

# **Capitalism in a Post Enron World**

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## **Issue 1 – CAPITALISM AND ITS TROUBLES**

**1.** The sudden collapse of Enron, followed by other scandals such as WorldCom and a growing list of companies that have inflated earnings figures, has shaken the trust in corporations and their management. Each time we think we have seen it all, another story unfolds but lets not forget that the underlying causes remain the same (as do the responses required to restore confidence). The blame is falling on corporate executives who have taken excessive risks and who have distorted financial statements and on accountants who have not been perceived to have provided adequate assurance. Andersen's auditing of WorldCom and Enron particularly comes to mind.

The implications of corporate failure are felt most by stakeholders, particularly employees who in some cases lose their jobs and savings which have been invested in the company.

**2.** Many business decisions have a moral dimension as well as a technical or commercial one. Ethical behaviour by corporate managers and accountants must govern and inform everyday decisions – unfortunately this has not always been the case of late, particularly in the US. In Britain, corporate disasters such as Marconi have not been down to scandal but incompetence.

An appropriate ethical culture has to be established by the Board. If an organisation lacks a sense of responsible behaviour, decisions on the job at all levels will slide. At Enron for example, the CEO adopted an aggressive culture where any behaviour, which led to good reported performance, was accepted.

**3.** Lack of integrity and trust in corporations has led to a crisis of confidence in the capital markets manifested in lower share prices, which has two major effects:

-Increased cost of capital for companies, which leads to lower investment by companies and in turn may damage consumer confidence and impact the wealth effect (a circular effect).

-Lower credit worthiness

Confidence in the capital markets is essential. Without that confidence, capital to finance day-to-day business and longer term investment funds will be less forthcoming and more expensive as higher costs of capital and greater security are sought to offset the perceived high risk involved.

For the first time since 1990, every day Moody's is downgrading the bonds of five companies for every company it upgrades.

**4.** Concerns about corporate accounts are particularly behind the crisis of confidence infecting global markets. A McKinsey survey published last week confirms what we knew before - confidence depends crucially on the quality of reporting by listed

companies. It is the most important factor influencing the decisions of institutional investors. Many companies are far more concerned with ensuring a perception of wealth creation for shareholders rather than generating actual wealth on robust business models and strategies. Undoubtedly the collapse of Enron and WorldCom has dented that confidence and we need to understand why and what steps might be taken to reduce the likelihood of similar occurrences.

## **Issue 2 – THE PARTICIPANTS**

The purpose of financial reporting is to achieve the provision of financial information of the highest quality to capital markets. If there is any silver lining to be had from WorldCom, it is that it has emphasised the importance of these relationships as well as the need for all significant organisations to have quality internal and external assurance.

There is a network of participants who contribute to the goal of producing quality financial statements:

### **Internal**

- ✓ Preparation of true and fair financial information by an effective and well resourced company accounting function
- ✓ Internal audit
- ✓ Informed review by directors, audit and risk committees

### **External**

- ✓ External audit and external review subject to quality assurance systems that inspire public confidence
- ✓ Effective enforcement bodies
- ✓ Sponsors, advisers and investment bankers committed to high quality financial reporting particularly in respect of complex transactions
- ✓ Investors, analysts, rating agencies and the financial press, all of whom should have clear ethical obligations to raise issues of dubious financial reporting

Investors and analysts also share in the blame for the spate of recent corporate mis-managements as they have ignored or missed deficiencies until it was too late.

## **Issue 3 – TRUST**

The Enron debacle and the many other companies that are in the spotlight for their business and accounting practices have eroded public trust both in the capital markets and in the accountancy profession.

Companies need to recognise that they can only build a reputation based on stakeholder trust if they behave according to the public's value expectations and are transparent about their business activities. This is contrary to the traditional view of some CEOs who feel obliged to generate predictable earnings streams quarter after quarter – this is in response to investors' clear preference to reward companies that show steady profit growth. Now companies, which have over the years had predictable earnings growth such as GE, are being heavily scrutinised. The pressure to manage earnings has led the Economist to use CFO as a different acronym –

Chief Fiddling Officer. The Generally Accepted Accounting Principles (GAAP) is becoming known as the difference between accounting theory and practice.

Recently, two of the leading journals are highlighting the word ‘trust’ in their reporting. The Financial Times editorial centred on the erosion of public trust and a three page Economist survey on Wall Street expanded on the value of trust.

The Financial Times stressed the importance of trust between a company and

- Its employees
- Its customers
- Its business partners; and
- Its investors.

The systemic stability of the capital markets requires a high level of **trust**, within the business community and society, in the effectiveness of auditing.

#### FINANCIAL TIMES QUOTE

In light of Enron and crises at companies such as Tyco, Global Crossing, WorldCom and others it stated that:

*“Managing big companies unethically can produce short term gain but usually it is short lived. Long-term success demands ethical behaviour that encourages the trust on which all social endeavours ultimately depend”*

Given this real loss of confidence, how can we rebuild the trust required?

#### Issue 4 - TRUST – POST ENRON ISSUES

There are four critical areas for review and improvement:

- Transparency of disclosure
- Corporate Governance, including risk
- Auditor Independence
- Other conflicts of interest

#### TRANSPARENCY OF DISCLOSURE

- ✓ Transparency is a matter of survival rather than choice

In the wake of the recent accounting scandals, investors are becoming hypersensitive to the reliability of published accounts and suspicious of the possibility of inflated earnings. The slightest hint of wrongdoing now has the potential to deflate investor confidence and bring share prices down substantially.

Transparency is becoming a matter of survival rather than choice. The way to address at least some of the inefficiencies mentioned above is to advocate more transparency in financial reporting. This essentially means that companies would start providing all the information the market considers to be relevant rather than simply fulfilling their mandatory regulatory requirements. There needs to be greater reporting from companies on the business risks and intangible assets that are behind the corporate value-creation process, are not captured in company financial statements, and are behind stock price changes.

✓ The new OFR

A new model of reporting must be based on 3 principles: transparency, accountability and integrity.

The proposal in the Company Law Review for a new mandatory Operating and Financial Review (OFR) is a positive step in improving transparency by enhancing public reporting to shareholders on long term issues. We fully support the OFR and see increased transparency by companies as a route to achieving greater management credibility and investor support.

It will facilitate greater disclosure by providing discussion and analysis of the performance of a business and the main trends and factors underlying the results and financial position and likely to affect performance in the future. It will enable stakeholders to assess the strategies adopted and potential for achieving them. Above all, it will facilitate an understanding on the intangible assets that are behind the corporate value-creation process, and are not captured in company financial statements and the major strategic risks facing a company and how these are being managed.

We are currently contributing to the debate on what the OFR should include with a joint research project with PWC.

Crucially, the OFR is an enhancement on the Combined Code. It seeks also to eradicate 'boiler plate' reporting. It is not enough, for example, to discuss systems of internal control in your business. Statements that fall short of disclosing and discussing actual risks lack context and relevance. It is an opportunity for Directors to demonstrate how well they know their business.

In the meantime, we continue to promote voluntary disclosures of business performance metrics which will facilitate understanding of business performance where this does not compromise commercial sensitivities.

- ✓ In the UK it is very clear that it first and foremost the responsibility of a Company's directors to prepare financial statements that are true and fair. It is then for auditors to give an opinion on whether they are true and fair.

In maintaining the quality and reliability of financial reporting, it is first and foremost the responsibility of company directors, along with their finance teams, to avoid the risk of standards of reporting company performance being undermined by commercial and similar pressures. The Board should be required to certify that a company has established reasonable procedures for assessing the accuracy and completeness of its financial results and disclosures.

Crucial in this is all Board directors understanding the business and where it differentiates itself from competitors and adds value.

- ✓ We are convinced that standards should be principle based, have substance take priority over form and that there should be the ability to over-ride (and disclose) standards if an alternative treatment gives a more fair and true view. The complex rules based approach in the US is more easily manipulated by aggressive companies. Furthermore, there is much criticism of the way

accounting standards are set in the US, including the governance of FASB, the US standards setting body.

- ✓ CIMA therefore fully supports the movement to International Accounting Standards. Ideally this will lead to a single set of quality reporting standards that promote transparency and enable cross border comparability that will enhance the capital markets' role in allocating scarce resources. Whether the US plays ball is debatable.
- ✓ Two tier standards. Most are agreed that unethical attempts at keeping risky investments off the financial statements are not good for transparency and maintaining trust in financial statements. However, the City is suspicious of the Government and its move to use PFI contracts to shift risk from the public sector to private sector. Its actions have been accused of being akin to using special purpose vehicles for off balance sheet financing (in the style of Enron). The decision to classify Network Rail's (formerly Railtrack) debt as private sector borrowing so it is kept off national Government accounts is to be reviewed. If risk cannot be genuinely transferred then the Government should own up to the actual cost of borrowing that the private sector is undertaking on its behalf.

## Issue 5 - CORPORATE GOVERNANCE

There are three main groups that have an important and continuing role to play in improving the focus that boards have on shareholders' interests and exerting influence over the boards and management of under-performing companies. These are non-executive directors, major institutional investors and executive boards and management.

- ✓ The role of NEDs

Much is directed at the need to counterbalance the power and influence of dominant individuals particularly in Chief Executive roles. That is why the Combined Code recommends splitting the roles of Chairman of the Board and the Chief Executive. It is also why it recommends that a third or more of the Board is made up of independent non-executive Directors. The role of non-executives is the subject of one of the many UK enquiries and CIMA has recommended that a code of best practice for non-executive directors should be established.

Perhaps the most important role of the non-executive is found in the Board Committees which typically include the audit committee, the nominating committee and the remuneration committee. We are suggesting that companies could consider renaming the Audit Committee given its potential wider responsibilities in corporate governance frameworks and risk management. It should be the key responsibility of NEDs to understand the risk framework and therefore the context under which the company operates.

The role of non-executive directors in corporate governance, post Enron needs to reaffirmed. For NEDs, several issues exist. They need:

- **Independent directors need more power**

Independent challenge at Board level requires a strong cadre of independent directors. CIMA believes that there needs to be an open process for finding and

selecting new independent directors and nomination committees should comprise 100 per cent independent NEDs. There also need to be clear guidelines on situations that compromise the independence of NEDs, for example conflicts of interest can arise where an individual has previously been a senior employee, has provided or continues to provide consultant services or is paid with incentive rewards such as stock options.

Independence is crucial. Too many NEDs sitting on the Boards of public companies are not sufficiently critical of executive management's preferred policies. NEDs need an independent view as well as ample experience and training in order to be robust, ask searching questions and exercise due diligence in finding answers.

At least one independent NED on the audit committee needs financial expertise and experience because NEDs need to ask auditors tough questions which could provide warning signs. For example, are we as NEDs able to access the underlying trends in any of our subsidiaries? Have you identified any turning points in business indicators such as orders and sales? If this was your business, what would keep you awake at night?

- **Time**

NEDs need adequate time to devote to the companies on whose boards they sit. Nowadays, a NED post is a commitment because it involves sitting on several board committees, attending full board meetings, being familiar with the business, making a strategic contribution and monitoring responsibilities and in some cases mentoring others.

- **A strong chairman**

The Chairman or senior NED's role in running the Board is absolutely key in ensuring robust corporate governance. There must therefore be extremely good reasons for any FTSE 100 company to combine the role of CEO and Chairman.

To support the role of NEDs in adding value to management, we have a recommended a code of best practice for NEDs which would:

- Identify the relevant training linked to the proposed Code
  - The financial skills required
  - Ability to ask rigorous, searching questions
  - Quality time
- ✓ Institutional investors – enhancing activism

**Key issues:** active engagement of institutional investors with executive and NEDs

Major research just published by CIMA, involving 40 of the largest UK institutional fund manager groups, has identified the considerable potential of extending the corporate governance role of fund managers. An extension of this institutional influence, such as encouraging transparency in governance processes and satisfying wider stakeholder governance aims, including environmental and ethical issues, could make them the key to asserting good corporate governance control in the UK and hence better returns on investment. Their potential power to protect the interests of investors is high.

Furthermore, all public listed companies should inform its shareholders either in the annual report or proxy statement how all its checks and balances work.

- ✓ In the same way as FRS 17 was a move to make companies reflect the cost of their pension schemes on the balance sheet, accounting for share options, if implemented, would require companies to subtract the cost of options from their profits. As with FRS 17, there has been vehement opposition to this, particularly in the US where executives tend to be largely rewarded with options and many companies would probably have to revise downwards their profit figures. Taking current share prices and what American companies take as their core operating profits in 2001 gives a price/earnings (p/e) ratio of 26. However, take the total profits reported by the same firms last year i.e. operating profits minus everything written off and considered as non-core, the p/e ratio becomes 41. Had the cost of share options been included when calculating profits, the p/e ratio rises to over 50 compared with a post-war average of 15.

Equity grants to directors in the form of stock options continue to rise in value despite the fact that it is debatable whether they help ensure that managers serve the long-term interests of shareholders. Share options are clearly a cost of employment but so far lobbying by companies has ensured that they are not included as costs when calculating profits. In the post Enron world, this position could be harder to argue. The way that executives and senior management are rewarded is being hotly debated with the tide turning against the use of stock options as an effective method to align the interests of management and shareholders. Other elements of variable pay should also be considered when remunerating executives such as actual shares.

## **Issue 6 - AUDITOR INDEPENDENCE**

There have been numerous studies on auditor independence in recent years in the US, the UK, Ireland and Australia to name but a few. Although, not surprisingly, they come to different conclusions, they all agree that it is not just about independence in fact but also appearance in the eyes of stakeholders. There is no doubt, however, that post Enron the international investor will focus more on the perception of auditor independence.

It is not just down to the auditor to review independence risks and appropriate safeguards but also for the Finance Director and other senior finance executives to ensure the company is monitoring and evaluating these issues. This will increasingly mean the full involvement of the audit committee. The benefit to the company is in ensuring credibility of the financial statements to stakeholders. CIMA recommends that auditors report to the audit committee. Audit committees need to develop policies and processes that ensure there is no doubt that the company's auditors report to them and work for them.

A key international guide is the International Federation of Accountants' Code of Ethics. Of its 120 or so pages, over half are dedicated to issues of auditor independence. These cover issues such as auditor rotation, audit employees moving to the client (otherwise known as the revolving door), provision of non-audit services etc. It defines the nature of potential threats to independence.

## Issue 7 - OTHER CONFLICTS OF INTEREST

There are several other areas of potential conflicts that investors will now be wary off. I will just touch on these.

- Aggressive earnings management whereby commercial pressures including remuneration can present financial performance in a favourable light does not necessarily reflect the underlying reality. The UK Auditing Practices Board has issued guidance to auditors in defending against this and it is as relevant to senior finance executives in business. This is key to management accountants who may be making estimates to be included in financial statements such as stock loss provisions, depreciation charges etc.
- Investment banks and stockbroker analyst recommendations. The recent allegations against Merrill Lynch have tarnished their reputation.
- Credit rating agencies where the company pays for the rating and rating agencies are slow to update the ratings.
- Issues over selective disclosure of sensitive commercial information to a favoured few who can gain from it. Need to assess the extent of current concern over their objectivity.

## Issue 8 - RISK MANAGEMENT

- ✓ **First line of defence against corporate failure – firm level risk management**

Why is risk rising up the corporate agenda?

Many under performing companies have not been flexible enough to manage the risk of strategic failure. There is an increasing acceptance that risk management activities add organisational value if there is a framework aligned with strategy for addressing the portfolio of risks that an organisation faces. The contemporary view of risk management involves treating risk in the context of business strategy and moving away from risk minimisation to risk optimisation so the process drives performance and creates shareholder value.

This is opposed to the traditional view, which has connotations of loss prevention and transfer through insurance mechanisms and the hedging of financial risks with derivatives (although this still has a role to play as will be discussed later).

The challenge for corporates is to integrate insurance and hedging decisions into the wider capital raising and capital structure decisions of the corporation and then into the overall risk management approach in the organisation.

- ✓ **Financial risk transfer** is an important area of risk management. Where major risks are correlated with existing financial instruments, targeted financial instruments such as derivatives can be an alternative to operational methods of reducing risk. To be effective and reduce costs, however, there needs to be aggregate risk coverage, so insurance contracts can be purchased to cover the net exposures rather than covering each risk separately.
- ✓ **Credit risk:** Where it is difficult to estimate the source or magnitude of a risk, a company's capital structure can be used as a buffer. By decreasing the amount of debt and increasing the equity component of the capital structure, the total risk

exposure for shareholders is reduced. The company has more flexibility to respond to volatility whatever the source. Microsoft for example has no outstanding debt and plenty of cash flow. Modifying a company's risk profile using target financial instruments has the advantage of shielding against tax but it increases the company's capacity to issue debt.

### **Risk transfer in the financial system**

Post Enron there has been concern over stated corporate profitability and debt. Now there is also concern as to where risk is being harboured in the financial system.

There is concern that the sustained consumer demand that has prevented the British economy entering a recession so far is based on the build up of personal debt. There is also worry about the build up of corporate debt and how that is affecting the economy.

Buying protection against credit events has become very popular as it allows companies and investors to hedge their exposure against corporate failure. The credit derivatives market has seemingly coped with the collapse of Enron and other corporate failures - The Banks have limited their losses after the Enron collapse via the credit derivatives market by parcelling up loans and selling them to insurance companies and other investors.

The Bank of England and the FSA have warned of the dangers of risk transfer between investment banks, insurance companies and capital markets. One of the most common approaches used by banks to shed credit risk to insurance companies is through collateralised debt obligations (CDOs), which have estimated to have grown from \$1 bn annually in 1995 to around \$350 bn globally today. The reason for this increase is predominantly based with the commercial banks' desire to shield their balance sheets from debt.

The FASB has spoken publicly of its worries about the accounting principles applied to credit risk transferral techniques. The Bank of England has pointed out that insurance companies suffering credit losses may need to have recourse to the banking system in order to meet their obligations under credit risk transfer instruments.

The FSA's concern that in some cases insurance companies have taken on excessive credit risks from banks is based on their view that some insurance companies do not fully understand the risks that underlay these structured investments and hence exposing themselves to unwanted risk and volatility.

On a corporate level, the Board and audit committees of insurance companies need to understand the nature and possible consequences of risk being taken on against the potential return.

On a macro level, nobody is sure exactly where risk is in the financial system. Rating agencies have said that exposure to Enron via CDOs should be manageable but has led to the downgrading of many CDO transactions to reflect the high risk. In principle, companies can use the markets to disperse risks to market shocks. However, in the financial system, particularly in regard to unfunded risk transfer, there is little knowledge on whether concentrations of risk declining in one area simply re-emerge in others.

✓ Brand/reputation risk

There is no doubt that reputation has become a strategic asset and a significant intangible asset to most global companies. The demise of Andersen demonstrates how a global brand, if not protected, can be destroyed. It is an asset that can be destroyed or damaged all too easily.

For finance professionals, the challenge is to develop ways of measuring the capital value of brands and there are now several valuation methodologies and indices. The next step is to analyse risks attached to them and develop risk management strategies.

It is said that reputation is just reality with a lag effect – this means that brands need to be built on solid foundations and the only way to achieve this is through a dialogue with a much wider range of stakeholders and being transparent about your actions.

### **Issue 9 – WILL ENRON/WORLDCOM HAPPEN HERE?**

Rules based reporting standards undoubtedly better than principle based. Corporate governance practices in the UK have undergone review and adaptation over the past 10 years in response to our own corporate failures such as Maxwell and Polly Peck. However, no guarantee can be offered. In summary we can all work to limit the chances by ensuring:

- Ethical conduct by Boards and their CEOs who must set the appropriate culture in organisations
- That the sub-committees of the Board do their job properly and independent directors have more power
- There is an expanded role for the audit committee to include overseeing risk management and corporate governance practices
- At least one of the independent NEDs on the audit committee has appropriate financial expertise and that the principal financial officer has the right level of financial management experience and understanding
- That there is culture of transparency by public companies to various stakeholder groups.

Thank you for listening and I am happy to take questions later during the Q&A session.