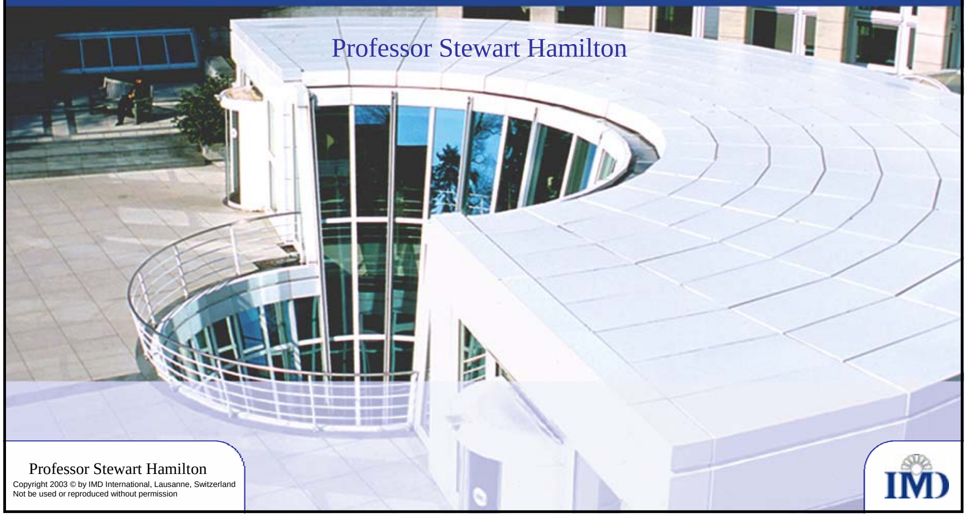
Corporate Governance after Enron *et al*: A non-American perspective

CFA Institute: South Africa & Mauritius, July 2005

Professor Stewart Hamilton



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The downfall of Barings shocked the « City ».

When Barings Bank, the oldest merchant bank in London, collapsed on February 27, 1995 after losses in its futures trading business in Singapore of £830 million, it had lost an amount equal to more than twice its capital base.

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but they shouldn't have been surprised…

"There can be few fields of human endeavour in which history counts for so little as in the world of finance."

J K Galbraith "A Short History of Financial Euphoria"

there had been a certain naivety……

"Until the collapse, Barings management in London believed the trading conducted by Barings Futures Singapore to be essentially *risk free and very profitable.*"

Board of Banking Supervision Report, (BBSR) 1.41, p.7

(My emphasis)

and little understanding of the business…

Q: “Were there members of the Board of Directors of Barings plc who were knowledgeable about derivatives trading?”

A: (Mr Norris) “No.”

Q: Nobody at all?

A: “No.”

Evidence to the House of Commons Treasury Committee

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there was a basic lack of supervision…..

“ No one in management accepts responsibility for Leeson’s activities between October 1993 and 1 January 1995………”

BBSR, 7.9, p.120

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compounded by ambiguity………

"......some members of management believed that the responsibility for certain activities (e.g. equity derivatives, BFS) rested with other managers, who deny they had such responsibility. This resulted in confusion ...."

BBSR, 2.28, p.23

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exacerbated by the "star" system….

"....Leeson was, in view of his high levels of reported profitability, considered to be a `star performer`: and that there was a concern not to do anything which might upset him."

BBSR, 7.12, p.121

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some danger areas which require special care….

“If remuneration is linked to profitability, it is important that the control environment should be particularly rigorous.”

Daniel Davies, Bank of England Financial Stability Review, Spring 1997.

Barings was only one of many European disasters…….

- Barings
- Metalgesellschaft
- (Daiwa Bank)
- BCCI
- Maxwell Pensions
- NatWest Markets
- Showa Shell
- Sumitomo
- Morgan Grenfell A M
- (LTCM)
- UBS
- Allfirst
- (National Australia Bank)

Control failures were a common feature..

"We are deeply embarrassed that our internal controls and procedures were not sufficient to prevent this fraudulent action"

Masahiro Tsuda, general manager, Diawa's New York branch, about Toshihide Iguchi

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....and again!

"There is a clear structure, and there was a breakdown of controls and supervision."

Michael Dobson, CEO, Deutsche Morgan Grenfell on the Peter Young saga.

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......and again!

"We have found a major deficiency in controls."

Martin Owen, Chief Executive, NatWest Markets, about Kyriacos Papouis's options mispricing

This resulted in the establishment of…

- The Hampel Committee (1995)

  and then,

- The Turnbull Committee (1998), whose principle remit was to look at how companies managed their internal controls

  ✓ Note: This in UK, not rest of Europe!

The deliberations of these two committees led to…

- The ICAEW producing proposals for a « Statement of Business Risk » (Note: Enterprise-wide risk, not just finance)
- The acceptance of this by the listing committee of the London Stock Exchange
- And the subsequent publication of « Guidance » for directors on internal controls

In terms of “the Combined Code”……

For accounting periods ending after 23 December 2000, all companies listed on the London Stock Exchange were required to have an embedded internal control system that monitors important threats to the company.

More recent high profile disasters

- WorldCom
- Global Crossing
- TXU Europe
- Marconi
- Swissair
- Ahold
- Parmalat
- And many more…..
- None of the major accounting firms have clean hands

Many sharing common characteristics…

- Inadequate Board Oversight & Knowledge
- Lack of Management Supervision
- Poor Risk Assessment and Management
- Poor Control Systems & Cash Forecasting
- Inadequate Auditing / Regulation
- The intentional or unintentional interplay of all five factors

Few parties have escaped criticism……

- Company directors (especially non-executive)
- Investment bankers
- Analysts
- Rating agencies
- Regulators
- Auditors
- Academics!

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The role of the Board of Directors in Enron’s collapse

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

Source: Report of the Permanent Subcommittee on Investigations
of the Committee on Government Affairs, United States Senate July 8, 2002

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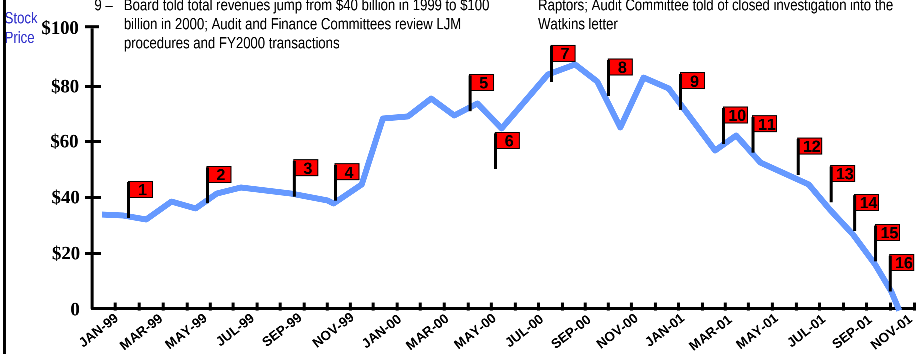
"RED FLAGS" KNOWN TO ENRON'S BOARD

1 – Audit Committee told Enron accounting practices "push limits"
2 – Board approves Fastow's Code of Conduct waiver for LJM1
3 – Whitewing moved off-balance sheet with $1.5 billion
4 – Board approves second Fastow waiver for LJM2
5 – LJM2 update: "Q41999: 8 days/6 deals/$125 million"; $2 billion in funds flow to Enron; Board approves Raptor 1
6 – Executive Committee approves Raptor II
7 – "Project Summer" to sell $6 billion in assets fails; Board approves Raptor III/IV
8 – Board approves third Fastow waiver for LJM3; Board told $27 billion in assets off-balance sheet
9 – Board told total revenues jump from $40 billion in 1999 to $100 billion in 2000; Audit and Finance Committees review LJM procedures and FY2000 transactions
10 – Fortune article questions Enron's earnings and accounting
11 – Board told 64% of international asset portfolio "Troubled" or "Not Performing"; 45 million Enron shares at risk in Raptors and Whitewing
12 – Board told of $2.3 billion deficit in market value of Enron's international assets
13 – Fastow sells interest in LJM to Kopper
14 – Skilling resigns; Finance Committee told of $6.6 billion in prepays and FAS 125 transactions
15 – Lay defends use of SPEs in online session with employees
16 – Finance Committee told of $800 million earnings write-down from Raptors; Audit Committee told of closed investigation into the Watkins letter



Prepared by U.S. Senate Permanent Subcommittee on Investigations, May 2002

Human nature……..

"Men are nearly always willing to believe what they wish"

Julius Caeser, *Gallic Wars*, Book 3, section 18 c.50 B.C.

The Aftermath

- Sarbanes-Oxley Act (US)
- Higgs report on role of non-exec directors (UK)
- Smith report on role of audit committees (UK)
- Revised “Combined Code” (UK)
- EU pronouncement on corporate governance (May 2003)
- Proposed EC Directive on Audit of Company Accounts (16 March 2004)
- EU recommendations on independent directors (Autumn 2004)

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Sarbanes-Oxley Act (US)

Three main threads:

Section 404: Internal controls

Independent Directors

Role of the Audit Committee

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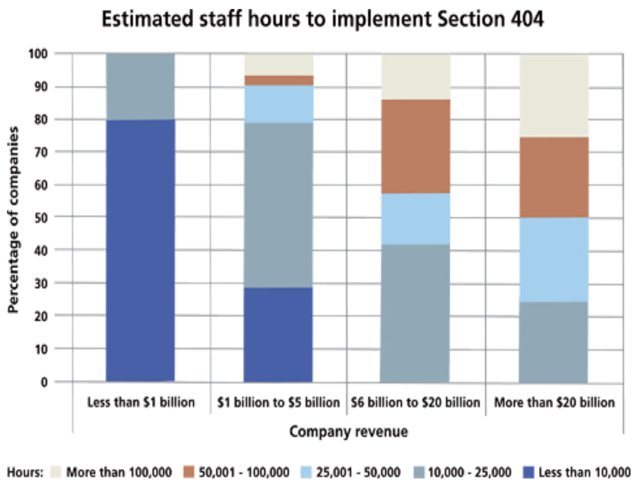
Ernst & Young SOX Survey, November 2004



These regulations have wide-ranging implications for Companies and Directors

- Corporate governance:
  - Independence of Directors
  - Relationship between directors and senior management
  - Role of the Audit committee
- Personal liability of Directors:
  - Equitable Life (UK)
  - Availability of insurance
- "Whistle-blowing"

Leonard Spacek's topics (1956-1969)

- "Accounting has failed to prevent major misrepresentations"
- "The elusive truth of business profits"
- "Professional accountants and their public responsibility"
- "Unrealistic profits and the Stock Market"
- "Accounting is being challenged – do we have the solution?"
- "The auditor is also accountable for his work"

  and many more

"A Search for Fairness in Financial Reporting to the Public", Leonard Spacek, Chicago 1969

How did it go wrong?

- "Low balling"
- Pressure for fees (and profits)
- Over-leveraging of partners' time
- De-skilling of the audit team
- Cutting corners?

Already we are seeing..

- "Defensive" auditing
- Re-evaluating "client risk" assessment procedures
  - "the dominant CEO"
  - "the unqualified CFO"
- "Special pleading"
  - Capping damages claims
  - Extent of non-audit work
- But little evidence of "*mea culpa*"

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What is needed to rebuild public confidence?

- An admission of some responsibility for what has happened!
- A clear statement of intent to put the house in order
- A drive to improve international auditing standards and their enforcement
- The consistent application of standards in the international firms
- Education of clients as to what an audit is, and is not
- Increasing the status of the internal audit

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Banks in the headlines…….

- Merrill Lynch
- JP Morgan Chase
- Citigroup
- Bank of America
- CSFB
- Royal Bank of Scotland
- And many more

Enron settlements so far…..

• J.P. Morgan	$ 2.2 billion
• Citigroup	$ 2.0 billion
• Lehman Brothers	$ 222.5 million
• Bank of America	$ 69 million
• CIBC	$ 80 million
• Merrill Lynch	$ 80 million

Interesting Comparisons!

Market Cap	*Net World*	*Real World*	*Market Cap*
$149.8 bn	AOL	Pfizer	$149.8 bn
$34.5 bn	Yahoo	Allied Sig	$34.7 bn
$24.0 bn	eBay	JP Morgan	$24.3 bn
$23.0 bn	Amazon	Alcoa	$23.0 bn
$12.9 bn	E*Trade	AMR	$13.5 bn

As at 12 May 1999.Source: *Fortune*, June 7, 1999

An extreme example….

	eToys	*Toys 'R' Us*
Sales	$117 million	$11.9 billion
Earnings / (loss)	($126.7 million)	$12 million
Market Value	$5.2 billion	$3.9 billion
Employees	300	70,000

Analysts Recommendations

Strong buy		33.9%
Buy		35.5
Hold		29.7
Sell		0.7
Strong sell		0.2

Survey of 27,700 individual stock recommendations by analysts
Source:First Call;Thomson Financial, October 1, 1999
Quoted in the *Financial Times*, 27 October 1999

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Irrational exuberance…

- Lack of credibility in quality of research being done on the stock market
- Lack of clarity and accuracy with which it is communicated to the public
- Media accounts tend to be superficial and thus encourage basic misconceptions about the market
  – Professor Robert Shiller, Yale University, 2000

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Implications for Investment banks

- Reputation loss
- Substantial financial penalties (>$ 10 billion so far)
- even jail terms
- Resulting in a re-examination of:
  - Future of structured finance
  - Understanding the intent of client transactions
  - Internal controls and remuneration systems
  - Role of the analysts

So beware…..

"[Bankers] who hire money hungry geniuses should not always express surprise and amazement when some of them turn around with brilliant, creative, and illegal means of making money."

Linda Davies, *Psychology of Risk, Speculation and Fraud,*
EMU Conference, Amsterdam, 2003

And the underlying lesson….

"Profit is an *opinion*, cash is a *fact*"

Sarbanes-Oxley

»Back-up Slides

The underlying Enron story is of…

- Highly dubious accounting practices dating back to the early 1990s
- The acceptance of these over a long time period by Andersen
- The ability to conceal the substance of transactions from the shareholders
- The inept analysis of Enron by a wide range of commentators

The underlying Parmalat story is of…

- Tanzi’s inability to distinguish between company & family funds
- Rapid expansion with expensive acquisitions, particularly overseas
- Highly dubious accounting practices and probable fraud dating back to the early 1990s
- The acceptance of these over a long time period by Grant Thornton & (later) Deloitte
- The willingness of the banks to continue to lend on a “name” basis
- The ability to conceal the substance of transactions from the shareholders
- The inept analysis of Parmalat by a wide range of commentators
- Inadequate oversight by Consob and the Bank of Italy

Audit Committee
New SEC/NYSE Governance Rules

- Audit committee continues to be required
- Minimum of 3 members
- All members must be independent directors
  - Tighter standards of independence than for other independent directors
  - No compensation from company other than director fees
- All members must be "financially literate"
- At least 1 member (typically the chair) must be an "audit committee financial expert"

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Audit Committee
Powers & Requirements

- Sole authority to hire and fire independent auditors
- Pre-approve all services, including non-audit services, to be performed by the independent auditors
- Approve and publicly disclose fees paid to independent auditors in the following categories: audit fees, audit-related fees, tax fees, all other fees
- Independent auditors and internal auditors must be accountable to the audit committee and the board (not to management)

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Audit Committee

- Committee must establish and publish explicit “whistleblower” procedures
- Committee should meet independently with outside auditors, internal auditors, and management on a regular basis

Audit Committee
Duties and Responsibilities

- Retain and terminate independent auditors
- Evaluate, at least annually, the independent auditor (including the lead partner)… and the audit firm’s professional record and internal quality control procedures.
- Discuss annual and quarterly financial statements with management and internal quality control procedures.
- Discuss annual and quarterly financial statements with management and internal auditor, including the company’s disclosure under “ Management’s discussion and Analysis of Financial Condition and Results of Operations”.
- Discuss earnings releases, as well as earnings guidance provided to analysts and rating agencies.
- As appropriate, obtain advice and assistance from outside legal, accounting, and other advisors (without board approval)

Audit Committee

- Discuss policies with respect to risk assessment and risk management
- Meet separately, periodically, with management, with internal auditors and with independent auditors.
- Review with the independent auditor any audit problems or difficulties and management's response.
- Set clear hiring policies for employees or former employees of the independent auditors.
- Report regularly to the board of directors.

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Audit Committee
Impact on Foreign Companies listed on U.S. Stock Exchanges

- Generally, the SEC rules apply equally to foreign private issuers and domestic issuers, as well as to their auditors.
- Some exceptions:
- Foreign companies are required to disclose interim financial statements only if required to do so in their home jurisdictions.
- Certain non-management employees can be on the audit committee
- 50% + shareholders and government representatives can be members of the audit committee, subject to certain restrictions.
- Rules also provide for a number of other narrowly defined exceptions.

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Proposed European Parliament Directive (Article 39)

- Public interest entities shall have an audit committee, composed of non-executive members of the administrative body or members of the supervisory body of the audited entity with at least, one independent member with competence in accounting and/or auditing
- The audit committee shall…….
- The statutory auditor or audit firm must report to the audit committee on key matters arising from the audit, in particular on material weaknesses in internal control in relation to the financial reporting process…

49 File name

Proposed Directive [Article 39, 2 (b)]

- Audit Committee requirements:
  - Monitor the financial reporting process
  - Monitor the effectiveness of the company's internal control, internal audit and risk management systems
  - Oversee the statutory audit of the annual and consolidated accounts
  - Review and monitor the independence of the audit firm and *in particular* the provision of additional services

50 File name