

# Financial Management after Enron

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**V**ia a disastrous example, the Enron collapse demonstrates the value of a strong management team, especially a strong *financial* management team. While there were other contributing factors, a downfall of this proportion comes only from reckless financial stewardship that abuses the company's assets, whether through speculative expenditures or overleverage, and permits corporate ego to overwhelm management's fiduciary obligations to stakeholders.

Poor financial stewardship not only took Enron to the brink it also brought the fatal blow, struck by the crisis in confidence in the company's financial reporting and investor relations. No one questions that Enron had at its core a very valuable set of assets and cash flow streams. But that value was ultimately offset by the huge liability and capital cost incurred when investors couldn't trust the company's financial management.

Even a perfect regulatory structure will never be as effective as strong financial management and control on the part of a company's top executives. Our economic system will always lure daring investment and produce failures along with successes. Within that investment and risk-taking environment, however, financial management plays a key role in maintaining capital market efficiency through transparent financial reporting and strong internal control. Senior financial executives—chief financial officers, finance directors, and controllers—have a special duty to stakeholders to protect the company's assets and provide full and fair disclosure to investors.

It appears that Enron's leaders failed to protect investor interests in a number of ways:

- They recorded sham transactions in which the economic risk stayed with the company, but liabilities and losses were transferred to off-balance-sheet entities.
- They should not have promoted the use of opaque financial disclosure. Every company owes its stakeholders accurate, complete, objective, and relevant information. To do otherwise is shortsighted and risks failing to capture proper value in the marketplace.
- They should have avoided all conflicts of interest, in fact and in appearance.
- They should not have fostered a culture that employed consistently aggressive accounting practices.
- They should have promoted a good control environment, not a culture based on oversized corporate ego.
- They should not have let the company get overleveraged. The art and science of finance were selectively abused and ignored.
- They should not have overly promoted unproven new economy investments as adding tremendous near-term value.

What can we learn, and how do we prevent another failure of this kind? Senior executives and directors need to continue the dialogue and ask themselves some hard questions, including the following.

**How do we increase the effectiveness of checks and balances to prevent situations in which corporate egos overwhelm good**

## **control systems, thereby destroying not only shareholder value but also companies themselves?**

Audit committees must immediately add true financial experts to their membership: directors who have hands-on experience in corporate financial management. The current definitions of audit committee financial experts are inadequate. Audit committees and management teams should do self-assessments on the aggressiveness of their accounting policies and disclosure posture. Further, audit committees should adopt a formal policy prohibiting the hiring of partners and managers from the auditor for employment on the company's finance staff

There also needs to be renewed emphasis on ethical codes of conduct at corporations. These codes should be signed off on, not only by executive management but also the rank and file. Some training in understanding these policies is also important, as is providing a safe channel for reporting perceived violations. Employees should be able to report violations to the board via an independent third party without fear of reprisal.

## **Has the CFO's strategic role taken him or her too far away from the core mission as chief advocate for shareholder return?**

Two decades of cost cutting and productivity demands may have gone too far. Corporations need to bolster investment in nuts-and-bolts infrastructure in finance and accounting staff and systems. Complex businesses require more talent and resources to analyze and report the facts, not less. Further, being a strategic business partner to the CEO does not override the requirement for financial management rooted in good reporting, analysis, and control.

Corporations and public accounting firms need to structure career paths and provide salaries that will attract talented staff. The number of students choosing careers in these areas has fallen off drastically.

## **Why did Enron's audit committee allow the CFO to engage in transactions that put him in a clear conflict of interest?**

It is unclear and unfathomable. Further, it has been recently reported that the chief accounting officer did not report to the chief financial officer. This condition is equally troubling.

The chief financial executive should be directly responsible for the financial reporting structure and subject to independent review by internal, as well as external, auditors. These auditors should report directly to the board.

## **What blame does the auditor hold in this situation?**

The auditors and regulators are loose-mesh backstops. Management teams, and especially financial managers, are the front line of defense for shareholders. This failure happened on that front line. It was a corporate control and culture failure. While the auditors also have a duty to the shareholders, their power is limited, no matter how much regulatory change is implemented. However, all auditors need to renew their commitment to professional skepticism and avoid a business-partnering mentality with their clients. The audit profession's checklist mentality of regulatory compliance is part of the problem here, too. We must empower auditors and give them incentives to act faster and more boldly.

## **Is the financial reporting and disclosure model broken? Was that model to blame here?**

Yes, the model is broken, but it was not the primary cause of this collapse. Decades of compounding disclosure checklists and a lack of overall vision for the accounting model have rendered financial reports largely unusable for even the most sophisticated reader. Enron's financial statements may have largely complied with the legalities of our disclosure system, and that may be the best proof that the model is broken.

For example, the Financial Accounting Standards Board (FASB) shelved the Consolidations Project, which included an examination of accounting for special-purpose entities (the core of the Enron problem), after more than 18 years of discussion.

## **What can be done to make sure that investors can have full confidence in a company's financial statements?**

All senior financial managers, whether a member of Financial Executives International (FEI) or not, should read and sign FEI's Code of Conduct, which requires managers to adhere to ethical practices, and provide a signed copy to the committee. Further, all financial statements should include a statement of management responsibility; within each organization, all top management should sign that statement. The stock exchanges should immediately strengthen their rules for audit committee financial experts. Further, we need to address the financial reporting model and its relevance to today's user. Bloomberg and Yahoo Finance are more timely than 10-Qs. The timeliness and user-friendliness of financial statements must be greatly improved.

We cannot wait five years to study and respond. As we've learned, a delayed response can only lead to further problems. The time to act is now.