Debating the Enron Effect

Business World Divided on Problem and Solutions

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To Thomas J. Donohue, the pugnacious president of the U.S. Chamber of Commerce, Enron is a rogue corporation, an unfortunate and dramatic exception to what is otherwise "the most transparent, honest and efficient capitalist system the world has ever known."

To Arthur Levitt, the former chairman of the Securities and Exchange Commission, Enron grew out of a pervasive culture of "gamesmanship" in a corporate world that has become so focused on stock prices and quarterly earnings that it has lost its moral compass.

"The business community now looks at things in terms of what they can get away with, not what is right," Levitt said this week as he shuttled between Enron hearings on Capitol Hill.

Those starkly conflicting views now define the poles of a crucial debate that is just beginning to play itself out -- in Washington, which must decide the scope of regulatory reforms necessary to prevent future Enrons, and on Wall Street, where investors and lenders will decide how much more they will charge for investment capital to reflect the risk that other companies could have Enron-like problems.

To a business community that largely views Enron as a corporate rogue, the widespread concern is that the media and political frenzy will generate excessive regulation that, in the words of the Business Roundtable, would unnecessarily inhibit the ability of U.S. corporations "to compete, create jobs and generate economic growth."

But those who see Enron as emblematic of wider, systemic problems with American-style capitalism see the need for fundamental changes in how executives are compensated, how companies report their financial results, how financial analysts rate stocks, how boards of directors are chosen, how accounting standards are devised and what rules should govern the legal and accounting professions.

Business lobbyists acknowledge that over the past two weeks public opinion seems to have swung toward the fundamentalists. A Gallup poll last week found that about 3 in 4 Americans believe that the type of business practices found at Enron could also be found at some or most other large corporations. Another survey found that public confidence in big corporations had fallen to the low levels long endured by Congress and health-maintenance organizations.

Scrambling to stay ahead of the wave, the Securities and Exchange Commission announced Wednesday that it would push new rules requiring companies to disclose more detailed and timely information about their finances and their executives' stock trades. Also, on Friday, the SEC's enforcement chief said the agency would ask Congress for authority to ban corporate officers and directors who have committed wrongdoing from serving in such positions in the future.

Within hours of Wednesday's SEC announcement, the Financial Accounting Standards Board, the industry-funded rulemaking group criticized for taking as long as a decade to close accounting loopholes, vowed to tighten rules that have allowed thousands of corporations to inflate reported earnings while keeping debt and other liabilities off their balance sheets.

On that same day, the New York Stock Exchange commissioned a panel co-chaired by former White House chief of staff Leon Panetta to review issues such as the independence of corporate board members and how they are compensated by companies whose shares are traded on the world's largest exchange.

Meanwhile, key members of Congress are putting together Enron-inspired packages, including a proposal to eliminate tax breaks that encourage companies to lavish stock options on top executives. While the options were once thought to better link the interests of managers with the interests of shareholders, even some former supporters now believe that the option awards have grown so large that they have distorted business and ethical judgment, encouraging some executives to do anything to report strong earnings every quarter so the stock price will rise.

"If a million-dollar salary doesn't align managers' interests with shareholders' interests, then they're the wrong person for the job," said Sarah Teslik, executive director of the Council of Institutional Investors, who previously supported the tax breaks.

Among the professions that cluster around the corporate boardroom, the accounting industry is in full battle gear now that the expression "our auditors have reviewed it and approved it" is viewed by many as an indication that something must be amiss. The president of the American Bar Association, Robert Hirshon, said he was considering appointing a special committee to figure out a way for lawyers to sound the whistle on corporate misdeeds without violating their ethical responsibilities.

The corporate chief executives who make up the Business Roundtable, horrified by top Enron executives and directors saying they didn't know what was going on in their own company, announced last week that they would move quickly to revise voluntary standards for corporate governance.

"We're trying hard not to say that everything's great except Enron," said Franklin Raines, chief executive of Fannie Mae and chairman of the Business Roundtable's task force on corporate governance. "We're also saying that everything isn't rotten, either."

Stocks and bonds of companies with accounting practices that are questioned by investors -- last week's list included International Business Machines Corp., chipmaker Nvdia, Marriott International Corp. and Krispy Kreme Doughnuts Inc. -- have come under pressure. Insurance companies that write policies protecting corporate directors and officers from liability suits are reportedly increasing premiums by 50 percent or more. Audit fees are also increasing, not only to cover higher insurance costs but also the extra training and manpower that have been demanded by corporate audit committees.

"Right now I'd say there is deep panic in the corporate world," said Pete Peterson, a former secretary of commerce and chairman of the Blackstone Group, an investment bank now working on financial restructuring of several bankrupt companies accused of accounting deception, including Enron.

Writing last week in the New York Review of Books, Felix Rohatyn, the former Wall Street investment banker who served as ambassador to France, warned that Enron was giving aid to foreign critics of American-style capitalism who had always complained of its speculative excesses, outlandish executive compensation and slavish subservience to financial markets.

"Unless we take the regulatory and legislative steps required to prevent a recurrence of these events, American market capitalism will run increasing risks and be seen as defective here and abroad," Rohatyn wrote.

Award-Winning Tricks

On the baseline question -- rotten apple or rotting barrel -- expert opinions span the spectrum.

"Enron is indicative of nothing," said Alan "Ace" Greenberg, chairman of the executive committee at Bear, Stearns & Co., a Wall Street investment firm. "There's always people who do something they shouldn't and you'll never be able to legislate against it. This stuff happens."

Critics of the system argue that it is highly improbable that one company, Enron, happened to attract so many bad or incompetent executives, auditors, directors, lawyers, investment bankers and Wall Street analysts. They suspect that the reason nobody blew the whistle all those years was that what was going on at Enron was only a step or two beyond what was going on elsewhere in the corporate world.

"It may be comforting to say that Enron was an isolated situation, but not very convincing," said Patrick McGurn, vice president of Institutional Shareholder Services, an advisory firm to pension and mutual funds. "The Enron board looks like lots of other boards. The opaque and misleading financial statements look like lots of other financial statements. Off-balance sheet financing -- well, that's now commonplace, too. It's hard to just dismiss this as one bad apple."

Consider, for example, that Andrew S. Fastow, now widely credited as the genius behind Enron's off-balance-sheet partnerships, won the 1999 Excellence Award for Capital Structure Management awarded annually by CFO Magazine. The trade journal in particular cited Fastow's "groundbreaking" techniques, which allowed Enron to raise billions of dollars of new capital without increasing the debt on the company balance sheet or diluting its earnings per share -- the financial equivalent of a free lunch.

One of the techniques Fastow pioneered was so successful that Credit Suisse First Boston, which helped designed them, tried to sell them to other major energy firms, including Williams Cos. and El Paso Corp., which also used them. Only now, under pressure from rating agencies and investors, are those companies restructuring the arrangements.

In hindsight, it appears extraordinary that Enron's directors allowed Fastow to run some of Enron's partnerships, negotiating deals with Enron employees who were his subordinates. But in at least one offering document designed to lure investors to the partnerships, prepared in part by blue-chip lawyers (Kirkland & Ellis), auditors (PricewaterhouseCoopers) and investment bankers (Merrill Lynch), that glaring conflict of interest was not shunned; rather, it was touted as a potential advantage for investors who might benefit from inside knowledge.

Hidden Reality

"Managing may be giving way to manipulation; integrity may be losing out to illusion," Levitt warned in a speech in September 1998. To deal with the relentless pressure to deliver smooth, steady increases in quarterly profits, Levitt said, too many executives resorted to accounting tricks that, while usually legal and within the bounds of generally accepted accounting principles, were clearly meant to obfuscate and deceive.

Even as SEC chairman, however, Levitt was unable to stem the trend toward "earnings management," as it was politely called. In some industries, the practice became so widespread that smart purchasing managers realized they could get lower prices by waiting until the last week of a financial quarter in the hope of winning big discounts from sales managers desperate to meet their quarterly sales goals.

Executives who successfully managed their earnings and the earnings expectations of Wall Street analysts were rewarded with high stock prices, favorable ratings from stock analysts, glowing news articles and, not coincidentally, huge personal profits from stock options that have value only if share prices goes up. Many who refused to play the earnings-management game were dismissed as fuddy-duddies; their companies soon found themselves at a competitive disadvantage.

"In terms of earnings management, Enron stands tall but it hardly stands alone," said John C. Coffee, a corporate expert at the Columbia University Law School. "In the euphoria surrounding the Nasdaq bubble, there was big money to be made telling shareholders what they wanted to be told. . . . Of course there were people suspected there were problems, but everyone played along. Nobody likes the obnoxious child who says the emperor is naked."

Sen. Jon S. Corzine (D-N.J.), who headed the investment firm of Goldman, Sachs & Co. before he entered politics, agreed. "There has developed a culture of excess that is linked directly to this earnings-per-share mentality which, inevitably, has come to undermine the broader business ethos," Corzine said. "It was always there to some degree, but mostly at the fringes. Now it's getting very close to the core."

Jeffrey Pfeffer, professor of organizational behavior at the Stanford Business School, said the belief that stock price is all that matters has been hard-wired into the corporate psyche. It not only dictates how people judge the worth of their company but also how they feel about themselves and the work they're doing. And over time, he said, it has clouded judgments about what is acceptable corporate behavior.

In many companies, Pfeffer said, the ethical backsliding starts with a small, relatively innocuous deception -- backdating a contract by a couple of days or tucking a vague reference to a major screw-up in the footnotes of the annual report -- the financial equivalent of running a red light at a deserted intersection. Then, each successive quarter requires a bigger and bigger deception to keep the earnings momentum going.

Meanwhile, the auditor who looked the other way for the first few times realizes later that to stop it would require not only refusing to certify the books for the next quarter but also starting a process that would almost inevitably reveal the past mistakes, possibly triggering professional censure, lawsuits or an SEC investigation.

"I think it's very hard to argue that Enron is just an exceptional case," Pfeffer said. "Long booms like we had in the 1990s inevitably bring on excesses and corruption. We know that lots of people were playing fast and loose with the rules. . . . There's too many of them to believe it's a random, isolated event."