a secondary nature to them; it was the prime reason for their existence.

7. Independence of directors is critical to achieving the required level of probing of management. Directors can no longer just attend meetings, they have to understand the business, the risks it faces and the extent of the power granted to and the responsibility imposed on them.

8. Audit committees need to proactively monitor management and decisions taken to ensure that a realistic picture is presented to the users of the financial statements.

9. Corporate governance is not just an optional extra, in today's business world, it is the life-blood of the corporate world, carrying away waste, providing the antibodies to fight disease, carrying life giving oxygen to the cells.

10. Corporate governance is the check and balance as it ensures that controls work as expected, risks are managed and a "comply or explain" environment fostered.

11. The implications of the collapse of Enron (and other large corporate entities such as Worldcom) have led to massive revisions of, *inter alia,* the role and independence of auditors, the role of audit committees, the role and independence of non-executive directors, the role of investment analysts and investment banks. Almost all modern economies are questioning business ethics, including the implications of the excessive compensation paid to CEOs and executives in many cases. In the USA the Sarbanes-Oxley Act, passed in mid-2002, will have a number of major implications for businesses conducting business there. In certain cases the legislation will also impact on entities in other countries; almost the entire business world, regardless of location will be affected.

Part 2 - Introduction

Aim of this study

12. The aim of this case study is to examine the Enron collapse looking specifically at corporate governance issues. This case study will, *inter alia*, point out: why the independence of directors is critical to transparent operations of a company; why effective boards are necessary for companies to avoid disasters such as Enron; why the audit committee should be a working committee comprising a majority of independent non-executive directors.

13. Underlying all these findings and recommendations are the seven characteristics of corporate governance, namely: discipline, transparency, independence, accountability, responsibility, fairness and social responsibility[1].

14. This case study will also identify some of the global impacts of the breach of corporate governance at Enron. This case study is not the

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[1] OECD document "Principles of Corporate Governance", dated 21 June 1999

definitive case study of Enron but rather an insight to corporate governance lessons that have been learnt from Enron.

15. Before we examine the corporate governance failures and lessons, it would be useful to give a brief background to Enron and the economic climate it operated in.

<u>Background</u>

16. As a company that was generally considered to be the largest natural gas and electricity trader in the world, and one that sparked international awe for having had the Midas touch, any indications that Enron may have faltered were quickly dispelled. In just 15 years, Enron grew from nowhere to be America's seventh largest company, employing 19,000 staff in more than 40 countries.

17. How had Enron managed to become such a large player? Some factors that set the scene in which Enron operated are[2]:

- Years of US restructuring/reorganisation limited the viability of cost based strategies.

[2] KWR International – Board of Directors retreat 2002. (www.kwrintl.com)

- Need to "compete" with, and seek the same inflated valuations, as the highflying Internet and tech companies.
- Low interest rates throughout the 1990's helped to perpetuate an already overheating economy.
- Insufficient income/revenue growth created the need for ever more aggressive accounting/business practices.
- The US economy was during the 1990's experiencing the longest bull market in its history.

18. In 1985, after the deregulation of the natural gas pipelines, Enron was born from the merger of two market players. In the process of the merger, Enron incurred massive debt and as the result of deregulation, no longer had exclusive rights to its pipelines. In order to survive, the business had to alter its business strategy. It did this by employing Jeffery Skilling. From his background in banking and asset and liability management, he proposed that Enron become a "gas bank" whereby Enron would buy gas from a network of suppliers and sell it to a network of consumers, contractually guaranteeing supply and price.

19. By the end of 1997, after a number of strategic acquisitions, Enron developed a division called "Enron Capital and Trade Resources" into the largest wholesale buyer and seller of natural gas and electricity in the

world. Revenue grew from $2 billion to $7 billion and the number of employees in this division grew to 2000 from 200. Using the same concept that had been so successful with the "gas bank", Enron was ready to create a market for anything that anyone was willing to trade including weather derivatives.

20. Enron Online, created in late 1999, was an electronic commodities trading website and was one of Enron's most progressive developments. Firstly, Enron were the counterparty to every transaction conducted on the platform. This allowed them to receive valuable information regarding the market players, "long" and "short" views, as well as the products' prices in real time. Secondly, given that Enron was either a buyer or a seller in every transaction, credit risk management was crucial and Enron's credit rating was the cornerstone that gave the energy community the confidence that Enron provided a safe transactions environment. Enron Online became an overnight success, handling $335 billion in online commodity trades in 2000[3].

21. Early in 2001, Enron had plans for greater earnings for the year after two consecutive quarters of earnings increases; however the company faced

[3] The Rise and Fall of Enron – C William Thomas, Journal of Accountancy April 2002.

one key obstacle - concentration risk associated with its energy trading business. It was hoped that Enron's strong second quarter earnings report could help offset the liquidity risks it had thus far faced. Liquidity risk fears appeared to have been offset by the fact that Enron was a world-class company with a worldwide network and a market capitalization of $36 billion and assets of over USD 65 billion of which $7.3 billion were current assets and reportedly $288 million in cash[4].

22. Enron earned more than 90% of its revenue from a business it called "wholesale services," Enron's euphemism for trading. Enron, in its 2000 annual report described that activity as follows: "Enron builds wholesale businesses through the creation of networks involving selective asset ownership, contractual access to third-party assets and market-making activities." The statement, as one market commentator at Forbes[5] said, is "*characteristic of Enron's discussion of its finances as it reads like something written in German, translated to Chinese and back to English by way of Polish.*"

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[4] Financial Services Board strategic planning workshop 5 February 2002 – Enron Case Study

[5] Forbes – Enron the Incredible (http://www.forbes.com/2002/01/15/0115enron.html)

23. In fact, 97 percent of Enron's profits came from the company's wholesale services division, which included its trading unit. In addition to its concentration exposure, Enron was exposed to the added risk-drivers of softening demand, dropping market prices for energy and the belief that the California energy crisis had peaked.

Revenue

24. Most of the attention paid to Enron's finances has focused on its balance sheet - in particular how it hid debt by allocating it to supposedly independent private partnerships. But the jet engine of Enron's share-price rise was not its asset and liability picture, but its otherworldly increase in revenue: between 1996 and 2000, Enron reported an increase in sales from \$13.3 billion to \$100.8 billion. To put Enron's 57% five-year sales growth rate in perspective, during that same period, Cisco Systems enjoyed a 41% sales growth rate. Intel's rate was 15%[6].

25. Enron more than doubled its reported sales between 1999 and 2000. Before it declared bankruptcy, Enron said it was on track to double revenue again. Had it done so, it would have become the second-largest

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[6] Forbes – Enron the Incredible (http://www.forbes.com/2002/01/15/0115enron.html)

corporation in the world in terms of revenue. It might even have edged Exxon Mobil (2000 revenue: $206 billion) for the number-one slot. By way of comparison, in 2001, the current GDP of South Africa, when converted at an average rate of R8.60 to the US Dollar, was $110 billion. It is highly unlikely that a relatively obscure energy-trading company would after a fairly short period of time be the world's largest company by revenue. Yet this did not seem to generate a lot of questions from the market.

How did Enron make this revenue?

26. Enron was able to book such large revenues by exploiting an accounting loophole. This loophole occurred because the Financial Accounting Standards Board (FASB) could not decide how energy contracts should be accounted for. Enron booked revenue from huge energy-derivative contracts at their gross value, not their net value as is done with other securities transactions.

27. But beyond the trading of energy futures contracts back and forth with huge notational values, Enron's sales grew because it was a "market maker" serving as the middleman on deals. It would put a buyer together

with a seller, take "delivery" of the contract for one fleeting moment and book the entire "sale" as revenue to Enron.

The People at Enron

28. Forbes believes Enron's reported performance is even more incredible when observing revenue generated per employee. As of 2000, Enron had 19,000 employees and per employee, Enron claims it generated $5.3 million per employee in revenues. This figure is more than triple that of Goldman Sachs, which generated $1.7 million per employee. The men and women of Enron made the monopolists at Microsoft (revenue per employee: $610,256) look like slackers. They put the workers of Citigroup ($469,748 per employee) and IBM ($283,333) to shame. Once again these signs failed to arouse the suspicions of the market.

Part 3 - The end of the seventh largest corporation in the US

The end

29. Enron filed for the largest bankruptcy in US history on 2 December 2001. Enron lost, according to Newsweek's estimates, $2 billion on broadband, $2 billion on water, $2 billion on a Brazilian utility and $1 billion on the electricity plant in India[7]. The collapse destroyed the awe surrounding Enron to reveal the crippling debt that Enron had managed to hide from the market.

30. Billions of US dollars had been consistently concealed in annual balance sheets, which overstated Enron's income by as much as $600 million during the last five years. Over the period of the next two months, the company's assets plummeted to $24.7 billion, down by more than $40 billion. As mentioned, shares of Enron, which had once ranked seventh on the Fortune 500 list of large corporations, last traded at 67c on January 10, a far cry from a record $90.56 in August 2000[8]. One

[7] www.thedailyenron.com

[8] Financial Services Board strategic planning workshop 5 February 2002 – Enron Case Study

analyst's report stated that the company had burned through $5 billion in cash in 50 days leading to the December bankruptcy[9].

31. Since December 2001, when Enron filed for Chapter 11 protection in the USA, it has been subject to several investigations surrounding its accounting and disclosure policies. Untangling the collapse of Enron has been hindered by its secretive culture. But while rivals ascribe Enron's downfall to arrogance in the face of investors' concerns, those who have known the company from its inception also cite lack of internal control.

32. The debacle revolves around a number of off-balance-sheet partnerships. In order to hide their debt, Enron engaged in what has been termed "aggressive accounting". Enron created partnerships with nominally independent companies, some of which were based offshore. These were used to obscure debt exposure and allegedly to cover losses at Enron's broadband entity. These companies had been set up by and headed by Andrew Fastow, the former chief financial officer and were backed, ultimately, by Enron stock.

[9] The Rise and Fall of Enron – C William Thomas, Journal of Accountancy April 2002.

33. Enron never regarded their partners debt as their own, using "off-balance-sheet" accounting. Companies can use off-balance-sheet financing legitimately; however Enron's aggressive use of partnerships was questionable because it failed to disclose the extent of its contingent liabilities.

34. As the company was being liquidated, shareholders saw their investments of over $50 billion vanish. Worse still, the implosion wiped out Enron's employees' savings in pension funds, part of which were converted into equities through the purchase of Enron stock.

Why did Enron end up in this predicament?

35. Management use stock options to align management interests with shareholders without causing undue strain on the balance sheet. Jeffrey Skilling, former Enron CEO in his Senate testimony has the following comment on share options, "*There are cases where you can use equity to impact your income statement, the most egregious, or the one that's used by every corporation in the world is executive stock options ... what you do is you issue stock options to reduce compensation expense and increase your profitability.*" In effect companies manage to pay directors excessive salaries as was the case at Enron without impacting the income

statement. This allows the share price to grow, which benefits not only the shareholder, but the director who has share options.

Who was responsible apart from management for this disaster?

36. Arthur Andersen ("Andersen") signed off on Enron's books and helped structure its deals. Andersen, on whom the general public relied on for accurate information clearly failed in their job. They earned more in 2001 providing consulting services ($27million) to Enron, than they did from the entire audit ($25million). This raised serious questions that will be looked at in the "Post Enron" section of the report.

37. Enron's law firm, Vinson & Elkins ("V & E"), investigated alleged irregularities. They asked few real questions, failed to talk to key witnesses and blessed Enron's controversial partnerships.[10] V&E issued their report one day before Enron restated its financials on November 8 2001 to reflect consolidation of the special purpose entities it had omitted. The restatement added another $591 million in losses and a further $628 million of debt because of those partnerships[11].

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[10] Forbes (www.forbes.com)

[11] The Rise and Fall of Enron – C William Thomas Journal of Accountancy April 2002.

38. Another group that has let the public down are the analysts who work for stock brokerage houses. Even when the problems of Enron were beginning to be highlighted by newspapers, out of 17 analysts who followed Enron, 16 had 'strong buy' or 'buy' recommendations and one had 'hold'. These are so-called experts who are knowledgeable about the firm and the industry and they failed in their duty[12].

39. Conversations with Wall Street analysts who covered Enron indicate they had little or no understanding of how Enron reported such huge numbers. Asked to compare how Enron or Dynegy booked revenue with other businesses, most analysts said that Enron was a trading business and that revenue was not important. Asked to compare the energy traders to securities firms, who are also engaged in trading, one stumbled for an answer and finally said, "You know, that's a really good question".

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[12] Corporate governance failures at Enron – C Gopinath

Impacts

40. In summary, these are the main impacts that Enron had on the financial landscape:

- Decreasing investor confidence (negative).
- Retreat to simplicity & easy-to-understand models (positive and negative).
- Increased call for corporate transparency (positive).
- Review of bank/analyst and auditor/consultant relationships (positive and negative).
- Return to fiscal conservatism and practices (positive and negative).
- Call for increased regulation and scrutiny (positive and negative).
- Political fallout and manoeuvring on all levels (negative).

41. According to a range of companies, energy experts and bankers, the collapse of Enron, so far a political, legal, accounting and investor crisis as detailed above, is now imposing widespread costs on the US economy.

42. The case of Enron employees who invested a large proportion of their retirement savings in company stock is, if anything, even more catastrophic. Some employees have brought a separate suit against the

company under employee retirement law, claiming the company recklessly endangered their retirement funds and illegally prevented share sales that would have prevented some losses. Enron denies these allegations.

43. Shareholders are unlikely to recover more than a fraction of their losses, even if they can prove they were defrauded. Proving securities fraud is normally extremely difficult and proving fraud against auditors is even tougher. Shareholders cannot bring securities fraud lawsuits against Enron, because the company is involved in bankruptcy proceedings, which automatically freezes suits against it. In any case, shareholders would have to take their place behind secured creditors; little, if anything, is likely to be left for them. Investors are therefore largely left with only Enron's directors and its auditors to sue. Even if they prevail, and can tap combined insurance coverage estimated at several hundred million dollars, this will do little to recoup their losses.

44. The insurance industry's losses are estimated at around $2 billion. These losses are expected to be manageable if they are well diversified among insurers and reinsurers.

45. Consequently, there is a search for anything that smacks of the excesses of the 1990s – bloated CEO bonuses, large debt build-ups by companies, and bad corporate practices. The danger is that many practices that are above-board and are, if anything, merely innovative, will get caught in the crossfire. Knee-jerk regulatory changes, often motivated by nothing more than political posturing, can also have unintended negative consequences and should be guarded against.

Part 4 - Corporate Governance

Background to corporate governance at Enron

46. The Financial Services Board reported that as more details of Enron's demise emerged, industry insiders saw similarities with a trading scandal that Enron faced in the late 1980s - in Kenneth Lay's early years as chairman and chief executive. The affair led the company to incur a loss of $142m, a substantial amount, as it reported just $6m in revenues in 1987[13].

47. The trading case, which was settled in 1990 when two former senior Enron executives pleaded guilty to fraud charges, received scant attention at the time because Enron was a much smaller company. The case revealed loose controls that allowed Louis Borget, head of its oil contracts trading subsidiary, and Thomas Mastroeni, the unit's vice-president and treasurer, to operate a trading scheme that eventually cost Enron $142m in petroleum trade losses between October 1985 and October 1987. The two men defrauded Enron by setting up four phony offshore shell corporations to "arrange sham oil trading contracts" with

[13] Financial Services Board strategic planning workshop 5 February 2002 – Enron Case Study

Enron. They masked the unauthorised trading activity by keeping false financial records. Perhaps more troubling, in the light of recent events, is that no explanation to shareholders appeared in subsequent annual reports.

48. The oil-traders scandal showed that Enron did not have a "checks and balances" system in place. Expert opinion was that Enron's actual track record over the years, with regard to both trading incidents and new business development, suggested a consistent difficulty in managing their own risks.

Was there a conspiracy to commit fraud?

49. While certainly extreme and clearly over the line, it appears unlikely the Enron cover-up began as a widespread conspiracy to commit fraud. Rather it seems mostly a case of a business strategy not delivering expected results (quickly enough) and a short-term solution getting totally out of hand. A widening circle of basically good people appear to have gotten swept up in the pressure to behave in a manner mandated by the "frenzy of greed" that characterized U.S. business practices at the time.

50. Despite the trading scandal it suffered in the late 1980s, Enron did not seem to have done much to strengthen its corporate governance and to mitigate further failures in its internal controls. In addition to its poor reporting practices, there were insufficient controls over employees thus allowing many executives to enrich themselves at the expense of the company.

51. Following Enron's acknowledgment of an inquiry by the Securities and Exchange Commission in October 2001, Lay sought to reassure investors, which included many employees, by stating that there was a "Chinese wall" between the partnership (LJM) and Enron. By November 8 2001, however, Lay was forced to admit that several of these special purpose vehicles, which helped to shift debt from the balance sheet, should have been consolidated with the records of Enron for accounting purposes. Many industry peers saw a pattern of delegation, and subsequently poor monitoring of management, emerging.

Overview of the US corporate governance environment

52. Forbes[14] in a recent article wrote, "What do an abandoned child, a stray dog and a derelict automobile have in common with the modern U.S. corporation? They all need someone to be responsible for them. They have no owners. No matter how many segments of society are moved by their plight, how many volunteer agencies work in their behalf, or how many laws and regulations are enhanced for their benefit, there is no substitute for the responsible owner. This vacuum is the appropriate context for understanding the situation of Enron".

The role of the Enron Board

53. In May 2002, five directors of Enron swore before the Senate subcommittee that they were not responsible for the company's collapse. Whether true or false, there is an element of truth about their testimony; corporate directors are not really directing companies. This may seem unconscionable negligence, but it is more fundamentally a result of the design of corporate governance. There is a view that boards of directors

[14] Forbes.com: Where are Enron's owners? (www.forbes.com/2001/11/28/1128enron.html)

don't govern because all essential governance happens before the board meets. In the US, state law mandates directors must act in the best interests of the corporation and its shareholders; which courts interpret to mean maximum share price. So as long as the share price remains high, directors feel confident. Yet it was precisely the hyperinflation of the share price that destroyed Enron.

54. "When the stock is rising and shareholders are getting rich, there is little incentive for the board ...and investment community to question the executives ...closely. The board is at fault for permitting the suspension of Enron's own code of conduct to permit the conflicts ...inherent in the off-books corporations ...A few analysts recommended (to)...stay out of Enron, but not many."[15]

55. Management theory tells us that the board performs three roles: control (overseeing the functioning of the corporation and its management), service (being a link between the corporation and its external stakeholders), and strategy (providing a direction for the enterprise into the future). Of these three roles, control is the most basic and traditional role that provides the raison d'etre for a board.

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[15] Interview with Kirk Hanson, Executive Director of the Markkula Center for Applied Ethics, in Nikkei Newspaper

Findings of the Permanent Subcommittee on Investigations ("the PSI") of the Committee on Governmental Affairs, United States Senate

56. In a report ("the PSI Report") compiled by the PSI entitled "The Role of the Board of Directors in Enron's Collapse"; the Board was found to have failed in its duties in the following areas:

    a) Fiduciary failure,
    b) High-risk accounting,
    c) Inappropriate conflicts of interest,
    d) Extensive undisclosed off-the-books activity,
    e) Excessive compensation,
    f) Lack of independence.

    Each of these is covered in more detail below.

***a) Fiduciary failure*[16]**

57. Finding: "*The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive*

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[16] The PSI Report – pages 11 to 14

compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates."

58. During interviews before the PSI, Enron Directors indicated that they were as surprised as everyone at the demise of the company. There were, however, more than a dozen incidents over the years that should have raised Board concerns. Examples of these incidents are the following:

- Board members were advised in February 1999 that the company was using accounting practices that were "at the edge" of acceptable practice.
- LJM, an unconsolidated associate, produced over $2 billion funds inflow for Enron in only 6 months and Enron's gross revenues jumped from $40 billion in 1999 to $100 billion in 2000. Although these figures are striking, no Board member questioned them.
- In April 2001, the Board was advised that 64 per cent of assets were "troubled" or performing "below expectations". They were also told of international assets that were overvalued on Enron's books by $2.3 billion.

- Sherron Watkins wrote to Ken Lay and warned him that the market perceptions surrounding Jeff Skilling's abrupt departure would be extremely negative. Neither Lay nor the Board used Skilling's resignation as a warning to more closely scrutinize the company's operations.

59. Although there are indications that, in some instances, Enron Board members were misinformed or misled, the PSI investigation found that overall the Board received substantial information about Enron's plans and activities and explicitly authorised or allowed many of the questionable Enron strategies, policies and transactions. Enron's high-risk accounting practices, for example, were not hidden from the Board. The Board knew of them and took no action to prevent Enron from using them.

60. During their interviews, all thirteen Enron Board members strongly refuted that the Board had failed in its oversight duties. They contended that they had reasonably relied on assurances provided by Enron management, Andersen, and V & E, and had met their obligation to provide reasonable oversight of company operations. During the hearing, all five Board witnesses explicitly rejected any share of responsibility for Enron's collapse.

61. The failure of any Enron Board member to accept any degree of personal responsibility for Enron's collapse is a telling indicator of the Board's failure to recognize its fiduciary obligations to set the company's overall strategic direction, oversee management, and ensure responsible financial reporting.

b) High-risk accounting[17]

62. Finding: "*The Enron Board of Directors knowingly allowed Enron's use of High-risk accounting practices.*"

63. There is much evidence that the Board knowingly allowed the use of high-risk accounting practices. Outside experts concluded that the Board, after having being told that the accounting practices being followed were high-risk, should have asked a lot of questions. Furthermore, being told of high-risk activities by the auditors "is a giant red flag".

[17] The PSI Report – pages 15 to 24

64. There are several instances where Andersen advised the Audit Committee that Enron was engaging in accounting transactions that could be deemed high-risk.

65. Andersen's legal team stated that one document provided to the Audit Committee was intended to advise the Audit Committee that, even with Andersen's backing, Enron's use of the identified accounting practices invited accounting scrutiny and ran the risk that the company could later be found to be in non-compliance with generally accepted accounting principles. In addition, Andersen's legal counsel indicated that the firm intended to convey to the Audit Committee that Enron's use of highly structured transactions, with multiple special purpose entities and complex overlapping transactions, ran the risk that, if one element failed, the entire structure might fail and cause the company to fall into noncompliance.

66. On February 7, 1999, Andersen informed the Audit Committee members that Enron was engaged in accounting practices that "push limits" or were "at the edge" of acceptable practice. In the discussion that followed, Andersen did not advocate any change in company practice, and no Board member objected to Enron's actions, requested a second opinion of Enron's accounting practices, or demanded a more prudent approach.

67. In addition to the Audit Committee's receipt of explicit briefings on Enron's high-risk accounting practices, many other documents demonstrate that the Board knowingly allowed Enron to use high risk accounting techniques, questionable valuation methodologies, and highly structured transactions to achieve favorable financial statement results.

68. When confronted by evidence of Enron's high-risk accounting, all of the Board members interviewed by the Subcommittee pointed out that Enron's auditor, Andersen, had given the company a clean audit opinion each year. None recalled any occasion on which Andersen had expressed any objection to a particular transaction or accounting practice at Enron, despite evidence indicating that, internally at Andersen, concerns about Enron's accounting were commonplace. But a failure by Andersen to object does not preclude a finding that the Enron Board, with Andersen's concurrence, knowingly allowed Enron to use high-risk accounting and failed in its fiduciary duty to ensure the company engaged in responsible financial reporting.

c) *Inappropriate conflicts of interest*[18]

69. Finding: *"Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing".*

70. The Board waived the company's code of conduct and allowed its CFO, Andrew Fastow to establish and operate off-the-books entities designed to transact business with Enron. This arrangement allowed inappropriate conflict of interest transactions as well as accounting and related party disclosure problems, due to the dual role of Fastow as a senior officer at Enron and an equity holder and general manager of the new entities. Nevertheless, with little debate or independent inquiry, the Enron Board approved three code of conduct waivers enabling Fastow to establish three private equity funds in 1999 and 2000.

[18] The PSI Report – pages 24 to 39

71. The Enron Board approved code of conduct waivers for Fastow knowing that the LJM partnerships were designed to transact business primarily with Enron, and controls would be needed to ensure the LJM transactions and Fastow's compensation were fair to Enron. The Board failed, however, to make sure the controls were effective, to monitor the fairness of the transactions, or to monitor Fastow's LJM-related compensation. The result was that the LJM partnerships realized hundreds of millions of dollars in profits at Enron's expense.

72. Most of the interviewed Board members said they had not been troubled by the conflicts of interest posed by the LJM partnerships due to the controls adopted to mitigate the conflicts.

73. The Enron Board failed to uncover the deficiencies in the LJM controls or to make up for them through its own oversight efforts.

74. The Board's role in overseeing Fastow's LJM compensation was also very lax. For the first year, the Board apparently relied on Skilling to review Fastow's LJM-related income and asked no questions. In October 2000, after LJM1 had been operating for more than one year and the Finance Committee was told that LJM1 and LJM2 were engaging in multiple, high dollar transactions with Enron, the Finance Committee

asked the Compensation Committee to conduct a one-time review of Fastow's compensation.

75. In October 2000 the Chairman of the Compensation Committee attempted to obtain information requested by the Finance Committee relating to Fastow's compensation from the company's senior compensation officer but was fobbed off and the matter dropped. It was only after an article in the Wall Street Journal in October 2001 stating the Fastow had received compensation from the LJM transactions exceeding $7 million, was the matter pursued further. It was then ascertained that the compensation received by Fastow was actually in the region of $45 million.

76. A number of Board members claimed that the Board had been misled or misinformed regarding key aspects of the LJM partnerships. However, the information it did have should have triggered a demand for more detailed information and, ultimately, a change in course. But the Board allowed the LJM-Enron transactions to go forward with few questions asked. All of the consequences that followed flowed from the initial Board decision to allow the LJM partnerships. While the Board was advised that Enron management and Andersen supported going forward, the final decision on whether to allow Fastow to form, manage and profit

from the LJM partnerships rested with the Board itself. The Board cannot shift the responsibility for that decision to any other participant in the matter.

d) Extensive undisclosed off-the-book activity[19]

77. Finding: *"The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse."*

78. Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron Board and received Board approval as a explicit strategy to improve Enron's financial statements. In fact, Enron's massive off-the-books activity could not have taken place without Board action to establish new special purpose entities, issue preferred Enron shares, and pledge Enron stock as the collateral needed for the deals to go forward. In the end, the Board knowingly allowed Enron to move at least $27 billion or almost 50 percent of its assets off-balance sheet.

[19] The PSI Report – pages 38 to 52

79. During their interviews, only one Board member expressed concern about the percentage of Enron assets that no longer appeared on the company balance sheet; the remaining Board members expressed little or no concern.

80. Accounting and corporate governance experts were of the opinion that Enron's off-the-book transactions were "at the top of the scale in terms of extent". Although it is sometimes appropriate to have some items off-balance sheet, they should not be to the same extent as Enron's.

81. The Board's lack of knowledge of certain aspects of certain transactions (the Raptor transactions), however, does not justify its handling of these transactions. At best, it demonstrates a lack of diligence and independent inquiry by the Board into a key Enron liability. It does not excuse or explain the Board's approval of these transactions based upon what they did know nor does it excuse the Board's failure to ensure adequate public disclosure of Enron's ongoing liability for the transactions.

82. The Enron Board failed in its fiduciary duty to ensure adequate public disclosure of Enron's off-the-books assets and liabilities. Enron's initial public disclosures regarding its dealings with its "unconsolidated

affiliates" such as JEDI, Whitewing, LJM, and the Raptor SPEs are nearly impossible to understand and difficult to reconcile with the transactions now known to have taken place.

83. In October 2000, the Finance Committee reviewed a chart showing that \$27 billion out of \$60 billion of Enron's assets, or almost 50 percent, were held off Enron's books in "unconsolidated affiliates". No Board member objected to this corporate strategy or urged Enron to change course.

84. When asked about Enron's extensive off-the-books activity, one of the Board members, Mr. Blake, stated during his interview that transferring assets off a company's books "is not immoral as long as disclosed." But here, too, the Enron Board failed in its fiduciary duty to ensure adequate public disclosure of Enron's off-the-books assets and liabilities.

e) Excessive compensation[20]

85. Finding: "*The Enron Board of Directors approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed, multi-million dollar, personal credit line.*"

86. Enron provided its executives with lavish compensation. On more than one occasion, it paid tens of millions of dollars to a single executive as a bonus for work on a single deal. Stock options were distributed in large numbers to executives. One executive, Lou Pai, accumulated enough stock options that, when he exercised them and sold the underlying stock in 2000, he left the company with more than $265 million in cash. Kenneth Lay alone accumulated more than 6.5 million options on Enron stock. In 2000, Lay's total compensation exceeded $140 million, including $123 million from exercising a portion of his Enron stock options, an amount which exceeded average CEO pay at U.S. publicly

[20] The PSI Report – pages 52 to 54

traded corporations by a factor of ten and made him one of the highest paid CEOs in the country.

87. The Enron Board, through its Compensation Committee, was not only informed of the company's lavish executive compensation plans, it apparently approved them with little debate or restraint. One Board member said during his interview that Enron's philosophy was to provide "extraordinary rewards for extraordinary achievement"; others claimed that the company was forced to provide lavish compensation to attract the best and brightest employees.

88. The Compensation Committee appeared to have exercised little, if any, restraint over Enron's compensation plans, instead deferring to the compensation plans suggested by management and the company's compensation consultants. During their interviews, the Committee members said it had not occurred to them that, by giving Enron executives huge stock option awards, they might be creating incentives for Enron executives to improperly manipulate company earnings to increase the company stock price and cash in their options. One Board member admitted, however, that Enron was a culture driven by compensation. Another said, when asked why Enron executives misled the Board and cheated the company, that he "only can assume they did it for the money".

f) Lack of independence[21]

89. Finding: *"The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor."*

90. With regard to **board independence**, the PSI found as follows:

- Expert witnesses testified that financial ties between Enron and certain Directors had weakened the independence and objectivity of the Enron Board. These financial ties, which affected a majority of the outside Board members, included the following:
  - Since 1996, Enron paid a monthly retainer of $6,000 to Lord John Wakeham for consulting services, in addition to his Board compensation. In 2000, Enron paid him $72,000 for his consulting work alone.
  - Since 1991, Enron paid Board member John A. Urquhart for consulting services, in addition to his Board compensation. In

[21] The PSI Report – pages 54 to 58

2000, Enron paid Urquhart $493,914 for his consulting work alone.

- Enron Board member Herbert Winokur also served on the Board of the National Tank Company. In 1997, 1998, 1999, and 2000, the National Tank Company recorded revenues of $1,035,00, $643,793, $535,682, $370,294 from sales to Enron subsidiaries of oilfield equipment and services.
- In the five years prior to 2002, Enron and Kenneth Lay donated nearly $600,000 to the M.D. Anderson Cancer Center in Texas. In 1993, the Enron Foundation pledged $1.5 million to the Cancer Center. Two Enron Board members, Dr. LeMaistre and Dr. Mendelsohn, have served as president of the Cancer Center.
- Since 1996, Enron and Belco Oil and Gas engaged in hedging arrangements worth tens of millions of dollars. In 1997, Belco bought Enron affiliate Coda Energy. Enron Board member Robert Belfer is former Chairman of the Board and CEO of Belco.
- Since 1996, Enron and the Lay Foundation donated more than $50,000 to the George Mason University and its Mercatus Center in Virginia. The Mercatus Centre employs Enron Board member Dr. Wendy Gramm. (In addition, Gramm

(spouse of a Republican Senator) was formerly Chairman of the Commodities Futures Trading Commission ("CFTC") of the federal government. Enron's trading in energy derivatives was exempt from regulation by the CFTC. Shortly after that decision, she quit the commission and joined Enron's board. She is presently Director of Regulatory Studies Program at George Mason University.)

- Charls Walker, a noted tax lobbyist, was an Enron Board member from 1985 until 1999. In 1993-1994, Enron paid more than $70,000 to two firms Walker/Free and Walker/Potter that were partly owned by Walker, for government relations and tax consulting services. This sum was in addition to Walkers's Board compensation. Enron was also, for more than ten years ending in 2001, a major contributor of up to $50,000 annually to the American Council for Capital Formation, a non-profit corporation that lobbies on tax issues and is chaired by Walker.

91. With regard to **auditor independence** the PSI found as follows:

- The Enron Board and its Audit Committee were criticised for inadequate oversight to ensure the independence and objectivity of Andersen in its role as the company's outside auditor.

- Enron Board members told the PSI staff that they had been unaware of any tensions between Andersen and Enron and unaware of the many concerns Andersen had with Enron's accounting practices.
- The Board members observed that they had given Andersen regular opportunities outside the presence of Enron management to communicate any concerns about the company, including whether company officials were pressuring Andersen accountants who raised objections to company proposals. They expressed shock and dismay that Andersen had never conveyed its many concerns about Enron's accounting and transactions to the Enron Board.
- The interviewed Board members indicated that they had not considered whether Andersen might be reluctant to express serious concerns about Enron accounting practices out of an unwillingness to upset Enron management or endanger its fees.

Role of the chairman

92. For many years, Lay was both the Chairman and CEO. For a brief while the two positions were separated, when Skilling functioned as the CEO. When Skilling resigned in August 2001, Lay again took on both roles.

His claim that he did not know too much of the details of the accounting falsification that was going on is, at best, disingenuous.

93. On the eve of January 23, 2002, Lay resigned as Chairman and CEO of the Enron Corporation, under pressure from outside creditors. The resignation came after a string of revelations that raised questions about the conduct of Enron's top executives, including Lay himself. Disclosures by Congressional investigators have shown that Lay helped create and oversee some of the financial arrangements that helped lead to Enron's collapse. Investigations into the collapse of Enron have revealed the following transactions, among others, by Lay[22]:

- Lay had used his shares to repay a loan extended by Enron to him. The value of the loan was not disclosed, and neither was the timing of the transaction, so it could not be determined what value the company placed on these shares.
- Lay was a big seller of Enron stock. Even as he was selling his own shares of Enron stock in September and October, he was reassuring employees that the company would rebound and encouraging them to buy.

[22] Financial Services Board strategic planning workshop 5 February 2002 – Enron Case Study

- In early 2001, Lay sold Enron shares on almost every business day. He acquired these shares by exercising stock options and made a cumulative profit of $21 million on these sales.
- Lay was among a group of 29 Enron executives and directors who made $1.1 billion by selling 17.3 million shares from 1999 to mid-2001. Insider trading investigations continue.

Audit Committee[23]

94. The charter of the Enron Audit Committee explicitly required the Committee to ensure the independence of the company's auditors, assess Enron's internal controls and the quality of its financial reporting, and review Enron's financial statements.

95. The Audit Committee had very limited contact with Andersen, essentially communicating with Andersen personnel only at Board meetings. The Audit Committee Chairman for more than ten years was Dr. Jaedicke. Despite his long tenure on the Audit Committee, the PSI Report concluded that Jaedicke had "rarely" had any contact with Andersen outside of an official Audit Committee or Board meeting.

[23] Extracted from The PSI report pages 1 to 59.

None of the other interviewed Audit Committee members had ever contacted anyone from Andersen regarding Enron outside of an official Enron Committee or Board meeting. None had ever telephoned Andersen directly.

96. Materials produced by the Enron Audit Committee and Andersen indicate that Andersen personnel regularly briefed the Enron Audit Committee about Enron's accounting practices, and that Andersen regularly informed the Audit Committee that Enron was using accounting practices that, due to their novel design, application in areas without established precedent, or significant reliance on subjective judgments by management personnel, invited scrutiny and presented a high degree of risk of non-compliance with generally accepted accounting principles.

97. The Audit Committee formally reviewed Andersen's independence annually, and Committee members told the PSI staff there had never been any sign of a problem. The evidence suggests, however, that the Audit Committee did not probe the independence issue, nor did it initiate the type of communications with Andersen personnel that would have led to its discovering Andersen concerns with Enron accounting practices.

98. The Audit Committee members indicated that they had thought Andersen and Enron had a good working relationship, and taken great comfort in knowing that Andersen was more than Enron's outside auditor, but also provided Enron with extensive internal auditing and consulting services, combining its roles into what Enron called "an integrated audit." Jaedicke maintained that it was a significant benefit to Enron for Andersen to be involved with Enron's activities on a day-to-day basis and to help the company design its most complex transactions from the start. Although one Board member, Lord Wakeham, indicated that he had been concerned that this high level of involvement meant Andersen might be too close to Enron management, most Board members indicated that issue had not been a concern. No Board member expressed any concern that Andersen might be auditing its own work, or that Andersen auditors might be reluctant to criticize Andersen consultants for the LJM or Raptor structures that Andersen had been paid millions of dollars to help design.

99. The Audit Committee was charged by the Board with performing an annual review of the LJM transactions. This task was apparently assigned to the Audit Committee, because its charter included ensuring compliance with Enron's code of conduct and the LJM transactions were

being reviewed to ensure that Fastow was complying with his fiduciary obligations to Enron.

100. On paper, the Audit Committee conducted two annual reviews of LJM transactions in February 2000 and February 2001. In reality, these reviews were superficial and relied entirely on management representations, with no supporting documentation or independent inquiry into facts. The Audit Committee's second review of LJM transactions was equally cursory.

101. An audit committee is almost a 'working' committee and needs to meet more frequently than a full board. Having non-residents on the committee hampers its functioning. One of the Enron members, Mr Ronnie Chan, missed 75 per cent of the meetings in 2001[24].

102. CFO Magazine notes[25] "In the wake of the Enron scandal, shareholders are tightening the screws on audit committees. Now all they have to do is find executives who are willing to serve on the things." Companies should consider board members with corporate finance or Wall Street

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[24] Corporate governance failures at Enron – C Gopinath

[25] CFO.com February 28 2002

experience, argue institutional investor Bert Denton, "rather than wooing former senators. " At the very least, corporate stakeholders, will spend the next year meticulously reevaluating the makeup of audit committees.

Education of Directors

103. The PSI report states: "The board was denied important information that might have led it to action, but the Board also did not fully appreciate the significance of some of the specific information that came before it.[26]" Here is another acknowledgement of responsibility; if they did not have sufficient information, they should have gone seeking it. Reports suggest that Enron operated about 3,500 Special Purpose Entities, that is, partnerships that shifted debt and losses off Enron's balance sheet. If the directors did not understand what was being reported to them, it was their job to educate themselves more about it by asking the right questions and getting more information. This they failed to do.

[26] William Powers, Jr., Member of the Enron Board of Directors and Chairman of the Special Investigation Committee, 1 February 2002

Part 5 - Post Enron

104. *"The rules are already in place; we just have to figure out how to enforce them effectively. When someone runs a stop sign, you don't change the law, you enforce it."* - Bob Williamson, CFO, vFinance Inc.

105. 2001 will go down in the history books as the one that almost brought Corporate America to its knees with the collapse of Enron and several others.

106. Many successful companies suffer from one or more of the faults described above in the corporate governance section. When the company performance is satisfactory, the tendency is to overlook these drawbacks. In Enron's case too many of their faults came together at the same time, causing the company to implode.

107. The US government recognised that there was an immediate and greater need for independent direction in the running of a company. Also, in the public interest, some thus far self-regulating professions had to be more open to scrutiny.

<u>The Sarbanes-Oxley Act - reporting, controls and other provisions</u>

108. As a result, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) was enacted on July 30, 2002, largely in response to a number of major corporate and accounting scandals involving some of the most prominent companies in the United States. Sarbanes-Oxley establishes new standards for corporate accountability as well as penalties for corporate wrongdoing. The legislation contains 11 titles, ranging from additional responsibilities for audit committees to tougher criminal penalties for white-collar crimes such as securities fraud. The US Securities and Exchange Commission (SEC) is required to issue rules implementing several of these provisions.

109. Although Sarbanes-Oxley has implications beyond the US borders, South African companies unless registered with the SEC, will not be directly affected by this Act. Nevertheless, we need to take heed of some of the key lessons and adapt some of the best practices in our market when applicable[27].

[27] PricewaterhouseCoopers – Implications of Sarbanes-Oxley – www.pwcglobal.com

110. In terms of additional disclosures, the Sarbanes-Oxley requires new or more expeditious disclosures and directs the SEC to issue rules requiring other disclosures:[28]

a) Quarterly CEO/CFO certification of periodic reports that the information contained in the report "fairly presents, in all material respects, the financial condition and results of operations of the issuer" [§ 906(a)].

b) Quarterly CEO/CFO certification and report on internal controls. The CEO and CFO must certify that based on their knowledge, there are no materially false statements or material omissions therein; that the report fairly presents the issuer's financial condition, cash flows and results of operations; that the signing officers are "responsible for establishing and maintaining internal disclosure controls and procedures", have designed the controls and procedures to be effective, and have evaluated their effectiveness of the controls within the last 90 days, and that they have presented their conclusions about the effectiveness of the controls in the report; that they have disclosed internal control deficiencies and any fraud by management or employees with a significant role in internal those controls (regardless of materiality) to the auditors and

[28] Summary Of Sarbanes-Oxley Act By David Priebe and Paul Blumenstein. Updated August 30, 2002

the Audit Committee, and that they have disclosed any material weaknesses in internal controls to the auditors.

c) Other quarterly disclosures regarding finance-related procedures in each periodic report include: has the senior finance code of ethics been adopted, who is the Audit Committee financial expert and what non-audit services the auditors provided?

d) Any changes to the senior finance code of ethics need to be reported [§ 406(b)].

e) Section 16(a) requires that stock transaction reports be provided within two days and with next-business-day Internet posting by issuer and the SEC.

f) An annual management report on internal controls which will state the responsibility of management for establishing an adequate internal control structure and procedures for financial reporting, and assess the internal control structure and procedures [§ 404(a)(1)].

g) Quarterly disclosure of off-balance sheet transactions that may have a material current or future effect on financial condition, results of operations, and other metrics [§ 401(a)].

h) Other corporate governance provisions. The Act also establishes new rules affecting other areas of corporate governance. In particular, several provisions affect officer and director compensation and stock trading.

i) No loans to directors or executive officers. Issuers cannot make loans to directors and executive officers, subject to very limited exceptions [§ 402(a)]. Issuers also cannot materially modify or renew any existing loans.

j) New crimes and enhanced penalties. The Act establishes new crimes and increases the maximum penalties for certain existing crimes.

The Sarbanes-Oxley Act - Auditors

111. The auditing profession has until the Sarbanes-Oxley been a self-regulated profession. The Sarbanes-Oxley has the following impact on the auditing firms and the way they do business[29]:

a) The auditors must also attest to and report on the annual management report on internal controls; the Act does not state whether this document is to be included in the report or otherwise made publicly available [§ 404(b)].

b) Auditing firms will "report directly" to the Audit Committee, which is "directly responsible" for the appointment and compensation of the auditors and the "oversight" of their audit-related work [§ 301].

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[29] Summary Of Sarbanes-Oxley Act By David Priebe and Paul Blumenstein. Updated August 30, 2002

In selecting auditors, Committees should be aware that auditors cannot audit an issuer if the CEO, CFO, Controller or Chief Accounting Officer of the issuer was employed by the auditing firm and participated during the previous year on the audit of that issuer [§ 206]. Committees also should note that lead audit partners now must rotate every 5 years [§ 203].

c) Restrictions on non-audit services. Registered public accounting firms cannot perform a list of specified non-audit services for their audit clients, subject to a case-by-case exemption by the SEC [§§ 201(a), (b)]. Any non-audit services that are still allowed by auditors must be pre-approved by the Audit Committee and disclosed in periodic reports [§ 202].

112. Post-Enron, it is clear that the pursuit of profits must stay within ethical bounds, and that executives and shareholders may not enrich themselves by extorting the public or employees. Toothless codes of ethics like Enron's are no help. Ethical concerns must grow teeth – which means biting into reform of corporate governance. While most proposals for reform today merely tinker at the margins, some get to the heart of the matter such as the ones mentioned below:[30]

[30] www.business-ethics.com/corporate

- Ensure auditors really audit by making them fully independent.
- Bar law-breaking companies from government contracts.
- Create a broad duty of loyalty in law to the public good.
    - Today a corporate duty of loyalty is due only to shareholders, not to other stakeholders, and Enron behaved accordingly. Such piracy against the public good would be outlawed under a state Code for Corporate Citizenship, proposed by Robert Hinkley, formerly a partner with Skadden, Arps. His change to the law of directors' duties would leave the current duty to shareholders in place, but amend it to say shareholder gain may not be pursued at the expense of the community, the employees, or the environment.
- Find truly knowledgeable directors: Employees.
    - If Sherron Watkins had been on the Enron board, the whole scandal might have been averted.
- Regulators should be encouraged to enforce sanctions against delinquent directors and to be more pro-active in monitoring governance issues. The Registrar of Companies should establish a register of delinquent directors, which should be available for public scrutiny.

113. Enron will no doubt be viewed as the beginning of a new corporate governance world. Some of the most pertinent issues coming out of the Enron debacle include:

- Financial literacy and an "inquiring mind " are more important than ever, particularly on the Audit Committee.
- Board Membership requires more responsibility than ever before and should not be seen as a retirement hobby.
- Directors need to be actively involved in understanding a company's business - its operation, finances & management.
- Directors cannot simply rely upon the word of management, auditors, and outside professionals.
- Directors must be independent and able to represent the interests of shareholders as they relate to other stakeholders.
- Directors must seek to balance short-term performance pressures with the need to sustain and expand value over the long term.

The Sarbanes-Oxley Act - Audit Committee

114. The Sarbanes-Oxley Act establishes new rules for the composition and duties of Audit Committees. Audit Committees also will be affected by

regulations applicable to auditors, and some of the disclosure rules noted in the Act[31].

- All Audit Committee members must be "independent", meaning that they cannot be an affiliated person of the issuer or any subsidiary thereof, and that they cannot accept any "consulting, advisory, or other compensatory fees" from the issuer (other than in the capacity as a Board or Committee member) [§ 301].
- The Act introduces the concept of an Audit Committee member who is a "financial expert". While the Act does not require that any member be a financial expert, as noted above, it directs the SEC to issue rules requiring each issuer to disclose whether any member of the Audit Committee is a financial expert, and if not, why not [§ 407(a)].
- Audit Committees must establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and for the "confidential, anonymous submission by employees" of "concerns regarding questionable accounting or auditing matters" [§ 301].

[31] Summary Of Sarbanes-Oxley Act By David Priebe and Paul Blumenstein. Updated August 30, 2002

- Audit Committees are authorized to engage independent counsel and other advisers, and issuers must provide appropriate funding for such advisers (as well as for auditors) [§ 301].

115. The time of turning a blind eye or saying that you as a director did not know what was going on has passed. As in England, a comply or explain environment is being developed in the post Enron environment.

Part 6 - Conclusion

116. Hindsight is the only exact science and looking at Enron it's easy to ask, "how could that have happened?" In all honesty - too easily. We all know instances where things are not as they are supposed to be for a number of reasons but we don't speak out for fear of rocking the boat.

117. What has been learned from the multi-billion dollar Enron lesson? Enron has shown that it was not merely an individual or group of individuals that destroyed the 7th largest corporation in the United States. This was the same as was the case with Nick Leeson and Barings Bank. Both cases clearly illustrate the dangers of weak systems and controls, acceptance by directors of what was being fed to them by management, both masked by the apparent success and profitability of the entities.

118. Accountants failed by not deciding how to account for energy contracts. Auditors failed by not maintaining their integrity and independence. The company failed by not giving enough real power to their risk committees and internal controls.

119. For each of these groups, the thing they failed at was not something of a secondary nature to them; it was the prime reason for their existence.

120. Independence of directors is critical to achieving the required level of probing of management. Directors can no longer just attend meetings, they have to understand the business, the risks it faces and the extent of the power granted to and the responsibility imposed on them.

121. Audit committees need to proactively monitor management and decisions taken to ensure that a realistic picture is presented to the users of the financial statements.

122. Corporate governance is not just an optional extra, in today's business world, it is the life-blood of the corporate world, carrying away waste, providing the antibodies to fight disease, carrying life giving oxygen to the cells.

123. Corporate governance is the check and balance as it ensures that controls work as expected, risks are managed and a comply or explain environment fostered.

JA Martin

Partner

KPMG