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A Modest Proposal for Dealing with the Enron Crisis

By Martin Lipton and Jay W. Lorsch *

The Enron/Andersen debacle has called into question our nation's accounting and corporate boardroom practices. Both are critical to maintaining the global preeminence of our capital markets. Without reliable accounting and effective corporate governance the public cannot have confidence in financial statements. Without such confidence, capital markets do not function efficiently.

We draw a sharp distinction between what is necessary to restore confidence in the accounting profession and what is necessary to promote effective corporate governance. Accounting is in a state of crisis and requires immediate major initiatives to restore confidence of clients and the investing public. The guidelines for effective boards of directors have evolved over the past decade and need only be more rigorously applied in every boardroom.

The Enron/Andersen scandal is the most notorious and far-reaching of a series of failures by the accounting profession. Unfortunately, wrongdoing and/or sloppy practices appear to be so pervasive that it compels the conclusion that the public will no longer be willing to accept that self-regulation and peer review can be relied upon to ensure credibility. The underlying problem is that accountants have changed over the past five decades from watchdogs to advocates and salespersons. Auditing has become just one of a number of services, services which include various forms of consulting and tax planning and advice. In these nonaudit areas, accountants "sell" creative tax avoidance and creative financing structures. Statement on Auditing

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StandardsNo.50letters,whichareusedbyaccountantstoadviseclientsastohowatransaction willbeaccountedf orunderGAAP,areoftenusedforanotherpurpose:enablingaclienttostru c-tureatransactionthatcomplieswithGAAPbutislackingintransparencyandisaggressivein maximizingearningsandminimizingdebt.Accountantsnowcompetetomarketcreative a c-counting.TheBigFivelobbypoliticianstoobtainapprovalofthestructuresandtransactions thattheymarket.

Thesetrendsarealsotheresultofthefactthatthebusinessofauditinghasb e-comehighlycompetitivewiththeresultoflowerfeesand profitmarginstothefirms.Asaco n-sequencethefirmspartnershavesoughtmoreprofitablepracticesandhavemoreefficientand low-costmethodstoprovideauditingservices,whichdonotensurequalityaudits.

Asaresultofthisracetoshapeupthe bottomlineintheauditfunctionandthe failureoftoomanyaccountantstomaintainthehighprofessionalstandardsinauditingessential foreffectivenessandcredibility,webelievethatthenationneedslegislationcreatinganind e-pendent,self -regulatoryorganization(SRO)tooverseetheaccountingfirms.Thissolutiontothe crisiswouldleaveaccountingintheprivatesectorwithself -regulation,notgovernmentregul a-tion,butwouldprovidethegovernmentinvolvementthathasnowbecomecriticalt orestoreco n-fidence.TheSROwouldhaverule -making,inspection,oversightanddisciplinarypowerssim i-lartothoseofthestockexchangesandtheNationalAssociationofSecurityDealers,andlike themwouldreporttotheSECandbesubjecttoitsovers ight.Alsolikethoseorganizations,the SROshouldhaveaboardofdirectorsmadeupinpartofactivemembersoftheaccountingpr o-fession,butwithmorethanhalfwhowouldrepr esentthepublicinterest.

If it is not possible to enact legislation creating an SRO, the SEC should use its existing statutory authority to set accounting standards that prevent accountants from initiating or accepting accounting principles that do not truly reflect financial results and financial condition. Where there are several permissible ways to account for a transaction and the differences are material, the SEC should require disclosure of the range of possibilities and the differences in the financial statements if the most conservative and the most liberal methods were applied. These disclosures should be set forth in designated sections of the financial statements and in the MD&A.

The problems that the accounting profession has cannot be off-loaded onto the stock exchanges, securities analysts or the securities industry, or boards of directors or their audit committees. They must be dealt with at the source: the accounting firms themselves and the accounting principles and standards that they apply. In light of the failure of the accounting firms and their existing organizations to provide reliable monitoring, this can now be done only under the auspices of a government agency and the SEC is the obvious choice.

The Enron scandal also raises questions about corporate governance by boards of directors and their audit committees. Ten years ago, we wrote an article in <u>The Business Lawyer</u> titled *A Modest Proposal for Improved Corporate Governance*. Our fundamental thesis was that there was nothing wrong with American corporation laws; the problem was a failure by boards of directors to follow procedures that would result in knowledgeable directors holding corporate management accountable for the performance of their companies. It is still clear to us that, notwithstanding the Enron scandal, there is no need for new laws and regulation in the area of corporate governance. What is needed is even greater compliance with the guidelines we recommended ten years ago and especially the extension of the principles underlying those guidelines

totheproceduresofauditcommittees.Thoseprinciplesareleadership,independence,informa-tionandexpertise.

Leadership.TheindependentdirectorsneedtohavealeaderwhoisnotalsotheCEO.SinceinalmostallAmericancompaniestheCEOandchairmanarethesameperson,werecommended,then,andstillbelieve,thatoneamongtheindependentdirectorsshouldbethatleader.Whileweusedtheterm“leaddirector”todesignatethatperson,thetitleisnotasimpor-tantasthedesignationofsuchaleaderwhoisacceptabletotheoutsidedirectors.Withsuchaleader,directorswhohaveconcernsaboutcompanyconditionsandperformance,haveanindi-vidualwithwhomtheycandiscussthoseissuesandwhocancausediscussionoflegitimatecon-cernsamongallthedirectors.

Wealsobelievethatthechairoftheauditcommitteeshouldbecompletelyinde-pendentandhave“accountingorrelatedfinancialmanagement”experience.TherulesoftheNYSErequirethatallmembersoftheauditcommitteebeindependentandfinanciallyliterateandth atatleastonememberhaveaccountingorequivalentexperience.Exceptinspecialsitua-tions,thechairshouldhavethatexperience.UnlessthechairissoqualifiedititislikelythattheCFOortheauditingfirmpartnerwillbethedominantvoiceinthemeetingsoftheauditcommit-tee.Thechairmusthaveboththerequisiteexperienceandthestaturetobeabletoinsistonfullandcompletediscussionsuntilallmembersofthecommitteearesatisfiedthattheyhavethein-formationtheyneedtomakedecisions.

Further,thisexperienceandstructureshouldenablethechairmantoestablishastrongrelationshipwiththepartneroftheauditingfirm.Theauditorsmaybeworkingwith,and

compensated by management, but they should believe that they have at least an equal responsibility to the audit committee and the chair, who is its spokesperson.

<u>Independence</u>. The majority of the board and the members of the audit committee must be independent. The NYSE defines independence and, if complied with in spirit as well as letter, this definition should be sufficient. First, the audit firm and its key personnel on the company's audit team must also be independent. They and their firms should have no unrevealed ties to the company. While the Big Five auditing firms have exited their major consulting businesses, they continue to provide other advisory services. Accordingly, the audit committee should consider and make an independent determination whether to insist on restricting its auditing firm to only an audit role or not and disclose its reasons for its determination. A similar determination should be made with respect to the rotation of auditing firms: whether they should be changed every three, four or five years in order to prevent long-term, close relationships between the management and the auditing firm. To further assure independence of the auditors, the audit committee should consider prohibiting the company from hiring key personnel of the auditing firm for three years after the person is no longer engaged on the company's account. The audit committee should also have ample opportunity for consultation with the auditor without management present; meetings of the committee should start and end with an executive session without management being present, and the committee as part of the sessions should meet alone with the external and internal auditors.

Independence is important in a further respect. Directors must be able to maintain an independent relationship with their CEO. As directors serve on a board for many years, it is not surprising that they develop a close personal relationship with their CEO. The problem is that they can become so close to the CEO that they lose their critical capacity. This is especially

truewhen,asinthecaseofEn ronandMessrs.LayandSkilling,itsCEOs,boththecompanyand theCEOappeartobedoingwell.Ifdirectorslosetheirindependenceinthissense,theyareno longerc apableofevaluatingtheCEO'sorthecompany'sconductorperformance.

Information. StatementonAuditingStandardsNo.61setsforthmattersthatmust bediscussedbytheauditorwiththeauditcommittee.Itiscomprehensiveandshouldprovide theinformationnecessaryforthecommitteetoperformitsoversightfunction.YetEnronand otherrecentcasesmakeitclearthatitisnotsufficient.Additionally,thecommitteemustbe providedwithinformationregardingalternativeGAAPmethodsthatwouldresultindifferent revenuesandexpenses,assetsandliabilities,profitsandlossesa ndwhatthosedifferencesare. Thecommitteeshouldalsodocumentcarefullywhyitacceptedthemanagement'sandauditor's recommendationsandbesatisfiedthattheinformationisclearlydisclosedinthefinancialstat e-mentsand/ortheMD&A.Theauditc ommitteeshouldreviewalltheanalystreportsandany pressstoriesaboutthecompany'saccountinganddisclosures.Wherethiswouldentailrevie w-ingvoluminousmaterial,amemberoftheinternalauditorcompliancestaffshouldbeassigned tohighlight anynegativecomments.Managementandtheauditorshouldberequiredtoexplain negativecommentsandthecommitteeshouldmakeadeterminationwhetherthecriticismr e-quireschangingthewaythecompanyaccounts.Finally,theauditcommitteeshoulddoa full reviewwithlegalcounselofitsproceduresandpracticestomakesurethattheyarestate -of-the-art.

Whileourfocushasbeenoninformationfortheauditcommittee,theproblemof informationexistsalsoforthefullboard.Itistheauditcomm ittee'sdutytokeeptheotherd irec-torsinformedonthesefinancialmatters.Iftheauditcommitteeisinthedark,sowillbethe wholeboard.Butdirectorswhodonotserveontheauditcommitteealsohaveanobligationto

keepthemselvesinformedby readingcompanyandpublicdocumentsandbyquestioningthe auditcommittee,theCEO,andmanagementwhenthisinformationraisesdoubts.

Expertise.Finally,boardmembersneedtohavetheexpertisetounderstandand interprettheinformationtheyarerec eiving.Formostindependentdirectorsthisexpertiseis builtintheirprimarycareersandastheygainitfromservingontheboard.AstheNYSErules suggest,membersoftheauditcommitteehaveaspecialneedtohavetheexpertisethatisusually labeled“financialliteracy.”

Ofevenmoresignificancethanthefinancialliteracyoftheauditcommitteeisthe expertiseoftheauditingfirmanditskeypersonnelonthecompany’saccount.Theauditco m-mitteeshouldreviewtheresumesofthesekeyperson nelandmeetwiththem.Further,theco m-mitteeshouldreviewthequalitycontrolproceduresthattheauditingfirmfollowsandobtaina satisfactoryexplanationofanysituationslikeEnronwherethefirmhasadmittedorbeenaccused ofnegligenceormalp ractice.ThereisnorequirementthatAndersenoranyotherfirmbeterm i-natedbecauseofpastproblems,providedthecommitteeissatisfiedthateffectiveremedial measureshavebeentaken.

Wheretheauditcommitteehasfollowedtheseproceduresandiss tillindoubt,it shouldconsultwithanoutsideadvisor.Thereareacademicaccountantswhowillprovideco n-sultingservicestoauditcommittees.

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Theboardhasadutytomonitorperformance,complianceandfinancialreporting. Auditcommitte esaretheboard’svehicletomonitorfinancialreporting.However,neitherthe boardnortheauditcommitteeisaguarantorandneitherhasanobligationtoassureperfecta c-

countingorperfectdisclosure.Theirobligationistousereasonableeffortst oensurethatma n-agementandtheauditorsaredischargingtheirobligations.Itwillnotbepossibletoobtainqual i-fiedpeopletoserveonauditcommitteesifwedonotfindasolutiontotheproblemwefacet o-day,orexacerbateitbylimitingtheirD&O insurance.Auditcommitteesmusthavetheguid e-linesandinformationtheyneedtofulfilltheirfunction.Itisnotenoughtogivethemsafeha r-bors,exculpation,indemnity,andinsuranceagainstlitigation;theyneedthetoolstodotheirjob and,most important,tosafeguardthereputationofthecompanytheyrepresent.Finally,boards haveresponsibilitybeyondaccountingandfinancialreporting.Theboardistheretooverseeall facetsofthecompany.Thisrequiresaboardconsistingofdirectorsw hotogetherintheaggr e-gatehavetheexpertisetoaccomplishthisove rsight.