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## G-24 Discussion Paper Series

# Enron and Internationally Agreed Principles for Corporate Governance and the Financial Sector

**Andrew Cornford**

*No. 30, June 2004*

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# PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

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# ENRON AND INTERNATIONALLY AGREED PRINCIPLES FOR CORPORATE GOVERNANCE AND THE FINANCIAL SECTOR

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**G-24 Discussion Paper No. 30**

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## *Abstract*

*Recent corporate scandals have led to a wide-ranging re-examination of standards for corporate governance with repercussions that extend to financial regulation and the key standards for financial systems which are a major component of current initiatives to strengthen the international financial architecture and include corporate governance as one of their subjects. This paper contains an account of the breakdown of corporate governance in the most baroque of recent scandals, that involving the collapse of Enron, where there were not only conflicts with standards for good corporate governance but also unusually extensive use of sophisticated techniques and transactions to manipulate the firm's financial reports. Good corporate governance presupposes satisfactory performance not only on the part of auditors but also of other "watchdogs" or "gatekeepers" from the private sector such as credit rating agencies, lenders, investors and financial analysts. Their role in turn must be complemented by effective regulation, which in the case of a firm with operations as complex as Enron involves several different bodies. The paper documents the extensive failures of these different parties in the Enron case.*

*This discussion serves as a backdrop to a discussion of policy initiatives in the aftermath of Enron's collapse and other corporate scandals at the international level – most importantly the strengthening of the OECD Principles of Corporate Governance - and in the United States – where the response has included the far-reaching Sarbanes-Oxley Act whose repercussions will also be felt outside the United States owing to global importance of the country's financial markets. The discussion also points to links between policy responses involving corporate governance proper and initiatives regarding international financial regulation. The paper also includes reflections on alternative models of corporate governance and of some of the implications of the weaknesses of the much touted United States model highlighted by recent scandals for the development and reform of corporate governance in emerging-market and other developing countries.*

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# ENRON AND INTERNATIONALLY AGREED PRINCIPLES FOR CORPORATE GOVERNANCE AND THE FINANCIAL SECTOR

**Andrew Cornford***

## A. Introduction

Recent corporate scandals in the United States and elsewhere have led to a wide-ranging re-examination of standards for corporate governance with repercussions that extend also to financial regulation. The key standards for financial systems whose application is a major component of current initiatives to strengthen the so-called international financial architecture include three which are pertinent to this re-examination and which will themselves be affected by the policy response: the OECD Principles of Corporate Governance, and the initiatives concerning International Financial Reporting Standards (IFRS) and International Standards on Auditing.[1] This paper contains an account of the breakdown of corporate governance in the most baroque of recent scandals, that involving the collapse of Enron, which involved not only conflicts with standards for good corporate governance but also unusually extensive use of sophisticated techniques and transactions to manipulate the firm's financial reports. This account serves as a backdrop to a discussion of policy initiatives in the aftermath of Enron's collapse and of implications for the development and reform of corporate governance in emerging-market and other developing countries. This is a vast area and the discussion here is largely limited to the general principles of corporate governance and pertinent parts of financial regulation. The remarks on auditing and accounting are restricted to topics closely related to these subjects in the Enron case and to the relation of progress in the elaboration of internationally agreed principles under these two headings to that on standards for corporate governance, and do not address more specialised issues under these two headings.

## B. A sketch of Enron

At the time of its filing for bankruptcy in December 2001 the complex industrial structure of Enron was fully grasped by few outsiders, and more complete information as to the true levels of its assets, liabilities and off-balance-sheet positions was still unfolding. An idea of the firm's complexity can be obtained from such features as its 2,800 offshore units and the 54 pages required to list people and companies owed money by Enron. This was a far cry from the firm which in the 1980s specialized in the provision of natural gas pipelines and related services. But from these origins Enron expanded

* The author is grateful for the comments of Stewart Hamilton, Anthony Travis, and members of UNCTAD's Investment and Enterprise Competitiveness Branch. However, the views expressed are his own, as is the responsibilty for remaining errors.

relentlessly into trading activities in 1,800 products or contracts and 13 currencies (which included bandwidth, pulp and paper, and contracts such as weather and credit derivatives), the great majority of which were not subject to the regulatory oversight of the CFTC. It was in connection with expansion into trading that Enron engaged in increasingly aggressive and creative accounting and in other transactions and techniques described in more detail below.

Part of the motivation of Enron's conduct was similar to that of many other firms in the 1990s, deriving from the links between stock prices and executives' remuneration and wealth, above all through stock options. But in Enron's case the factor of its credit rating was also crucial. The firm's rapid expansion required access to large amounts of financing; and as its involvement in trading activities grew, so did the importance of its credit rating since this determined its financing costs and crucially the willingness of its counterparties to trade with it. A favourable earnings picture and the avoidance of excessive leverage on Enron's balance sheet were perceived by its management as essential to maintaining the firm's credit rating.

The means used to achieve these objectives involved extraordinary departures from transparency which affected the firm's relations with investors and creditors, its own board of directors (and thus an important part of its internal control), and other stakeholders of the corporation. The firm's use of special purpose entities (SPEs) was part and parcel of the practices employed to manipulate the firm's earnings figures and balance sheet, as was recourse to hedging and the use of derivatives in conflict with reporting rules or business logic (or both). Many of the transactions associated with this manipulation were also associated with self-dealing by Enron executives leading to substantial personal enrichment.

## C. Accounting and transactional techniques used by Enron

Seven accounting and transactional techniques were extensively used by Enron and provide an idea of the ways in which the firm pushed against or overstepped the limits imposed by regulation.[2] Not all Enron's use of these techniques was in conflict with accepted accounting rules and practice. Nevertheless, a great deal of what has been classified as questionable or improper in investigations since the firm's bankruptcy belongs under these seven headings.[3]

### *(1) FAS 140 transactions[4]*

These transactions were used by Enron to monetize liquid assets on (and thus remove them from) its balance sheet, while at the same time actually retaining control over them. This was achieved by the sale of the assets through a number of steps to an SPE not consolidated in its financial statements. The resources of the SPE consisted of borrowings and equity in the proportions of 97 and 3 per cent. Enron's continuing control over the assets (and thus also its continuing assumption of financial obligations linked to them) was typically achieved by a Total Return Swap, a credit derivative through which Enron retained most of the economic benefits and risks of ownership of the assets and committed itself to meeting the costs of the SPE's borrowings. Thus transactions classified as sales were more truly financing and part of Enron's debt. Enron also recognised as income the difference between the cash proceeds of the "sale" and the carrying value of the assets in question.

### *(2) Tax transactions*

These transactions typically boosted reported income through the creation of future tax deductions, sometimes several years hence, and the recording in the current period of the projected benefits associated with them.

### *(3) Non-economic hedges with related parties*

Under this technique Enron hedged the value of investments marked to market (see below) by entering into derivative contracts with counterparties related to itself. The acceptability of a hedge from the point of view of accounting rules or business logic turns on the correlation between two mutually offsetting positions or on the existence of an unrelated party prepared to assume through a contract part or all of the economic risk of the position being hedged. These conditions are not fulfilled if one of the counterparties to the contract is closely related to the firm or if the value of the two positions depend on the same underlying assets. These conditions were thus not fulfilled for a number of important hedges entered into by Enron since, firstly, the counterparties to the hedges were entities in which

Enron employees participated and over which they exercised managerial control and, secondly, the resources of these entities were largely Enron stock, forward contracts to purchase such stock, and warrants on the stocks of firms in which Enron had controlling investments.

### *(4) Share trust transactions*

Under this technique Enron established entities for the purpose of removing assets and liabilities from its balance sheet. One of the entities (the issuer) issued securities of which the proceeds were received by another entity (the holding entity) that also held assets contributed by Enron itself. The assets of the holding entity were then used to meet obligations on the issuer's securities and to purchase assets from Enron or repay its debt. The capacity of the issuer to meet its obligations was effectively guaranteed by Enron, which also retained control over and the benefits of the holding entity's assets. This rendered questionable the moving of assets and liabilities from Enron's consolidated balance sheet by this technique.

### *(5) Minority interests*

This technique enabled Enron to raise money which was classified on its balance sheet as "minority interests", a category of financing treated by credit rating agencies as hybrid equity rather than debt. A majority-owned subsidiary was established by Enron with a minority interest being taken by another entity, financed by debt and equity in the proportions of 97 and 3 per cent. The minority shareholder in the subsidiary was not consolidated with Enron for accounting purposes, and the financing for Enron from this source was not counted as debt with the result that key credit ratios of the firm were improved.

### *(6) Prepays*

The technique of prepaid swaps was used by Enron to disguise the nature of financial transactions between the firm and major banks. In prepays one counterparty is paid a fixed sum up front in return for a stream of future payments (the receipts and payments in this case being linked to the oil price and being made partly through an offshore conduit SPE). The cash flows of the prepay mimic those of a loan but so long as the swap meets certain conditions, now judged not to have been met in Enron's case, the transaction can be accounted for as a hedge.[5] As such prepays can boost operating cash flows, while also keeping down debt.

### *(7) Mark-to-market accounting*

Mark-to-market accounting, which enabled Enron to value its longer-term and some of its more complex contracts, involves the revaluation of assets on a regular basis. Such accounting can be relatively straightforward, for example, when unambiguous market prices are available for the assets and liabilities in question. But it is less so when applied to non-standardised OTC transactions and to complex, long-term contracts. In the latter case recourse is typically had to models for valuation (a process known as mark-to-model), which depend on assumptions about an inherently uncertain future and provide scope for judgement. Such accounting can be (and in Enron's case was) a major generator of reported earnings. However, it can be the source of divergences between reported earnings and cash flow, a problem Enron addressed by combining mark-to-market accounting with techniques for monetizing assets, some of which are part of other transactions already described.

Enron's court-appointed bankruptcy examiner has made estimates of the of the impact of these techniques other than mark-to-market accounting on Enron's financial statements for 2000, the last year for which Enron issued an audited annual financial statement, as well as on components of Enron's key credit ratios and on the key credit ratios themselves for 31 December 2000. These are shown in tables 1–3 below and the results are frequently dramatic. Note in particular the more than doubling of Enron's debt and the drastic falls in net income and in funds flow from operations.

Yet even these estimates understate the magnitude of the divergence between Enron's reported debt and a truer picture just before its insolvency. In its filing for the third quarter for the third quarter of 2001 Enron's debt reported according to GAAP principles was $12.97 billion. But in a presentation to bankers on the day on which this figure was released Enron's own executives acknowledged that this took no account of off-balance-sheet obligations of $25.12 billion – $14 billion of which was incurred through structured-finance transactions involving SPEs – so that the truer figure for its debt was $38.09 billion.[6]

*Table 1*

**EFFECTS OF APPLICATION OF SIX ACCOUNTING TECHNIQUES ON ENRON'S FINANCIAL STATEMENTS FOR 2000**

| | *Net income* | *Funds flow from operations* | *Total assets* | *Debt* |
|---|---|---|---|---|
| As reported *(dollars)* | 979.0 | 3,010.0 | 65,503.0 | 10,229.0 |
| Adjustments for: | | | | |
| (1) FAS 140 transactions | (351.0) | (1,158.3) | 812.5 | 3,353.4 |
| (2) Tax transactions | (269.1) | (60.6) | - | - |
| (3) Non-economics hedges | (345.7) | - | (867.0) | (150.0) |
| (4) Share trusts | 29.7 | (418.0) | 4,178.0 | 4,871.0 |
| (5) Minority interests | - | - | - | 1,740.0 |
| (6) Prepays | - | (1,527.0) | - | 4,016.3 |
| Total adjustment | (936.7) | (3,163.9) | 4,123.5 | 11,830.7 |
| Total after adjustments *(dollars)* | 42.3 | (153.9) | 69,626.5 | 22,059.7 |
| Adjustments as percentage of amount originally reported | (96) | (105) | 6 | 116 |

***Source:*** United States Bankruptcy Court Southern District of New York, *Second Interim Report of Neal Batson, Court-Appointed Examiner*. In re: Enron Corp., et al., *Debtors*, 21 January 2003, pp. 48–49.

*Table 2*

**ADJUSTED COMPONENTS OF ENRON'S KEY CREDIT RATIOS**

| *Credit ratio component* | *As reported* (Dollars) | *As adjusted* (Dollars) | *Change* (Per cent) |
|---|---|---|---|
| Funds flow from operations | 3,010.0 | (153.9) | (105) |
| Debt | 10,229.0 | 22,059.7 | 116 |
| Total obligations | 10,466.0 | 22,297.0 | 113 |
| Shareholders' equity and other items | 14,788.0 | 10,342.0 | (31) |
| Earnings for credit analysis | 2,492.0 | 1,793.0 | (28) |
| Interest | 944.0 | 1,567.0 | 66 |

***Source:*** As for table 1.

***Table 3***

**ENRON'S ADJUSTED KEY CREDIT RATIOS FOR 2000**

| *Key credit ratio* | *As reported* | *As adjusted* | *Percentage change* |
|---|---|---|---|
| Funds flow interest coverage | 4.07 | 0.90 | (78) |
| Pretax interest coverage | 2.54 | 1.11 | (56) |
| Funds flow from operations/ total obligations *(per cent)* | 28.8 | (0.7) | (102) |
| Total obligations/total obligations plus total shareholders' equity and certain other items *(per cent)* | 41.4 | 68.3 | 65 |
| Debt/total capital *(per cent)* | 40.9 | 68.1 | 67 |

***Source:*** As for table 1.

## D. Enron's financial reports

Coverage of many of Enron's operations in its financial returns to the Securities and Exchange Commission (SEC) and in its proxy statements to shareholders was frequently skimpy. Commenting on coverage of Enron's related-party transactions, the Powers Committee (appointed by Enron's board to look into the firm's accounting in October 2001) concluded that "while it has been widely reported that the related-party transactions ... involved 'secret' partnerships and other SPEs, we believe that is not generally the case" but also that "Enron could have, and we believe in some respects should have, been more expansive under the governing standards in its descriptions of these entities and Enron's transactions with them".[7] Indeed, arguably only with the report of the Powers Committee itself and other subsequent investigations triggered by the firm's decline and bankruptcy in late 2001 did it become possible to develop a reasonably wide-ranging picture of the functioning of the complex network which by then constituted Enron and its closely related entities.[8]

## E. Some other examples of Enron's activities

Many other activities of Enron have been the focus of special attention of commentators. One was a particularly aggressive and targeted use of political lobbying – backed by large financial contributions –, which, *inter alia*, enabled Enron to avoid proper regulatory oversight for much of its trading.

Another, which generated much controversy and was a source of much unfavourable publicity for the firm, was its gaming[9] of California's system of energy supply during the state's energy crisis.

Enron's questionable practices in the California energy market took place after the market's deregulation in 1996. Under the new regime the state's utilities sold their own power plants and bought their electricity from a single wholesale pool, the California Power Exchange. They were forbidden to enter into long-term supply contracts. Ironically in view of subsequent events, the reason for this prohibition was the perceived danger that the utilities would be locked into higher prices. But the new regime left the utilities exposed to fluctuations in the spot market for electricity. At first the system functioned reasonably well but there was a change in 2000 as the effects of a hot summer were superimposed on an economic boom of which a major feature was an increase in demand due to expanded use of power-hungry computer equipment. The consequent rises in prices generated considerable ill will towards electricity traders, of which Enron was the largest.

Although there were quickly suspicions that energy traders were gaming the market, only later was the scale of Enron's use of such practices disclosed.[10] There was eventually concern within Enron itself as to the resulting danger of regulatory sanctions, and in a memorandum of December 2000 from an outside law firm to an in-house Enron lawyer the firm's practices are described in some detail.[11] This concern led Enron to cease such operations later in the same month. Some of the practices described in the memorandum consisted of legitimate arbitraging of interstate price differentials due to differences in regulatory frameworks. The more questionable practices involved the earning of Congestion Fees paid by California's Independent System Operator (ISO) to firms to reduce the power scheduled for delivery over the state's transmission lines during periods when these lines were overloaded. Enron traders found a number of ways to earn Congestion Fees by creating such overloading or the appearance of such overloading (phantom congestion). The practices were often given picaresque names such as "Death Star", "Get Shorty", and "Fat Boy".

## F. Different parties and non-observance of good corporate governance

Corporate governance is concerned with the relationships between a business's management and its board of directors, its shareholders and lenders, and its other stakeholders such as employees, customers, suppliers, and the community of which it is a part.[12] The subject thus concerns the framework through which business objectives are set and the means of attaining them and otherwise monitoring performance are determined. Good corporate governance follows principles which still vary significantly among countries and which are currently the subject of various initiatives designed to achieve agreement on an acceptable framework of basic standards of in which a central role is attributed to the OECD's Principles of Corporate Governance (discussed at length below). Implementation of principles of good corporate governance presupposes satisfactory performance on the part of several different parties from both the private and public sectors. Those from the private sector include the firm's own board of directors and auditors but also other so-called private-sector "watchdogs" such as credit rating agencies, lenders and investors, and financial analysts. The role of these parties must be complemented by effective regulation, which in the case of a firm with operations as complex as Enron includes not only major regulators of the financial sector but also the regulator of the energy sector.

Much of the commentary on failures of corporate governance in the Enron case has tended to focus on the performance of the board of directors and the external "private-sector watchdogs". However, good corporate governance depended no less on the conduct of the firm's management and other employees internally and thus crucially on its system of incentives and sanctions, the first of the subjects taken up in what follows.

### *1. Enron's system of incentives and sanctions*

While Enron's system of remuneration and other incentives to its employees and the closely related subjects of its hiring system and its staff evaluation was in major respects specific to Enron, many of its features can also be found in practices of other firms, though not generally pushed to the same extremes.

The influence of the firm's stock price on the incentive system for Enron's employees became increasingly important during the long financial boom of the 1990s. In the case of senior staff this reflected a remuneration system of which a key part consisted of stock options. For other staff much of their savings was invested in Enron stock with the active encouragement of Enron's own management. An important part of this process consisted of retirement savings plans under which staff's own contributions were topped up by contributions from Enron itself.

Enron's corporate culture has been widely described as cutthroat. It combined pressure on employees to accept a very high degree of subordination of personal objectives to those of the firm – pressure for the creation of Enron Men and Enron Women – with fierce internal competition, especially between the constituent units of business divisions and between the divisions themselves.

Enron's hiring practices were rigorous and targeted, with an emphasis on top graduates and undergraduates recently out of universities rather than more experienced employees. This produced a flexible workforce more easily moulded to the firm's goals as well as a relatively inexpensive one. Once on board Enron's employees were subject to a system of incentives and sanctions characterised by continuing pressures due to the risk of being fired under a process which came to be known as "rank and yank". At the centre of this process was a twice-yearly Performance Review Committee (PRC), an exercise taking several days for managers gathered in a hotel for the purpose.[13] For many years employees were evaluated on a bell curve, the resulting ranking placing them in categories 1 to 5. Those placed in category 1, the lowest, risked being "yanked". They were given six months to improve their performance: during this period this period they had to spend about an hour a day documenting their activities and their contributions to Enron. The consequent pressures actually led many employees to accept severance packages in short order. Those in categories 2 and 3 were made aware that they were susceptible to "yanking" in a slightly more distant future if their performance did not improve.

Systems of such "yanking" are not limited to Enron among major companies but Enron's version does seem to have been extreme. This quality probably explains the failure of other United States energy firms to copy Enron. Apparently these firms believed that the PRC system was not conducive to good teamwork. According to Sherron Watkins, the Enron "whistle blower", Enron's management eventually realised that the system was proving counterproductive. As she puts it, "Enron Gas Services was developing a reputation as a predatory place where people would sell each other out to survive. People outside the company got the word, too, and blue-chip recruits became leery of signing on."[14] Ratings based on the bell curve ceased from 1995, though the PRC process continued.

Another noteworthy outcome of the corporate culture of Enron was to contribute to the insertion of a specific provision in the Sarbanes/Oxley Act (of which more below). As already mentioned, many Enron employees had invested substantial sums in Enron own stock, the active encouragement of this practice by Enron's own management continuing right into the autumn of 2001. But at the same time Enron officers and a few directors were themselves selling the firm's stock on a massive scale – to the tune of $1.1 billion between January 1999 and July 2001, sales no doubt partly due to normal portfolio diversification but also likely to have been increasingly influenced by insider knowledge of the growing precariousness of Enron's real situation.[15] By contrast sales of Enron stock in employees' retirement plans were subject to restrictions and actually became impossible during the period from 17 October until 19 November 2001 (when Enron's position was becoming increasingly critical) owing to a change in the plans' administrators. The latter restrictions were an example of a "blackout period", namely one of more than three business days during which there is a suspension of the right to sell the firm's equity for 50 per cent or more of the participants in, and beneficiaries of, individual-account retirement plans.

## 2. *Board of directors*

A fundamental role in the achievement of good corporate governance is attributed to actors in the board of directors and independent external auditors. Key functions of the board of directors, which were particularly relevant in the case of Enron, include selection and remuneration of executives, being alert to potential conflicts of interest adversely affecting the firm, and ensuring the integrity of the company's systems of accounting and financial reporting. Prerequisites for satisfactory performance include access to accurate and timely information bearing on the fulfilment of these responsibilities. The role of the board in the area of conflicts of interest clearly includes the monitoring needed to avoid self-dealing by management.

The primary finding of a report to a committee of the United States Senate on the role of the Enron's board in its collapse is damning:

> 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.[16]

In a review of this finding the experience and credentials of the Enron board should be borne in mind: in 2001 this consisted of 15 members, many of them with 15 or more years of experience on the Board of Enron and its predecessor companies, and many of them also members of the boards of other companies. Of the five committees of the Enron board the key Audit and Compliance Committee (the primary liaison body with the external auditors) had six members, of whom two had formal accounting training and professional experience and only one limited familiarity with complex accounting principles; and the Compensation Committee had five members, three with at least 15 years of experience with Enron.[17]

Acknowledgement is due that for a number of key decisions the board of directors did not have access to the information required for them to perform their monitoring role in an informed way. None the less the board approved or acquiesced in several decisions with problematic features (major examples being transactions discussed in annex I), and were aware of Enron's recourse to questionable accounting. The record is replete with developments (such as an increase in revenues from $40 billion in 1999 to $101 billion in 2000) which would appear to have deserved more questioning by the board than they actually occasioned. Moreover Arthur Andersen provided regular briefings to the board concerning Enron's accounting practices at which Andersen pointed to features that were novel and involved serious risk of non-compliance with generally accepted accounting principles. The increase in the complexity of Enron's corporate structure does not seem to have led to questioning or critical review by the board. For example, Enron's annual filings for 1999 and 2000, which were approved and signed by board members without any indication of concern, listed almost 3000 related entities, with over 800 in offshore jurisdictions – 120 in the Turks and Caicos and 600 in the Cayman Islands.[18]

The report to the Committee of the United States Senate cited above criticised the board's Compensation Committee for exercising inadequate oversight over compensation for Enron executives. For example, it drew special attention to the fact that in 2001 executives received almost $750 million in cash bonuses for performance in 2000, a year in which the company's entire net income amounted to $979 million.[19] Moreover the board's approval of partnerships discussed in annex I which were likely to lead to conflicts of interest involving Enron's employees or to be associated with abusive self-dealing point to serious weaknesses in its performance regarding these two subjects.

One widely accepted principle of good corporate governance is that the board be independent of management. The finding of the report to the Senate Committee concerning the effect on Enron's board of financial ties between the company and certain Board members suggests that this requirement was not met in the case of Enron. Economic ties between the board and Enron took such forms as retainers or payments for consultancy services (or both) to two board members, another Board member's service on the board of directors of a company making substantial sales of oilfield equipment and services to Enron subsidiaries, donations by Enron to medical and educational institutions with which board members were associated, hedging transactions between Enron and an oil company of which a board member was a former chairman and chief executive officer, and payments for services and other contributions to organisations engaged in governmental relations, tax consulting and lobbying where a former board member had ownership interests or otherwise played a prominent role.[20] It should also be mentioned here that of the compensation paid to the board a substantial proportion was in the form of stock options, a practice capable of exerting on the board pressures to approve decisions likely to have a favourable influence on the firm's stock price similar to those also exerted on management.

### 3. *Accountants/auditors*

Regarding auditing good corporate governance requires high-quality standards for preparation and disclosure, and independence for the external auditor. Enron's external auditor was Arthur Andersen, which also provided the firm with extensive internal auditing and consulting services. Some idea of its relative importance in these different roles during the period leading up to Enron's insolvency is indicated by the fact that in 2000 consultancy fees (at $27 million) accounted for more than 50 per cent of the approximately $52 million earned by Andersen for work on Enron.

The history of relations between Enron and Arthur Andersen suggests that they were frequently characterised by tensions due to the latter's misgivings concerning several features of Enron's accounting.[21] However, overall Andersen's performance, revelations concerning which were to lead to the break-up of the firm, led to the following assessment by the Powers Committee: "The evidence available to us suggests that Andersen did not fulfil its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal contracts over the related-party transactions."[22] Both the Powers Committee and bodies of the United States Senate which have investigated Enron's collapse have taken the view that lack of independence linked to its multiple consultancy roles was a crucial factor in Andersen's failure to fulfil its obligations as Enron's external auditor.[23]

## 4. *Banks*

Enron's banks were deeply involved in the firm's recourse to techniques for the manipulation of its reported earnings and balance sheet under the seven major transactional and accounting headings described earlier. A typical summary of the role played by banks in Enron's way of doing business in the report of the court-appointed bankruptcy examiner reads as follows:

> The Examiner concludes that there is evidence that: (i) [the bank] had actual knowledge of the wrongful conduct in the transactions giving rise to the breaches of fiduciary duty [by Enron's officers]; (ii) [the bank] gave substantial assistance to certain of [Enron's] officers by participating in the structuring and closing of such transactions; and (iii) injury to [Enron] was the direct or reasonably foreseeable result of such conduct.[24]

## 5. *Financial analysts*

Most financial analysts covering Enron stock continued to recommend it to investors well into the autumn of 2001, even as revelations concerning Enron's accounting and management failings began to proliferate. Many of the analysts made this recommendation even though they admitted that they did not fully understand the firm's operations and structure. The overall verdict of the staff report to the United States Senate cited earlier is that "Wall Street analysts [were] far less focussed on accurately assessing a company's performance than on other factors related to their own employers' businesses", citing here the employment of many of them by banks that derived large investment-banking fees from Enron transactions, that were investors in Enron's off-balance-sheet partnerships, and that had credit exposure to Enron.[25] Concerning this failure the report draws attention not only to the links between analysts' bonuses and the profitability of the firms employing them but also to more general pressures for favourable recommendations on a stock such as complaints and even legal threats from firms evaluated negatively and restrictions on the access of analysts responsible for such evaluations to the information required for their work.[26]

## 6. *Credit rating agencies*

The major credit rating agencies enjoy great power by virtue of the influence of their ratings over firms' access to capital markets and over the cost of their financing. Their influence is associated with the granting to them since 1975 by the SEC of the status of nationally recognised statistical ratings organisation (NRSRO). Their reliability has been called into question by a number of events in recent years, one of which was the failure of three major agencies to lower Enron's rating to below investment grade until a few days before the firm's bankruptcy despite a series of unfavourable disclosures. Here the report to the United Sates Senate cited above attributes the agencies' shortcomings to lack of inquisitiveness (despite the indications in Enron's financial reports of a propensity to engage in manipulation) and excessive attention to the firm's cash flow, the confidence of its counterparties, and the announcement shortly before its bankruptcy of a possible merger with Dynegy, another large trader of gas and electricity.[27]

## 7. *SEC*

In the Enron case the SEC, the regulatory body responsible reviewing firms' financial statememts, missed warning signs concerning Enron's misconduct.[28] This failure reflected partly resource constraints. The SEC's stated goal was to review every company's annual report at least once every three years. However, in practice the annual returns of less than 50 per cent of public companies had been reviewed in the previous three years at the time of Enron's bankruptcy, and no review of Enron's returns had taken place after that of 1997 despite the warning signs.

### 8. *Federal Energy Regulatory Commission (FERC)*

Enron was also subject to the oversight of the FERC, the body responsible for regulation of the interstate transmission and wholesale of electricity and natural gas, licensing of hydroelectric projects, and oil transmission by interstate pipelines. Under these headings the FERC is concerned with rate levels, the maintenance of competition, and construction of pipelines. The FERC's oversight did not concern Enron as a corporation *per se* but various activities of the firm. A report to the United States Senate on the FERC's oversight focussed on areas where Enron is now known to have engaged in questionable transactions (such as the California energy crisis), and on financial risks to which it was exposed by its trading activities. For example, the FERC conducted in May 2001 an investigation into Enron Online, the firm's electronic platform for transactions in electricity and natural gas, with the objective of discovering whether it was associated with abusive market practices. In the view of a report for the United States Senate, the FERC failed to follow through on various concerns raised during this investigation, including some with a bearing on the firm's eventual bankruptcy such as a trading model exposing it to large financial risks and the dependence of its trading capability on its creditworthiness. The overall verdict of the report for the Senate is that FERC "was no match for a determined Enron" and "has yet to prove that it is up to the challenge of proactively overseeing changing markets."[29]

## G. Corporate governance and the OECD Principles

As mentioned earlier, the main set of standards for corporate governance agreed at international intergovernmental level is the OECD Principles of Corporate Governance.[30] These Principles provide the principal overall framework within which international discussions on this subject take place including that of policy responses to the Enron case and other recent corporate scandals. The OECD Principles cover five basic subjects: (1) protection of the rights of shareholders; (2) equitable treatment of shareholders, including full disclosure of material information and the prohibition of abusive self-dealing and insider trading; (3) recognition, and protection of the exercise, of the rights of other stakeholders (a somewhat imprecise term denoting not only those directly involved in a firm's process of wealth creation but also other parties sufficiently strongly affected by this process); (4) timely and accurate disclosure and transparency with respect to matters material to company performance, ownership and governance, which should include an annual audit conducted by an independent auditor; and (5) a framework of corporate governance ensuring strategic guidance of the company and effective monitoring of its management by the board of directors as well as the board's accountability to the company and its shareholders.

The models of corporate governance found in reality belong to a spectrum not everywhere characterised by clear-cut breaks. At the extremes of the spectrum there are none the less important differences in such characteristics as the regulatory framework for management and boards of directors, the priority attributed to the interests of different stakeholders in the firm, and the prevalent systems of business financing. Financial systems which have progressed beyond the rudimentary level mostly incorporate the same major features as building blocks but differ in the relative importance of these blocks and in the links between them. At one extreme is often placed the German model with its emphasis on multiple stakeholders and the influence exerted by banks through their shareholdings on firms' decision making; and at the other is the Anglo-Saxon model with its attribution of a major role in the efficient use of resources to the discipline imposed by open financial markets and its institutionalization of priority for shareholder value.[31] Between the two extremes are many other variants typically including features from one or the other extreme (and often from both).

The preamble to the OECD Principles acknowledges that there is no single model of good corporate governance, and the Principles mostly avoid detailed prescriptive rules in an area where rules unsupported by consensus would be likely to seem intrusive. But the generality and flexibility of the Principles have the consequence that potential inconsistencies amongst them as well as other problems likely to arise in their application are glozed over. Importantly for the Enron case the Principles pay little attention to the issues of management incentives and remuneration. This matter is taken up – to the extent that it is – primarily under various headings covering the role of the board of directors and transparency. Under disclosure and transparency companies are enjoined to include in the former material information on the remuneration of key executives. But nowhere do the OECD Principles address the problem of too close a link between executive remuneration and reporting of financial results, especially short-term results.

The flouting of OECD Principles in the Enron case was particularly evident in the four areas of shareholders rights, disclosure and transparency, the execution of its responsibilities by the board of directors, and the prohibition of abusive self-dealing. Failures under these different headings were linked in various ways, perhaps most importantly through inadequate disclosure and transparency.

## H. The policy response to recent corporate scandals

### *1. International: corporate governance and financial regulation*

The Enron case and other recent corporate scandals have unsurprisingly led to widespread calls for changes in accounting standards and strengthening of other features of regimes of corporate governance and the discussion which follows is necessarily selective.

The OECD has committed itself to a drive to strengthen corporate governance worldwide. The focus of a meeting in Paris in November 2002 to discuss national and international initiatives addressing weaknesses in market foundations and improving market integrity included not only the OECD Principles of Corporate Governance but also other relevant OECD instruments such as the OECD Guidelines for Multinational Enterprises and the Anti-Bribery Convention.[32] OECD ministers have decided to bring forward to 2004 their comprehensive review of the OECD Principles and have expressed the hope that the revision would embody more specific guidance than the existing Principles.

A reasonable assumption is that international initiatives on financial regulation will also reflect policy responses to recent corporate scandals. For example, although the connection is an unacknowledged one and recent scandals have involved financial firms in the role of aiders and abetters rather than directly, the influence of certain features of these scandals appears to have penetrated the process of drafting a New Basel Capital Accord for Banks. It can be sensed, for example, in the elaboration in the consultative paper of April 2003 (CP3) of the treatment of residual credit risks after shifts of assets to SPEs through securitisation.[33] The elaboration includes an extended treatment of the definition of different categories of securitisation which serves as the basis for setting conditions as to the degree of risk transfer achieved by a securitisation. These now comprise not only the transfer to SPEs of underlying assets themselves ("traditional securitisation") but also of guarantees or credit derivatives linked to these assets ("synthetic securitisation"). Regulatory wariness concerning the possibilities for shifting risks between different parts of corporate structures is also evident in rules for cases where a bank conducts an internal hedge in its banking book through a credit derivative in its trading book.

### *2. International: regulatory gaps and conglomerate firms*

It might also be hoped that under international initiatives there will eventually be an extension and intensification of work on regulatory problems posed by large conglomerate firms supplying goods and services that are currently often subject to regimes involving several different regulators which may none the less leave significant gaps. Issues connected to the regulation of financial conglomerates supplying traditional banking, securities and insurance services through the same corporate structure have become a subject for international initiatives in their own right, the body established for this purpose being the Joint Forum on Financial Conglomerates.[34] The Joint Forum has the task of facilitating the exchange of information between supervisors within and between sectors, and to study legal and other impediments to such exchange. Beyond this the Forum is also to examine possible assignments of roles to different supervisors as part of improving their co-ordination and to develop principles for more effective supervision of financial conglomerates. The issues covered under these headings include not only supervisory methods and capital levels for such firms but also intra-group exposures, management structures, the suitability of managers, shareholder ownership, and intra-group conflicts of interest.[35]

The latter group of subjects seems pertinent to the case of Enron, and many of the principles enunciated by the Joint Forum actually cover failings in the firm's functioning identified since its bankruptcy. However, even for the entities covered by the Joint Forum's work, namely financial conglomerates, application of these principles in practice is still at a preliminary stage, depending as it does on their incorporation in rules and standards set by other regulatory fora such as the Basel Committee on Banking Supervision, IOSCO, and IAIS, their eventual embodiment in national laws and regulations, and further development of co-operation between supervisors in different sectors and countries. As things stand, these initiatives do not cover firms like Enron with its extensive participation in activities outside specialised regulation.[36] There is an argument for reconsidering this lacuna for conglomerates which cannot be characterised as financial but which trade in several different organised and OTC markets owing to the possibility of contagion effects and systemic risks associated with their practices.

### 3. *International: reconciling the different dimensions of reform*

A successful outcome of international initiatives on corporate governance and related subjects of financial regulation confronts considerable difficulties. Some of these are due to the interrelated character of the initiatives, which means that impediments to speedy progress in one area – such as agreement on international accounting standards – can also slow movement overall. Others are due to the problem of reconciling with national legal regimes any increasingly detailed rules which may be enunciated as part of the initiatives through a process widely considered to lack representativeness.

The effects of the interrelated nature of ongoing initiatives bearing on corporate governance is particularly evident in the case of accounting standards. While additional impetus has been given to the negotiation of international accounting standards by recent corporate scandals, many of the outstanding issues remain extremely contentious among the different parties involved.[37] One of the issues is that of SPEs which, as the Enron case illustrates, can be used to manipulate financial reports. Other difficult issues include the way in which gains on the investments in companies' pension funds should be included in earnings, the extent to which assets and liabilities should be valued on the basis of mark-to-market, and the appropriate balance in accounting standards between dependence on highly prescriptive, detailed and voluminous rules (the approach traditionally favoured by the United States), on the one hand, or on more general, principles-based regulations (the approach more favoured by European countries), on the other.[38]

Movement from the enumeration of general principles for corporate governance, of which the largely checklist approach of the OECD Principles is an example, to more detailed core rules is likely to be gradual as well as constrained by considerations of national sovereignty. Corporate governance is a subject linked to several parts of countries' private, company, and insolvency law.

Here should also be raised the issue of the representativeness of the process of enunciating more detailed, globally applicable rules for corporate governance. So far this process has been carried out within the OECD, an organisation which has extended its membership beyond its founding and mainly industrialised original member countries but which still falls well short of being universal or even of including all countries with developed or rapidly developing systems of company law. Resolving the issue of representativeness may well slow international agreement on detailed rules for corporate governance but is a problem which will not go away.

### 4. *National: the United States*

The reverberations of recent corporate scandals for regimes of corporate governance and financial regulation are understandably proving particularly far-reaching in the United States.

One of the responses has been by the Financial Accounting Standards Board (FASB) which has issued new rules governing conditions under which avoidance of accounting consolidation of SPEs is permitted.[39] This is an area where hitherto standards have not been clear-cut: according to prevailing practice, based partly on no more than remarks of a senior SEC accountant, Amando Pimentel, at an annual American Institute of Certified Public Accountants (AICPA) conference in 1997, consolidation was not required if independent third parties made an equity investment of no more than 3 per cent of the fair value of the SPE's assets and if the equity was at risk during the entire term of the SPE.[40] Enron had exploited the latitude provided by this rule up to and beyond its permissible limits.

But the most important policy response so far, especially for the cross-border financial relations of the United States has been the Sarbanes-Oxley Act passed in the summer of 2002.[41] This Act is directed at a wide range of the abuses revealed in recent scandals and prescribes stringent penalties under several of its headings. Provisions of the Act affecting directors and senior executives include a requirement for certification of reports filed with the SEC, prohibition of insider lending to a firm's executives and directors, penalties for accounting restatements reflecting misconduct, bans on trading by executives and directors in the firm's stock during certain "blackout periods" for retirement plans,[42] and a requirement for independence for members of audit committees. Enhanced disclosure is to be achieved by various provisions including the following: the requirement that the SEC review a firm's periodic financial reports at least once every three years; the obligation on directors, officers and others owning 10 per cent or more of the firm's securities to report changes in their ownership within a specified, short period; new requirements for disclosure concerning subjects such as off-balance-sheet transactions, internal controls, and the existence or absence of a code of ethics for a firm's senior financial officers;[43] and timely disclosure of material changes in firms' financial condition (so-called real time disclosure). Auditor independence is to be strengthened by limiting the scope of non-audit and consulting services for audit clients, and by requiring that a firm's audit committee pre-approve non-audit services provided by the firm's auditor. Under the same heading an audit firm will not be permitted to provide audit services to a client if the lead or co-ordinating partner with primary responsibility for the audit or the partner responsible for reviewing the audit has performed audit services for that client in the previous five fiscal years.

The Act also establishes a Public Company Accounting Oversight Board (PCAOB) with wide-ranging authority to ensure compliance. The PCAOB will be responsible for setting standards for auditing, this role constituting a radical strengthening of public control over auditors and accountants.

Other provisions of Sarbanes-Oxley include rules to strengthen the independence of research analysts, lengthening the statute of limitations for litigation involving the violation of certain securities laws, the establishment of new securities-related offences and increases in certain criminal penalties, and new protections for employee "whistleblowers". And section 302 prohibits entities incorporated in the United States from reincorporating abroad to avoid or lessen the legal force of the Act's provisions.

Sarbanes-Oxley does not generally distinguish between United States and non-United-States firms, covering as it does all those to which the Securities Exchange Act of 1934 applies. This Act, whose primary objective is to assure the public availability of company information, applies not only to firms with publicly traded stocks but also to those (in the United States) with more than a threshold number of shareholders and value of assets. The disclosure requirements and the authority of the PCAOB have already been a source of source of difficulties with countries outside the United States. As far as firms from developing countries are concerned, other problems are likely to involve various features of legal regimes in jurisdictions not conforming with Sarbanes-Oxley. As far as firms from developing countries are concerned, its direct impact will be non-United-States issuers of securities in United States financial markets, and consequent difficulties are likely to involve features of legal regimes in other jurisdictions not conforming with Sarbanes-Oxley. Such features may include insider loans (since many legal regimes permit loans to executives and directors), the rules to be followed by audit committees, the code of ethics for senior financial officers, and the oversight of and some of the more detailed rules for auditors.

Another area where revelations concerning Enron may eventually lead to further legislative action is taxation. The revelations in a recent lengthy report to Finance Committee of the United States

Senate by Congressional tax experts, which has not been reviewed for this paper, document complex transactions structured for the purpose of tax avoidance and use for the same purpose of offshore subsidiaries which were part of the extensive network of such entities described in section B.[44] Here too Enron was provided with assistance by accountancy firms and investment banks. Tax matters are not ignored in Sarbanes-Oxley: under title X, section 1001, it is stated that "it is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation."

## I. Corporate governance and key financial standards

A major lesson of the Enron case and other recent corporate scandals is that, like other social constructs, regimes of corporate governance and the financial systems to which they are inextricably linked are susceptible to the effects of flaws and fault lines which are the product of financial innovation, human ingenuity (not all of it necessarily legal), and other changes in mores and in the social and economic context. Many (but not all) of the problems revealed by recent corporate scandals are more pertinent to the corporate governance of developed than of emerging-market or other developing countries. However, in view of the pressures exerted on architects of corporate governance in developing countries, they may take comfort from the confirmation by recent revelations that there is no nirvana for such governance, and no blueprint providing an alternative to step-by-step improvement, which may draw lessons from the experience of countries with more developed regimes but which attributes national conditions and history an integral role in the framework for system design.

The OECD Principles are one of the 12 financial standards which have been identified as essential to the soundness and stability of financial systems and as having a key role in measures to strengthen the so-called international financial architecture.[45] Observance of these standards is now a subject covered by IMF Article IV surveillance. From the first there have been queries as to the suitability of corporate governance as a subject for application of the incentives and sanctions envisaged as part of the global promotion of key financial standards. The grounds for such queries have included many already discussed: the summary nature of the OECD Principles, the complexity of the subject and the potential intrusiveness of international initiatives, and the non-representativeness of the process which has so far enunciated these Principles. To these queries there will now be added others reflecting acknowledgement that in important respects the state of the art even in regimes considered the most developed has recently demonstrated shortcomings hitherto unrecognised or only partially recognised.

Corporate governance has in fact so far been one of the less scrutinised subjects in the Reports on Standards and Codes (ROSCs) of the IMF and World Bank assessing countries' progress regarding key financial standards.[46] This seems understandable in the light of the subject's difficulties. Much good can eventually result from a patient process of development and reform in which international co-operation through exchange of experience and technical assistance can play a significant part. But this process should also incorporate acknowledgement of the proven limitations – graphically illustrated by the Enron case and other recent corporate scandals – as well as the strengths of all known models of corporate governance. Progress regarding such governance requires practical experimentation, and this experimentation in turn can only take place if national policy makers are left considerable discretion as to choices regarding their route to development and reform.

## Annex I

## Illustrations of Enron's accounting and transactional techniques

Early recourse by Enron to SPEs included arrangements (Volumetric Production Payments or VPPs) to finance the operations of small oil and gas companies. VPPs were used to lend to producers in exchange for agreed amounts of oil or gas, the financing being secured by the production fields and not by the producing company. The VPP itself was already a form of SPE but Enron then took the process a step further by securitization, pooling securities backed by the VPPs in limited partnerships called Cactus Funds and using derivatives to smooth the earnings from sales of the oil and gas in the VPPs. Some of the securities so created were placed in SPEs which were used to meet the obligations due to bank loans incurred by Enron in connection with the VPPs, and others were sold directly to financial institutions. In either case the financial exposure of Enron resulting from the creation of the VPPs was removed from its balance sheet. Such SPEs were an extension of practices involving partnerships and other entities which had long been common in the energy business.[47]

Another SPE, which was eventually to play an important role in difficulties regarding Enron's financial reporting in 2001, was the partnership with the name of Joint Energy Development Investors or JEDI, formed between Enron and the California Public Employees Retirement System (CALPERS) in the early 1990s. This committed Enron and CALPERS each to invest $250 million in natural gas projects during a three-year period. In late 1997 Enron sought a new partner for JEDI since it wished to engage in a new and larger partnership with CALPERS. For this purpose, in accord with a plan drawn up by its future chief financial officer, Andrew Fastow, Enron established a new partnership to buy CALPERS's stake in JEDI with an arrangement designed to ensure that JEDI remained an independent entity which would not have to be consolidated with Enron itself in its financial statements. If this condition was to be fulfilled, the new partnership, Chewco,[48] had to meet a number of requirements: 3 per cent of its equity had to be invested by a third party unrelated to Enron; the investment had to be genuinely at risk; and, finally, the entity had to be controlled by a party other than Enron. The approach to solving the last problem chosen by Enron was to place some restrictions on the Enron employee, Michael Kopper, selected to manage Chewco and to establish a new outside limited partner for Chewco William Dodson (Michael Kopper's domestic partner), an arrangement eventually replaced by a set of entities controlled by Kopper and Dodson. The equity investment of Chewco's partners was financed with bank loans whose conditions included a requirement for the maintenance of cash collateral, which was met by a special distribution from JEDI to Chewco.

This arrangement was subsequently to be criticised on various grounds: for example, that the investment financed with a bank loan had only a doubtful status as equity; that part of the 3-per-cent equity consisted of an investment by Kopper, an Enron employee; and that the equity did not consist of an investment at risk since the loan backing it was secured by cash collateral provided by JEDI itself, to invest in which Chewco was established in the first place. Further questions over Chewco's independence were raised by fees it paid Enron for the provision of guarantees for its bank financing and for management.[49]

In early 2001 Enron bought out Chewco in a transaction which generated handsome returns for Kopper and Dodson. However, this step did not end the story of Chewco's relations with Enron. In the autumn of 2001 Enron's accountants, Arthur Andersen, reviewed the accounting treatment of Chewco, concluding on the basis of information now available to them concerning the bank financing of the supposedly outside equity investment in Chewco and the associated cash collateral that the SPE had not been independent of Enron. As a consequence JEDI was consolidated into Enron's financial statements from 1997 onwards, contributing to sharp downward revisions of reported income in 1997–2000 and increases in the firm's debt during these years in the range of $561 million to $711 million. These restatements played a major role in the loss of creditworthiness which preceded Enron's filing for bankruptcy at the beginning of December.

SPEs were also employed by Enron as part of hedges of exposures linked to its assets. A major instance, which served as a model in certain respects for subsequent hedging operations, involved Enron's investment in the stock of Rhythms Netconnections ("Rhythms"), an internet service provider.[50] This investment, purchased in March 1998 for $10 million while Rhythms was still a privately held company, had appreciated in value to about $300 million after the public issuance of its stock in Spring 1999. The problem for Enron was that in consequence fluctuations in the value of the Rhythms investment were capable on imparting volatility to its reported income but that gains could not be quickly realized or easily hedged: short-term realization was impossible because investors in a privately held company are barred from selling shares for six months after the date of the initial public offering (IPO), and effective hedging was impeded by the absence of options on the stock (owing to its illiquidity and thus its potentially extreme volatility) and by the lack of comparable stock whose correlation with that of Rhythms would have made them suitable hedges.

Enron's response to this problem was a series of transactions carried out through two SPE's, LJMI and LJM Swap Sub L.P. (Swap Sub), created for the purpose of enabling the firm to hedge its exposure to fluctuations in its Rhythms investment. The hedge took the form of a put option sold to Enron by Swap Sub, whose assets consisted principally of Enron shares.[51] This hedge was potentially unstable since Swap Sub's ability to meet its obligations under the put option depended on the value of Enron's own stock and could be compromised if the Rhythms and Enron stock declined together. In the view of the Powers Committee the transaction did not meet the conditions of "a typical economic hedge, which is obtained by paying a market price to a creditworthy counterparty who will take on the economic risk of a loss."[52] The arrangement was also vulnerable to the charge of involving conflicts of interest since LJM was managed by Fastow, and since Fastow and other employees of Enron were investors in LJM through a partnership called Southampton Place L.P.

The restriction on Enron's ability to sell its Rhythms stock expired in October 1999 but only in early 2000, after limits to the hedge's affectiveness in reducing earnings volatility had become evident and when the price of the Rhythms stock began to decline, thus meaning that its puts were in the money,[53] did Enron decide to unwind the positions related to its Rhythms exposure. Several features of the unwinding were questioned by the Powers Committee, including the lower than appropriate value of the assets received by Enron when it exercised the put on its Rhythms shares, a lucrative put option provided by Enron itself to Swap Sub during the negotiations on unwinding the Rhythms hedge in order to stabilize the latter's position as its obligations to Enron under the put began to mount, and large windfall gains to the investors in LJM.[54] Moreover, as in the case of Chewco, questions were raised concerning the level of Swap Sub's independent capitalization, and eventual consolidation into Enron's financial statements in November 2001 led to downward revisions of the firm's income in 1999 and 2000.

Another instance of Enron recourse to SPEs to hedge equity exposures, which incorporated mechanisms similar to those used for Rhythms and which led to eventual downward revisions in the firm's consolidated earnings, involved a set of entities called Raptors.[55] The financial capacity of each of the Raptors for meeting obligations under hedges consisted of Enron's own stock or stock owned by Enron, arrangements once again rendering the hedges questionable since Enron's stock and the SPEs' financial capacity would decline in step with the result that in the event of a sufficiently large decline in the price of Enron shares the latter would have to be replenished with additional Enron stock or by other means. Additional questions raised about the Raptors concerned the extent of their independence from Enron, conflicts of interest owing to Enron employees' involvement in their management and to their investments in the controlling partnership (LJM2),[56] the size of payments between Enron and the SPEs (which on occasion made possible increases in Enron's reported earnings) and the valuation of the services or asset transfers which were the reason for these payments, and other accounting issues.

Raptor I was established in the spring of 2000 with financial capacity of which by far the largest part consisted of Enron's own stock and stock contracts[57] and sold a put option (effective as of October) to Enron on 7.2 million Enron shares. This arrangement was replaced in the autumn by derivative transactions mostly taking the form of total return swaps on Enron investments, which served as a form of insurance to Enron since Raptor I compensated it for losses on these investments in return for receiving the gains on them.[58]

The establishment of Raptor II and Raptor IV followed similar lines: put options on its stock were sold to Enron by entities, a large part of whose financial capacity consisted of contingent forwards contracts on Enron shares.[59] In the case of Raptor I the stock and stock contracts provided by Enron were subject to restrictions on selling or hedging for three years which led to their being valued for the purpose of the transaction at a substantial discount from their market prices, and similar restrictions applied to the stock contracts provided to Raptors II and IV. However, later in the year some of the Enron investments hedged through the Raptors began to decline in value, raising the question of whether the commitments under the hedges could be met. Enron's solution to this problem took the form of a costless collar, a structure based on options under which a floor was placed under the value of the Raptors' financial capacity: if the price of Enron's stock fell below a specified figure, Enron would pay the Raptor the difference in cash; and in exchange, if the price rose above a specified ceiling, the Raptor would pay Enron the difference. The costless collar was established in violation of the agreement originally transferring the Enron stock to the Raptors at a particular discount, since the discount reflected the restrictive effect of the provision that the stock would not be hedged for a three-year period. Thus Enron's hedging of the restricted stock transferred to the Raptors represented a transfer of value to them in return for which it should arguably have received additional consideration. It should also be noted that the costless collar did nothing to deal with the fundamental flaw of the hedging operations, that Enron was in effect engaging in a hedge with itself.

Raptor III was established to hedge a particular Enron investment in The New Power Company (TNPC). Wishing to realize a portion of the gains on its holding in TNPC Enron formed an SPE called Hawaii 125-0 (Hawaii) with an outside institutional investor to which it sold part of its interest in TNPC. Enron then entered into a total return swap with Hawaii under which it retained most of the risks as well as the rewards of this interest and would thus have to reflect in its earnings statements resulting gains and losses on a mark-to-market basis. Raptor III was set up to hedge this accounting exposure: once again there was an investment by LJM2 but the greater part of Raptor III's financial capacity was based on warrants on TNPC stock (which were the economic equivalent of TNPC stock) transferred to it a price approximately 50 per cent of that reached at the time shortly afterwards when the stock was publicly issued. The resulting capital gain to Raptor III provided it with the capacity to engage in hedging transactions with Enron in the form of a total return swap under which Raptor III received the gains on the TNPC stock in return for insuring Enron against losses on the same stock. Here too an SPE was being used to hedge an Enron investment with financial capacity which depended on the value of the asset being hedged.

Declines in stock prices putting the Raptor structures at risk soon followed, that of TNPC, for example, falling 50 per cent in comparison with its level at the time of its IPO by the late autumn of 2000. In consequence by the end of 2000 Enron had a gain on its hedges, which it estimated at more than $500 million, but one which it could only use to offset corresponding losses on the investments being hedged if the Raptors still had the capacity to meet their obligations.[60] Various approaches to solving the resulting problems were tried. For example, since the financial capacity problems were initially located in Raptors I and III, the capacity of Raptors II and IV was deployed to shore up that of those under pressure through devices such as a temporary cross-guarantee agreement which effectively merged the credit capacity of all four Raptors, and through the infusion into them of additional Enron stock, subject to restrictions as to selling and hedging similar to those of the initial transfers but on which Enron itself none the less again provided hedges to the Raptors in the form of costless collars, thus increasing its own liability even as it attempted to prevent the collapse of the hedges of the value of its assets. However, such solutions were capable of providing only a temporary respite, and in September 2001 a decision was taken to terminate the Raptors, the accounting treatment for the transaction chosen for this purpose resulting in a charge of $544 million to Enron's after-tax earnings for the third quarter of 2001.[61]

Many of Enron's other arrangements designed to keep debt off its balance sheet or adjust its reported earnings, which involved SPEs, were variants of more commonly used transactions. For example, sale and leaseback deals used to supply equipment for energy projects were placed in joint ventures with the equipment manufacturer, thus removing the associated debt from Enron's balance sheet. The LJM partnerships described above served as counterparties in a number of transactions involving sales of assets which enabled Enron to record gains in its financial statements or to avoid consolidation (or both). However, the Powers Committee questioned the legitimacy of the presentation of these asset sales as involving third parties independent of Enron as well as their accounting treatment. The Committee noted that Enron frequently bought back the assets in question after the close of the relevant financial reporting period; that the LJM partnerships always recorded profits on these transactions; but that the same transactions also generated earnings for Enron. This could be explained in some cases by undocumented side deals insuring the LJM partnerships against losses. The general conclusion of the Powers Committee concerning such transactions was that "Enron sold assets to the LJM partnerships that it could not, or did not wish to, sell to other buyers."[62]

Another SPE, which facilitated manipulation of Enron's financial statements, was Whitewing Associates which was formed in December 1997 with funding of $579 million provided by Enron and $500 million by an outside investor. In March 1999 this arrangement was changed so that control was shared between Enron and the outside investor, thus allowing Whitewing to be deconsolidated from Enron. Whitewing was to be the purchaser of Enron assets, including stakes in power plants, pipelines, stocks and other investments.[63]

## Annex II

## A look at some of Enron's financial reports

The 1998 report contains description of Enron's risk management but mostly at a general level. The note to its consolidated financial statement on accounting for price risk management gives an idea of the contents and the limits of this description:

> Enron engages in price risk management activities for both trading and non-trading purposes. Financial instruments utilized in connection with trading activities are accounted for using the mark-to-market method. …
>
> Financial instruments are also utilized for non-trading purposes to hedge the impact of market fluctuations on assets, liabilities, production and other contractual commitments. Hedge accounting is utilized in non-trading activities when there is a high degree of correlation between price movements in the derivative and the item designated as being hedged. In instances where the anticipated correlation of price movements does not occur, hedge accounting is terminated and future changes in the value of the financial instruments are recognized as gains or losses. If the hedged item is sold, the value of the financial instrument is recognized in income.[64]

A little later the Report goes into a bit more detail but still at a general level concerning the firm's exposures and instruments for hedging and risk management:

> The investments made by Enron include public and private equity, debt, production payments and interests in limited partnerships. These investments are managed as a group, by disaggregating the market risks embedded in the individual investments and managing them on a portfolio basis, utilizing public equities, equity indices and commodities as hedges of specific industry groups and interest rate swaps as hedges of interest rate exposure, to reduce Enron's exposure to overall market volatility. The specific investment or idiosyncratic risks which remain are then managed and monitored within the Enron risk management policies.

In the section of the financial review dealing with financial risk management Enron does discuss its use of value-at-risk (VAR) analysis in the management of its exposure to market risks.[65] But there is no mention of the role of SPEs in its management of price risk. In the note to the consolidated financial statements on minority interests there is a reference to the formation of Whitewing Associates but its role in Enron's management of assets on and off the firm's balance sheet is not described.[66]

In the 1999 annual report, in the note on minority interests, Enron mentions its recourse to limited partnerships as follows: "Enron has formed separate limited partnerships with third-party investors for various purposes."[67] But these purposes are not described more specifically. In the note on unconsolidated equity affiliates there is a reference to the accounting deconsolidation of Whitewing Associates following a change allowing the equal sharing of control between Enron and the third-party investor,[68] and in the note on related party transactions mention is made of the acquisition by Whitewing of $192 million of Enron's assets at prices leading Enron to recognize neither gains nor losses on the transactions.[69] The same note also includes a description of the establishment of the LJM partnerships which deserves to be quoted at some length in view of the role played by these partnerships in the account above:

> In June 1999, Enron entered into a series of transactions involving a third party and LJM Cayman, L.P. (LJM). LJM is a private investment company which engages in acquiring or investing in primarily energy-related investments. A senior officer of Enron is the managing member of LJM's general partner. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) LJM received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable and certain finan-

cial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, LJM agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. …

LJM2 Co-Investment, L.P. (LJM2) was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses. In the fourth quarter of 1999, LJM2, which has the same general partner as LJM, acquired, directly or indirectly, approximately $360 million of merchant assets and investments from Enron, on which Enron recognized pre-tax gains of approximately $16 million. In December 1999, LJM2 entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million. Additionally, LJM acquired other assets from Enron for $11 million.

The first paragraph describes the infusions of Enron stock into LJMI which provided the financial capacity which made possible the put option purchased on its Rhythms stock. But the hedging operation itself is not described. The second paragraph exemplifies the asset transactions in which Enron engaged with the LJM partnerships.

The 2000 annual report is a little more revealing but still falls far short of providing the information required for a reasonable picture of the risks associated with Enron's operations and structure.[70] Under the note on minority interests there is a further reference to the separate limited partnerships formed by Enron, this time also mentioning a limited liability company formed for similar purposes. In the note on unconsolidated equity affiliates there is a reference to sales to Whitewing of Enron investments and assets amounting to $192 million in 1999 (already mentioned above) and $632 million in 2000 – sales on which Enron recognised neither gains nor losses. The same note also includes further description of the shifting of assets around the network of Enron and related parties which is worth quoting at length.

Additionally, in 2000, ECT Merchant Investments Corp., a wholly-owned Enron subsidiary, contributed two pools of merchant investments to a limited partnership that is a subsidiary of Enron. Subsequent to the contributions, the partnership issued partnership interests representing 100 per cent of the beneficial, economic interests in the two asset pools, and such interests were sold for a total of $545 million to a limited liability company that is a subsidiary of Whitewing. These entities are separate legal entities from Enron and have separate assets and liabilities.

Note 16 on related party transactions is more forthcoming about Enron's use of SPEs for the purpose of hedging, and the information provided is such as should have raised questions in the mind of a financial analyst as to the source of these entities' financial capacity and its relation to the value of Enron's own assets – the very assets which the arrangements were being used to hedge. Key parts of the note merit quotation at length and commentary, covering as they do transactions also discussed in annex I.

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

This would appear to be a further description of Enron's relationship to the LJM partnerships ("the Related Party").

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets value at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover

> basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock.

Here Enron is describing its provision of financial capacity to the Raptors. Matching the figures in the note with those in the account of the Powers Committee is not always possible. However, according to the Powers Committee, the three identical put options on its own shares purchased from Raptors I, II and IV by Enron involved payments totalling $123 million on 21.7 million shares – the figures also specified in the note. There is also a reference here to the restrictions on the Enron shares (though the nature of the restrictions is not specified), and to the contingent right to receive up to 18 million additional shares in March 2003 subject to certain conditions (which, thanks to the Powers Report, are known to have referred to their price level). And there is a mention of the note worth $259 million received by Enron in connection with the establishment of Raptor III recorded by Enron at zero.[71]

> In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

This passage clearly refers to the costless collars into which Enron entered with the Raptors but without mentioning the inconsistency of this arrangement with the restrictions on selling, pledging or hedging these shares.

> In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities.

This passage concerns the gains of Enron on it derivative transactions with Raptors I, II and III (mentioned in annex I). However, realisation of the gains depended on the financial capacity of the Raptors and, as would be indicated by a careful reading of the note on related party transactions, this capacity depended heavily on the value of the very stock being hedged. The remainder of the note contains description of other transactions involving transfers of assets and liabilities between Enron and the LJM partnerships as well as of the termination of a put option on Enron shares sold by Enron to the partnerships.

## Notes

1 IFRS cover requirements for recognition, measurement, presentation and disclosure for transactions and events that are important in general purpose financial statements. They may also set out such requirements for transactions and events that arise mainly in specific industries or sectors. This initiative is carried out under the auspices of the International Accounting Standards Committee Foundation (IASCF), an organisation established in 2000. Since 2001 the International Accounting Standards Board (IASB), whose members are appointed by the Trustees of the IASCF, has had the responsibility of developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements, cooperating for this purpose with national accounting standard-setters and also being advised and otherwise assisted in its work by other bodies operating under the auspices of the IASCF. On its inception the IASB adopted the then existing body of International Accounting Standards (IAS) issued by its predecessor, the Board of the International Accounting Standards Committee (IASC). International Standards on Auditing are issued by the International Federation of Accountants (IFAC), a body which was established in 1977 to promulgate international standards in auditing and closely related subjects and which nominates 5 of the 19 Trustees of the IASCF. The standards of IFAC are directed at international harmonisation of external auditing (in areas such as auditors' responsibilities, audit planning, assessment of internal controls, audit evidence, using the work of other auditors or experts, and audit conclusions and reporting), a task complicated by variation in countries' company law with respect to such subjects as qualifications, the respective authority of the profession and the government, and the degree of local control in countries with federal systems.

2 The descriptions here rely largely on those in United States Bankruptcy Court Southern District of New York, *Second Interim Report of Neal Batson, Court-Appointed Examiner*. In re: Enron Corp., et al., *Debtors*, sections IV–VIII and X–XI.

3 For a narrative account illustrating Enron's use of the accounting and transactional techniques described see annex I.

4 FAS 140 governs the sale of financial assets and specifies the conditions which must be fulfilled if their transfer is to be considered a sale.

5 Major features of prepays in the Enron case resemble those of "pre-export financing" used in certain international trade transactions. In a model of "pre-export financing", simplified for the purpose of exposition, a bank lends to a SPE which uses the money to prepay a producer of a commodity under a forward contract and enters into another contract to sell the commodity to a buyer at the future spot price. The SPE also enters into a commodity swap with a dealer under which the proceeds of the sale of the commodity are converted into a stream of payments matching those on the interest and principal of the loan. Such financing may be used when the producer is restricted in its borrowing possibilities, and has the attraction to the counterparties of reducing market and credit risks associated with the transaction. The question of whether Enron's prepays were forward purchase contracts or disguised loans became an issue in a court case involving JP Morgan Chase and insurance companies which had issued to SPEs surety bonds guaranteeing obligations of Enron entities under forward purchase contracts for oil and natural gas. The insurance companies claimed that they had been fraudulently committed to providing guarantees on transactions which were loans rather than bona fide forward purchase contracts, the significance of the distinction being that under the law of New York, the relevant jurisdiction, insurance companies are not permitted to guarantee loans. Under a settlement reached during the trial the insurance companies agreed to pay $600 million of the claim which exceeded $1 billion. As an authority on the law of serivatives succintly commented, "This case is unlikely to improve the reputation of at least certain insurers as credit enhancers in the structured finance markets, nor to increase the public's admiration for the ingenuity of the arrangers of structured financings." See S.K. Henderson, *Henderson on Derivatives* (London and Edinburgh: LexisNexis UK, 2003), sections 8.7 and 10.8.

6 See United States Bankruptcy Court Southern District of New York, *Third Interim Report of Neal Batson, Court-Appointed Examiner*. In re: Enron Corp., et al., *Debtors,* 30 June 2003, pp. 9–10.

7 See W.C. Powers, R.C. Troubh and H.S. Winokur, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (February 2002) (which is better known simply as the Powers Report), pp. 201–202.

8 For illustrations of the treatment accorded to the firm's hedging practices and SPEs in Enron's annual reports of 1998, 1999 and 2000 see annex II.

9 The rules of the Independent System Operator (ISO) for California's electricity market define gaming as follows: " 'Gaming' or taking unfair advantage of the rules and procedures set forth in the FX or ISO tariffs, Protocols or Activity Rules, or of transmission constraints in period in which exist substantial Congestion, to the detriment of efficiency of, and of consumers in, the ISO Markets. 'Gaming' may also include taking undue advantage of other conditions that may affect the availability of transmission and generation capacity, such as loop flow, facility outages, level of hydropower output or seasonal limits on energy imports from out-of-state, or actions or behaviors that may otherwise render the system and the ISO Markets vulnerable to price manipulation to the detriment of their efficiency" (ISO Market Monitoring and Information Protocol, section 2.1.3).

10 Enron's trading profits during the California energy crisis were large, though the proportion due to its gaming of the state's electricity market is for understandable reasons unidentifiable. A large part of these profits – a sum probably well in excess of $1 billion – was placed in undisclosed reserves. See L. Fox, *Enron: the Rise and Fall* (Hoboken, New Jersey: John Wiley, 2003), p. 220.

11 The memorandum is reprinted in P.C. Fusaro and R.M. Miller, *What Went Wrong at Enron: Everyone's Guide to the Largest Bankruptcy in U.S. History* (New York: John Wiley, 2002), pp. 209–216.

12 The term "stakeholder", is unavoidably imprecise. It includes not only those most directly involved in a firm's process of wealth creation but also other parties so long as they are sufficiently strongly or directly affected by this process.

13 There is a graphic description of the working of the PRC in the book co-authored by the Enron "whistle blower", Sherron Watkins. See M. Swartz and S. Watkins, *Power Failure: the Inside Story of the Collapse of Enron* (New York, etc.: Doubleday, 2003), pp. 59–62,

14 *Ibid.*, p. 61.

15 See, for example, L. Fox, *op. cit.* at note 10, pp. 259–260 and 289–290, and Swartz and Watkins, *op. cit.* at note 13, pp. 257–259.

16 United States Senate, *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, 8 July 2002, p. 11.

17 See *ibid.*, pp. 1–2 and 9. Enron's Audit and Compliance Committee thus fulfilled the requirement of a recommendation of a United States Blue Ribbon Commission on Improving the Effectiveness of Corporate Audit Committees in 2000 that audit committees should consist of "financially literate" members, of whom at least one has accounting or financial management expertise (*ibid.*, p. 6).

18 See *ibid.,* p. 23.

19 See *ibid*., p. 54.

20 See *ibid*., pp. 54–56.

21 For example, in March 2001 a senior Andersen partner, Carl Bass, was removed from functions involving oversight of Enron. See *ibid.*, p. 58. Bass was the primary contact between Enron and Andersen's Professional Standards Group, accounting experts whose task was to make sure that Andersen's accountants observed accounting rules in their work for clients. Bass had expressed reservations concerning Enron's methods for bolstering the Raptors when they ran into difficulties, hedging connected to investments of the LJM partnerships, and other Enron transactions with the effect of boosting the firm's reported income for 2000. See Fox, *op. cit.* at note 10, pp. 211–212 and 228–230.

22 Powers et al., *op.cit.* at note 7, p. 24.

23 United States Senate, *op. cit.* at note 16, pp. 57–58 and Staff, *Financial Oversight of Enron: the SEC and Private-Sector Watchdogs*, Report to the United States Senate Committee on Governmental Affairs, 8 October 2002, p. 28.

24 See, for example, United States Bankruptcy Court Southern District of New York, *op. cit.* at note 6, p. 54.

25 See Staff, *op. cit.* at note 23, p. 70.

26 *Ibid.*, pp. 81–90.

27 Staff, *op. cit.* at note 23, pp. 11 and 31–40.

28 See *ibid.*, Part Two, section II.D.

29 See Majority Staff (United States Senate Committee on Governmental Affairs), "Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp.", *Staff Memorandum*, 12 November 2002, pp. 2–3 and 19–23.

30 See OECD Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (Paris, 1999).

31 A recent World Bank paper on corporate governance (M.R. Iskander and N. Chamlou, *Corporate Governance: a Framework for Implementation* (Washington, DC: The World Bank Group, May 2000), pp. 22–23) provides the following particularly fulsome account of this model:

> THE DISCIPLINE OF COMPETITIVE FINANCIAL MARKETS ... Equity markets continuously monitor and place an objective value on corporations and, by extension, on their management. The day-to-day performance of a company's shares on a stock exchange is a transparent reminder to managers and owners of the company's perceived viability and value ... An active market for corporate control, fluctuations in stock prices, and the influence of shareholders keep managers focused on efficiency and commercial success. ...
>
> Debt markets impose additional and often more stringent and direct discipline through threats of bankruptcy or an end to a poorly performing firm's access to capital. Transparent and properly regulated markets for debt finance prod corporations to employ debt profitably by servicing it or by covering creditor losses if the debt cannot be repaid.

The same study acknowledges that "share prices can be an effective measure of performance only if equity markets are deep and well regulated to ensure fairness, efficiency, liquidity and transparency", and that other factors also play a role in "external discipline for good corporate governance". These include "reputational agents" such as lawyers, investment bankers, investment analysts, credit rating agencies, consumer activists, environmentalists, and accounting and auditing professionals, who "exert enormous pressure on companies to disclose accurate information to the market, to improve human capital, and to align the interests of managers, shareholders, and other stakeholders." This paper was written before the proliferation of recent disclosures concerning corporate scandals and its consequent irony will not be lost on students of the Enron case.

32 "OECD launches drive to strengthen corporate governance", 15 November 2002, http://www.oecd.org.

33 See Basel Committee on Banking Supervision, *The New Basel Capital Accord* (Basel: BIS, April 2003).

34 The Joint Forum was established in 1996 under the aegis of the Basel Committee, IOSCO and the IAIS to take forward the work of an earlier entity, the Tripartite Group, established in 1993 to address issues related to the supervision of financial conglomerates. See Basel Committee on Banking Supervision, *Compendium of Documents produced by the Joint Forum* (Basel: BIS, July 2001), p. 5.

35 For an extensive review of the work of the Joint Forum and before it of the Tripartite Group see G.A.Walker, *International Banking Regulation, Law, Policy and Practice* (New York, etc.: Kluwer Law International, 2001), Part II, chapter 3.

36 Problems arising in the supervision of mixed conglomerates, i.e. firms including substantial non-financial activities, have been addressed by the Basel-based bodies, the Tripartite Group in a 1995 report recommending some form of supervisory ring-fencing of such activities. But the principal focus of the bodies' work were the conglomerates' financial activities. See, for example, *ibid.*, pp. 190 and 203.

37 Concerning this initiative see note 1.

38 The consequences of the differences between these two approaches can be illustrated for leases where the treatment under the IFRS is less than one-tenth as long as that of the United States Financial Accounting Standards Board (FASB). See J. Dini, "Can one honest man save accounting?", *Institutional Investor*, July 2002, p. 42.

39 FASB, "Consolidation of Variable Interest Entities: an Interpretation of ARB No. 51", *FASB Interpretation No. 46 (Financial Accounting Series)* (Norwalk, Conn.: FASB, January 2003).

40 See United States Bankruptcy Southern District of New York, *op. cit.* at note 2, Appendix B (Accounting Standards), 21 January 2003, pp. 25–29.

41 The discussion which follows makes extensive use of the review of Simpson Thacher and Bartlett, *Sarbanes-Oxley Act of 2002: CEO/CFO Certifications, Corporate Responsibility and Accounting Reform*, 31 July 2002.

42 On "blackout periods" see section F.1.

43 The code of ethics is to cover standards necessary to promote honest and ethical conduct (including the ethical handling of conflicts of interest), adequate disclosure in periodic financial reports, and compliance with official rules and regulations. If such a code of ethics does not exist, the firm is to disclose the reason.

44 See D.C. Johnston, "U.S. tax report is 'eye-popping' ", *International Herald Tribune*, 14 February 2003, and J. Chaffee, "Enron tax shelters bring calls for reform", *Financial Times*, 14 February 2003. The report to the Senate Finance Committee is 2,700 pages in length.

45 For the role envisaged for these key financial standards and commentary see UNCTAD, *Trade and Development Report, 2001,* Part Two, chapter IV, reprinted as A. Cornford, "Standards and regulation", chapter 2 of Y. Akyüz (ed.), *Reforming the Global Financial Architecture: Issues and Proposals* (London: Zed Books for UNCTAD and Third World Network, 2002.); and B. Schneider (ed.), *The Road to International Financial Stability: Are Key Financial Standards the Answer?* (Basingstoke: Palgrave Macmillan, 2003).

46 The ROSCs are the result of a joint programme of the IMF and the World Bank to assess progress in the implementation of key financial standards. Each assessment of a standard results in a ROSC module, only those standards believed by a country to be most relevant to its circumstances being covered. Although the exercise is a voluntary one, the subjects of the financial standards will still be included in IMF Article IV surveillance for countries not volunteering but on the basis of other sources of information.

47 See L. Fox, *op. cit.* at note 10, pp. 31–32 and 63–64.

48 On the history of Chewco see Powers et al., *op. cit.* at note 7, chapter II, and Fox, *op. cit.* at note 10, pp. 123–127, 232, and 275–276. The resemblance between the names of some Enron partnerships (such as JEDI and Chewco) and characters figuring in the film, *Star Wars*, is not coincidental. Chewco was named after the character, Chewbacca.

49 See Powers et al., *op. cit.* at note 7, pp. 49–58, which comments that its authors were unable to decide "whether Chewco's failure to qualify [as having sufficient outside equity] resulted from bad judgement or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper and other Enron employees putting their own interests ahead of their obligations to Enron" (*ibid.*, p. 54).

50 On the hedging of Enron's exposure to Rhythms see Powers et al., *op. cit.* at note 7, chapter IV, and Fox, *op. cit.* note 10, pp. 148–154 and 159–162.

51 To strengthen the hedge Enron subsequently entered into further derivative transactions (in the form of put and call options) with Swap Sub. See Powers et al., *op. cit.* at note 7, p. 85.

52 *Ibid.*, pp. 82–83.

53 A put option is in the money when its exercise price exceeds that of the asset on which it is written (in this case the Rhythms stock).

54 The Fastow Family Foundation received $4.5 million on an investment of $25,000 and two other Enron employees received approximately $1 million on investments of $5,800. See Powers et al., *op. cit.* at note 7, pp. 92–96.

55 In this case the eponymous characters were the dynosaurs in the film, *Jurassic Park.* The story of the Raptors is covered in *ibid.*, chapter V, which notes that the transactions and structured finance vehicles involved were extremely complex so that "although we describe these transactions in some depth, even the detail here is only a summary"(*ibid.*, p. 99).

56 LJM2 was managed by Enron employees (Fastow, Kopper and Ben Glisan) and made an investment in each of the Raptors on which it was to receive an initial guaranteed return before any hedging or derivative transactions with Enron could take effect. The results were extremely favourable to LJM2: Fastow reported to investors in October 2000 that the internal rates of return on their investments in the four Raptors were 193 per cent, 278 per cent, 2500 per cent, and 125 per cent (in the last case a projection). See *ibid.*, p. 128.

57 The stock contracts were in the form of a contingent forward contract under which Raptor I had a contingent right to receive Enron stock at a future date so long as its price exceeded a certain level. (See *ibid.*, p. 100.) The contingent character of these contracts increased the risks to the financial capacity of the Raptor.

58 The description of these contracts in *ibid.*, pp. 107–108 is a little vague in that it fails to specify the way in which losses and gains would be calculated.

59 Concerning such contracts see footnote 57.

60 The availability of Enron stock to the Raptors could be compromised by falls in its share price since under the stock contracts provided to them by Enron delivery was contingent on the condition that the share price exceed a certain level at a specified future date.

61 As the Raptors came under pressure, a separate accounting problem due to the hedges but this time involving Enron's balance sheet emerged. When the Raptors were established, the promissory notes received from them in return for Enron shares and share contracts received accounting treatment leading to an increase in shareholders' equity. In September 2001 Andersen and Enron concluded that this had been incorrect, and that there should have been no net effect on Enron's equity. The result of this correction was a downward revision of $1 billion in Enron's equity in its financial statement for the third quarter of the year. See *ibid.*, pp. 125–126.

62 *Ibid.*, p. 135. Chapter VI of the Powers Report exemplified its conclusion with details of six transactions.

63 Fox, *op. cit.* at note 10, p. 157.

64 Enron, *Annual Report 1998*, p. 50.

65 VAR is the worst-case loss expected during a period at a specified level of probability. Larger losses are possible but only at lower levels of probability.

66 See *ibid.*, p. 56.

67 Enron, *Annual Report 1999*, p. 52.

68 See *ibid.*, p. 53.

69 See *ibid.*, p. 59.

70 Enron, *Annual Report 2000*.

71 According to the Powers et al., *op. cit.* at note 7, p. 117 the note was recorded at zero "because it had essentially no basis in the TNPC stock" made available to provide the financial capacity of Raptor III.

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