Lessons from enron: bad management, negative consequences

Business, Management

One of the classic examples of bad management, Enron's collapse according to the Economist (2002) was a result of bad management and poor decision-making of the auditing firm Andersen in handling the account of the company. The primary root of Enron's collapse was bad management and the power of the management to delegate auditing and accounting responsibilities to a firm that they have chosen. The dependence of the auditing firm on the management in essence creates the break in the accounting and auditing ethics: in order not to lose an all-too important account such as Enron, they would need to abide by the decisions of the management.

The lack of willpower of Andersen to question the unethical practices of Enron made it culpable in the same way as Enron's managers. This led a domino and cascading effect in the corporate world of America: the government scrambling to look for other companies who are also hiding in their auditor's books, the deterioration of the auditing and accounting profession, lack of trust in companies, and investor apprehension. The collapse of Enron was largely a decision by the top management which also involves its accountants to provide a bogus statement of finances to make Enron look like a profitable company.

Auditors of Enron on the other hand, have sought to protect the company by shredding incriminating documents. From an agency theory perspective, the role of the Enron's top management to that of the shareholders is one that is governed by the principle that managers will act in a way that will benefit the owners or shareholders of the company (Abrahamson and Park, 1994). In essence, what happened to Enron was that the managers or the agents gained too much power and the shareholders did not perform its function of overseeing the operations of their company.

Fundamentally, what the shareholders and the managers who did not take part in the Enron scandal could have done was to have the government to appoint an auditing or accounting firm that will monitor the financial movement of the company. In this way, accountants and auditors will not be obliged to follow what the top managers would want them to do. Managers need to be wary of decisions made by the top management or their colleagues. To a significant extent, appointments should be made independent of the managers.

In an era where auditing and accounting fraud are prevalent, managers can protect themselves by safeguarding their companies among their peers. References Abrahamson, E. and Park, C. (1994) Concealment of negative organizational outcomes: An agency theory perspective. Academy of Management Journal, 37: 1302-1334. Barefoot, JA. (2002). What can you learn from Enron? How to know if you are creating a climate of rule-breaking. ABA Banking Journal, 94. The Economist. (2002) The Lessons from Enron. 362, 8259: 9-10. Retrieved 1 July at http://www.

csupomona. edu/~smemerson/PLS499%20Greed_Need/Enron. doc. Appendix 1. Enron Article Title: THE LESSONS FROM ENRON , Economist, 0013-0613, February 9, 2002, Vol. 362, Issue 8259 Database: AcademicSearch Elite Section: Leaders THE LESSONS FROM ENRON After the energy firm's collapse, the entire auditing regime needs radical change THE mess just keeps spreading. Two months after Enron filed for Chapter 11, the reverberations from the Texas-based energy-trading firm's bankruptcy might have been expected to fade; instead, they are growing.

On Capitol Hill, politicians are engaged in an investigative orgy not seen since Whitewater, with the blame pinned variously on the company's managers, its directors, its auditors and its bankers, as well as on the Bush administration; indeed on anybody except the hundreds of congressmen who queued up to take campaign cash from Enron. The only missing ingredient in the scandal--so far--is sex. The effects are also touching Wall Street. In the past few weeks, investors have shifted their attention to other companies, making a frenzied search for any dodgy accounting that might reveal the next Enron.

Canny traders have found a lucrative new strategy: sell a firm's stock short and then spread rumours about its accounts. Such companies as Tyco, PNC Financial Services, Invensys and even the biggest of the lot, General Electric, have all suffered. Last week Global Crossing, a telecoms firm, went bust amid claims of dubious accounts. This week shares in Elan, an Irish-based drug maker, were pummelled by worries over its accounting policies. All this might create the impression that corporate financial reports, the quality of company profits and the standard of auditing in America have suddenly and simultaneously deteriorated.

Yet that would be wide of the mark: the deterioration has actually been apparent for many years. A growing body of evidence does indeed suggest that Enron was a peculiarly egregious case of bad management, misleading accounts, shoddy auditing and, quite probably, outright fraud. But the bigger lessons that Enron offers for accounting and corporate governance have long been familiar from previous scandals, in America and elsewhere. That makes it all the more urgent to respond now with the right reforms.

Uncooking the books The place to start is auditing. Accurate company accounts are a keystone for any proper capital market, not least America's. Andersen, the firm that audited Enron's books from its inception in 1985 (it was also Global Crossing's auditor), has been suggesting that its failings are representative of the whole profession's. In fact, Andersen seems to have been unusually culpable over Enron: shredding of incriminating documents just ahead of the investigators is not yet a widespread habit.

But it is also true that this is only the latest of a string of corporate scandals involving appalling audit failures, from Maxwell and Polly Peck in Britain, through Metallgesellschaft in Germany, to Cendant, Sunbeam and Waste Management in America. In the past four years alone, over 700 American companies have been forced to restate their accounts. At the heart of these audit failures lies a set of business relationships that are bedevilled by perverse incentives and conflicts of interest. In theory, a company's auditors are appointed independently by its shareholders, to whom they report.

In practice, they are chosen by the company's bosses, to whom they all too often become beholden. Accounting firms frequently sell consulting services to their audit clients; external auditors may be hired to senior management positions or as internal auditors; it is far too easy to play on an individual audit partner's fear of losing a lucrative audit assignment. Against such a background, it is little wonder that the quality of the audit often suffers. What should be done? The most radical change would be to takeresponsibilityfor audits away from private accounting firms altogether and give it, lock, stock and barrel, to the government.

Perhaps such a change may yet become necessary. But it would run risks in terms of the quality of auditors; and it is not always so obvious that a government agency would manage to escape the conflicts and mistakes to which private firms have so often fallen prey. As an intermediate step, however, a simpler suggestion is to take the job of choosing the auditors away from a company's bosses. Instead, a government agency--meaning, in America, the Securities and Exchange Commission (SEC)--would appoint the auditors, even if on the basis of a list recommended by the company, which would continue to pay the audit fee.

Harvey Pitt, the new chairman of the Securities and Exchange Commission, is not yet willing to be anything like so radical. He has been widely attacked because, when he acted in the past as a lawyer for a number of accounting firms, he helped to fend off several reforms. Yet he now seems ready to make at least some of the other changes that the Enron scandal has shown to be necessary (see pages 67-70.) Among these are much fiercer statutory regulation of the auditing profession, including disciplinary powers with real bite.

Hitherto, auditors have managed to get away with the fiction of self-regulation, both through peer review and by toothless professional and oversight bodies that they themselves have dominated. There should also be a ban on accounting firms offering (often more profitable) consulting and other services to their audit clients. Another good idea is mandatory rotation, every four years or so, both of audit partners--so that individuals do not become too committed to their clients--and of audit firms. The most effective peer review happens when one firm comes in to look at a predecessor's books.

The SEC should also ban the practice of companies' hiring managers and internal auditors from their external audit firms. In search of better standards Then there is the issue of accounting standards themselves. Enron's behaviour has confirmed that in some areas, notably the treatment of off-balance-sheet dodges, American accounting standards are too lax; while in others they are so prescriptive that they have lost sight of broader principles. Past attempts by the Financial Accounting Standards Board to improve standards have often been stymied by vociferous lobbying.

It is time for the SEC itself to impose more rigorous standards, although that should often be through sound principles (including paying less attention to single numbers for earnings) rather than overly detailed rules. It would also be good to come up with internationally agreed standards. Although audit is the most pressing area for change, it is not the only one. The Enron fiasco has shown that all is not well with the governance of many big American companies. Over the years all sorts of checks and balances have been created to ensure that company bosses, who supposedly act as agents for shareholders, their principals, actually do so.

Yet the cult of the all-powerful chief executive, armed with sackfuls of stock options, has too often pushed such checks aside. It is time for another effort to realign the system to function more in shareholders' interests. Companies need stronger non-executive directors, paid enough to devote proper attention to the job; genuinely independent audit and remuneration committees; more powerful internal auditors; and a separation of the jobs of chairman and chief executive.

If corporate America cannot deliver better governance, as well as better audit, it will have only itself to blame when the public backlash proves both fierce and unpleasant. PHOTO(COLOR)

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