

by Phil Livingston  
plivingston@fei.org



## PREVENTING FUTURE ENRONS

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 only comes from reckless financial stewardship that abuses the company's assets, whether through speculative expenditures or over-leverage, and permits corporate ego to overwhelm management's fiduciary obligations to stakeholders.

Not only did poor financial stewardship take Enron to the brink, but it also brought the fatal blow, which was struck by the crisis in confidence in the company's financial reporting and investor relations. Enron had at its core a 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 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. But within that investment and risk-taking environment, financial management plays a key role in maintaining capital market efficiency through transparent financial reporting and strong internal control. Senior financial executives — namely, CFOs, finance directors and controllers — have a special duty to stakeholders to protect the company's assets and provide full and fair disclosure to investors.

What can be learned, and how do we prevent another failure of this kind? Senior executives and directors across America need to continue the dialogue and ask themselves some hard questions, among them:

**How do we increase the effectiveness of checks and balances to prevent situations where corporate egos overwhelm good control systems?**

My response — 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.

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

My response — 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.

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

My response — The auditors and regulators are loose-mesh backstops. Management teams, and especially financial managers, are the front line of defense for shareholders. The Enron failure 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 must recommit to its primary mission as a key element in the checks and balances system of good corporate governance and control.

**Is the financial reporting and disclosure model broken or not? Was that model to blame here?**

My response — 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. We need broad reform in the standards-setting process, and we need to immediately begin to employ Web-based financial reporting to make the end product user-friendly.

---

### 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.

---