A Preliminary Perspective on the Major Policy Lessons from the Collapse of Enron

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Introduction

The collapse of the Enron Corporation in late 2001 has led to two broad concerns:

> There may be more "Enrons" out there, since many other corporations share the primary characteristics that led to the Enron collapse. This concern is reflected by the weakness in the stock markets and the foreign exchange value of the dollar, even though almost all of the subsequent economic news has been better than expected.

> The collapse of other major corporations has undermined the popular and political support for free market policies. This effect has already led to increased demands for regulation of accounting, auditing, and corporate governance and increased criticism of any proposal for privatization. Any number of critics seem prepared to blame many of the problems of the modern world on the corporate culture, with a potential effect similar to that of the muckrakers in shaping and promoting the early progressive legislation.

These two concerns have led the Cato Institute to initiate a project on the major policy lessons from the collapse of Enron. This paper summarizes my perspective on these lessons at the *beginning* of this project, with an expectation that the subsequent studies may well reverse, revise, or strengthen my judgment on some of these issues.

Major Policy Lessons of the Collapse of Enron

Enron is a Symbol of a Broader Problem

Enron declared bankruptcy on 2 December 2001, a consequence of the combination of too much debt and some unusually risky major investments. Such conditions are characteristic of firms that declare bankruptcy and, by themselves, are not sufficient evidence of a broader problem. The optimal number of bankruptcies is not zero, because our broader interests are served by corporations using some amount of debt finance and taking some risks. Moreover, Enron did not collapse because it broke the rules, although it may have broken the rules to cover up its financial weakness. The collapse of Enron led to huge losses to Enron's investors, creditors, and employees but, by itself, with little effect on other parties. The conditions specific to Enron will be adequately sorted out by the market and the courts.

As expressed by one blunt-speaking investment manager, however, "Enron ain't the problem ... The unremarked gut issue today is that over the past decade there was a landslide transfer of wealth from public shareholders to corporate managers. Enron was just the tip of the iceberg ready to happen.[1]" For the larger community, the important issues are not the specific reasons why Enron collapsed but whether the general rules affecting all corporations lead managers to use too much debt and to incur too many risks. The other important issues raised by the Enron collapse are why these conditions often either escape notice or are not acted on by any link in the audit chain.

The broader pattern of financial developments since the mid-1990s is clearly more consistent with a description of Enron as "the tip of the iceberg" than with a view that the Enron collapse was merely the tail of a stable distribution of potential corporate failures. This pattern includes the following major developments:

- the explosion of corporate executive compensation,
- the downward revision of stated earnings by nearly 1,000 major firms since 1997, capped by the recent announcements that both Rite Aid and WorldCom had overstated their earnings by at least $1.6 billion!
- the substantial decline in the broad stock-market indices since March 2000 and, contrary to the usual pattern, a continuation of this decline during the current general economic recovery,
- major accounting scandals and the collapse of a number of other large firms,
- a growing number of investigations of corporate misconduct by the Justice Department and the Securities and Exchange Commission (SEC), and
- a recent survey indicating that about 70 percent of corporate ethics officers expect six or more major new

corporate ethics scandals in the next 12 months. Something is seriously wrong in corporate America. General shareholders, now a majority of Americans, have a financial interest in correcting the conditions that led to these problems. Those of us who are concerned about maintaining the necessary popular and political support for a market economy have a special political stake in correcting these conditions.

Some Important Corrective Actions are Underway

The collapse of Enron has proved to be a valuable wake-up call to a number of affected groups. In the absence of any significant federal government responses to date, the following actions have been initiated by private organizations:

- The Business Roundtable, members of which are the chief executives of about 150 large firms, urged corporations to adopt a number of voluntary changes in corporate governance rules, including that a "substantial majority" of the corporate boards be independent "both in fact and appearance."
- Committees of the New York Stock Exchange and the National Association of Securities Dealers have proposed major additions and changes in the rules for accounting, auditing, and corporate governance as necessary conditions for listing of a corporation's stock for trade on the exchange. Members of the New York Stock Exchange are scheduled to vote on these proposals on August 1. The major continuing uncertainty is how the exchanges will monitor and enforce these rules.
- A committee of the International Corporate Governance Network (ICGN), institutional investors that control about $10 trillion in assets, has proposed a set of international standards for corporate governance that its members would use their voting power to promote. The ICGN is expected to approve these standards at its July meeting in Milan.
- Merrill Lynch, the nation's largest retail broker, signed an agreement with the New York State Attorney General that its stock market analysts "will be compensated for only those activities and services intended to benefit Merrill Lynch investor clients," as determined by their superiors in the research department. This agreement was designed to reduce any conflict of interest between the market analysis and investment banking activities of Merrill Lynch and is expected to be adopted by other major brokerage firms.
- Standard and Poor's (S&P), one of the three major credit-rating agencies, has developed a new concept of "core earnings" as a measure of the earnings from a company's primary lines of business. Compared with earnings as defined by the Generally Accepted Accounting Principles (GAAP), for example, the S&P measure will include employee stock options grants as expenses and exclude gains and losses from a variety of financial transactions. S&P plans to report this measure of earnings for all publicly held U.S. companies.

Most important, the long bear market has changed the attitude of many corporate managers and directors. In good times, no one minds the store in management-friendly firms that make an adequate return, even though shareholder-friendly firms may have a significantly higher rate of return.[2] Over the past two years, however, corporate managers have been quicker to reduce employment and close plants in response to weak demand, productivity growth has continued to be unusually high as a consequence, and boards appear to have been more cautious in approving major new investments and increased executive compensation. The important test is whether the costly lessons of this period will survive a recovery of demand and another long bull market.

In the meantime, Congress and the SEC are still fussing over the details of a new public board to regulate the accounting industry, the primary purpose of which seems to be to demonstrate both their concern and their lack of understanding about the reasons for this serious crisis in corporate governance.

Lessons for Related Markets?

Does the collapse of Enron have any important lessons for the markets in which it operated and for the specialized financial instruments that it used? For the moment, my tentative answer to this question is "No," but I remain open to a more nuanced answer from further study.

Enron was primarily an energy trader in the markets for oil, gas, and electricity. There are several problems in these partially deregulated markets, but Enron's energy trading was generally profitable and was not the cause of its collapse. But there are several policy issues that remain to be addressed -- specifically, the alleged manipulation of the California electricity market and the inflation of reported trading volumes by Enron and other energy traders by wash trades. The primary business lesson from the experience of several companies is that it is unwise for a highly leveraged company to trade in the very volatile markets for energy futures.

Enron also made extensive use of "special purpose entities" (SPEs) to increase the use of debt to finance specific activities. Current accounting rules permit the debt of an SPE to be off the books of the parent company if the debt is no more than 97 percent of the assets, outsiders own a majority of the equity, and the parent company has not guaranteed this debt. Enron apparently violated these accounting rules in numerous cases, most importantly by not revealing that it had guaranteed the debt of some of the SPEs, debt that was effectively a contingent liability of Enron. This practice apparently exacerbated Enron's financial problems but was not the primary cause of these problems. Many other firms also make extensive use of SPEs for good business reasons. The primary policy issues are whether the accounting rules for SPEs should be changed and whether the performance against these rules is sufficiently transparent. The Financial Accounting Standards Board (FASB) has already proposed that the maximum allowed debt of SPEs be reduced to 90 percent of its assets.

Taxes Strongly Bias Corporate Decisions

One issue that has been broadly ignored in discussions about the policy implications of the Enron collapse is that the current U.S. tax code biases the decisions by all corporations in several ways that increase the probability of bankruptcy.

The corporate income tax code allows the deduction of interest payments, but not dividends, as an expense. This induces corporations to rely more on debt finance than would be the case in the absence of this bias. The U.S. corporate income tax rate is now one of the highest among the industrial nations, and one should expect U.S. corporations to be unusually leveraged.

The difference between personal income tax rates and the long-term capital gains rate induces corporations to rely more on capital gains rather than dividends as the return to equity. In turn, this reduces the threshold rate of return on corporate investments relative to the rate of return on dividends -- increasing the incentive of corporate managers to approve risky investments and increasing their relative role in the allocation of capital.

An obscure provision of the 1993 tax legislation limited the direct compensation of corporate executives that could be deducted to $1 million a year, unless the compensation is "performance based." This contributed to the rapid increase in the use of stock options to compensate corporate executives, increasing their incentive to approve risky investments because the options have no downside risk.

In summary, the tax code increases both of the conditions that lead to bankruptcy -- unduly high debt and unduly risky investments. A major reform of the U.S. tax code would be necessary to reduce or eliminate these biases. A piecemeal reform might include only a reduction of the corporate income tax rate and of the difference between personal income tax rates and the long-term capital gains rate. A more comprehensive reform that would *eliminate* all of these biases would be to allow the deduction of dividend payments from the income subject to the corporate income tax. This would increase the dividend payout rate, reduce retained earnings, and reduce the relative role of corporate managers in the allocation of capital.

Don't Count Too Much on Financial Accounting

The collapse of Enron has highlighted several accounting issues that also affect other corporations, most important of which are the accounting treatment of stock options and SPEs and the current FASB monopoly in setting accounting standards.

Accountants and economists often differ on the accounting treatment of stock options. Accountants generally favor the explicit expensing of stock options as valued by the Black-Scholes formula. Economists are more likely to point out that there is no nonarbitrary way to value a nontradable stock option and to recommend a focus on fully diluted earnings as the best guide to investors.[3] My sense is that this is a tempest-in-a-teapot; current accounting rules seem to provide all the information that a careful investor could use to evaluate the effects of stock option grants.

Similarly, the only apparent accounting issue with respect to the SPEs seems to be whether the parent company has accurately reported the SPE debt that it has guaranteed, in which case such debt should at least be reported as a contingent liability. Again, as with stock options, there is no obvious was to value a liability that is contingent on the exercise of the guarantee.

A third accounting issue raised by the Enron collapse is whether investors would be better served if American firms adopted the international accounting standards (IAS), whether the standards should be set, monitored, and enforced by the stock exchanges rather than by FASB; and whether a firm should be allowed to choose among competing standards, maybe by its choice of the exchange on which to list its stock. Again, accountants and economists often differ on this issue -- accountants favoring the harmonization of accounting standards, economists more likely to favor a competition among accounting standards.

More important, the broader community appears to expect too much of financial accounts, even if they are strictly by-the-rules and fully transparent. At best, a good financial account is a measure of the value of the assets owned by the company. The earning potential of modern firms, however, is increasingly dependent on "intangible" assets that it does not own and for which there is no objective way to value other than by selling the firm. Such assets include the distinctive rules by which the management operates, the reputation of its products, customer service, employee relations, and investor relations; the skills, creativity, and loyalty of the employees; the breadth and turnover of the supplier and customer base, and the market power of the firm in the product and supplier markets. The value of these intangible assets is indicated by the fact than the equity value of many firms is a multiple of its book value, even in the recent weak stock market. A change in these intangible assets can substantially change the market value of the firm, even if there is no change in its financial accounts. Such intangible assets cannot be independently valued but many can be measured. The primary contemporary challenge for accountants may be to develop a set of nonfinancial measures of these intangible assets as a complement to the best possible financial accounts.

As may be apparent, accounting is not my specialty, and I am not confident about my judgement of these issues. Comments and corrections are welcome.

Don't Count Too Much on Auditing

One of the important lessons of the Enron collapse is that *every* link in the audit chain failed to discover its weak financial status and to act to correct this condition -- including the audit committee of the board, the board, the presumably independent auditor, the market specialists in Enron stock, the stock exchanges, Enron's major creditors, the credit rating agencies, FASB, and the SEC. Moreover, the business press ranked Enron as among the nation's best managed companies through the winter of 2001. No one in the audit chain or the business press appears to have had a sufficient incentive to discover and report the truth, even for personal gain. Every party that might have made a difference seems to have acted as a free rider, hoping that someone else would perform the necessary audit role.

Most of the attention of politicians and the press has focused on the role of Arthur Andersen and the other major accounting firms, jumping too quickly to a conclusion that audit failures are a consequence of a conflict of interest between the auditing and consulting activities of the accounting firms. For some time, however, the accounting profession has warned that audits "may not detect a material misstatement," a conclusion consistent with the failure of each of the major accounting firms to detect some major fraud. After the disclosure by WorldCom, a leading consultant to the accounting industry concluded that audit reports are "probably not even worth their weight in paper"[4] -- a conclusion that is disturbing even if overdrawn.

The Cato project will explore the potential policy issues at each link in the audit chain. If the independent auditors cannot or do not discover and report accounting misstatements of the magnitude of the major recent corporate scandals, however, there is little reason to expect other links in this chain to be more effective without some independent access to information from the audited firm.

The Rules of Corporate Governance Are the Major Problem

Finally, and most important, the major lesson from the collapse of Enron and other major corporations is that the rules of corporate governance do not adequately protect the interests of the general shareholder against the increasingly divergent interests of corporate managers. In other words, "the agency problems" from the separation of ownership and control posed by Berle and Means in 1932 have not yet been adequately solved and may have recently increased. The rules of corporate governance -- in effect the "constitution" of a corporation -- are a complex combination of federal securities law, the conditions for listing on some stock exchange or for access to credit, the corporate regulations of the state in which the firm is incorporated, and company-specific rules approved by the corporate board. These rules differ widely among firms depending on the conditions imposed by the stock exchanges and creditors, the state of incorporation, and the relations between the corporate managers and the board.

Over time, moreover, there has been some drift from rules that protect the shareholder to rules that protect the management from a hostile takeover. The first major policy change in this direction was the federal Williams Act of 1968, which substantially increased the cost for outsiders to organize a successful tender offer and entirely removed the potential for surprise. More important were decisions by state legislatures and state courts in the 1980s in response to demands by corporate managers. And the superstar CEOs of the 1990s were able to command almost any rule from their passive boards. Over this period, in addition, the major outside shareholder in an increasing number of firms was some pension or mutual fund whose own interests were to be so diversified as to have little interest in the performance of any one stock in their portfolio; these funds very rarely use their voting power to place a representative on a corporate board. Very few corporate boards now include a member with a sufficient portion of the total shares to be a credible threat to replace the incumbent management. As a consequence, according to the leading scholar of the market for corporate control, "It should come as no surprise that, as hostile takeovers declined from 14 percent to 4 percent of all mergers, executive compensation started a steep climb, eventually ending for some companies with bankruptcy and management scandal ... Enron is a predictable consequence of rules that inhibit the efficient functioning of the market for corporate control.[5] "

The new rules for listing on the major stock exchanges may substantially improve the private rules of corporate governance if they are adequately monitored and enforced. The most important policy lesson from the collapse of Enron, however, is that the change in private rules should be complemented by repealing or reversing those laws, regulations, and court decisions that now restrict successful tender offers. The probable results would be a reduction in executive compensation, less pressure to cook the books, an improved allocation of capital, and an increase in the rate of return to the general shareholders.

Conclusion

A lot is at stake, and my preliminary perspective does not reflect a complete knowledge and understanding of the relevant issues. The success of the Cato project on the major policy lessons of the Enron collapse will depend, importantly, on the contribution of others who share the same concerns but have other relevant knowledge or a different understanding of these issues. Comments, contributions, and criticisms are welcome.

Notes

1. Sosnoff, Martin T., Enron ain't the problem, *Directors & Boards*, spring 2002, pps. 38-39.
2. Gompers, Paul A., Joy Ishii, and Andrew Metrick, Corporate Governance and Equity Prices, NBER Working Paper No. 8449, August 2001.
3. Varian, Hal, Knowing About Diluted Earnings Is a Powerful Tool, *New York Times*, May 9, 2002.
4. Quote from Allan D. Koltin, Value of Audit Reports Disputed, *Washington Post*, June 27, 2002.
5. Manne, Henry G., Bring Back the Hostile Takeover, *Wall Street Journal*, June 26, 2002.