



# Information Overload

Issue 23, July 2004

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## Welcome:

Welcome to this month's issue of Information Overload. This month we will be looking at the issues surrounding "Corporate Governance." We take another look at the issues surrounding the collapse of Enron and other organisations and the lessons that can be learned.

As always, if you would like to see us cover any other topics, we would love to hear from you. Just send an e-mail to [training@iea.com.au](mailto:training@iea.com.au). We would like to thank you in advance for forwarding this edition to friends and colleagues.

We hope you enjoy reading, have a great week.

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## In this Issue we will be looking at:

- What is Corporate Governance?
- What Fraudulent Activities?
- Enron – A potted history and beyond;
- The Role of the Sarbanes Oxley Act;
- A Thought to Ponder.

## What is Corporate Governance?

According to "The Corporate Library" (<http://www.thecorporatelibrary.com>) Corporate Governance is "The relationship between the shareholders, directors and management of a company, as defined by the corporate charter, bylaws, formal policy and rule of law."

Corporate Governance is concerned with three key issues, (1) how an organisation develops strategic goals and direction, (2) how the board of the organisation monitors the performance of the organisation to ensure it achieves these strategic goals, and (3) ensuring that the board acts in the best interests of the members, shareholders and other interested parties.

This should be achieved by:

**Independence** — independent views and opinions, objective assessment and freedom

from constraints of internal and external influence.

**Transparency and disclosure of information and decision-making** — the governance system is open to relevant stakeholders in terms of strategy, decision-making and financial and operational performance;

**No conflict of interest** — the people working within the governance system have no actual or perceived conflicts of interest in decision making and are not in a position to influence outcomes (publication of all actual or perceived conflicts of interest is a sign of good governance practice);

**Quality practices** — the governance system is based on quality standards and practices as set out by the Australian Quality Council;

**Process-based, not people-based** — the governance system is not reliant on individual people and their skills to ensure the continuation and operation of the organisation. The system should be based on strong processes and procedures, not just talented people;

**Linkages between responsibility and accountability** — those who are responsible for an activity, or outcome are actually held accountable for it as well;

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**Practical and reliable** — the governance system should not be overly complex and should be flexible to change.

Poor corporate governance on the other hand can come from a variety of sources including director inexperience, conflicts of interest, failure to manage risk, inadequate financial controls and poor business systems and reporting, as we shall see in later sections.

### What Fraudulent Activities?

#### Companies Accused of Fraud Have Fewer Independent Directors

Charlottesville, VA, United States – Corporate boards and oversight committees that have a greater proportion of independent directors are less likely to be accused of fraud, according to a study in the June issue of Financial Analysts Journal. The study looked at 133 companies that had faced fraud charges between 1978 and 2001, and compared them to 133 similar-sized companies in the same industry that had never been accused of fraud. The results indicated that companies accused of committing fraud: had a lower percentage of outside and/or independent directors; were less likely to have an audit committee; were more likely to have a compensation committee; and, had a lower percentage of independent directors on its audit, compensation and nominating committees. The study found no significant difference between non-fraud and fraud companies in terms of: board size; the frequency of committee meetings; whether or not there was a nominating committee; the company's financial performance; whether the president or CEO also served as chairman; and, the length of the CEO's tenure on the board. *BusinessWire, June 28, 2004*

The Treadway Commission issued a report on "Fraudulent Financial Reporting 1987–1997: An analysis of US Public Companies" evaluating 200 cases of publicly traded companies involved in financial statement fraud. Among other findings, the report stated that companies with fraudulent financial statements appeared to have boards "dominated by insiders" and "weak" audit committees that rarely met. The report stated that its results "highlight the need for an effective control environment, or 'tone at the top' and urged improvements in companies' internal controls, governance and ethics.

*Taken from "The Role of the Board of Directors in Enron's Collapse." Report Prepared by the Permanent subcommittee on investigations Of the Committee on governmental affairs United States Senate. Report 107-70*

[http://www.senate.gov/~gov\\_affairs/070702enreport.pdf](http://www.senate.gov/~gov_affairs/070702enreport.pdf)

### Enron – A Potted History and beyond

Perhaps the best way to explain poor corporate governance is to take a look at one of the most infamous of all corporate collapses in recent history: Enron. On December 2, 2001, Enron Corporation, then the seventh largest publicly traded corporation in the United States, declared bankruptcy. That bankruptcy sent shock waves throughout the country. Thousands of Enron employees lost not only their jobs but a significant part of their retirement savings; Enron shareholders saw the value of their investments plummet; and hundreds, if not thousands of businesses around the world, were turned into Enron creditors in bankruptcy court likely to receive only pennies on the dollars owed to them.

(In an article in the West Australian on Saturday July 17, it was reported "Enron has won approval to emerge from bankruptcy under a plan in which creditors will receive less than 20c in the dollar....")

Based upon the evidence before it, including over one million pages of subpoenaed documents, interviews of thirteen Enron Board members, and the Subcommittee hearing on May 7, 2002, the U.S. Senate Permanent Subcommittee on Investigations made the following findings with respect to the role of the Enron Board of Directors in Enron's collapse and bankruptcy.

(1) **Fiduciary Failure.** The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

(2) **High Risk Accounting.** The Enron Board of Directors knowingly allowed Enron to engage in high risk accounting practices.

(3) **Inappropriate Conflicts of Interest.** Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds, which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing.

(4) **Extensive Undisclosed Off-The-Books Activity.** The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

(5) **Excessive Compensation.** The Enron Board of Directors approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed, multi-million dollar, personal credit line.

(6) **Lack of Independence.** The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.

*"The Role of the Board of Directors in Enron's Collapse." Report Prepared by the Permanent subcommittee on investigations Of the Committee on governmental affairs United States Senate. Report 107-70*

[http://www.senate.gov/~gov\\_affairs/070702enreport.pdf](http://www.senate.gov/~gov_affairs/070702enreport.pdf)

Unfortunately Enron is not the first organisation to have poor corporate governance and have paid the ultimate price.

Harvard's Rakesh Khurana argues that An inordinate number of today's chief executives have been valued by their boards not so much for their business skills and experience as for their ability to project optimism to investors, and by directors and investors for their capacity to inspire employees to take risks and "think outside the box." Former Enron employees have described a "yes man" culture in which a top executive such as Andrew Fastow (Enron's former chief financial officer and the architect of many of the firm's notorious off-the-books partnerships) would do anything to please the boss. WorldCom's Scott Sullivan evidently bought into Mr. Ebberts's "vision" to the extent of abdicating the CFO's traditional role of keeping the chief executive honest. He said that based on his "research on CEO successions at 850 companies over most of the 1980s and '90s, I know that many executive suites around the Fortune 500 are populated by CEOs chosen by a succession process very similar to those that led to the selection of Jeff Skilling at Enron, Joe Nacchio at Qwest, Dennis Kozlowski at Tyco, John Roth at Nortel and Bernie Ebbers at WorldCom.

The most important common trait possessed by these CEOs and many others like them in corporate North America today is their supposedly "visionary" character. Another example was Jean-Marie Messier, who resigned yesterday as CEO of Vivendi Universal SA. Hailed by Forbes as a "rock-star CEO" of the new economy, he flaunted his messianic ego on his own personal Web site, J6M.com, which stood for Jean-Marie Messier-moi-meme, maitre du monde (Jean-Marie Messier, Me, Myself, Master of the World). "

*False Prophets, Lost Profits July 3, 2002 By Rakesh Khurana The Globe and Mail Metro Bell Globemedia. Rakesh Khurana, an assistant professor at the Harvard Business School, is author of a forthcoming book, Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs.*

[http://www.cglv.hbs.edu/pdf/ViewpointsKhurana\\_prophets.pdf](http://www.cglv.hbs.edu/pdf/ViewpointsKhurana_prophets.pdf)

According to the entry on corporate governance in the Wikipedia – the free encyclopedia, the board of directors is nominally selected by and responsible to the [shareholders](#), but perverse incentives have pervaded many corporate boards in the

developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Most often members of the boards of directors are CEO's of other corporations, which some see as a conflict of interest (see <http://theyrule.net>).

[http://en.wikipedia.org/wiki/Corporate\\_governance](http://en.wikipedia.org/wiki/Corporate_governance)

### **The Role of the Sarbanes Oxley Act**

In a move to eliminate perceived conflicts of interest as we have seen with Andersen and Enron, Senator Paul D Sarbanes (D-Md) and Republican Michael G Oxley introduced a bill to the US Senate that was quickly adopted by the Bush administration. The Bill sought to ensure that auditing firms could no longer perform non-auditing work for their clients. The services to be banned included consulting, internal accounting and information system design.

<http://www.accountancyage.com/News/1129572>.

Of course, cynics will say that the reason the act was so quickly adopted was because of the perceived conflict of interest between the CEO of Enron – Mr Kenneth Lay who is a personal friend of the US President, George W Bush, and the fact that Mr Lay contributed thousands of dollars to both political parties during his tenure at Enron. Whatever the main reason behind the introduction of the legislation, organisations now have to comply in full with Sarbanes Oxley or face large fines and/or those found guilty of obstruction or non-compliance will be faced with lengthy jail terms.

The impact of the Sarbanes Oxley act has far reaching implications. **ANY** company or organisation that is an SEC (the United States Government's Securities and Exchange Commission) registrant, as well as those subsidiaries of US or European parent companies that are SEC registrants **MUST** comply in full with Sarbanes Oxley.

In an interesting article in the WA Business News (April 22, 2004) "EY leads audit market" Mark Beyer highlighted the practice of Australian accounting firms cross selling of services, with auditing being the "loss leader" in a bid to pick up other work. This cross selling of services is surely the same conflict of interest that Arthur Andersen fell foul of in its dealings with Enron. If ErnstYoung, Australia has structured its organisation in such a way as to be listed on the US SEC then it (and other organisations like it) will not be able to cross sell its services to clients in the future, causing a significant loss of revenue to Australia and Australian businesses.

And on the subject of complying with overseas legislation, it could be argued quite strongly that if the Free Trade Agreement with the United States comes into force, Australian businesses will have even more reasons to comply with US led legislation as well as our own. The Act can be viewed in its entirety at:

<http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>

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### **A Thought to Ponder:**

"One of the symptoms of an approaching nervous breakdown is the belief that one's work is terribly important."

**Bertrand Russell (1872 – 1970)**

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Your comments and suggestions on the subject of this newsletter are most welcome. Or if you would like to see other issues covered in future editions, please email [training@iea.com.au](mailto:training@iea.com.au)

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**Information Enterprises Australia Pty Ltd**  
Unit 4, Upper Level, 201 High Street, FREMANTLE WA 6160  
Tel: 08 9335 2533 Fax: 08 9335 2544 e-mail: [training@iea.com.au](mailto:training@iea.com.au)